

Turkey: Request for Stand-By Arrangement and Extension of Repurchase Expectations—Staff Report; Staff Supplements; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Turkey

In the context of the request for Stand-By Arrangement and extension of repurchase expectations by Turkey, the following documents have been released and are included in this package:

- the staff report for the Request for Stand-By Arrangement and Extension of Repurchase Expectations, prepared by a staff team of the IMF, following discussions that ended on April 12, 2005, 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 April 27, 2005. 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.
- staff supplements of April 28, 2005 and May 6, 2005, an assessment of the risks to the Fund and the Fund's liquidity position and updated information on recent developments, respectively.
- a Press Release summarizing the views of the Executive Board as expressed during its May 11, 2005 discussion of the staff report that completed the request.
- a statement by the Executive Director for Turkey.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Turkey*

Memorandum of Economic and Financial Policies by the authorities of Turkey*

*May also be included in Staff Report

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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Washington, D.C.**

INTERNATIONAL MONETARY FUND

TURKEY

Request for Stand-By Arrangement and Extension of Repurchase Expectations

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Liam P. Ebrill

April 26, 2005

- **Stand-By Arrangement.** To support their three year economic program, the Turkish authorities are requesting a new three-year US\$10 billion (SDR 6.7 billion) Stand-By Arrangement under the exceptional access procedures. They are also requesting that the repurchase expectations for a total of SDR 2.5 billion falling due in 2006 be extended to an obligations basis. Total access under the previous SBA was SDR 12.8 billion (1,330 percent of quota), of which SDR 11.9 billion was purchased. By the end of this new SBA, outstanding Fund credit to Turkey should fall to around SDR 6.0 billion. An initial purchase of SDR 555 million becomes available on approval of this request.
- **Discussions.** During September 16–29, October 11–26, November 30–December 14, 2004 and April 4–12, 2005 the staff team met with State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Chairman Ertürk, Privatization Agency President Kilci, other senior officials, and representatives from the banking and business communities.
- **Staff.** The team comprised Reza Moghadam (head), Lorenzo Giorgianni, Mark Griffiths, Donal McGettigan and Christian Keller (all EUR), Ernesto Ramirez, Mark Horton and Koshy Mathai (FAD), Maike Luedersen (LEG) and John Austin (LEG consultant), Mats Josefsson (MFD), Chris Lane and Arend Kapteyn (PDR), Hugh Bredenkamp and Christoph Klingen (resident representatives), Joy Villacorte (EUR, staff assistant), Julie Burton and Arlene Tayas (EUR, administrative assistants). Levent Veziroglu (OED) attended most meetings.
- **Publication.** The Turkish authorities have consented to the publication of this staff report. In addition, the authorities have agreed to the publication of the staff report for the 2004 Article IV consultation and the report for the Eighth Review under the previous arrangement.

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GLOSSARY

BK	Bağ-Kur, Social Security Fund for Farmers and the Self Employed
BRSA	Banking Regulation and Supervision Agency
CBT	Central Bank of Turkey
ES	Emekli Sandığı, Social Security Fund for Civil Servants and the Military
MPC	Monetary Policy Committee
PFMCL	Public Financial Management and Control Law
SDIF	Savings Deposit Insurance Fund
SSK	Social Security Fund for Employees
TL	Turkish Lira
UHI	Universal Health Insurance
YTL	New Turkish Lira

I. INTRODUCTION: SUSTAINING AND ADVANCING RECENT GAINS

Over the last four years, Turkey's economic program has delivered impressive results. Output has grown rapidly, inflation has fallen to its lowest level in a generation, and government debt has declined markedly. However, significant vulnerabilities remain, important structural reforms need to be advanced to help sustain the recent gains, and Turkey has large financing needs over the next few years. The authorities have thus prepared a three-year economic program for which they are seeking the support of the Fund. Implemented successfully, the program should help Turkey converge towards the economies of the European Union and exit successfully from Fund financial support.

1. **In response to the economic crisis of 2000–01, the Turkish government launched an ambitious program of economic and structural reform.** To address concerns over debt sustainability and debt rollover, it made a new commitment to prudent fiscal policy, with the primary surplus over the last four years averaging almost 6 percent of GNP and reaching nearly 7 percent of GNP in 2004. To help reduce inflation under the new floating exchange rate regime, the central bank was granted independence to pursue a new and clear objective—price stability—and freed from any responsibility to finance the government deficit. To overcome the worst of the financial crisis, the banking system was strengthened: state banks were re-capitalized, the weakest private banks were intervened, and open foreign exchange positions closed. The 2004 Article IV Consultation (Country Report No.05/163) discusses this strategy, the results it achieved, and draw lessons for future policy implementation.

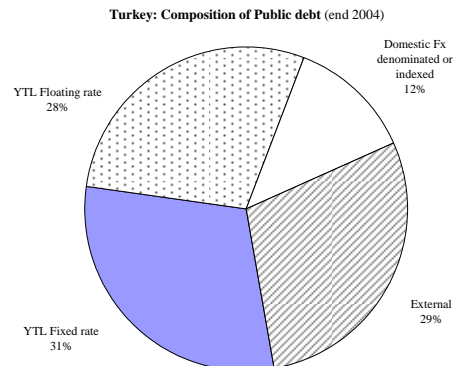
2. **Over the last four years, these reforms have delivered a decisive break with Turkey's history of high and variable inflation, and low and volatile growth (Table 1).** Despite interruptions from political tensions and external shocks, interest rates have fallen significantly and the lira has remained strong. Inflation is now well below 10 percent, its lowest in thirty years, while output has recovered strongly from the 2001 recession, with annual growth rates averaging almost 8 percent over the last three years. Once at risk of becoming unsustainable, government net debt has fallen to less than 65 percent of GNP. Implementation of the program has played a key role in achieving these results. However, the exceptional financial assistance provided by the Fund (which addressed debt rollover concerns in 2001 and 2002), the prospect of additional financing (in case of fallout from Iraq), and low world interest rates have been important too.

3. **Despite the strong economic performance under the program, significant vulnerabilities still need to be addressed (Box 1, Table 2).** Although government debt has declined, it is still high, with short maturities creating rollover risk. While macroeconomic conditions are now much stronger, the high current account deficit is adding to short-term external debt and poses a significant risk for the economy. A sudden shift in investor sentiment could cause a sharp correction in exchange rates and interest rates, which would undermine disinflation, weaken balance sheets and add to the public debt burden. Though declining substantially, real interest rates are still high and dollarization widespread. The

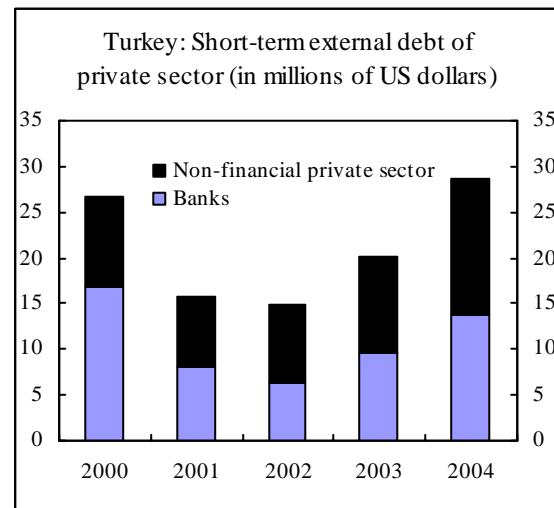
Box 1. Turkey: Vulnerabilities

While the economy has become more resilient under the program, vulnerabilities remain. The restoration of macroeconomic stability and the move to a floating exchange rate regime have created the conditions for a much less crisis-prone economy. However, several sources of risk remain: although lowered since the crisis, public debt remains high, dollarization pervasive, and the economy's rapid growth under an open capital account creates additional exposure to potentially volatile foreign capital flows. This could in turn pose challenges for the stability of a relatively underdeveloped financial sector.

High public debt and roll over requirements, and interest rate and exchange rate exposure remain key vulnerabilities. The envisaged debt reduction under the program, although ambitious, will leave the net public debt-to-GDP ratio over 50 percent, still very high for an emerging market country. The high share of foreign currency and floating rate debt, and the still short average maturity of fixed rate lira debt, imply strong roll-over pressures and high exposure to sudden changes in exchange rate and interest rates. This exposure is reflected in the sudden rise of the public debt ratio that occurs under certain scenarios in the public debt sustainability assessment (Appendix III, Annex A). Even with skilled debt management it will take time to improve the public debt structure and thus reduce this exposure.



The accumulation of external debt by the private sector and strong foreign capital inflows create additional vulnerabilities. With a private-demand led widening of the current account deficit, more than 40 percent of Turkey's external debt is now owed by the private sector, of which 43 percent is at short maturity. EU-accession prospects could further stimulate private external financing. Although financing could take the form of FDI, this will take some time and meanwhile much of it is likely to remain debt-creating. The surge of foreign demand for local bonds and equities following the EU summit on December 17 also gave an indication of how strong capital inflows driven by positive investor sentiment can cause rapid currency appreciation and a boost in domestic asset prices. Conversely, a sudden shift in sentiment and a reversal of these flows could trigger a similarly sharp drop in asset prices. The associated exchange rate adjustment would abruptly raise the financial burden for those with foreign debt and create liquidity pressure for those whose external credits are not being rolled over.

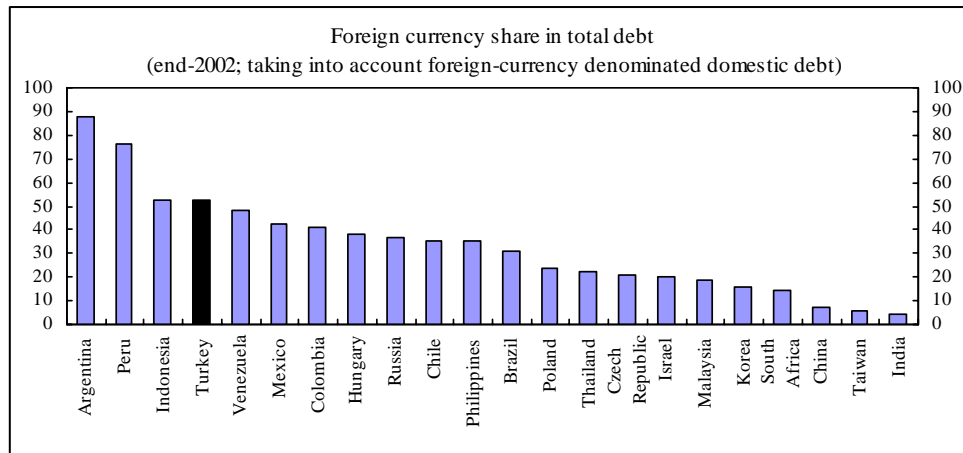


High domestic liability dollarization adds to exchange rate related risks. Turkey is still among the most dollarized economies and, despite significantly improved inflation expectations, reversing this currency substitution has been limited. Foreign currency deposits still comprise a large share of banks' domestic funding, which banks match by extending foreign currency loans to corporations and by buying foreign currency linked government paper (making it for the government to switch out of these instruments). A sudden exchange rate adjustment would create similar pressure for domestic foreign currency debt as it does for foreign debt.

Exchange and interest rate developments depend on future global liquidity conditions, which are beyond the control of domestic policies.

Faster-than-expected interest rate increases in the U.S. or the Euro area could have a large impact on capital flows to emerging markets. This would negatively affect the Turkish

currency and domestic interest rates, a key risk.



A continuing rapid expansion of domestic bank lending could pose additional challenges to financial sector stability. Despite its rapid recovery, bank lending is still low as a share of GDP, implying a vast potential for further credit growth. Indeed, new credit instruments are now being aggressively marketed as banks compete for market share: the sharp rise in credit card loans in 2004 is one example, and the planned introduction of a mortgage loan market in 2005 could be another. Fast expansion of such activities could create new vulnerabilities, even if regulations are in place.

Empirical evidence confirms that Turkey's vulnerability has decreased, but also shows that it remains above the average of emerging markets. Using the safety ratios proposed by Manasse and Roubini (2005), it can be seen that while comfortably meeting several of the thresholds, Turkey remains slightly above some of the important ones, related to external debt (see also Appendix III, Annex B).

Manasse-Roubini rules of thumb for "relatively safe fundamentals"		Turkey (2004)
(in descending order of "safety")		in percent of GNP
1. Total external debt	< 50	54
2. Short-term external debt over reserves	< 130	137
3. Public external debt over revenue	< 214	104
4. Inflation	< 10	9.3
5. Growth	> -5.5	9.9

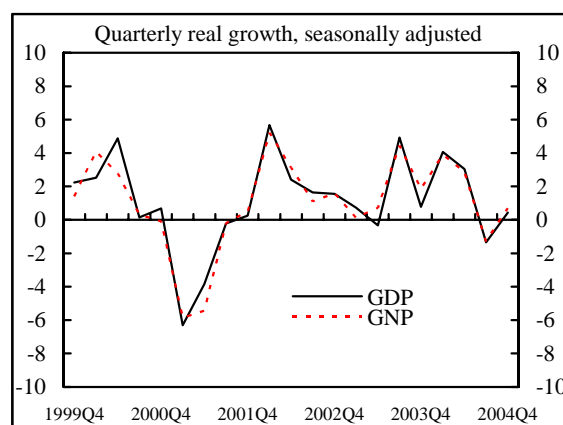
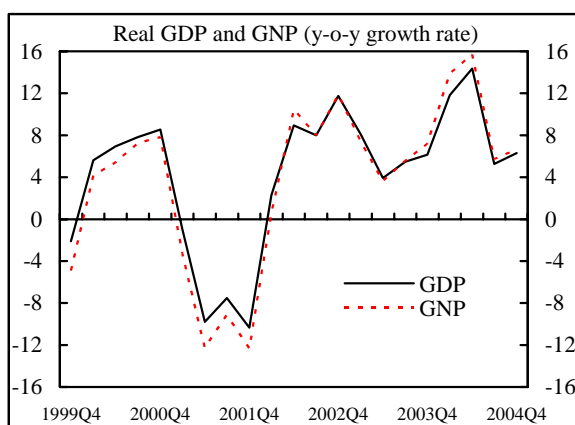
financing outlook is also challenging. Over the next three years, the government must make more than US\$40 billion in external debt repayments, more than half of this to the Fund. Without further financial support, gross reserves would fall sharply. Finally, despite strong growth, unemployment remains high and foreign direct investment very low.

4. **A considerable structural reform agenda needs to be implemented to sustain the improved performance.** While the primary surplus has risen under the program, sustaining this performance will not be easy. The social security system runs a deficit of 4½ percent of GNP; tax evasion is widespread, due to the large unregistered economy; and, with a narrow tax base, revenues depend too much on distortionary indirect taxes. Reform in all these areas is needed to underpin debt sustainability. Although the banking system has been strengthened, further reforms are needed. The legal framework for banking supervision and asset resolution needs to be overhauled, and state bank reform reinvigorated. Steps are also needed to improve the business environment, foster employment, and spur foreign direct investment.

II. A FAVORABLE ECONOMIC BACKDROP TO THE NEW PROGRAM

Unlike in 1999 and 2002, the new economic program is being put in place in a favorable economic setting. Turkish financial markets have become much more resilient and macroeconomic indicators are strong. EU accession prospects also add a new positive dimension, serving as a catalyst for reform (Box 2). However, the large current account deficit continues to pose a risk despite signs that its deterioration is moderating, and Turkey remains vulnerable to swings in international investor sentiment towards emerging markets.

5. **Financial market conditions have continued to improve and confidence is strong (Figure 1).** Financial market conditions improved significantly during 2004 and the EU's decision in mid-December to begin accession negotiations has helped consolidate and advance these gains. Both policy interest rates and domestic bond yields have fallen below 20 percent, the lowest since the onset of the crisis. The lira remains strong and has more than regained the ground it lost during the April–May 2004 emerging market tensions. A surge in foreign investments into domestic bonds and stocks has driven up asset prices and enabled the central bank to increase reserves. Even so, recent financial market pressures continue to highlight Turkey's vulnerability to global economic developments (e.g. tightening of liquidity) and domestic factors (such as earlier uncertainty about IMF relations and EU accession).



Box 2. Turkey's EU Accession Negotiations

On December 17, 2004 the European Council pledged to open EU accession negotiations with Turkey by October 3, 2005. Recognizing the decisive progress made by Turkey in its far reaching reforms, the Council found that Turkey sufficiently fulfills the *Copenhagen political criteria* to open accession negotiations, provided that it brings into force six specific pieces of legislation identified in the Commission's 2004 report. During the Council meeting the Turkish Government also confirmed that it was ready to sign, prior to the actual start of accession negotiations, an extension of the Ankara Agreement to the ten new EU members, including the Republic of Cyprus, which Turkey does not recognize. The negotiations aim at achieving full EU membership for Turkey, but the so-called *framework for negotiations* also sets out that (i) the process is open-ended and its outcome cannot be guaranteed beforehand; (ii) negotiations could be suspended in case of a serious and persistent breach of EU founding principles (liberty, democracy, respect for human rights and fundamental freedoms and the rule of law); and (iii) long transition periods or permanent safeguard clauses may have to be considered, e.g. for areas such as the freedom of movement of persons. A target date for Turkey's accession has not been set, as was the case for the ten 2004 enlargement countries, and is generally assumed to be at least a decade away.

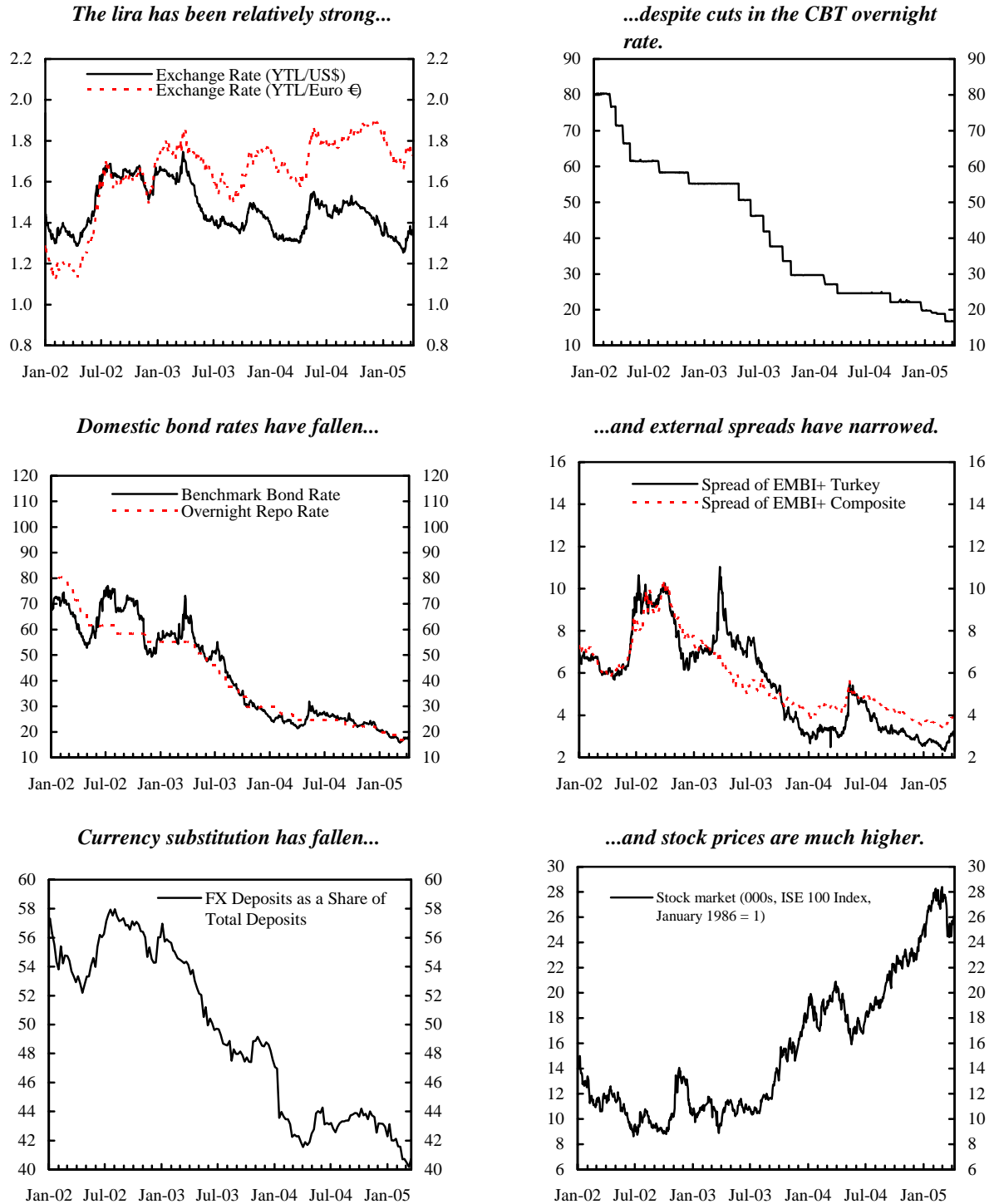
Turkey-EU relations have a long history. Turkey's membership perspective arose as early as 1963 with the EEC-Turkey Association Agreement. In 1995, a customs union was formed, and in 1999, Turkey became a candidate country for EU accession at the Helsinki summit. The 2002 European Council pledged to open accession negotiations without delay if the December 2004 Council decided, on the basis of a report to be prepared by the Commission, that Turkey fulfilled the *Copenhagen political criteria*. The Commission report of October 6, 2004 came to a positive assessment regarding human rights, democracy, the rule of law, and protection of minorities, subject to certain legislation under preparation entering into force.

Accession talks will bring economic issues increasingly into focus. While compliance with political criteria has dominated EU-Turkey discussions so far, Turkey will now have to demonstrate that it has a functioning market economy and the capacity to withstand competitive pressures and market forces within the Union. This requires maintaining macroeconomic stabilization policies, so as to reduce vulnerabilities, and introducing further decisive steps toward structural reforms. Fulfilling the economic conditions is a prerequisite for initiating negotiations on the economic chapters of the *acquis communautaire*, such as competition policy, industrial policy, taxation, financial control, EMU, and customs union.

Accession negotiations with Turkey will be a multi-stage process, largely following the pattern of previous enlargements. A "screening process" at the outset identifies existing discrepancies between the *acquis communautaire* and practices in Turkey. Each of the over thirty chapters of the *acquis*, which comprise the entire body of EU legislation, are opened individually for negotiation. Closure of each chapter requires the consent of all member countries. Building on the lessons learned from previous enlargements, the EU will place heightened emphasis on the implementation of the commitments that Turkey makes during the negotiations before it agrees to close a chapter. Thus, negotiations are likely to specify concrete implementation benchmarks for closure. Once all chapters are closed, the Commission will be asked to recommend that the negotiations be concluded. In case of a positive assessment, an Accession Treaty will be drawn up for the approval of the Council, the European Parliament, EU countries, and Turkey. Some EU member countries might hold referenda on Turkey's accession – a source of uncertainty as Turkey's EU membership currently lacks sufficient popular support in many countries.

The accession process should bring Turkey many economic benefits. The firm membership perspective reassures investors that economic policies will remain prudent. This should lead to an upfront reduction of risk premia and a gradual rise of inward investment, consistent with the developments witnessed since the December 17 decision. Structural improvements, institutional upgrading, and infrastructure investment resulting from adjustment to the *acquis* should greatly enhance the business environment and raise living standards. Turkey will also benefit from EU financial transfers: grants under the pre-accession facility will rise gradually from €250 million in 2004 to €1 billion annually by the end of the decade. After accession, the net transfers to Turkey, mainly for agricultural and regional policies, would be even larger. However, this depends on future revisions of the *acquis* and economic developments in Turkey and the EU. The *framework for negotiations* explicitly states that for a conclusion of the negotiations it is necessary that the financial aspects of accession fit into the EU's *Financial Framework* for the period from 2014.

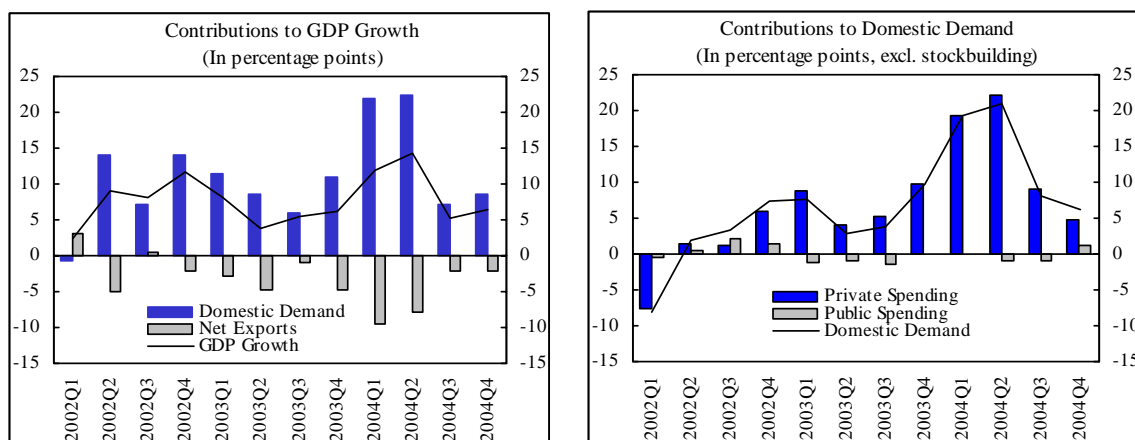
Figure 1. Turkey: Financial indicators, 2002–05
(in percent, unless otherwise indicated)



Source: Data provided by the Turkish authorities.

6. Growth in 2004 surpassed program projections for the third successive year.

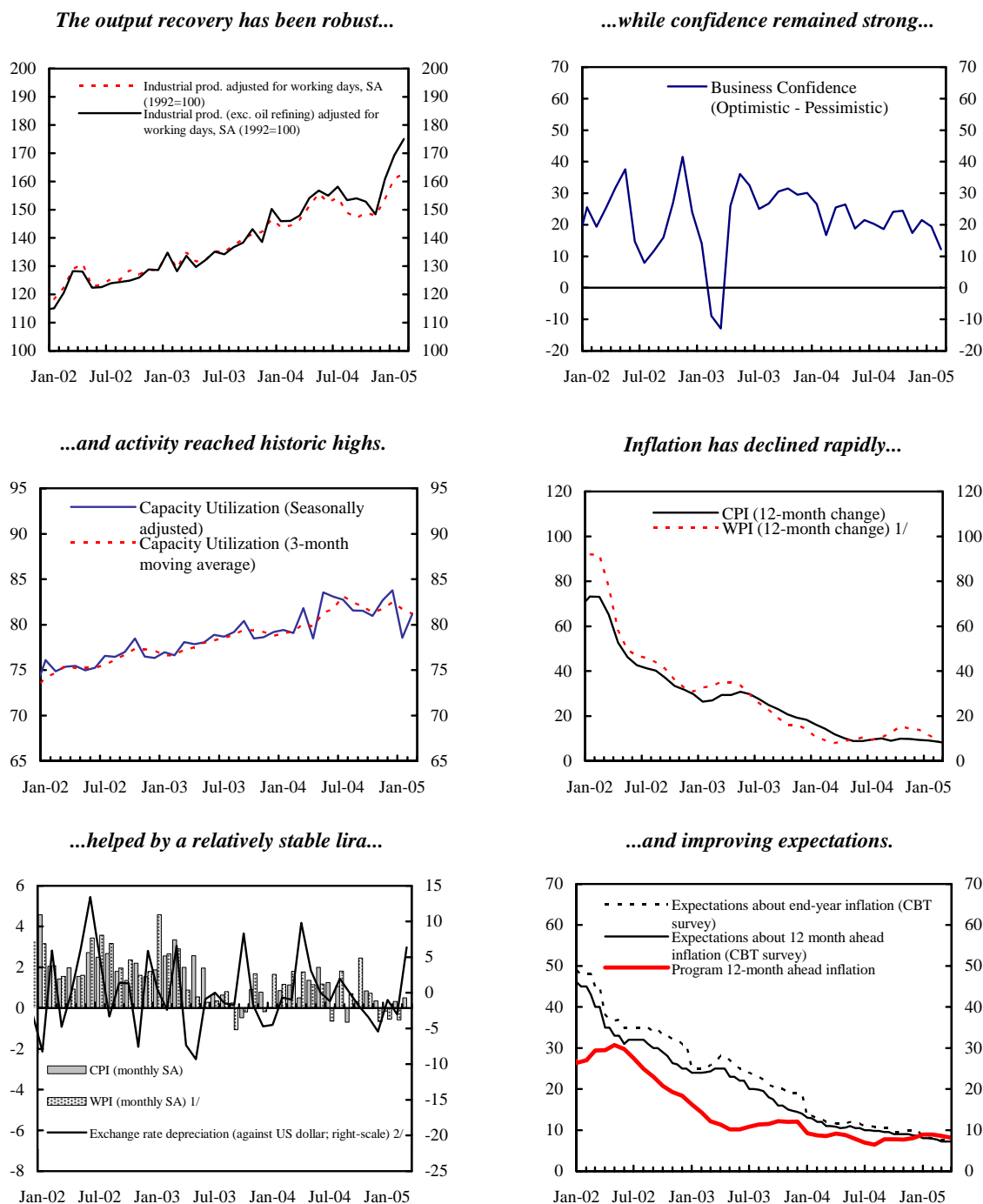
Annual GNP growth reached 9.9 percent for the year as a whole, twice as strong as the original 5 percent projection. Growth was driven by private domestic demand, with almost equal contributions from consumption and investment expenditures. Spending on durable goods and machinery and equipment were particularly strong, fueled by lower interest rates and a credit boom. However, domestic demand slowed markedly in the second half of the year, bringing production down to more sustainable levels and helping to cut the large negative contribution from net exports. Most recent indicators point to a soft landing for the economy, with domestic demand indicators growing much more slowly while production indices continue to show relatively robust activity. The contribution from net exports is becoming less negative, and growth seems to be converging towards the program projection of 5 percent in 2005 (Figure 2 and Box 3).



7. Despite strong growth, inflation has come in below the central bank target.

Annual CPI inflation ended 2004 at less than 10 percent compared with an original target of 12 percent. Continued slack in the labor market and rising productivity prevented strong domestic demand from translating into price pressures. Pass-through from the weakening of the lira in April–May 2004 turned out to be limited, and inflation expectations remained broadly stable even during episodes of exchange rate volatility. Since the beginning of 2005, year-on-year consumer price inflation has continued to decline on the back of a strong lira and lower-than-expected winter food prices. CPI inflation fell to 7.9 percent in March, and although more recent oil price hikes and some weakening of the lira may be reflected in April prices, the latest expectations survey continues to indicate strong confidence that the central bank will be able to attain or even outperform this year's 8 percent target.

Figure 2. Turkey: Output and inflation, 2002–05
(in percent, unless otherwise indicated)



Sources: State Institute of Statistics; and Central Bank of Turkey.

1/ From January 2005, Producer Price Index (PPI).

2/ Negative indicates appreciation.

Box 3. Turkey: Recent Growth Performance

Growth in 2004 was driven by strong private domestic demand, which boomed in the first half of the year and then slowed markedly in the second. Domestic demand surged by over 20 percent in the first half of 2004 relative to the same period in 2003 and then slowed to an average growth rate of just above 8 percent in the second half of the year. The contribution to this growth came in almost equal parts from both private consumption and investment spending, and the pattern of this spending (consumer durables, machinery and oil) created a similar pattern for imports. On the production side, this was reflected in strong output growth in manufacturing and retail and wholesale business services. At the same time, Turkey experienced a boom in tourism, which contributed to exports and prevented an even larger deficit in the external balance. For the year as a whole real GNP (GDP) grew by 9.9 (8.9) percent.

Turkey - Quarterly Real Output and Expenditure in 2004

	quarterly				annual
	Mar-04	Jun-04	Sep-04	Dec-04	2004
(year on year growth rate, in percent)					
Gross National Product	13.9	15.7	5.7	6.6	9.9
Gross Domestic Product (production side)	11.8	14.4	5.3	6.3	8.9
Agriculture	2.7	4.3	-1.4	9.1	2.0
Industry	10.4	15.7	7.5	4.0	9.4
Construction	12.7	6.5	3.9	-0.5	4.6
Services (residual)	13.3	15.6	7.2	7.6	10.6
Gross Domestic Product (demand side)	11.7	14.4	5.3	6.3	9.0
Domestic Demand	20.6	21.4	8.1	8.5	14.1
Consumption	11.6	15.4	5.9	4.7	9.0
Private	12.4	18.4	7.3	3.6	10.1
Public	2.6	-7.8	-7.0	11.1	0.5
Gross Investment	47.9	33.5	14.6	17.8	27.4
Gross Fixed Investment	57.6	47.4	26.1	11.2	32.4
Private	65.5	63.1	38.9	17.7	45.5
Public	-5.9	-8.7	-10.8	0.9	-4.7
Exports of g & nfs	10.9	17.2	8.2	14.4	12.5
Imports of g & nfs	31.3	32.7	16.1	19.6	24.7
(contribution to growth, in percent)					
Gross Domestic Product (demand side)	12.4	14.7	4.9	6.4	9.0
Domestic Demand	22.0	22.5	7.0	8.6	14.0
Consumption	9.3	10.8	3.9	3.3	6.4
Private	9.1	11.5	4.3	2.2	6.4
Public	0.2	-0.6	-0.4	1.1	0.0
Gross Investment	12.7	11.7	3.1	5.3	7.5
Gross Fixed Investment	10.0	10.2	4.3	2.7	6.4
Private	10.1	10.6	4.7	2.7	6.6
Public	-0.1	-0.4	-0.5	0.1	-0.2
Change in Stocks	2.7	1.5	-1.1	2.5	1.1
External Balance	-9.6	-7.8	-2.1	-2.2	-4.9
Exports of g & nfs	5.0	7.6	3.3	6.4	5.4
Imports of g & nfs	14.5	15.4	5.4	8.7	10.3

Sources: State Institute of Statistics, SPO and CBT.

Very preliminary indicators for the first quarter of 2005 seem to support the scenario of a soft landing, with output growing broadly in line with potential.

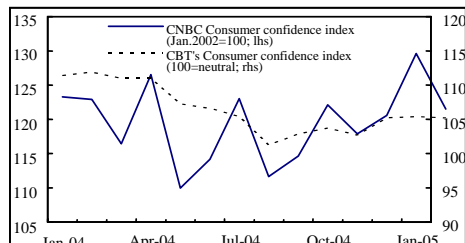
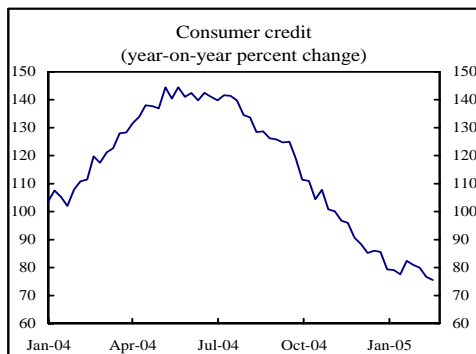
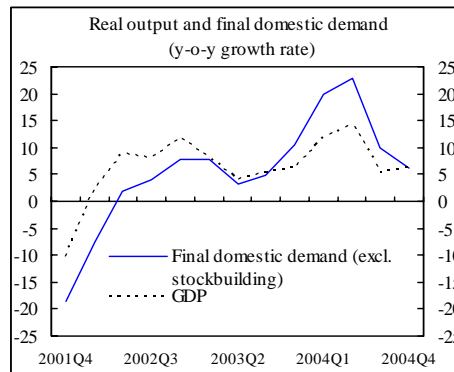
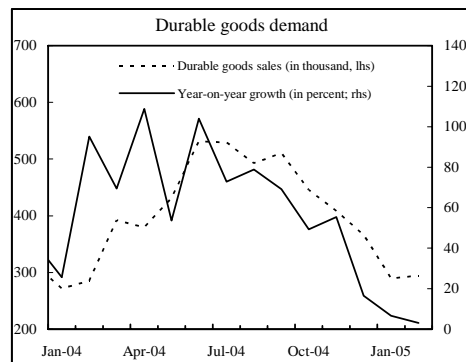
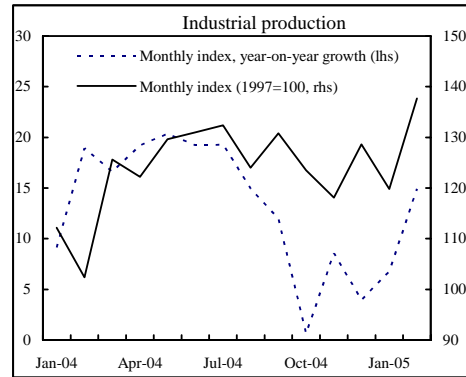
Industrial production increased by an average of almost 11 percent year-on-year in the first two months of 2005. Even though indications are that producers may have further built up inventory in those two months and their production may slow in upcoming months, this robust performance dampens concerns about a too rapid decline in production.

On the demand side, **sales of cars** and **durable goods**, the main components of private consumption in 2004, have become subdued, after a steep decline in their growth rates in the second half of 2004. Although demand may be shifting into other goods, in particular semi-durables, thus far there has been no strong indication of such a shift (e.g. prices in CPI subcomponents).

Import growth has been slowing further in 2005. In February, the three month average of imports grew at a slower pace than the same average for **exports** (year-on-year) for the first time since November 2003. A combination of robust production and strong export growth could reduce reliance on domestic demand to more export-driven growth, which was already partly observable in the converging growth rates of GDP and final domestic demand in the final quarter of 2004.

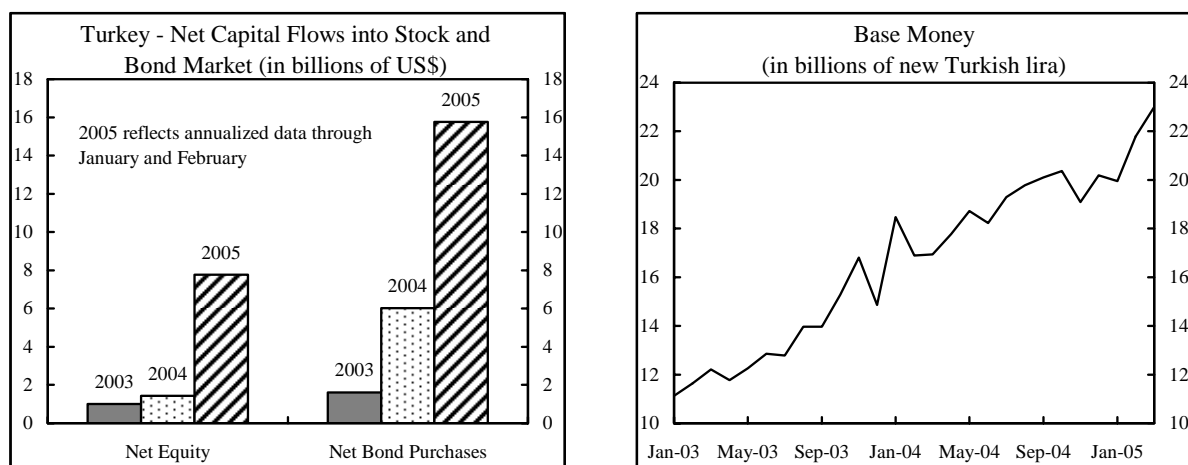
Year-on-year growth rates for **consumer credit** have not reversed their declining trend thus far in 2005, despite some recent signs of a pick up in week-on-week growth rates. However, **confidence** seems to remain strong despite the volatility in some of the indices. Thus, in an expectations-driven economy like Turkey, private consumption demand may quickly revive, possibly propelled by falling interest rates and rising asset prices as a result of resurging inflows.

Against this background, **the growth target of 5 percent seems well attainable**, and closer to the economy's potential. However, a stronger-than-expected decline in production, e.g. due to an appreciated exchange rate that impairs export growth could possibly put the target at risk.



8. **Monetary developments have also been positive:**

- **Credit growth** (Figure 3). Reflecting the pattern of economic growth, credit grew rapidly in early 2004, but eased in the second half, especially on the consumer side. Although consumer credit growth regained momentum in the early months of 2005, possibly reflecting lower interest rates, this has not yet fed through to higher overall credit growth.
- **Currency substitution.** Turkish lira deposits increased strongly during 2004, as did public demand for Treasury paper. While foreign currency deposits also grew rapidly, these have fallen in dollar terms in recent months (to a low of 40 percent of total deposits, also reflecting valuation effects), signaling a possible resumption of reverse currency substitution.
- **Capital inflows.** Demand for Turkish lira assets by foreign investors has also been strong, with bond and equity flows averaging US\$3¾ billion and US\$1¼ billion over the past two years, and the pace of inflows picking up in the early months of this year.

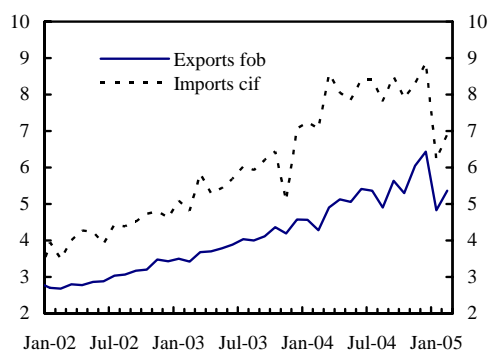


- **Base money.** Reflecting strong economic growth, increasing confidence in the lira in a declining interest rate environment, and ongoing financial deepening, base money has registered strong growth over the past two years—increasing by more than 20 percent in real terms each year.

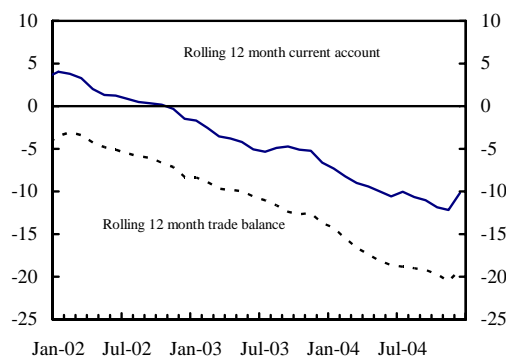
9. **Preliminary data indicate that the authorities achieved a record primary surplus of nearly 7 percent of GNP in 2004.** The central government primary surplus exceeded the program target, largely on the strength of increased revenues. Corporate income tax and VAT receipts were particularly robust, but cuts in fuel taxes early in 2004 left annual excise collections below target, despite increases in the second half of the year. There were also

Figure 3. Turkey: External indicators, 2002–05
(in billions of U.S. dollars; unless otherwise indicated)

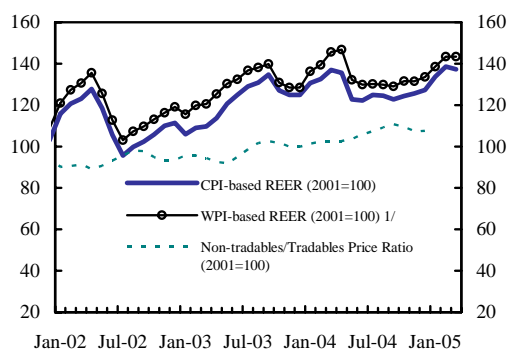
As imports outpaced exports...



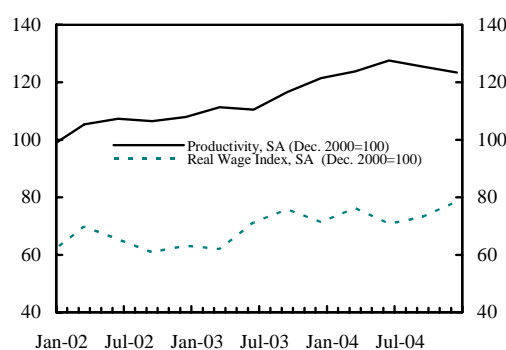
...the current account deficit widened.



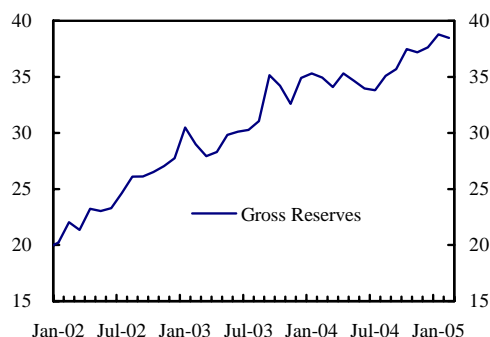
The real exchange rate appreciated...



...but productivity and subdued wage growth helped competitiveness.



Strong capital inflows and valuation gains strengthened gross reserves...



...and the net reserve position turned positive.



Sources: State Institute of Statistics; and Central Bank of Turkey.

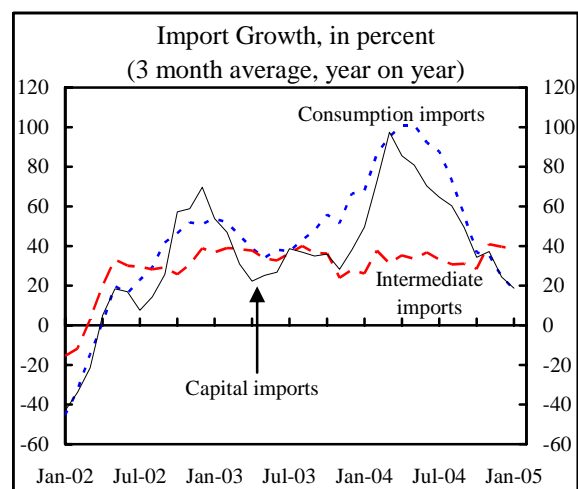
1/ From January 2005, uses Producer Price Index (PPI).

2/ Net international reserves measured at cross-exchange rates under previous arrangement.

shortfalls in the write-over of extrabudgetary special revenues, which the authorities offset with cuts in defense and capital transfers late in the year. These reductions were facilitated by savings on foreign-currency expenditures, reflecting the stronger-than-expected lira. Overall, primary expenditures were kept in line with the program. Outside the central government, the state economic enterprises (SEEs) overperformed, notwithstanding the impact of high oil prices on the railway, airline, and electricity companies. The social security institutions were modestly under target, but this was more than offset by savings on procurement by the Defense Fund, and higher revenues for local administrations and revolving funds (hospitals and other fee-based institutions).

10. The main macroeconomic concern has been the widening current account deficit (Figure 3).

The current account deficit for 2004 exceeded 5 percent of GNP, as the strong performance of exports and tourism receipts could not compensate for the even faster growth of imports, which surged due to strong domestic demand for imported durables and investment goods. Higher oil prices added to the problem. To contain the current account deterioration, the authorities took active measures, which included stopping state banks' aggressive expansion of consumer credit, reducing generous tax credits for buying new cars, and raising the intermediation tax on consumer credit. In November and December, they raised natural gas prices, and petroleum and motor vehicle excises, while saving much of the 2004 revenue overperformance. As a result of these measures and a moderation of pent-up demand for consumer durables, import growth has been slowing and the current account deficit appears to have peaked.



11. Despite the large current account deficit, gross reserves increased as a result of strong capital inflows, a large share of which remained short-term and debt-creating. Although the maturity structure of these inflows improved somewhat relative to 2003, Turkey remained exposed to a sudden reversal in market sentiment. At the same time, the inflows consisted mainly of foreign borrowing (trade-related credits, interbank and corporate borrowing) as foreign direct investment remained low and portfolio investments into government bonds were larger than those into equities.

Composition of External Financing			
	2002	2003	2004
	US\$ bln	US\$ bln	US\$ bln
Current Account	-1.4	-8.0	-15.4
Capital Account & E&O/1	7.7	12.1	16.2
Public Sector	7.0	-1.8	-4.9
Private Capital Flows			
FDI Net	0.9	1.2	1.7
Portfolio Investment	-0.6	2.6	8.0
<i>of which government debt securities</i>	1.5	2.9	8.0
Banks (medium term)	-0.2	-0.4	2.8
Banks (short term)	-1.1	3.6	-1.7
Other private (medium term)	2.0	1.2	4.9
Other private (short term)	-0.4	0.7	2.6
Reserve Assets ("-" = increase)	-6.2	-4.0	-0.8
Errors & Omissions	0.1	5.0	2.8
Memorandum Items			
Medium Term (incl. FDI)	10.7	1.7	6.5
Short Term (incl. portfolio minus Eurobonds)	-3.0	10.4	9.8
Debt Related /2	8.8	6.2	11.7
Non-Debt Related /2	-1.2	0.8	1.7
Percent Current Account Covered by FDI	56.7	14.9	11.0
Source: CBT			
1/ Excluding Reserve Asset Movements			
2/ Excluding Reserve Asset Movements and E&O			

III. THE AUTHORITIES' THREE-YEAR PROGRAM

The staff and the authorities were able to reach consensus quickly on the main objectives of the program and on a three-year macroeconomic and financing framework. However, developing the policies needed to help achieve these goals proved a more prolonged process than expected. This was in part because of the inherent complexities and sensitivities associated with key structural reforms such as social security and banking supervision. From the staff's point of view, it was also essential that the authorities' request for exceptional access was accompanied by policies that addressed decisively the remaining vulnerabilities and the structural reform agenda identified during the 2004 Article IV consultation.

12. The authorities have developed a detailed new three-year economic program in support of their request for exceptional access (¶2).¹ The overriding goals of the new program are to create conditions for sustained growth that will raise living standards and

¹ Numbers refer to paragraphs in the Memorandum of Economic and Financial Policies.

reduce unemployment; facilitate convergence towards the EU economies; and bring about an orderly exit from Fund support. To achieve this, the program aims to:

- Deal effectively with short-term macroeconomic challenges and, in particular, reduce the current account deficit to more sustainable levels.
- Secure permanently lower inflation, by retaining the floating exchange rate, preserving central bank independence, and adopting formal inflation targeting.
- Make the government debt position more sustainable through continued sizable primary surpluses, shifting towards longer debt maturities, and underpinning the fiscal adjustment with structural fiscal reforms.
- Restore Turkey's net foreign exchange reserve position and lower its vulnerability to balance of payments shocks.
- Maintain financial sector stability by further improving the supervisory and regulatory framework, accelerating asset recovery and restructuring state banks.
- Implement a structural reform agenda that enhances Turkey's growth prospects, lowers unemployment, and improves the investment climate.

A. Macroeconomic Framework

Both sides agreed that the program's macroeconomic framework should be built on a robust but sustainable rate of growth, a continued decline in inflation towards EU levels, a reduction in the current account deficit to improve external sustainability, and a 10 percentage point reduction in the ratio of public debt to GNP.

13. **The program's macroeconomic framework is centered on achieving high and sustained growth but at a more moderate pace than in the past three years (¶3).** With the output gap now considerably diminished, growth is assumed to converge towards

potential. However, past volatility makes Turkey's potential growth rate hard to determine. Staff analysis presented during the 2004 Article IV Consultation and recently updated indicates that potential

Macro-framework for Previous and New Program						
	Previous program			New program		
	2002 actual	2003 actual	2004 actual	2005 prog.	2006 prog.	2007 prog.
GNP growth rate (in percent)	7.9	5.9	9.9	5.0	5.0	5.0
CPI inflation (end-of period, in percent)	29.7	18.4	9.3	8.0	5.0	4.0
Current account deficit (in percent of GNP)	-0.8	-3.4	-5.1	-4.4	-3.5	-2.8
Public sector primary balance (in percent of GNP)	4.1	6.3	7.0	6.5	6.5	6.5
Public sector overall balance (in percent of GNP)	-11.9	-9.9	-6.1	-4.6	-2.3	-1.1
Public sector net debt (in percent of GNP)	78.5	70.4	63.5	60.0	57.3	53.4

growth in Turkey could be as high as 7 percent per year provided macroeconomic stability is maintained and in particular declining inflation, trade liberalization, and structural

reforms continue (Chapter I of the Background Studies). The authorities noted the many improvements in factors that had constrained growth in the past, including greater political and macroeconomic stability, and progress in structural reform, as well as the prospective benefits (including additional FDI) that would come from the EU accession process and implementation of the program. However, it was agreed that the program should be based on a more prudent medium-term growth rate of 5 percent.²

14. **Slower domestic demand and continued growth of exports are expected to lower the current account deficit to around 4.5 percent of GNP in 2005 (Table 3).** The authorities believed that much of the import surge in 2004 reflected pent-up demand for durables and investment goods. Indeed, the sharp slowdown in the rate of growth of domestic demand as well as imports in the second half of the year was consistent with this hypothesis. The elimination of tax incentives for purchase of cars and the increase in special consumption taxes should also help curtail consumer spending in 2005. Export volume growth continues to be robust and business surveys point to strong export orders. Productivity growth should help sustain the increases in export market shares and net tourism receipts should continue to cover a sizeable share of the trade deficit. The program also envisages a 5 percentage point decline in the overall fiscal deficit that should help facilitate a further improvement in the current account deficit over the program period.

15. **However, there are risks to the current account projections, and policies need to remain flexible to ensure program targets are achieved.** The phasing out of international quotas on Turkey's textile exports (one-third of merchandise exports) means that export projections face risks and the increase in international energy prices—if sustained—would weigh heavily on the trade balance. At the same time, the positive outlook for EU accession and a reinvigoration of structural reforms could lead to a surge in confidence, stronger demand, upward pressure on the lira, and larger current account deficits than envisaged. There were glimpses of such a pattern emerging in the first few months of this year. The authorities pointed out that they had allowed the automatic stabilizers to work in 2004 by saving the revenue overperformance, and had taken additional fiscal measures to contain the current account deficit. They stood ready to repeat this in 2005 and take measures, if needed, to ensure the current account deficit does not endanger the macroeconomic objectives of the program (¶11).

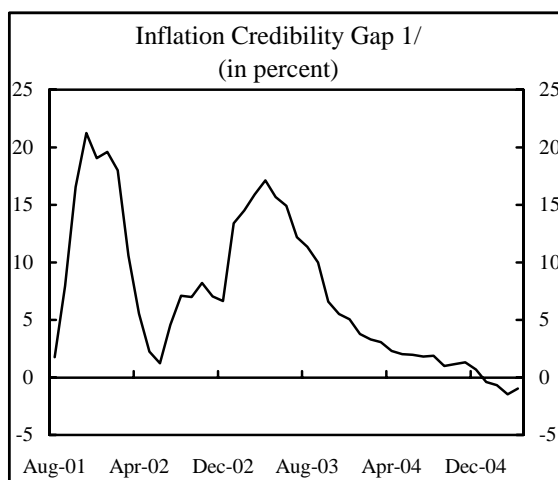
B. Monetary and Exchange Rate Policies

Monetary policy will aim at bringing inflation closer to EU levels. The move to formal inflation targeting should help, as should continued fiscal prudence. Safeguarding the independence of the CBT will also be critical. On the external side, the net international reserve position will be further improved to reduce Turkey's vulnerability to shocks.

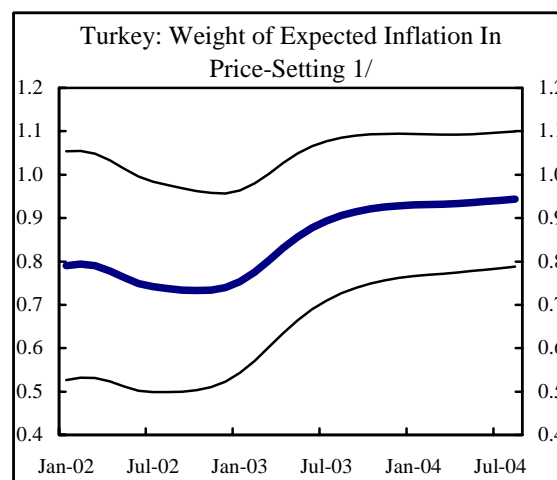
² The statistical agency is expected to issue new national accounts data later this year. If this leads to a large revision in GDP, the macroeconomic framework of the program would have to be reviewed.

16. While bringing inflation closer to EU levels will be a challenge, both the authorities and staff agreed that this should be the program's objective (¶4):

- **Prospects for continued disinflation were good.** For three successive years, the CBT had outperformed its end-year inflation target. As a result, monetary policy credibility had improved considerably, and reliance on forward- rather than



1/ Expected annual inflation minus CBT's announced inflation target.



1/ See Celasun and McGettigan, 2004, for details. Chart shows the weight of future prices in a price-setting equation. The higher the weight on future prices, the greater the credibility of the inflation target.

backward-looking price-setting had increased. The move to formal inflation targeting would also help, if handled carefully.

- **Even so, there were still risks to the inflation outlook, both domestic and external.** Although growth had recently moderated, rapid (though declining) credit expansion (Figure 4), high capacity utilization, and the shrinking output gap meant that demand pressures on inflation

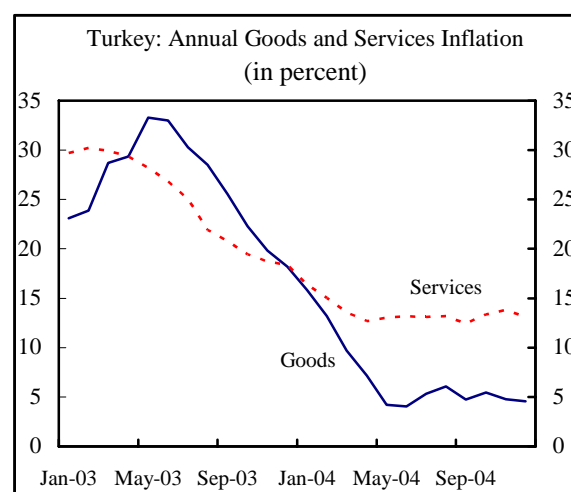
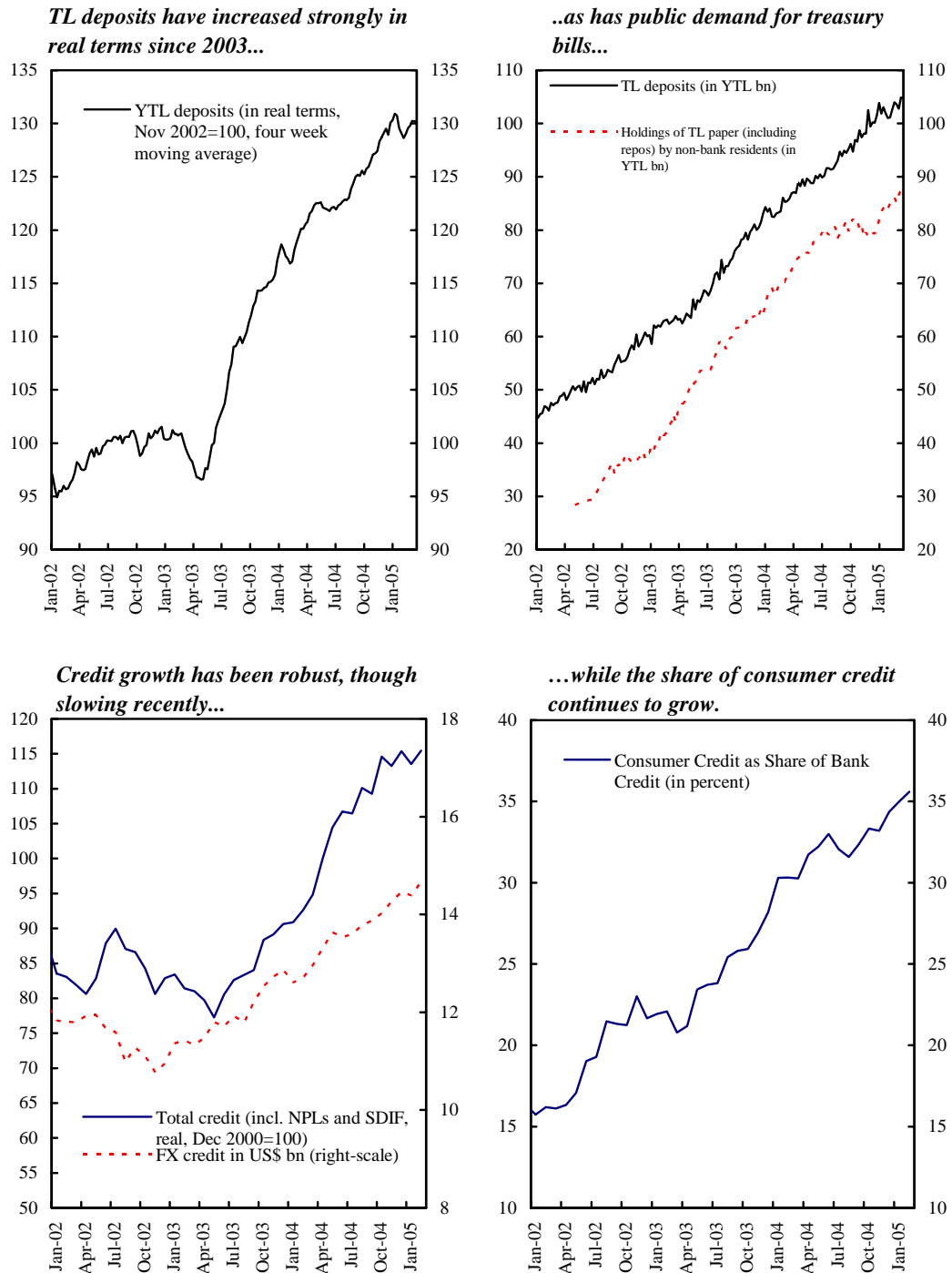


Figure 4. Turkey: Recent Credit Developments, 2002–05



Source: Central Bank of Turkey.

could emerge. The CBT noted that inflation stickiness in non-traded goods could be a problem (although lower traded goods inflation might simply reflect productivity growth or more rapid exchange rate pass-through). The use of indirect tax increases to meet the primary surplus target could also add to price pressures. Attainment of the inflation target could be disrupted if the exchange rate adjusts sharply to correct the current account deficit or in response to a worsening of the external environment.

17. Staff and the authorities noted that inflation could not be lowered permanently unless fiscal discipline were maintained and recent institutional reforms preserved.

Safeguarding CBT independence remained critical. Looking ahead, staff cautioned that public debt servicing costs remained highly responsive to short-term interest rates, which could lead to conflict if monetary tightening is required. Continued high primary surpluses, underpinned by credible structural fiscal reforms, were needed to help address these fiscal dominance concerns.

18. Both the CBT and staff agreed that the introduction of formal inflation targeting early in the program would make it easier to achieve the inflation reduction (¶5). With inflation now much lower and shifts in money demand assuming greater importance, the deficiencies in base money targeting were becoming more apparent (Tables 4–5). In response, over the past few years the CBT had adopted a form of implicit inflation targeting. Although formalizing this approach was not without risks, the government's commitment to sustaining high primary surpluses over the course of the program lent support to such a move, as did the improved condition of the banking system.

19. The staff therefore welcomed the move to formal inflation targeting, and stressed the need for developing a solid understanding of the monetary transmission mechanism in Turkey for it to become effective. Under the move, monetary policy transparency and predictability—critical elements of inflation targeting—have been further enhanced by fixing the time of Monetary Policy Committee (MPC) meetings and interest rate decisions in advance, and making a summary of the MPC's deliberations public. Marking the final stage in the transition to formal inflation targeting, the MPC would assume full responsibility for setting interest rates in early 2006. During the transition to formal inflation targeting, it was agreed that the current configuration of base money performance criteria and indicative NDA targets should remain in place (¶4). Base money was targeted to grow broadly in line with overall economic activity, with some room for financial deepening.

20. With inflation in single digits, on January 1, 2005 the authorities introduced a new redenominated currency—the New Turkish Lira (YTL) (¶4). The YTL drops six zeros from the existing currency, and will co-circulate with the TL during 2005, after which the YTL becomes the sole legal tender. Staff welcomed the move, agreeing that it marked renewed confidence in the Turkish currency.

21. There was strong consensus that the floating rate regime remained central to the success of the new program. This was an important safety valve to protect against shocks and to reduce risk-taking in the economy. While it could also provide insurance against a

deteriorating current account, given the sensitivity of debt dynamics to the exchange rate, it was essential that the floating rate regime be supported by an appropriate mix of monetary and fiscal policies. The strength of the lira, particularly against the dollar, had raised questions about competitiveness. However, the real effective exchange rate had been more stable and continued growth in exports, high productivity, and the increasing share of Turkish exports in the global markets do not point to concerns regarding competitiveness (Box 4).

22. **The CBT also committed to raise its net international reserve position substantially over the program, to further reduce Turkey's vulnerability to external shocks and allow for a successful exit from Fund support (¶6).** To do this, it had restarted its foreign exchange purchase auctions, with daily minimum purchases fixed in advance for the year. Though the cumulative impact through the year is significant, the daily amounts are low and should not disrupt the market. The CBT and staff agreed that daily amounts should remain fixed and any suspension should only be temporary in extreme circumstances. This would help prevent a recurrence of the confusion caused previously by frequent changes to the auctions, and would also be more compatible with the floating exchange rate regime. However, the CBT would also need to retain the option of using occasional discretionary intervention, as it had done recently, to rebuild reserves and prevent excessive exchange rate volatility.

23. **It was agreed that the CBT's policy response to the recent capital inflows had been appropriate.** The central bank had used occasional large discretionary intervention to smooth volatility, which, in addition to its daily foreign exchange purchase auctions, had helped to rebuild reserves. The Treasury's overborrowing had helped sterilize this. At the same time, with inflation declining and the inflation credibility gap having disappeared, the CBT also continued easing its monetary stance, lowering the overnight policy rate by 500 basis points since mid-December. In line with experience in other countries (see Background Studies, Chapter III) the Turkish lira had also seen some appreciation within the floating exchange rate regime during the recent capital inflow episode. Staff commended the CBT for its skilful handling of the inflows and argued that a similar policy combination was needed should inflows persist. Given the risk of exchange rate reversal and its impact on inflation, however, staff argued for a conservative approach towards further lowering rates.

C. Debt Management

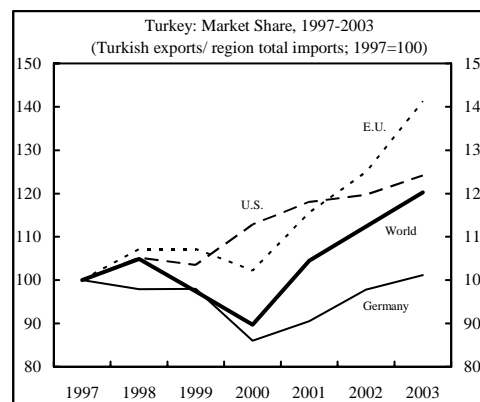
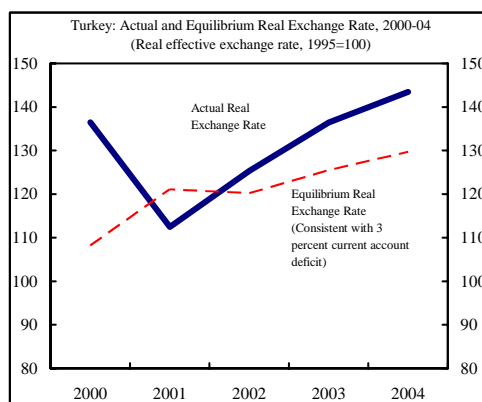
Debt management will remain focused on moving to longer-term Turkish lira borrowing. Treasury also plans to increase its cash reserves at the CBT. While both goals will help lower debt rollover concerns, higher domestic borrowing by the Treasury to build up reserves can also help to sterilize the CBT's foreign exchange purchases in case of strong capital inflows.

24. **Staff welcomed the authorities' goal of further shifting public debt into longer-term local-currency instruments (¶23).** Longer maturities would help address rollover

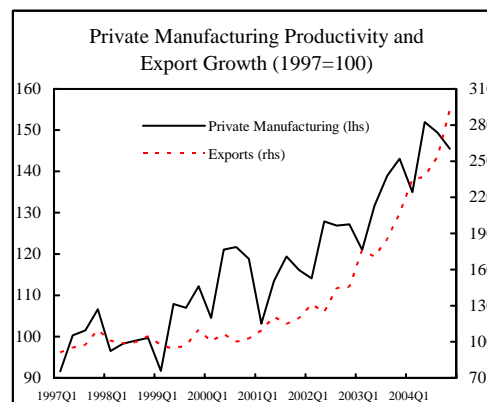
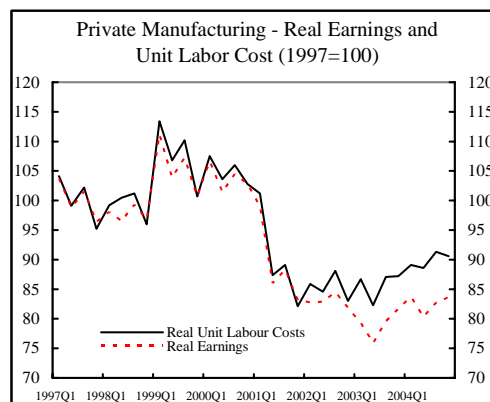
Box 4. Turkey—Competitiveness

While Turkey's external trade performance has been exceptionally strong since the 2000–01 financial crisis, the real effective appreciation of the lira (20 percent during 2003–2004), and the sharp increase in the current account deficit, raise the question of whether the lira is overvalued. Although standard models for calculating equilibrium exchange rates suggest that this may be the case, other indicators do not suggest a competitiveness problem.

Using estimates of trade responsiveness to exchange rate changes, the recent Article IV report estimated the “equilibrium” exchange rate that would deliver a debt stabilizing current account deficit when the Turkish economy and its trade partners operate at full potential. While such an assessment is sensitive to the target current account balance, estimates of potential output gaps and assumed trade and output elasticities, it provides an indication of exchange rate divergence relative to the long run equilibrium. These calculations suggest that, by end-2004, market forces had appreciated Turkey's exchange rate roughly 10 percent above the long run equilibrium rate (Box 3, Article IV report), which can be explained by such factors as a positive assessment of future productivity gains associated with EU accession, higher real interest rates and the risk preferences of investors. However, given the large margins of error in such estimates, this does not automatically imply an “overvaluation” of the exchange rate.

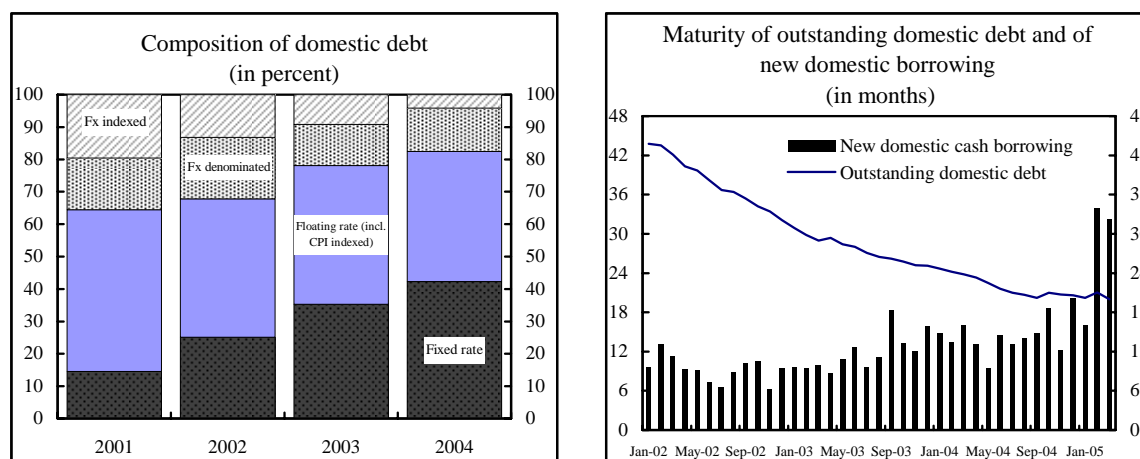


Other indicators, however, suggest that Turkey's exports remain competitive. Turkey's market share in key export markets has continued to increase since the 2001 lira devaluation (by 15 percent on average and by 22 percent in the EU, aided by the appreciation of the euro).



Productivity and unit labor cost indicators also remain favorable. Productivity per worker in manufacturing industry increased by 20 percent since early 2003, due in part to lay-offs in the public sector, although it seems to have dropped off slightly in the last two quarters of 2004. At the same time, against the background of continuing high unemployment and underemployment, private wage growth has been subdued. Following a decline of around 25 percent during the crisis, real wage growth has been broadly flat during the last two years (increasing by roughly 2 percent). These developments have helped contain unit labor costs and increase the competitiveness of exports in external markets.

concerns and local currency liabilities would better match the government's revenues. Creating a liquid local-currency bond market along an extended yield curve would also facilitate risk management for financial institutions and help develop Turkey's capital markets.



25. **The authorities noted that they had taken advantage of recent favorable financial market conditions to improve the structure of public debt.** Although there had been some market turbulence earlier in 2004, Treasury had since been able to lengthen maturities, issuing a three-year lira-denominated bond last October and following this in February and March this year by issuing five-year domestic paper. While the average maturity of new borrowing has increased, the average maturity of outstanding domestic debt is still declining, as long-term bank recapitalization papers are being gradually replaced by shorter-maturity market debt. However, an increasing share of debt is now in the form of local-currency, fixed-rate instruments.

26. **However, the authorities indicated that they faced trade-offs in improving the composition of their debt.** With little demand from retail investors, switching to longer-term fixed rate lira instruments would only be successful if there was demand from banks. This would in turn depend on banks' funding, which remained short-term and still reliant on foreign currency. Forcing changes in banks' portfolios would carry the risk of large interest rate increases. This problem was mitigated to some extent by the recent emergence of strong foreign demand for YTL government bonds, as evidenced by the success of the five-year bond issue. In any event, the authorities agreed that they needed to press ahead and gradually improve their debt structure, as a passive approach was risky.

27. **Debt management should also aim at increasing Treasury's cash reserves to reduce domestic roll over risk.** The authorities have raised the level of Treasury reserves at the CBT. Staff agreed with the authorities that given the large magnitude of redemptions (over 3 percent of GNP per month), the increase in cash reserves would have to be gradual. The authorities' plans to lengthen maturities would also contribute to lower rollover pressures. In the baseline projections, it was also agreed that Treasury would continue to

30. **The new program aims to underpin these fiscal objectives by improving the composition of the budget.** Fiscal adjustment to date had relied heavily on tax increases, with little improvement in the composition of spending. Excises covered a wider range of goods than in the EU, and excises on fuel, cigarettes, and alcohol were especially high. While Turkey's VAT had been an effective source of revenue, personal and corporate income taxes were complex and generated low yields. On the spending side, the central government wage bill remained too high (8½ percent of GNP), while the social security deficit had risen steadily, despite the 1999 reforms, and was now almost the size of the central government primary surplus. While subsidies to agriculture, banks, and state enterprises (SEEs) had been reduced, capital investment had also been cut back.

31. **It was agreed that far-reaching structural reforms were needed to secure improvements in budget composition.** Improving revenue collection from Turkey's large informal sector was critical and would be helped by the program's tax administration reforms. Personal and corporate income tax bases also needed to be broadened to support lower and less distortionary taxes, although it was acknowledged that reforms here would take time to implement. On the spending side, social security and civil service reforms were essential. These reforms would need to be supported by improvements to medium-term budgeting practices.

32. **The 2005 budget includes some initial improvements in the composition of revenues and expenditures (¶11).**

- On the **spending** side, investment in infrastructure and social sector projects and outlays on research were set to increase substantially. Investment spending in the 2005 budget was increased by some ½ percent of GNP from 1.7 in the amended 2004 budget to 2.1 percent of GNP in 2005.³ The cost of this would be offset by containing wage increases and by achieving savings on drug spending, as agreed in mid-December with the pharmaceutical industry.
- The budget's **tax** reforms were also welcomed as a useful first step. Corporate income tax rates were cut from 33 to 30 percent (eliminating a temporary surcharge that had been introduced during the crisis to bolster revenues), and the top rate of PIT was reduced by 5 percentage points. The VAT rate was also cut from 18 to 8 percent on a few socially important categories, including private health and education services (e.g., eye and dental examinations), selected school materials, and a narrow range of socially important food products (at a modest expected cost of 0.1 percent of GNP).

³ Final investment spending in 2004 was higher (1.9 percent of GNP) as some of the unused contingency was used for additional investment. A similar pattern may occur in 2005 if the budget contingency is not fully utilized.

33. **Nevertheless, staff would have preferred a stronger package of measures to close the budget gap.** Specifically, staff had recommended a modest increase in the standard rate of VAT, revenue-enhancing PIT changes, and lower spending on wages. Other proposals included reduced agriculture support payments for farmers with pension contribution arrears, lower growth of defense and security spending, and reduced outlays for temporary staff. However, the authorities argued that the VAT rate was already too high and encouraged tax evasion, while higher personal income taxes or slower spending increases in sensitive areas were not feasible. Instead, the authorities opted to increase excises on fuels, consumer goods, tobacco and alcohol and to raise energy prices, yielding nearly 1½ percent of GNP (including from the VAT on final prices).⁴

34. **Staff also noted risks to achieving the 2005 primary surplus target.** The increase in excises and energy prices might prove difficult to maintain if oil prices continued to rise. With the high level of excises, there was also a risk that smuggling and evasion might escalate. While the projected surplus of the state enterprises was realistic, it crucially depended on maintaining their efficiency and ensuring that their prices increased in line with inflation. On the spending side, staff noted the risk that public worker wages—initially to be agreed with the labor unions in March, but now delayed—might exceed the conservative budget assumptions. There was also a risk that the latest efforts to limit drug spending could prove ineffective. The staff therefore urged that contingency measures be identified, noting that these would be helpful in any event given the need to contain the current account deficit.

2005 Program—Central Government		
	2004 Prel.	2005 Prog.
	(In percent of GNP)	
Primary balance	5.1	5.1
Total primary revenues	24.5	25.2
Tax revenues, of which:	23.6	24.7
Personal income taxes	4.6	4.4
Corporate income taxes	2.2	1.8
VAT	8.0	8.4
Excise taxes	6.1	7.3
Total primary expenditures, of which:	19.4	20.2
Personnel	8.3	8.1
Transfers to social security	4.5	4.5
Public investment	1.9	2.1
Other transfers 1/	1.4	2.0
Source: Turkish authorities and staff estimates.		
1/ Including capital transfers and research outlays.		

⁴ Since the VAT is levied on the final price inclusive of excise, these measures also increase the VAT base and more than offset the modest decline in VAT receipts due to the rate cut for socially important categories mentioned above.

35. **The authorities emphasized that the 2005 budget contained a number of safeguards including a contingency of nearly ½ percent of GNP.** Moreover, they underlined their commitment to take additional measures, if needed, to achieve the primary surplus target and to save any revenue overperformance (¶11). They pointed to their track record in this regard during the previous program, including the large fiscal overperformance in 2004. They noted that the budget had been prepared on the assumption of a much more depreciated exchange rate (year average YTL1.6 to the dollar) and that this provided scope—at least later in the year—to reduce outlays on defense and other goods and services with high import content. While neither the staff nor the authorities favored cutting investment spending, the authorities noted that the increase in investment spending is concentrated in a few very large projects, developed with the World Bank and other IFIs. Complexities in project implementation may limit outlays below budgeted amounts. Finally, the authorities confirmed that revenue measures would also be considered if the need arises. While fiscal performance had been in line with or even better than projected so far this year, both sides agreed that an assessment of whether fiscal developments are on track and appropriate in light of current account development, would form a key element of program reviews.

36. **After the budget approval, a number of initiatives undermining the quality of adjustment and opening a fiscal gap contributed to delays in bringing the program to the Board.** Pensions were increased beyond the budgeted amount and envisaged increases in excises on consumer goods were not implemented as planned. The authorities also proposed expanding their existing regional development scheme, by subsidizing personal income taxes and employer social security contributions for firms in the 49 poorest regions, which they claimed would promote economic development. After considerable delay, the scheme was ultimately revised to improve its efficiency and substantially reduce its cost: employment subsidies were more narrowly focused on *new* employment generation, selection criteria were put in place to simplify the scheme's administration, and safeguards were introduced to enhance its transparency.⁵ The authorities decided to offset the cost of the higher pension increase, shortfalls in indirect taxes, and the regional scheme through reducing the cost of health care services, which could give rise to reduced bonus payments to doctors and nurses and through implementing the delayed excise increases.

37. **Though the staff were sympathetic to the need for development in the poorer regions, they were skeptical that the authorities' proposed scheme was the best way to achieve this.** By comparison with the incentive regime introduced last year, the new scheme—while better targeted to employment generation than earlier proposals—still shifts

⁵ Firms in the targeted 49 provinces with more than 30 employees which increase employment by 20 percent or more would qualify for a PIT exemption for their employees (up to the minimum wage), as well as a rebate of employers' social security contributions (again up to the minimum wage) and electricity bills. Firms would also benefit from free access to state land. For each new employee, the firms would receive the PIT and social security subsidies for the new worker and two existing employees. The scheme will end in 2008.

subsidies towards existing jobs and thus had a deadweight loss. The expansion of the scheme both in terms of its generosity and the number of regions covered, and its introduction outside the regular budget cycle and only one year after the introduction of the original scheme, would also create uncertainty in the investment environment and an uneven playing field for investors. Financing the scheme by reducing health spending was also a questionable switch in scarce resources. However, with employment in the 49 regions accounting for only 10 percent of the total employment in Turkey, the authorities considered that incentives were essential. They pointed to the low cost of the final scheme and to the fact that it is fully financed as an indication of their continued commitment to fiscal prudence.

Structural fiscal reforms

Tax reform (¶18–19)

38. **The authorities agreed on the need to simplify the personal income tax during the program period but important details are still to be developed during 2005.** The current system had separate schedules for wage and non-wage income, six rates, and a complicated and administratively burdensome system of expenditure tax credits. Staff argued for a cut of the bottom rate, while reducing the number of brackets and setting them to yield additional revenues. The credit system (and a similar pensioner VAT rebate scheme) could be replaced by simple non-taxable allowances. Reform should also consider the taxation of civil service in-kind benefits and pension benefits or contributions. While the authorities were in favor of reducing and harmonizing the tax brackets, they were concerned that this should not raise the burden on middle income families. Taxing benefits or contributions was also likely to be socially very sensitive, especially at a time when social security reforms were being considered. It was agreed that PIT reform should only be implemented in the second year of the program, especially given the time needed to agree, plan, and implement such reforms.

39. **There was also agreement on the desirability of further reducing corporate income tax rates during the next three years, while broadening the tax base and improving compliance.** Corporate tax rates should be lowered gradually to recent EU accession country levels. Lower investment incentives could in part help pay for this reform; however, the authorities pointed out that, given the need to grandfather existing incentives, the revenue gains would be minimal. Any impact on the primary surplus would need to be offset elsewhere.

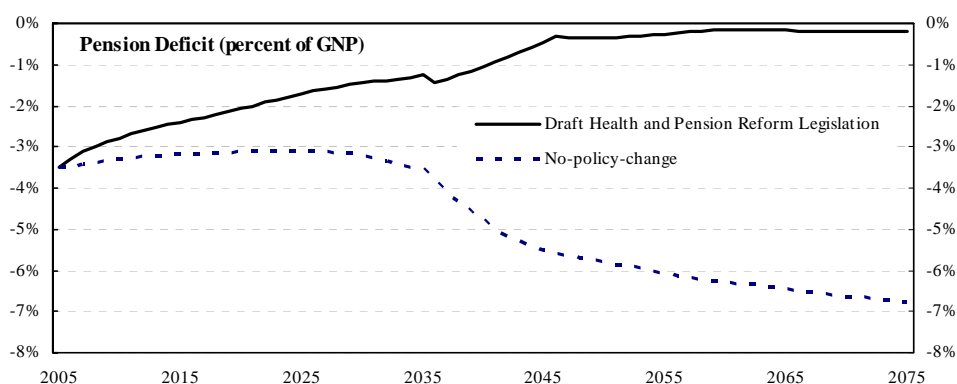
40. **The staff strongly advised against proposals for cutting VAT rates.** It was noted that the VAT remained the most stable and efficient revenue source in Turkey and that cutting VAT at a time of strong domestic demand and a widening current account deficit was risky. The authorities agreed, but argued that standard VAT rate cuts—or the reduction of VAT rates for sectors where compliance is weakest—could prove helpful in addressing evasion. They also noted that reduced rates were widespread in the EU. Staff indicated that while the elimination of the 1 percent VAT rate was advisable on efficiency grounds, the standard 18 percent VAT rate in Turkey was not high by international standards and that

rewarding tax evaders with lower rates in the hope that they would comply provided the wrong incentives. Reducing rates for specific sectors would also run counter to best practice. The authorities agreed to maintain the current VAT rates during the program period but decided to reduce the rate upfront for a few socially sensitive items with small revenue impact (0.1 percent of GNP).

41. **Staff considered that poor tax compliance would best be addressed by the effective implementation of the new revenue administration law.** Legislation approved by Parliament in April would overhaul revenue administration by creating a semi-autonomous authority organized along functional lines, more consistent with international best practice. Implementation of the new law, including introduction of a new large taxpayers unit, establishing a simpler system for small taxpayers, a substantial increase in the number of auditors, streamlining the system of VAT refunds, the restructuring of local tax offices, and computerization upgrades, would be critical to improving tax compliance. A shortcoming of the law is that it does not unify tax audit in Turkey. However, it was agreed that, as it gained experience, the revenue administration would also assume responsibility for collecting social security contributions, an area of chronic weakness.

Expenditure reform

42. **The authorities recognized the importance of dealing with the widening social security deficit (¶14–16).** Although the 1999 pension reform introduced statutory retirement ages and linked benefits to inflation, the transition to the higher retirement age was very gradual and in the last three years the indexation formula has been overridden and above-inflation increases granted. As a result, the pension deficit had increased from 2½ percent of GNP in 2000 to 3½ percent in 2004 and was set to widen to around 7 percent of GNP in the long run. Without reform, the overall social security deficit was projected to more than double in the long run from its current level of 4½ percent of GNP.



Source: IMF staff presentation based on World Bank estimates.

43. **The authorities have submitted comprehensive legislation to Parliament that will reduce the social security deficit.** The planned reforms—which alter pension parameters (replacement rate, annual indexation, and wage valorization) and unify the three existing

extrabudgetary social security institutions—should reduce the annual pension deficit by nearly 1 percent of GNP over the next ten years, and bring it well below 1 percent of GNP over the long run (Chapter 4 of the Background Issues). The legislation also introduces universal health insurance. The authorities agreed on the need to proceed cautiously in this area and intended to offset additional costs through savings from pharmaceutical procurement, enhanced medical referral systems, and tighter budget constraints on hospitals. They also agreed to develop a monitoring system for health expenditure to ensure that it remains under control (§16).

44. **Staff strongly supported these critical reforms—on which the authorities have worked closely in consultation with the World Bank—but would have preferred a more rapid reduction of the pension deficit.** The authorities agreed with this aim, but were concerned that more ambitious reforms such as bringing forward the increase in the pension age, taxing pension benefits or contributions, or raising contribution rates would have generated strong resistance, possibly derailing the whole reform. Instead, savings would come more gradually through lower replacement and indexation rates, unifying the SSIs (for efficiency gains and to harmonize benefits), and broadening the base for contributions. Against this backdrop, staff noted that the more controversial reforms may need to be revisited, if savings do not materialize as projected. The authorities also committed to cap the social security deficit at its 2004 level (4½ percent of GNP) during the entire program period.

45. **Both sides acknowledged that further expenditure reforms were essential during the program,** particularly on civil service pay and employment, health and education, and budgetary support for agriculture and SEEs (§17). The identification of specific measures would draw on public expenditure reviews of the Fund and the Bank. It was also critical to prevent backsliding: staff had argued for reversing wage compression in the civil service but this instead was worsened in the wage round for the 2005 budget. Staff also expressed strong reservations over the authorities' medium-term proposals for agriculture, which included moving from income support back to direct production subsidies and establishing a higher, 1 percent of GNP *floor* for budget support from 2006. The authorities emphasized that work on these issues was ongoing, including with the World Bank.

46. **Finally, the program incorporates further improvements in expenditure management and transparency (§20–22).** Secondary legislation under the Public Financial Management and Control Law (PFMCL) was needed to support the introduction of medium-term budgeting and strategic planning, as well as to improve local government accountability. It was essential that new spending mandates for provinces and municipalities in the government's proposed decentralization reforms were adequately matched by local revenue capabilities. Local government borrowing limits should also be tightened and strictly enforced. Legislation strengthening SEE governance, based on OECD guidelines and covering performance targets, audit, budgeting and procurement, was due to be submitted by September. A reassessment of the fiscal transparency ROSC was planned for 2005 to help set the agenda for the rest of the program.

E. Financial Sector

To consolidate the impressive gains that have been made under the current program, remaining reforms need to be accelerated and brought to closure, including on the legal and supervisory regime, asset resolution, state bank restructuring, and increasing financial intermediation.

47. **It was agreed that while the banking system had been restored to soundness, further reforms were needed to safeguard this achievement.** The regulatory framework had been brought closer to international standards, while state banks had been restructured and recapitalized, and their large overnight borrowing positions removed. Private banks were adequately capitalized (with average capital adequacy ratios of 22 percent at end-December 2004), their open foreign exchange positions had been largely eliminated, the ratio of non-performing to total loans had fallen to below 5 percent, and profitability had been restored (Table 7). Banks had also succeeded in rebalancing their portfolios away from government paper, allowing private sector credit and consumer lending in particular to expand rapidly. Despite these achievements, reforms needed to continue. The shortcomings in the legal and supervisory regime brought out, among others, by the Imar Commission, need to be addressed; asset sales which have been disappointing so far need to accelerate; and the momentum of state bank restructuring has to be regained.

48. **Deficiencies in the legal and supervisory system have impaired the effectiveness of the BRSA and SDIF.** Despite more than 20 successful interventions since the crisis, in a few cases former bank owners had won court decisions reversing BRSA actions, long after the banks had been taken over (in some cases even sold or merged into other banks), and even though they appeared to be clearly insolvent. This has undermined the BRSA's authority and, in the absence of corrective legal action, would also discourage the BRSA in the future from taking over insolvent banks. Insufficient legal protection may also have discouraged the SDIF from resolving bad assets for fear of being sued for causing losses to the state. Staff noted that the Imar Commission had also identified weak and outdated supervisory practices, particularly in on-site banking examination, as a key weakness, contributing to the failure to detect the Imar banking scandal. Accordingly, the Commission had made far-reaching recommendations on bringing supervisory practices into line with best international practice (see Box 5).

49. **To help overcome these difficulties, the authorities have submitted to Parliament a new draft Banking Law with the aim of bringing the framework more closely in line with international best practice (¶26).** The new law focuses on strengthening the provisions on "fit and proper" criteria, the licensing process, related party lending, the delineation of responsibilities between the BRSA and SDIF, and the legal protection of their staffs. The draft law also strengthens BRSA's onsite examination capacity by removing the exclusive right of Sworn Bank Auditors to examine banks—identified by the Imar Commission as a major weakness—and improving the co-ordination of on-site and off-site supervision. Staff welcomed the government's albeit delayed submission of this landmark legislation to Parliament. They stressed that the law's effectiveness would depend greatly on

the substance of the implementing regulations, and that the BRSA needed to act quickly if they are to be issued within one year of the law's passage (new structural benchmark), and on the BRSA's ability to develop more effective methods of on-site supervision. The BRSA's resistance to overhauling bank examination practices also raised questions about the effective implementation of the law.

50. **The Banking Law also addresses weaknesses with bank intervention and resolution encountered during the crisis.** The new law puts an end to open-ended bank resolution procedures, specifically limits the cost to the state, and puts in place the needed rules for deposit insurance. These procedures were welcomed by staff:

- **Liquidation and resolution.** The new resolution strategy is stricter and contains strong safeguards. Under the new law, if BRSA revokes a bank license it will automatically be transferred to SDIF for liquidation. If BRSA decides that an intervened bank is viable, it can transfer the bank to SDIF for sale or merger in whole or in part. The cost of bank resolution cannot exceed the amount of insured deposits and the sale or merger would have to be completed within one year, otherwise the bank's license would be revoked.
- **Deposit insurance.** Deposit insurance rules, including on coverage, would be decided by the SDIF upon the approval of the BRSA, CBT and Treasury. The risk-based insurance premium would be determined by the SDIF after consulting the BRSA.

The staff stressed that in the above areas, the effectiveness of the new law would be highly dependent on close co-operation between the BRSA and SDIF in implementing the legislation.

51. **Asset recoveries have so far been very disappointing, but the SDIF is now committing to dispose of at least 90 percent of its holdings during the program (¶31).**

- The bulk of SDIF holdings consist of **seized assets** and **assets of former bank owners**, including from Imar bank. These would be resolved through protocols, with details made public or, where negotiations failed, through legal action. Staff noted that judging by previous experience, this asset disposal process would likely prove difficult and face legal challenges. However, the authorities emphasized that they had already prepared supporting legislation to protect purchasers of the assets from lawsuits, and ensure that any transfer of assets cannot be reversed.
- The staff pressed for an acceleration in the disposal of **non-related party loans**. After having successfully completed its first auction in August 2004, the SDIF now plans to sell all remaining non-related party loans during 2005 by auction (structural benchmark). These loans have been non-performing for several years; the recovery rate for such loans at the last auction was about 10 percent of face value.

Box 5. The Imar Commission Report

After the failure of Imar bank, the government formed an independent commission to assess the supervisory lessons that should be learned from the scandal. The Commission consisted of Messrs. Jean-Louis Fort, former Director General of the Banking Commission in France, and Peter Hayward, former Secretary of the Basle Committee on Banking Supervision. The Commission published its report in August 2004.

The Commission noted three requirements of any effective supervisory authority: (i) a sound legal basis; (ii) adequate resources (financial and human); and (iii) an effective organizational structure.

To help fulfill these requirements, the Commission recommended the following legislative changes:

- **Board members appointed to banks by the BRSA**, should act as representatives of the BRSA and not as regular directors of the bank. In such banks, BRSA should also have the right to remove and appoint new members of the executive and auditing boards.
- The powers to conduct **onsite examination** and **to request information** should belong to the BRSA as a whole and not exclusively to the Sworn Bank Auditors. The Commission argued that expertise and experience found elsewhere among BRSA staff should be used in onsite examinations. The legal requirement that only Sworn Bank Auditors can perform onsite work removes a desirable element of flexibility, including the need to use outside expertise, and this can hinder effective supervision.
- The Sworn Bank Auditors' role as **tax auditors** should be removed. The Commission stated that "this is an extremely unusual element" and that in most countries it is felt important that supervisors should have no responsibilities in this area.
- **External auditors** should have the right to inform BRSA of their findings.
- **Overly detailed legislation** would reduce the flexibility of the BRSA. Detailed application of general requirements should be left to secondary legislation or regulations, in a way that can be easily altered to meet changes in the market environment.

The Commission also suggested ways to strengthen the BRSA's day to day operations:

- Regarding **resources**, the Commission found that BRSA has an insufficient number of staff with experience in banking, external audit, IT, trading and back office operations. Broadening the recruitment base, a more flexible pay structure, creation of short- and medium-term assignments and secondment of staff from the private sector could help strengthen the skill base.
- In the **organizational area**, the Commission firmly stressed the importance of better coordination of onsite and offsite supervision. According to the Commission, officers from the offsite department should be given overall responsibility either for the supervision of one large bank or a group of smaller banks. The officer should ensure full communication between various functions in BRSA, prepare briefs and determine areas for inspection, follow up on corrective actions, and coordinate with external auditors.
- Regarding the BRSA's **governance structure**, accountability should be pushed down from the chairman to the officers in charge of supervision of individual banks. There should also be procedures in place that allow the board to assess the performance of the agency and its staff, including external reviews of BRSA's efficiency.
- There might also be scope for improving the **performance of the BRSA board**. The status of board members should be reviewed, particularly the appointment of fulltime board members without executive functions. Consideration should be given to appointing at least some part-time members with private sector experience.

- On the **institutional** front, it was agreed that the SDIF would soon begin downsizing its staff, including Bayindirbank, since most of its assets would be sold within the next year or so. And, to ensure the solvency of the deposit insurance scheme, Treasury had agreed to write down the SDIF's debts closer to the amount it could be expected to recover.

52. **While state banks underwent considerable financial and operational restructuring at the start of the current program, they are far from ready for privatization (§29–30).** After being recapitalized and their duty losses and overnight positions removed, Ziraat and Halk (the two largest state banks) have cut 30,000 staff positions and closed more than 800 branches. However, no credible strategy has yet been put in place for their privatization. The authorities agreed that the main hurdles to privatization were the banks' large holdings of government securities—at Ziraat, the largest state bank, these accounted for almost 70 percent of total assets—and their privileges, such as the requirement that government agencies and state enterprises hold deposits at these banks, often at below market interest rates. Attempts to privatize the state banks had failed because private investors were not willing to invest in banks whose balance sheets were dominated by government bonds on the asset side and which were highly reliant on the liability side on their monopoly position in holding state deposits (26 percent of total deposits in Ziraat, 14 percent in Halk and 28 percent in Vakif). To prepare for privatization, existing privileges would have to be removed and state bank holdings of government securities reduced. The staff emphasized that it was essential to have a credible and detailed strategy for restructuring and eventual privatization of the state banks by mid-year, and encouraged the authorities to work with the World Bank towards this goal.

53. **The authorities are now preparing a strategy for removing the obstacles to privatization of the state banks as a first step in developing a credible timetable for their eventual disposal.** A recent FAD/MFD mission found that these privileges and burdens could be removed without any major impact on the performance of the three state banks since, at least initially, the loss of public deposits was likely to be limited as state banks are viewed as less risky than private banks. The biggest risk seemed to be that any rebalancing of state bank portfolios, away from government securities to lending, could lead to a rapid and potentially dangerous credit expansion. The authorities were working with the World Bank on the development of a state bank strategy, which is expected to be in place by the time of the first review.

54. **On a positive note, foreign investment interest in the banking sector is increasing.** The Fortis Group has announced that it is buying an 89 percent stake in Dişbank and talks are also taking place regarding the sale of Şekerbank to Rabobank. One of the largest remaining problems in the banking sector might also be solved. The sale of Yapi Kredi Bank has been an outstanding issue for almost three years but an investor has now expressed an interest in buying the bank and negotiations have been ongoing with its owner, the Cukurova group, since the beginning of the year. Although some issues still remain to be solved, the sale could be finalized before the summer. If the sale is carried through, together

with the sale of the group's shares in Turkcell, the Cukurova group is likely to be able to repay a large part of its debt to SDIF (US\$1.8 billion) and to Yapi Kredi.

55. For the remainder of the program, the staff stressed the importance of removing the remaining fiscal impediments to financial intermediation (¶18). While it was recognized that reducing intermediation taxes would have fiscal costs (about ½ percent of GNP), it was also agreed that these taxes had simply pushed many transactions onto the books of offshore branches of Turkish banks, or into foreign borrowing. In any case, the fiscal costs would also decline as interest rates fell. Accordingly, the authorities agreed to phase out these taxes during the program, macroeconomic (mainly current account) and budget considerations permitting.

F. Investment Climate

The costs of doing business in Turkey are considerable. Not surprisingly, foreign direct investment has been discouraged and the employment rate is very low compared to EU countries. To address these obstacles, the authorities plan to: (i) further simplify and streamline bureaucratic procedures; (ii) accelerate privatization; and (iii) enhance labor market flexibility. The authorities' medium term fiscal strategy and social security reform will also contribute to reducing business costs.

56. The authorities have made progress under the previous arrangement to improve the investment climate. Most notably, sound fiscal and monetary policies have contributed to a more stable macroeconomic environment, independent regulatory institutions have been created, and the passage of the 2003 Foreign Direct Investment (FDI) Law has helped level the playing field for foreign and domestic investors by establishing the principle of equal treatment. Political stability—identified by investors as one of the most important prerequisites for investment—has also contributed to a more favorable business environment. Following the creation of the Investment Advisory Council in early 2004 (a forum for dialogue between the government and high level private sector representatives), the government has embarked on a wide range of further structural reforms aimed at reducing red tape, improving the efficiency of the court system, accelerating privatization and bringing standards more in line with the EU. The second IAC meeting, planned for end-April, will review progress and help set a revised agenda for the coming year.

57. Building on the recommendations of the new Investment Advisory Council, the government has started to streamline administrative procedures and reduce red tape (¶32). The number of procedures required for opening a business has fallen from 13 to 8, and the average time required to register a business has recently been cut to less than one week, comparing favorably to other countries in the region and to other OECD countries. Legislation has also been prepared for the creation of a “one-stop-shop” system for obtaining business permits. The new system will make procedures for start-up permits easier by enabling investors to apply through a single agency. The legislation would also eliminate duplication of documents and make more transparent the approval periods for various permits. Customs procedures have been simplified and increasingly automated. In addition,

regulations have been introduced that reduce the number of documents needed to obtain an operating license from the Ministry of Labor from 18 to 3.

58. **Following several years of lackluster progress, privatization seems to be moving ahead.** In 2004, the privatization authority sold over 30 companies, yielding US\$1.3 billion in revenue (0.4 percent of GNP). The largest of these were a block sale in Tekel (alcoholic beverages) and a 23 percent public offering of Turkish Airlines shares, two thirds of which was taken up by foreign investors. Sales of flagship assets have thus far been hindered by numerous court challenges, a reluctance to accept low sales prices, and selection of bidders that lacked sufficient financial resources. More recently, the second attempt to sell Tekel's tobacco arm failed, with high tobacco excises blamed for lack of investor interest.

59. **Several major privatizations are envisaged during the Fund arrangement.** The authorities are committed to selling stakes in several major companies during the program period, including Türk Telekom, Turkish Airlines, Petkim (petrochemicals), Telsim and the National Lottery. On March 4 the Privatization Authority successfully sold a 15 percent stake in Tüpraş (petroleum refinery) to foreign investors, worth about US\$500 million, and a block sale for the remaining 51 percent in the company is expected to be launched shortly. To afford the authorities sufficient flexibility to take advantage of market conditions, the program does not set conditionality on the sale of individual companies. Instead, the strategy aims at bringing state enterprises to the point of sale and on agreeing on realistic overall targets for privatization receipts, monitored by indicative targets.

60. **The removal of international clothing and textile quotas in 2005 will constitute a significant challenge for Turkey's trade regime.** This reform is expected to benefit

consumers as well as some segments of the domestic textile sector by reducing input costs. However, in early January Turkey became the first country to invoke the textiles specific safeguards clause written into China's WTO accession protocol, and imposed import restrictions on a number of textile products. At the same time, exporters, which have so far benefited from quota protection (particularly those exporting to the EU and operating in mass market segments) will come under considerable pressure from lower cost producers such as China and India. In terms of Turkey's broader trade commitments, the customs union with the EU has catalyzed substantial tariff reduction. Even so, there is substantial scope for further reducing agricultural tariffs. Staff also cautioned that anti-dumping actions, which had increased in recent years, should be kept to a minimum.

Labor Law Rigidities: International Comparison 1/			
	Turkey	Regional Average	OECD Average
Difficulty of Hiring Index 2/	44	31	26
Rigidity of Hours Index 2/	80	52	50
Difficulty of Firing Index 2/	40	42	27
Rigidity of Employment Index	55	42	34
Firing Costs (weeks of wages)	112	38	40
1/ World Bank, Snapshot of Business Climate.			
2/ Index range from 0 (least rigid) to 100 (most rigid).			

61. **Both staff and the authorities agreed on the importance of translating the improved growth performance into lower unemployment.** While economic growth averaged 8 percent over the past three years, unemployment has remained stubbornly high at

more than 10 percent of the labor force. Staff highlighted the cost of complying with statutory employment legislation—estimated to be far higher than the OECD average—and pointed to high minimum wage increases in recent years as having contributed to the expansion of the informal economy and promoting more capital-intensive production methods. The authorities agreed to review the 2003 Labor Law with a view to identifying and reducing rigidities. They also committed to pursue prudent public sector wage policies and, subject to overall fiscal constraints, to lowering the employment tax wedge. Social security, health insurance and unemployment insurance premiums amount to between 36 and 42 percent for regular workers, higher than in other countries. Taken together, these reforms should help lower unemployment and shrink Turkey’s informal sector. Although the authorities believed that their regional incentive scheme (described above) would promote employment, the staff argued that its provisions were distortionary and would apply disproportionately to existing jobs and provide little incentive for new job creation for the country as a whole.

Turkey: Balance of Payments Projections, 2004-2008 - New Arrangement (in billions of US dollars, unless otherwise indicated)					
	2004	2005	2006	2007	2008
Current Account	-15.4	-15.4	-12.6	-11.0	-10.4
Capital Account 1/	19.8	22.0	16.7	14.8	13.3
Overall Balance	4.3	6.6	4.1	3.8	2.9
IMF (net)	-3.5	-4.5	-4.4	-3.1	-1.9
Change in gross reserves /2	-0.8	-2.1	0.2	-0.7	-1.1
Memorandum Items:					
Current Account (percent of GNP)	-5.1	-4.4	-3.5	-2.8	-2.5
Gross Reserves	37.6	39.7	39.5	40.2	41.3
Net International Reserves	1.3	7.6	11.7	15.5	18.4
Reserves to ST debt (original maturity, in percent)	118.0	104.7	91.0	82.7	76.7
Reserves to ST debt (residual maturity, in percent)	74.7	69.4	62.1	57.2	54.0
Reserves to Imports (in months)	3.6	3.5	3.3	3.1	2.9
Source: Fund staff projections.					
1/ Including errors and omissions					
2/ Includes extension of 2006 repurchase expectations to					

IV. PROGRAM MODALITIES

A. Program Financing

62. **Turkey’s balance of payments needs over the program period are projected to be substantial.** Although the current account deficit is projected to decline to below 3 percent of GNP by the end of the arrangement, gross external financing requirements are still projected at about US\$65–70 billion annually (excluding trade credit the financing requirement is around US\$30 billion).

63. **Much of the financing requirement is expected to be met by continued strong capital inflows:**

- **Foreign direct investment** is expected to increase towards levels typical of other emerging markets, supported by the accelerated privatization program. Some uncertainty has emerged on prospects for continued non-resident real estate investment (constituting over half of foreign direct investment in recent years), as this was recently declared unconstitutional. However, the government has been given a three-month grace period to make the necessary legislative amendments.
- **Portfolio flows**, particularly net purchases of domestic government paper, are expected to ease to more normal levels, following large inflows in 2004 and in the immediate period following the European Union's decision to commence accession negotiations. However, prospects for continued net inflows remain strong, with the share of non-resident holdings of Turkey's domestic bonds still well below that in several Central and Eastern European countries. International bond issuance is assumed to remain around US\$5½ billion annually.
- **Bank and corporate foreign financing** is expected to remain robust, with the projections implying a full rollover of existing exposure by foreign investors. With their foreign exchange positions now closed, banks are also expected to draw down part of their correspondent account balances abroad as reverse currency substitution continues.
- The **World Bank** is projected to provide program financing of US\$1 billion a year in 2005–06, consistent with the high case under the Country Assistance Strategy (CAS).

64. **Even so, absent new Fund financing gross reserves would deteriorate substantially.** Public sector medium- and long-term debt amortization will exceed US\$40 billion during 2005–07, with more than half of this falling due to the Fund. As a result, gross reserves would fall to around US\$27 billion in 2006, which would cover only 43 percent of short-term debt by remaining maturity, well below a desirable minimum.

65. **To help contain the reserve decline, the authorities are requesting a three-year arrangement in the amount of SDR 6.7 billion (691 percent of quota).** Fund financing will contribute to covering the projected balance of payments need and will be utilized to increase Turkey's gross international reserves. Access in this amount would avert a precipitous decline in gross reserves, while allowing the net reserve position to strengthen and preserving a buffer to withstand external shocks (Figures 5 and 6). At the same time, net repayments to the Fund would remain substantial and allow for a reduction in Fund exposure by slightly more than half, to around US\$9 billion at the end of the new program. The new arrangement is subject to the exceptional access procedures, and a separate report evaluating the four substantive criteria, including debt sustainability, is presented in Appendix III.

66. **The authorities believe that this level of financing is needed to ensure debt rollover rates are manageable.** As under the current program, the Treasury would deposit the Fund purchases at the CBT, and use these to help meet public debt repayments. This level of financing keeps the domestic debt rollover rate at around 90 percent (of the roughly

US\$100 billion in domestic debt falling due each year) over the program period, which the authorities believe is the limit of what markets would find comfortable to finance.

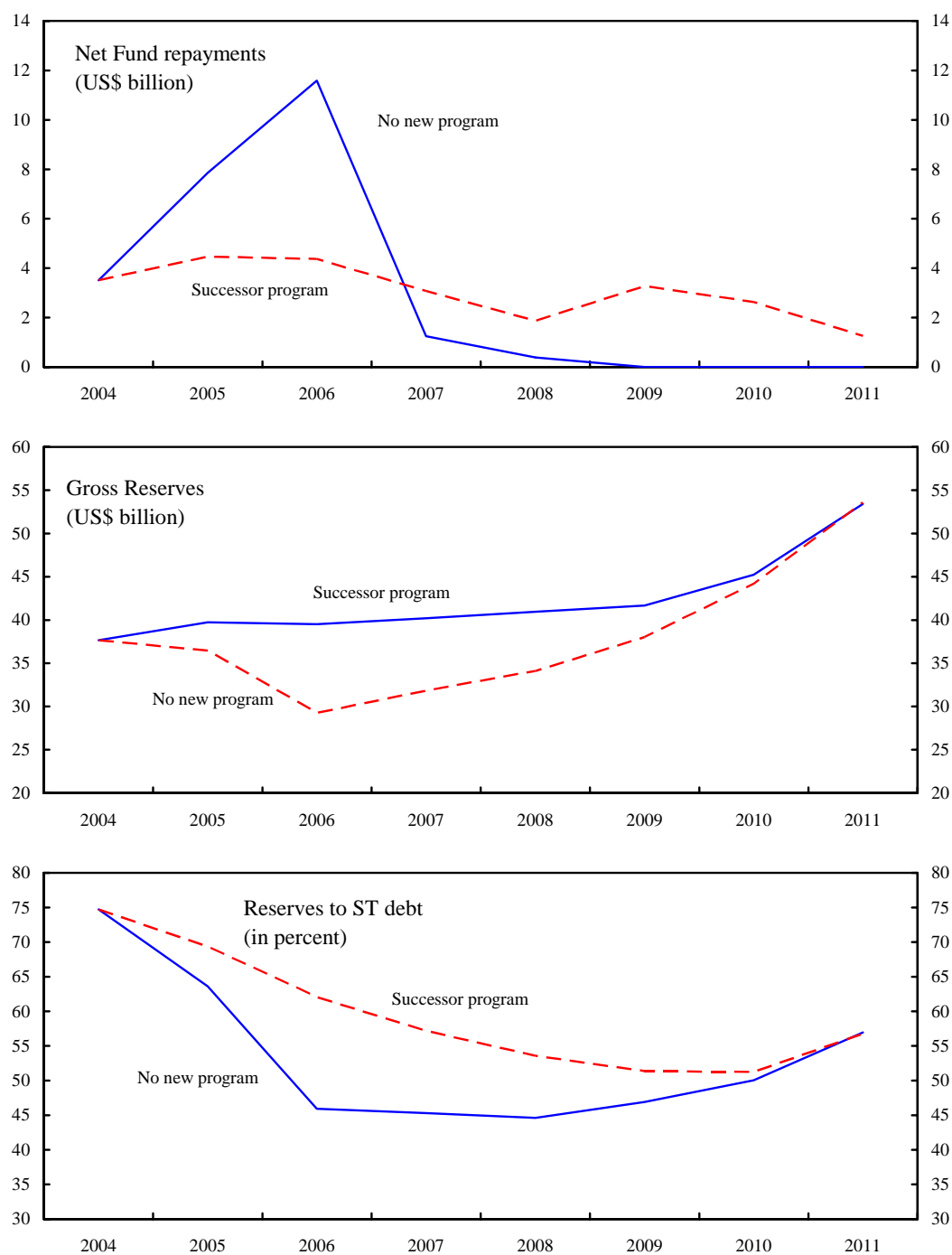
67. **The authorities are also requesting a one-year extension of repurchase expectations of US\$3¼ billion falling due in 2006.** This does not affect the financing gap over the program period but is aimed at smoothing the debt repayment profile. Although extensions are not typically approved this far in advance, delaying the decision would leave a substantial amortization peak in 2006 following the approval of the arrangement, posing undue risk and possibly unsettling markets. The authorities intend to make all other scheduled repurchases on an expectations basis. Accordingly, aside from the US\$3¼ billion that is moved to 2007 on an obligation basis, program projections reflect repurchases on an expectations rather than an obligation basis. They also indicated that, should the balance of payments turn out substantially stronger than expected, they intend to treat the arrangement as precautionary and forgo further purchases (LOI ¶4). In this regard, the authorities and staff will continue to explore the scope for further reserve build-up, including through opportunistic overborrowing by the government when market conditions permit.

B. Capacity to Repay the Fund and Risks to the Program

68. **Notwithstanding the strength of the authorities' policy commitments there are a number of risks to the program.**

- **First, there are a number of uncertainties surrounding the balance of payments projections.** Domestic demand may not slow down as expected, especially if confidence picks up following the EU accession decision. Turkey also remains vulnerable to fluctuations in oil prices, while tourism receipts have been susceptible to regional instability and other outside factors (for example, war in Iraq and fear of terrorism). Recent real appreciation adds to current account concerns. Prospects for market access also remain closely linked to developments in international financial markets, as evidenced by the volatility associated with changing expectations of Federal Reserve policy.
- **Second, the program is built on a demanding set of fiscal reforms, and there are implementation risks.** In particular, the pension and social security reform being envisaged is politically sensitive, and mustering the required consensus will be difficult. Details of the fiscal reforms will need to be agreed and implemented. Having said that, the government's commanding majority in parliament puts it in a strong position to implement its reform program. An assessment of Turkey's debt sustainability (Appendix III, Annexes A–B) indicates that there is very little room for policy complacency.

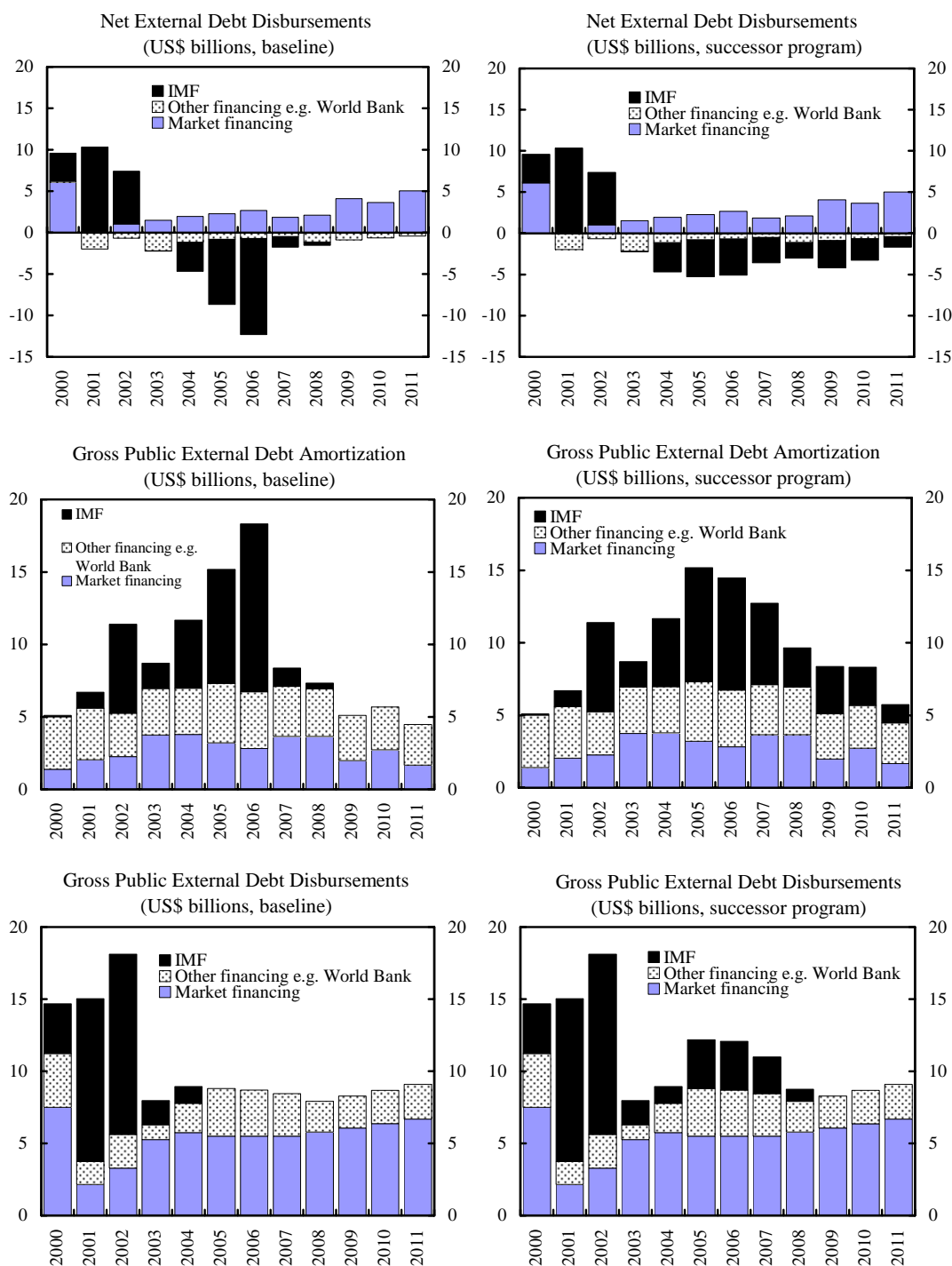
Figure 5. Turkey: Debt Service to Fund and Reserve Indicators, 2004–11 1/



Source: Staff projections.

1/ Under the scenario with no new program, it is assumed that there is no extension of repurchases falling due in 2006. The successor program scenario assumes US\$10 billion in new access and the extension of US\$ 3.7 billion in repurchases falling due in 2006 to 2007.

Figure 6. Turkey: External Disbursements and Amortization, Baseline and Program, 2000–11



Source: Staff projections.

1/ Successor program assumes US\$10 billion access and that 2006 repurchases are made on an obligations basis.

- **Third, as in the current program, repurchases are made by the Treasury rather than the central bank.** This implies some additional risk, as repurchases become dependent on the Treasury's ability to purchase foreign exchange from the CBT, which in turn depends on the level of liquid government deposits or its ability to borrow from the market (central bank legislation approved in 2001 prohibits any credit extension to the Treasury). The Treasury is committed under the program to raise the level of public deposits further, to reduce its rollover risk and ensure adequate liquidity for making Fund repayments.

69. **Indicators of Turkey's capacity to repay the Fund would remain challenging, but improve over time.** By the end of the arrangement, Fund exposure is expected to decline by more than half to 652 percent of quota, or 2 percent of GNP. As a percent of gross reserves, exposure would decline from about 54 percent to 23 percent by end-2007. Compared to other countries, however, Turkey's indicators of Fund credit remain very high, posing risks both to Turkey and to the Fund's balance sheet (Table 8).⁶ Annual repurchases would be demanding throughout the arrangement, and are expected to peak at 38 percent of public sector external debt service and 21 percent of reserves.

70. **Although the financing situation may be tight, the authorities should be able to make the required substantial net repayments to the Fund (Tables 9 and 10).** Turkey's unblemished record of payments to the Fund, the authorities' commitment to a strong reform program, and the likely continued improvement in access to international capital markets as debt ratios decline, provide assurances that Turkey will be in a position to discharge its obligations to the Fund in a timely manner.

C. Program Monitoring

71. **The stand-by arrangement will run for three years, and be subject to regular reviews (MEFP Annex A).** The arrangement would be evenly phased with an initial purchase upon approval of SDR 555 million (58 percent of quota), followed by 11 equally sized purchases. Given the exceptional access, reviews during the first year of the arrangement would be approximately quarterly, with the frequency of the reviews in the outer two years to be decided later. Although the first two purchase dates are somewhat closer than envisaged under the operational guidelines, it was decided that four test dates in 2005 would help provide safeguards in the initial stages of the program. In addition, the phasing of reviews in 2007 takes Turkey's electoral cycle into account.

72. **The authorities are implementing a number of prior actions in support of their request for the new arrangement (MEFP Annex C).** They include: (i) submission to Parliament of the draft Banking Law; (ii) separation of the boards of Ziraat and Halk banks;

⁶As required under the exceptional access procedures, a separate supplement accompanying this report assesses the impact of the new arrangement on Fund finances.

(iii) publication of SDIF's strategy whereby the bulk of asset recoveries will be completed before end-2007; (iv) submission to Parliament of pension reform legislation; and (v) Parliamentary approval of tax administration legislation. All prior actions have been completed.

73. Program performance will be monitored by quarterly quantitative performance criteria (MEFP Annexes B, D–I): (i) a floor on the cumulative primary balance of the consolidated government sector, and a separate floor on that balance excluding SEEs; (ii) ceilings on contracting or guaranteeing of new external public debt; (iii) a floor on the level of the combined net international reserves of the CBT and Treasury; and (iv) a ceiling on base money. In addition, indicative targets are set for (a) the overall balance of the consolidated government sector, (b) the stock of NDA of the CBT and Treasury, (c) privatization proceeds, and (d) the overall balance of the social security institutions (SSK, BK, ES). The new arrangement also has a strong structural component, centered on further financial sector and fiscal reform (Box 6).

74. The program also includes one continuous performance criterion and two structural performance criteria. The continuous PC is to ensure no new amnesties of arrears on public sector receivables are to be granted (with limited exceptions for firms that have been transferred to the Privatization Administration). The structural performance criteria are for Parliamentary approval of key banking and pension legislation.

75. Under the Fund's safeguards policy, the CBT is subject to a full safeguards assessment with respect to the new SBA. The CBT has implemented all the measures proposed under the safeguards assessment completed in 2003 under the previous program (see Country Report No.02/136). The new assessment, which has largely been completed, did not uncover new significant vulnerabilities.

V. STAFF APPRAISAL

76. The strong economic outcomes in 2004 and the EU's decision to open accession negotiations signal a sea change in Turkey's prospects. The strong growth over the past three years will bring real GNP to more than 10 percent above pre-crisis levels. With the unemployment rate stabilizing, the benefits of recovery should also be more widely shared. Looking ahead, there are signs that the economy's growth rate is slowing to a more sustainable pace, which should help narrow the current account deficit. Even so, the buoyancy of private investment and the steady rise in Turkey's export market shares—both underpinned by competitive unit labor costs—augur well for growth prospects in the near term. Meanwhile, inflation has continued to subside, ending 2004 below target and on track to stay in single-digits in 2005. Strong policies have created what is, in many respects, the most favorable macroeconomic environment in a generation, setting the stage for EU accession negotiations.

Box 6. Turkey—Structural Conditionality

Coverage of Structural Conditionality under the Three-Year SBA

The program carries forward a wide-ranging structural reform agenda, aimed at preserving macroeconomic stability and improving medium-term growth prospects (MEFP, Annex C). In order to sustain fiscal consolidation, the program contains extensive conditionality to improve the quality and composition of adjustment. Measures focus on broadening the tax base and reducing the size of the unregistered economy, reforming the system of social security and reducing the public sector wage bill, and redirecting savings toward more growth enhancing public investment. The clean-up from the banking sector crisis will continue with an acceleration in asset recovery and further restructuring of state banks to prepare them for eventual privatization. In addition, a new Banking Law will further improve the supervisory and regulatory framework. Remaining conditionality is focused on enhancing the role of the private sector and improving the investment climate.

Status of Structural Conditionality from Earlier Programs

Conditionality under the previous SBA was comprehensive but, due to a more difficult macroeconomic environment, had a more short-term focus. Structural reforms focused on banking sector restructuring, public debt management and public sector reform, monetary and incomes policy, corporate debt restructuring and private sector development. While privatization proceeded rather slowly, in part owing to weak market conditions, progress was made in other areas. A number of measures that were to take place towards the end of the previous arrangement—notably the passage of tax administration legislation and submission of social security reform legislation—have been made prior actions for this arrangement. Passage of the Banking Law, originally intended for end-November, has not proved feasible, due to the need for broad-based consultations and complex negotiations among different agencies. The submission of the draft Banking Law to parliament is a prior action (with passage a performance criterion for end-June).

Structural Areas Covered by the World Bank Lending and Conditionality

The Third Programmatic Financial and Public Sector Adjustment Loan (PFPSAL 3) has one remaining tranche scheduled for disbursement in the Spring of 2005 with conditionality focused on financial sector reform and public sector management. The financial sector conditions relate to (a) the regulatory framework for the banking sector and the institutional capacity of the supervisory agencies, (b) state bank restructuring and privatization, and (c) the legal regime for bankruptcy. The public sector management reform program contains conditions related to (a) structural fiscal policies, (b) budget reform, (c) financial accountability and liability management, and (d) public sector governance. Other World Bank loans with important outstanding conditionality cover health sector reform needed to support the planned introduction of Universal Health Insurance, and the continuation of agricultural reform.

Other Relevant Structural Conditions not Included in the Program

An area that is not covered by program conditionality is trade policy. This reflects the only moderately restrictive nature of Turkey's trade regime, and the substantial liberalization already being undertaken in 2005 with the elimination of international textile quotas. On privatization, the program does not include conditionality on the sale of specific enterprises by certain dates. Instead, Fund and Bank conditionality is aimed at preparing the ground for rapid privatization, allowing the authorities to take advantage of market conditions. However, to help monitor overall progress in privatization, indicative targets have been introduced for privatization proceeds.

77. **But the financial situation, though considerably improved over the past three years, remains fragile and allows no room for relaxation of policies.** Turkey's vulnerabilities remain large and years of effort will be required to sustain and build on recent gains. The high level and short average maturity of public debt exposes the Treasury to significant rollover risk. At the same time, the pace of economic expansion has driven the current account deficit to uncomfortably high levels, and has made the external financing position more challenging. The reliance on mostly debt-creating and readily reversible capital flows to finance this deficit compounds the risks associated with high government debt, should market sentiment turn sour. These considerations point to the need for a tight rein on the fiscal stance in the near term, and for ambitious debt reduction objectives over the medium term.

78. **The authorities' new three-year program, for which they are seeking support under a new Fund arrangement, represents a credible response to these challenges.** It is also aimed at fulfilling Turkey's aspirations for economic convergence with the European Union. The proposed fiscal framework would bring the overall budget close to balance by 2007 and achieve a significant further reduction in debt. Resolute implementation of this strategy should permit a substantial reduction in real interest rates, and help promote balanced economic growth over the medium term. For its part, the central bank will make the transition to formal inflation targeting, with a view to reducing inflation to low single digits by the end of the program, and will further strengthen its net international reserve position. Financial sector supervision will be consolidated and reinforced under new legislation. Privatization efforts will intensify, and assets taken over during the banking crisis will be resolved during the program period. The program is rounded out with a range of reforms aimed at cutting back the obstacles to entrepreneurship, investment, and job creation in Turkey.

79. **The authorities' fiscal framework is strong and their track record reassuring, but the quality of fiscal adjustment remains a concern.** The decision to maintain the 6½ percent of GNP primary surplus target throughout the program period is commendable. The authorities have also built an impressive track record in 2003 and 2004. The overperformance in 2004 and the implementation of measures to restrain demand and check the deterioration in the current account have been appropriate policy responses. The commitment to save any revenue overperformance in 2005 is also welcome. However, the improvements in the quality of the budget in 2005, while welcome, are marginal. Fiscal initiatives outside the budget cycle (higher pensions and proposals for regional tax incentives coming only weeks after the approval of the budget) also undermine the credibility of the budget process and lead to one-off compensating measures that tend to undermine the quality of fiscal adjustment. Ensuring that the fiscal targets in 2005 are met also requires continued vigilance. To make sure the targets are achieved and the envisaged quality of adjustment preserved, the authorities need to implement all of the fiscal measures according to the schedule underlying the program and adhere to the budget assumptions in public wage negotiations.

80. The staff regrets the authorities' decision to expand regional tax incentives.

Despite modifications made to reduce the cost of the scheme and improve its targeting on employment generation, the scheme will be less effective than strengthening infrastructure in promoting regional development. And, by encouraging lobbying, it will further erode the culture of tax compliance. No further extensions of the scheme should be contemplated and the government should reject continuing demands for selective tax relief, such as VAT cuts for textiles or tourism.

81. Looking ahead, the overriding goals of lower debt and reduced vulnerability will make it essential to improve the composition and efficiency of the budget, and the staff welcomes the authorities' undertaking to act accordingly.

Comprehensive structural reforms will be essential to sustain the adjustment. However, the authorities' uneven track record in implementing structural reforms in a timely manner during the last program is a cause for concern. Sustaining the recent macroeconomic gains will depend on careful implementation of the new program's reform agenda; delivering on these commitments will be no easy task and will require unwavering determination by the government.

82. The priorities for tax reform should be guided by considerations of efficiency and EU convergence. The staff supports the authorities' decision to hold off on major changes to the tax regime in 2005, so as to allow more time for analysis and careful design. But the broad direction in which reforms should head is clear. Over time, budget constraints permitting, personal income tax schedules should be harmonized, the number of bands reduced, and exemptions rationalized; and the corporate tax system should be simplified, with investment allowances reduced to make way for lower marginal rates. The VAT regime, which works well and is broadly aligned with the EU, should be maintained in its present form. Finally, intermediation taxes are a poor policy instrument and highly distortive, and should be phased out as quickly as possible. To complement and support the reform of the tax regime, it will be essential to achieve rapid improvements in tax administration and compliance under the new legislation.

83. Improving the composition of public expenditure will pose a number of challenges. A start has been made in the 2005 budget, which provides for a substantial real increase in investment spending while restraining current spending on health care costs and civil service wages. The social security reforms should also help from 2006 onwards, provided that the authorities pursue vigorously the measures needed to contain the cost of the universal health insurance scheme. Since the pension reforms are sensitive, the authorities will need to build public understanding and support, so as to avoid a repeat of the ineffective 1999 reforms. Another difficult element will be the government wage bill, where savings are likely to require a combination of pay restructuring and staffing cuts over the medium term. The authorities should use the forthcoming public expenditure review as an opportunity to initiate fundamental reform along these lines. Staff is concerned about plans to increase agriculture subsidies and switch to production support; and urges the authorities to reconsider these plans in consultation with the World Bank. Importantly, decentralization steps will need to be carefully planned and executed to avoid risks to the primary surplus targets.

84. **The skillful conduct of monetary policy bodes well for the future.** The independence and credibility of the central bank will be more important than ever in the next phase of disinflation. This is partly because reducing inflation typically becomes more difficult at lower rates. But also, as fiscal dominance recedes, it is the credibility of the central bank's own policy framework that becomes paramount. The authorities' plan to move to formal inflation targeting by January next year is therefore timely and appropriate. The staff strongly welcomes the first steps taken this year towards its implementation, including the strengthened role of the MPC and greater clarity on the timing of interest rate decisions. For this regime to be effective, it is vital that the central bank's operational freedom—including, when necessary, to raise interest rates—receive full government support.

85. **Clarity and predictability regarding the exchange rate regime will also be essential.** In this regard, the strong commitment of the authorities to the floating rate regime is very welcome. The float has served Turkey well, and should continue to do so. This requires that the central bank's foreign exchange purchases are seen to be divorced from exchange rate considerations, to the extent possible. The preannounced minimum daily purchase schedule is intended to achieve this aim, and the staff welcomes its introduction. In the first few months of this year, the central bank has shown good judgment in sticking to this rule, while also making discretionary foreign exchange purchases during peak inflows. The staff also welcomes the Treasury's successful attempts to issue much longer-dated paper in response to increased capital inflows.

86. **The new Banking Law will allow for a major improvement in Turkey's supervisory regime, but must be accompanied by operational changes at the supervisory agency.** Provisions in the new law regarding "fit and proper" criteria for bank owners, lending to related parties, legal protection for BRSA and SDIF board members and supervisory staff, and flexibility in the staffing of on-site examination all represent important progress toward international best practice. Once the law is passed, the BRSA should move quickly both to put in place the implementing regulations, and to reorganize its operations in accordance with the recommendations of the Imar Commission. Preparation of the implementing regulations will be a complex and time-consuming task. Success will depend on BRSA's willingness to put aside its objections to key reforms contained in the draft law, and its readiness to draw upon expert technical assistance from outside the institution. While the financial and operational autonomy of the BRSA must be protected, its credibility and effectiveness will depend on full implementation of the law.

87. **The post-crisis restructuring of the banking system needs to be completed in the course of the new program.** The SDIF has developed a credible plan under which it would, over the next three years, divest some 90 percent of the assets it has acquired in the bank resolution process. This is a commendable goal, and progress should be closely monitored to ensure that it is attained. Government and the regulatory agencies should provide the SDIF with the support it needs to recover as much value as possible for the taxpayer. The use of a state asset management company to handle residual assets should be avoided, as this puts off resolution and increases costs; instead, at the end of the process, all assets should be returned to private hands.

88. **The privatization of the state banks is likely to be a lengthy and difficult process.** While these banks may have a valuable franchise network, there are unlikely to be any buyers for banks whose balance sheets are dominated by government bonds and deposits of public entities. Restructuring the balance sheet of these banks will impact not only their own operations, but also Treasury's debt and cash management. In parallel to carefully conducting this difficult process, the government needs to ensure that the management of these banks and internal control procedures are strengthened, and that their branch network and staffing needs are rationalized.

89. **Despite recent improvements, the environment for doing business in Turkey still compares unfavorably with that of competitors, and more far-reaching reforms are needed.** Privatization will be critical in this regard, not only because of its direct impact in creating new opportunities for investment and competition, but also as a signal that Turkey's economy is opening up. Several major asset sales are scheduled for the first year of the new program, and they must not be allowed to fail, as previous efforts have, for want of adequate preparation. Plans for further cuts in red tape should be pursued aggressively, and the authorities should examine the possibility of measures (such as regionally differentiated minimum wages) that could help promote employment growth. The staff also welcomes the authorities' efforts to quickly resolve questions over the constitutionality of the law governing non-resident real estate purchases. Finally, judicial reform is routinely cited by foreign investors as a top priority, and—though it falls outside the scope of a Fund-supported program—it should be actively pursued, possibly with assistance from the EU.

90. **The exceptional level of access under the proposed arrangement (almost 700 percent of quota) strikes a balance between two competing considerations: financing need and reducing Fund exposure.** The scale of repurchases falling due to the Fund over the next two years will place a heavy burden on Turkey's official reserves. In the absence of new Fund financing, reserve coverage would fall to low levels and the required rollover of domestic debt would be very demanding. The proposed level of access, together with the requested one-year extension of repurchase expectations from 2006, should make for a more manageable financing position. At the same time, it approximately halves the Fund's exposure to Turkey over three years, to a level which should permit a credible exit from further Fund financial support. The authorities' intention to treat the arrangement as precautionary, should the balance of payments turn out significantly stronger than expected, provides an additional safeguard for the Fund.

91. **In view of Turkey's financing needs, the strong policies proposed by the authorities, and their impressive record in implementing the most recent Fund-supported program, the staff supports the authorities' request for an arrangement in the amount of SDR 6.7 billion, and for a one-year extension of repurchase expectations totaling SDR 2.5 billion falling due in 2006.**

Table 1. Turkey: Selected Indicators, 2000–05

	2000	2001	2002	2003	2004	Projections 2005
(In percent change)						
Real sector						
Real GNP growth rate	6.3	-9.5	7.9	5.9	9.9	5.0
GNP deflator	50.9	55.3	44.4	22.5	9.5	6.8
Nominal GNP growth rate	60.4	40.5	55.8	29.7	20.3	12.1
WPI (12-month, end-of-period)	32.7	88.6	30.8	13.9	15.3	8.0
CPI (12-month, end-of period)	39.0	68.5	29.7	18.4	9.3	8.0
Average nominal treasury bill interest rate	38.0	99.1	63.5	45.4	24.9	16.4
Average ex-ante real interest rate 1/	-9.5	35.5	38.2	34.8	16.6	9.4
(In percent of GNP)						
Central government budget						
Primary balance 2/	4.6	4.8	2.4	5.0	5.1	5.1
Net interest payments 3/	15.8	26.4	15.9	15.9	13.2	11.3
Overall balance	-11.2	-21.6	-13.4	-10.9	-8.0	-6.2
Consolidated public sector						
Primary balance	3.0	5.5	4.2	6.2	6.9	6.5
Net interest payments	16.0	26.4	16.1	16.0	13.1	11.1
Overall balance	-13.0	-20.9	-11.9	-9.8	-6.2	-4.6
Operational balance	-6.9	-4.7	-4.4	-4.8	-2.9	-1.0
Net debt of public sector	58.3	90.5	78.5	70.4	63.5	60.0
Net external	19.0	37.7	32.3	22.1	17.5	16.4
Net domestic	39.3	52.8	46.2	48.3	46.0	43.6
External sector						
Current account balance	-4.9	2.4	-0.8	-3.4	-5.1	-4.4
Gross external debt	59.0	78.9	71.3	61.0	53.6	48.3
Net external debt	39.3	55.1	56.2	47.4	40.4	36.5
Short-term external debt (by remaining maturity)	21.7	22.7	17.9	17.6	16.7	16.4
Monetary aggregates						
Seignorage 4/	1.8	1.1	1.0	1.2	1.2	1.0
Nominal growth of M2Y broad money (in percent)	40.2	87.5	25.4	13.0	22.1	16.7
(In billions of U.S. dollars, unless otherwise indicated)						
Privatization proceeds	3.3	2.8	0.5	0.2	1.3	1.5
Net external financing of central government	4.1	-2.3	-1.4	1.0	1.9	0.0
Amortization	6.2	6.7	11.4	7.0	7.0	12.2
Gross borrowing	10.3	15.0	18.1	8.0	8.9	12.2
Of which : Eurobond issues	7.5	2.2	3.3	5.3	5.8	5.5
GNP	201.3	144.0	182.7	238.5	301.7	349.0
GNP (in quadrillions of Turkish lira) 5/	125.6	176.5	275.0	356.7	428.9	481.0

Sources: Data provided by Turkish authorities; and IMF staff estimates.

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation.

2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds

3/ Interest payments minus interest receipts plus profit transfers from the central bank.

4/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

5/ In billions of new Turkish lira from 2005 onwards.

Table 2. Turkey: Indicators of External Vulnerability, 2000–05 1/
(In percent, unless otherwise noted)

	2000	2001	2002	2003	2004	Projections 2005
CPI inflation (end year)	39.0	68.5	29.7	18.4	9.3	8.0
Public sector borrowing requirement (percent of GNP)	-13.0	-20.9	-11.9	-9.8	-6.2	-4.6
Net debt of the public sector (percent of GNP)	58.3	90.5	78.5	70.4	63.5	60.0
Export volume (percent change)	6.6	15.7	17.2	19.1	15.2	11.9
Import volume (percent change)	29.5	-23.8	26.1	24.6	24.8	8.3
Current account balance, in percent of GNP	-4.9	2.4	-0.8	-3.4	-5.1	-4.4
Capital account balance (in billions of US\$)	6.8	-16.3	1.3	12.1	19.8	22.0
Of which: Foreign direct investment	0.1	2.8	0.9	1.2	1.7	3.9
Foreign portfolio investment	-5.2	-4.6	-1.2	1.2	6.1	4.8
Gross official reserves, in billions of US\$	23.2	19.8	28.1	35.2	37.6	39.7
In months of imports of goods and NFS	4.0	4.5	5.5	3.8	3.6	3.5
In percent of broad money	27.4	26.7	34.3	32.5	27.4	27.0
Gross total external debt, in billions US\$	118.8	113.7	130.2	145.4	161.7	168.7
In percent of GNP	59.0	78.9	71.3	61.0	53.6	48.3
In percent of exports of goods and NFS	225.2	218.5	230.0	202.3	174.0	154.7
Gross short-term external debt, in billions US\$ 1/	43.7	32.7	32.6	41.9	50.4	57.3
In percent of gross total external debt	36.8	28.8	25.1	28.8	31.1	34.0
In percent of gross official reserves	188.4	165.1	116.2	119.2	133.8	144.2
Debt service 2/	36.9	41.9	38.1	35.3	27.2	24.5
REER appreciation (CPI based, period average)	10.9	-17.2	12.7	10.3	6.0	...
REER appreciation (CPI based, end of period)	15.9	-21.2	7.8	12.1	1.8	...
Capital adequacy ratio 3/	17.3	15.3	25.3	30.9	28.8	...
State banks	7.9	34.0	50.2	56.3	41.4	...
SDIF banks	..	-17.8	-7.6	-21.6	-42.0	...
Private banks	18.3	9.0	19.6	23.5	22.3	...
Foreign banks	29.4	41.0	48.4	60.8	55.9	...
Nonperforming loans (in percent of total)	11.1	25.2	17.6	11.5	6.0	...
Real broad money, percentage change 4/	0.8	11.2	-3.3	-4.6	11.7	8.1
Real credit to the private sector, percentage change 4/	24.5	-27.5	-16.5	20.1	32.7	7.1
Banks' net foreign asset position, in billions of US\$	-5.4	-0.1	-0.4	0.3	-0.1	...
Banks' net open exchange position, in billions of US\$	-5.4	-0.1	-0.4	0.3	-0.1	...
EMBI Global bonds spread (in basis points)	800	707	693	309	265	...

Sources: Data provided by the Turkish authorities; and IMF staff estimates and projections.

1/ By residual maturity.

2/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excl. off. transfers).

3/ For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank.

4/ Deflated by the CPI.

Table 3. Turkey: Balance of Payments, 2003–10
(In billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009	2010
Current account balance	-8.0	-15.4	-15.4	-12.6	-11.0	-10.4	-9.3	-7.9
Trade balance	-14.0	-23.8	-26.3	-24.7	-24.0	-24.3	-24.1	-23.9
Exports (f.o.b.)	51.2	67.0	79.4	88.2	96.5	106.5	118.1	131.3
Of which:								
Exports (f.o.b.) in trade returns	47.3	63.1	75.0	83.8	92.1	102.1	113.7	126.9
Shuttle trade	4.0	3.9	4.4	4.4	4.4	4.4	4.4	4.4
Imports (f.o.b.)	-65.2	-90.7	-105.8	-112.8	-120.5	-130.8	-142.3	-155.2
Of which:								
Imports (c.i.f.), incl. non-monetary gold	-69.3	-97.4	-112.5	-120.0	-128.2	-139.2	-151.3	-165.1
Energy imports (c.i.f.)	-11.6	-14.4	-18.5	-19.4	-19.7	-20.4	-21.4	-22.5
Services and Income (net)	4.9	7.3	9.6	10.5	11.4	12.3	13.3	14.5
Services and Income (credit)	21.3	26.7	30.4	32.9	34.8	36.9	39.1	41.5
Of which:								
Tourism receipts	13.2	15.9	18.5	19.6	20.6	21.8	23.2	24.7
Services and Income (debit)	-16.3	-19.4	-20.8	-22.5	-23.4	-24.5	-25.8	-27.1
Of which:								
Interest	-6.9	-7.3	-7.8	-8.7	-8.8	-9.0	-9.2	-9.4
Private transfers (net) 1/	0.7	0.8	0.9	0.9	1.0	1.0	0.9	0.9
Official transfers (net)	0.3	0.3	0.4	0.6	0.6	0.6	0.6	0.6
Capital account balance	7.1	17.0	21.6	16.7	14.8	13.3	13.2	13.5
(including errors and omissions)	12.1	19.8	22.0	16.7	14.8	13.3	13.2	13.5
Direct investment 2/	1.2	1.7	3.9	4.0	3.9	3.3	3.0	3.5
Portfolio investment in securities	1.2	6.1	4.8	2.0	1.1	1.2	1.2	1.3
Public sector (central & local governments & EBFs)	-0.7	0.8	1.5	2.0	1.3	1.0	2.9	2.4
Bonds (net)	1.5	2.0	2.3	2.7	1.8	2.1	3.8	3.0
Eurobond drawings	5.3	5.8	5.5	5.5	5.5	5.8	5.8	5.8
Eurobond repayments	-3.8	-3.8	-3.2	-2.8	-3.7	-3.7	-2.0	-2.7
Loans (net)	-2.2	-1.2	-0.8	-0.7	-0.5	-1.1	-0.9	-0.7
Loan disbursements	1.0	2.0	3.3	3.2	3.0	2.1	2.2	2.3
Loan repayments	-3.2	-3.2	-4.1	-3.9	-3.4	-3.3	-3.1	-3.0
Central Bank of Turkey, (Excl. reserve assets, liabilities)	0.6	-0.1	0.0	0.1	0.1	0.1	0.1	0.1
Domestic money banks (net)	3.0	1.2	5.4	3.5	3.3	3.4	2.5	2.5
Domestic money banks (FX deposits abroad, -: accumulation)	0.7	-5.9	2.0	1.0	1.0	1.0	0.0	0.0
Domestic money banks (other, net)	2.3	7.0	3.4	2.5	2.3	2.4	2.5	2.5
Domestic money banks (medium and long-term, net)	-0.2	2.3	0.7	0.4	0.5	0.5	0.6	0.7
Domestic money banks (short-term, net)	2.5	4.7	2.7	2.1	1.8	1.8	1.8	1.8
Interbank credit lines from foreign commercial banks	2.0	3.3	2.7	2.1	1.8	1.8	1.8	1.8
Other private sector (net)	1.8	7.3	6.0	5.2	5.1	4.5	3.5	3.7
Other private sector (medium and long term, net)	1.6	5.3	3.7	3.1	3.2	2.9	1.9	2.0
Other private sector (short term, net)	0.2	2.0	2.3	2.1	1.9	1.6	1.6	1.7
Errors and omissions	5.0	2.8	0.4	0.0	0.0	0.0	0.0	0.0
Overall balance	4.1	4.3	6.6	4.1	3.8	2.9	3.9	5.5
Overall financing (NIR change excl. ST liabilities, + denotes decline)	-4.1	-4.3	-6.6	-4.1	-3.8	-2.9	-3.9	-5.5
Change in net international reserves (+ denotes decline)	-4.1	-4.3	-6.6	-4.1	-3.8	-2.9	-3.9	-5.5
Change in gross official reserve assets (+ denotes decline)	-4.0	-0.8	-2.1	0.2	-0.7	-1.1	-0.7	-2.9
Change in reserve liabilities (IMF)	-0.1	-3.5	-4.5	-4.4	-3.1	-1.9	-3.3	-2.6
Purchases	1.7	1.2	3.4	3.4	2.5	0.8	0.0	0.0
Repurchases	-1.7	-4.7	-7.9	-7.7	-5.6	-2.7	-3.3	-2.6

Table 3 (concluded) Balance of Payments, 2003–2010
(In billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009	2010
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, incl. shuttle trade	-3.4	-5.1	-4.4	-3.5	-2.8	-2.5	-2.0	-1.6
Trade account balance, incl. shuttle trade	-5.9	-7.9	-7.5	-6.8	-6.1	-5.8	-5.3	-4.9
Exports of goods and non-factor services	30.1	30.8	31.3	33.0	33.2	33.8	34.4	35.2
Imports of goods and non-factor services	31.3	34.1	34.0	34.8	34.5	34.7	35.0	35.4
Percent change								
Value growth in exports of goods (incl. shuttle trade)	27.6	30.8	18.6	11.0	9.4	10.4	10.9	11.1
Value growth in exports of goods (excl. shuttle trade)	31.0	33.5	18.9	11.7	9.9	10.9	11.4	11.6
Value growth in imports of goods	37.6	39.1	16.5	6.7	6.8	8.5	8.7	9.1
Volume growth in exports of goods	19.1	15.2	11.9	12.0	10.4	10.0	10.3	10.2
Volume growth in imports of goods	24.6	24.8	8.3	7.6	8.0	8.0	8.0	8.0
Terms of trade	2.0	3.0	-0.4	0.5	0.7	0.3	0.3	0.2
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey)								
In billions of U.S. dollars	35.2	37.6	39.7	39.5	40.2	41.3	41.9	44.9
Months of goods & NFS imports	3.8	3.6	3.5	3.3	3.1	2.9	2.8	2.7
External debt (end-of-period)								
In billions of U.S. dollars	145.4	161.7	168.7	174.9	181.6	189.0	196.2	204.1
Percent of GNP	61.0	53.6	48.3	48.0	46.3	44.8	43.2	41.8
Percent of exports of goods & NFS	202.3	174.0	154.7	145.6	139.4	132.8	125.7	118.8
Net external debt (end-of-period) 3/								
In billions of U.S. dollars	113.1	121.9	127.3	130.3	134.3	139.7	143.0	145.4
Percent of GNP	47.4	40.4	36.5	35.8	34.3	33.1	31.5	29.8
Short-term debt (end-of-period)								
In billions of U.S. dollars	23.0	31.9	37.9	43.4	48.6	53.9	59.4	65.3
Reserves to short-term debt ratio	152.8	118.0	104.7	91.0	82.7	76.7	70.6	68.7
Short-term debt plus MLT repayments								
In billions of U.S. dollars	41.9	50.4	57.3	63.7	70.3	76.4	81.1	88.3
Reserves to short-term debt ratio	83.9	74.7	69.4	62.1	57.2	54.0	51.7	50.8
Debt service ratio 4/	35.3	27.2	24.5	23.7	23.1	21.9	19.6	18.6

Sources: Data provided by the Turkish authorities; and Fund staff estimates and projections.

1/ Until 2003, remittances include tourism receipts from foreign citizens. These are now classified under the services account. Also, the "imports with waiver item" was reclassified in November 2004, leading to a revision of the current account balance for 2003 as well as 2004.

2/ Including privatization receipts.

3/ Non-bank external debt minus the net foreign assets of the banking sector and the central bank.

4/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excluding official transfers).

Table 4. Turkey: Monetary Aggregates, 2000-05
(In quadrillions of Turkish Lira) 1/

	2000	2001	2002	2003	2004	2005			
						Mar.	Jun.	Sep.	Dec.
						Projected			
Broad money (M2Y)	56.8	106.6	133.7	151.0	184.4	194.6	199.6	205.6	215.2
Lira broad money (M2)	31.9	47.2	61.9	82.7	108.5	114.7	118.3	122.0	127.4
Foreign exchange deposits 2/	24.9	59.3	71.8	68.3	75.9	79.9	81.3	83.6	87.8
Repos	6.0	2.8	2.8	3.1	1.7	3.4	3.5	3.6	3.8
Broad liquidity	62.8	109.4	136.4	154.1	186.1	198.0	203.1	209.2	219.0
Base money	5.8	7.8	10.4	14.9	20.2	23.0	23.4	24.4	24.9
Net foreign assets 2/ (in billions of U.S. dollars)	2.8 4.1	-1.9 -1.3	-6.3 -3.9	-6.8 -4.5	-0.1 -0.1	4.8 3.5	3.7 2.7	2.8 2.0	5.1 3.5
Net domestic assets	54.1	108.5	140.0	157.3	184.5	189.7	195.9	202.8	210.2
Net claims on government	31.6	89.7	122.8	139.1	151.4	152.4	158.0	163.2	166.8
Claims on business sector 3/ Turkish lira claims	31.7 22.3	38.7 23.1	42.0 24.5	59.6 40.7	90.3 71.2	91.1 70.3	92.7 71.6	95.3 73.6	100.1 77.3
Foreign exchange claims (est.) 2/	9.4	15.6	17.5	18.9	19.1	20.8	21.1	21.7	22.8
Other items (net)	-9.1	-20.0	-24.8	-41.4	-57.2	-53.8	-54.8	-55.8	-56.8
Memorandum items:				(annual percent change)					
Broad money (M2Y)	40.2	87.5	25.4	13.0	22.1	26.5	20.9	16.3	16.7
Lira broad money (M2)	42.5	48.0	31.0	33.7	31.2	23.9	21.4	18.5	17.5
Foreign exchange deposits 2/	37.3	137.9	21.0	-4.9	11.1	30.4	20.2	13.2	15.7
Claims on business sector 3/	73.0	22.3	8.4	42.1	51.4	38.7	18.4	15.7	10.9
				(billions of U.S. dollars)					
Broad money (M2Y)	84.6	74.0	81.8	108.2	137.4	142.0	145.8	145.4	147.4
Lira broad money (M2)	47.5	32.8	37.9	59.3	80.9	83.7	86.4	86.3	87.3
Foreign exchange deposits	37.1	41.2	43.9	48.9	56.5	58.3	59.4	59.1	60.1
Net claims on government	47.0	62.3	75.1	99.6	112.8	111.2	115.4	115.4	114.3
Credit to the private sector	47.1	26.9	25.7	42.7	67.3	66.5	67.7	67.4	68.6
				(in percent share)					
Base money/GNP 4/	4.6	4.4	3.8	4.2	4.7	5.2	5.2	5.3	5.2
Broad money (M2Y)/GNP 4/	45.3	60.4	48.6	42.3	43.0	44.4	44.6	44.3	44.7
Lira broad money (M2)/GNP 4/	25.4	26.8	22.5	23.2	25.3	26.2	26.4	26.3	26.5
Private credit/GNP	25.2	21.9	15.3	16.7	21.0	20.8	20.7	20.5	20.8
Foreign currency deposits/M2Y	43.9	55.7	53.7	45.2	41.1	41.1	40.7	40.7	40.8
Money multiplier									
Broad money (M2Y)	9.8	13.7	12.8	10.2	9.1	8.5	8.5	8.4	8.6
Lira broad money (M2)	5.5	6.1	5.9	5.6	5.4	5.0	5.1	5.0	5.1

1/ In billions of new Turkish lira from 2005 onwards.

2/ Evaluated at current exchange rates, monetary authorities and deposit money banks.

3/ Includes credit to local governments and state economic enterprises.

4/ Evaluated as percent of nominal GNP over previous four quarters.

Table 5. Turkey: Central Bank Balance Sheet, 2001–05 1/

	2001	2002	2003	2004	2005			
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec
	Actual	Actual	Actual	Actual	Actual	Projected		
1. Central Bank Balance Sheet								
	(In quadrillions of Turkish lira) 1/							
Net foreign assets	-12.7	3.9	8.8	11.0	18.5	16.8	15.8	17.8
Gross foreign assets	28.6	37.7	42.5	53.0	57.5	54.8	52.7	54.3
Gross foreign liabilities	41.2	33.8	33.6	42.0	39.0	38.0	36.9	36.5
International reserve liabilities	20.7	11.5	9.8	5.7	4.2	2.8	1.9	1.4
Other reserve liabilities 2/	10.1	13.2	14.5	22.3	22.2	22.1	22.0	21.9
Banks' FX deposits with CBT	10.4	9.1	9.3	14.0	12.6	13.1	13.1	13.3
Net domestic assets	20.6	6.5	6.0	9.2	4.4	6.6	8.6	7.1
Base money	7.8	10.4	14.9	20.2	23.0	23.4	24.4	24.9
Currency issued	5.3	7.6	10.7	13.5	14.6	16.5	17.4	17.5
Banks' lira deposits at the CBT	2.5	2.8	4.2	6.7	8.4	6.8	7.0	7.4
	(In billions of U.S. dollars)							
CBT gross international reserves	19.8	26.2	29.5	35.4	38.4	36.6	35.2	36.3
at current cross rates:	19.8	28.1	35.2	37.7	39.7	...	...	...
CBT gross international liabilities	28.6	23.5	23.4	28.1	26.0	25.4	24.6	24.4
CBT net foreign assets	-8.8	2.7	6.1	7.4	12.4	11.2	10.5	11.9
plus CBT forward position	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	14.8	14.7	14.7	14.6
minus Dresdner one year deposits	0.7	1.4	2.1	3.0	3.0	2.9	2.9	2.8
minus defence fund	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
CBT net international reserves	-2.9	10.0	13.6	18.9	23.8	22.7	22.0	23.4
Treasury net international reserves 3/	-1.3	-14.7	-14.2	-17.6	-17.6	-17.9	-17.0	-16.1
Net international reserves (Treasury plus CBT)	-4.2	-4.6	-0.5	1.3	6.3	4.8	5.0	7.3
	(In quadrillions of Turkish Lira, program exchange rate) 1/							
Net foreign assets (Treasury)	-1.8	-21.1	-20.4	-26.3	-26.3	-26.8	-25.5	-24.1
Net foreign assets (Treasury plus CBT)	-14.5	-17.2	-11.6	-15.3	-7.8	-9.9	-9.7	-6.3
Net domestic assets (Treasury) 4/	1.8	21.1	20.4	26.3	26.3	26.8	25.5	24.1
Net domestic assets (Treasury plus CBT)	22.4	27.6	26.4	35.5	30.8	33.3	34.1	31.2
Base money (Treasury plus CBT)	7.9	10.4	14.9	20.2	23.0	23.4	24.4	24.9
Exchange rate (TL per US dollar, in millions)	1.44	1.63	1.40	1.34	1.37	...	...	...

Source: Central Bank of Turkey and Fund staff projections. Although program targets for base money and NDA are five day averages, all observations in this table are end of period.

1/ In billions of new Turkish lira from 2005 onwards. Through December 2003, all foreign currency aggregates are valued at end-December 2001 exchange rates (program exchange rates). For 2004 onwards end-September 2004 program exchange rates are used.

2/ Mainly Dresdner deposit liabilities.

3/ Equals borrowing from IMF plus short-term foreign currency denominated liabilities.

4/ Since the Treasury cannot create base money, equals negative of Treasury net foreign assets.

Table 6. Turkey: Public Sector Finances, 2001–07

	2001	2002	2003	2004 8th review	2004 Prel.	2005 Prog.	2006 Proj.	2007 Proj.
(in millions of YTL)								
Public sector primary balance	9,706	11,356	22,239	27,266	29,581	31,315	34,988	38,405
Central government 1/	8,420	6,644	17,954	20,985	22,000	24,490	27,795	30,337
Total revenue, of which:	44,766	63,369	90,445	104,425	105,174	121,441	133,582	143,608
Tax revenue	39,768	59,634	84,335	97,927	101,058	118,585	130,573	142,299
Direct taxes, of which:	16,080	20,077	27,800	29,920	31,146	32,121	35,816	38,617
Personal income taxes	11,585	13,724	17,062	19,335	19,689	20,981	23,558	25,495
Corporate income taxes	3,680	5,578	8,646	8,810	9,619	8,890	9,717	10,463
Indirect taxes, of which:	23,687	39,557	56,535	68,007	69,912	86,464	94,758	103,683
VAT	12,439	20,401	27,028	32,117	34,324	40,445	45,033	49,406
SCT	6,782	13,651	22,299	27,228	26,288	34,939	38,906	42,687
Nontax revenue 1/	7,916	9,402	14,446	16,628	15,272	15,370	16,875	16,771
Tax rebates	-2,918	-5,666	-8,335	-10,130	-11,156	-12,514	-13,866	-15,462
Non-interest expenditure	36,346	56,726	72,492	83,440	83,174	96,952	105,787	113,271
Personnel	15,204	23,160	30,200	35,101	35,433	39,031	42,093	44,948
Other current	1,431	2,510	2,548	3,432	4,619	5,257	5,851	6,457
Defense and security	3,591	4,485	5,668	5,895	5,479	6,541	7,280	7,985
Transfers	12,218	19,289	26,911	32,113	29,671	36,052	39,354	41,588
Social security institutions	5,910	9,946	16,228	19,468	19,280	21,425	23,286	24,555
State enterprises and banks 2/	1,777	2,245	1,971	1,500	1,329	1,357	1,452	1,517
Agricultural subsidies	1,033	1,868	2,805	3,215	3,079	3,457	3,754	4,038
Other transfers	3,499	5,230	5,907	7,930	5,983	9,813	10,862	11,477
Investment	3,902	7,282	7,165	6,899	7,972	10,071	11,209	12,293
Rest of the public sector	1,286	4,712	4,285	6,281	7,580	6,825	7,193	8,068
EBFs	149	-249	390	49	538	379	420	552
Unemployment insurance fund	1,098	962	1,228	1,783	1,557	1,804	1,888	1,963
Local governments	59	538	-806	0	500	515	573	629
SEEs 3/	149	3,139	2,487	4,099	4,406	4,051	3,980	4,766
Social insurance institutions	-170	-85	53	0	-292	0	0	0
Revolving funds 4/	117	407	933	350	871	76	331	158
Public sector overall balance	-36,798	-32,583	-34,947	...	-26,404	-22,085	-12,209	-6,430
Interest expenditure (net)	46,504	43,938	57,186	...	55,985	53,400	47,197	44,835
Domestic	40,617	43,780	52,962	...	48,255	43,284	35,825	32,238
External	5,887	159	4,224	...	7,730	10,116	11,372	12,597
Public sector financing	36,798	32,583	34,947	...	26,404	22,085	12,209	6,430
Amortization	143,478	149,247	131,066	...	130,252	155,489	174,481	154,027
External	9,426	17,043	10,470	...	9,952	17,089	19,481	20,027
Domestic	134,052	132,204	120,596	...	120,300	138,400	155,000	134,000
Borrowing	175,666	181,225	165,632	...	155,178	178,535	187,473	158,134
External	18,436	27,108	11,906	...	12,709	16,813	17,394	18,255
Domestic	157,230	154,117	153,727	...	142,470	161,721	170,079	139,879
Deposits decrease	1,203	-205	81	...	-370	-3,030	-2,988	75
Privatization	3,407	808	299	...	1,848	2,067	2,205	2,248

Source: Turkish authorities; and staff estimates.

1/ Excluding privatization proceeds, transfers from the CBT, and interest receipts; including revenues from annexed budgets and other special revenues.

2/ Excluding recapitalization of state banks; including net lending to the private sector.

3/ Includes current and capital transfers (foreign and domestic) and contingency items.

4/ Excluding severance payments for retirees.

5/ Added to the public sector balance for 2002. Not included in the 2001 primary surplus calculation.

Table 6. (Continued) Turkey: Public Sector Finances, 2001–07

	2001	2002	2003	2004	2004	2005	2006	2007
				8th review	Prel.	Prog.	Proj.	Proj.
(in percent of GNP)								
Public sector primary balance	5.5	4.2	6.2	6.5	6.9	6.5	6.5	6.5
Central government 1/	4.8	2.4	5.0	5.0	5.1	5.1	5.2	5.2
Total revenue, of which:	25.4	23.2	25.4	25.0	24.5	25.2	25.0	24.5
Tax revenue	22.5	21.8	23.6	23.5	23.6	24.7	24.4	24.2
Direct taxes, of which:	9.1	7.3	7.8	7.2	7.3	6.7	6.7	6.6
Personal income taxes	6.6	5.0	4.8	4.6	4.6	4.4	4.4	4.3
Corporate income taxes	2.1	2.0	2.4	2.1	2.2	1.8	1.8	1.8
Indirect taxes, of which:	13.4	14.5	15.9	16.3	16.3	18.0	17.7	17.7
VAT	7.0	7.5	7.6	7.7	8.0	8.4	8.4	8.4
SCT	3.8	5.0	6.3	6.5	6.1	7.3	7.3	7.3
Nontax revenue 1/	4.5	3.4	4.1	4.0	3.6	3.2	3.2	2.9
Tax rebates	-1.7	-2.1	-2.3	-2.4	-2.6	-2.6	-2.6	-2.6
Non-interest expenditure	20.6	20.7	20.3	20.0	19.4	20.2	19.8	19.3
Personnel	8.6	8.5	8.5	8.4	8.3	8.1	7.9	7.7
Other current	0.8	0.9	0.7	0.8	1.1	1.1	1.1	1.1
Defense and security	2.0	1.6	1.6	1.4	1.3	1.4	1.4	1.4
Transfers	6.9	7.1	7.5	7.7	6.9	7.5	7.4	7.1
Social security institutions	3.3	3.6	4.5	4.7	4.5	4.5	4.3	4.2
State enterprises and banks 2/	1.0	0.8	0.6	0.4	0.3	0.3	0.3	0.3
Agricultural subsidies	0.6	0.7	0.8	0.8	0.7	0.7	0.7	0.7
Other transfers 3/	2.0	1.9	1.7	1.9	1.4	2.0	2.0	2.0
Investment	2.2	2.7	2.0	1.7	1.9	2.1	2.1	2.1
Rest of the public sector	0.7	1.7	1.2	1.5	1.8	1.4	1.3	1.4
EBFs	0.1	-0.1	0.1	0.0	0.1	0.1	0.1	0.1
Unemployment insurance fund	0.6	0.4	0.3	0.4	0.4	0.4	0.4	0.3
Local governments	0.0	0.2	-0.2	0.0	0.1	0.1	0.1	0.1
SEEs 4/	0.1	1.1	0.7	1.0	1.0	0.8	0.7	0.8
Social insurance institutions	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Revolving funds 5/	0.1	0.1	0.3	0.1	0.2	0.0	0.1	0.0
Public sector overall balance	-20.9	-11.9	-9.8	...	-6.2	-4.6	-2.3	-1.1
Interest expenditure (net)	26.4	16.1	16.0	...	13.1	11.1	8.8	7.6
Domestic	23.0	16.0	14.8	...	11.3	9.0	6.7	5.5
External	3.3	0.1	1.2	...	1.8	2.1	2.1	2.1
Public sector financing	20.9	11.9	9.8	...	6.2	4.6	2.3	1.1
Amortization	81.3	54.6	36.7	...	30.4	32.3	32.6	26.2
External	5.3	6.2	2.9	...	2.3	3.6	3.6	3.4
Domestic	76.0	48.3	33.8	...	28.0	28.8	29.0	22.8
Borrowing	99.5	66.3	46.4	...	36.2	37.1	35.0	26.9
External	10.4	9.9	3.3	...	3.0	3.5	3.2	3.1
Domestic	89.1	56.4	43.1	...	33.2	33.6	31.8	23.8
Deposits decrease	0.7	-0.1	0.0	...	-0.1	-0.6	-0.6	0.0
Privatization	1.9	0.3	0.1	...	0.4	0.4	0.4	0.4
Memorandum items:								
GNP (in millions of YTL)	176,484	273,463	356,681	417,600	428,932	480,963	535,311	587,116

Source: Turkish authorities; and staff estimates.

1/ Excluding privatization proceeds, transfers from the CBT, and interest receipts; including revenues from annexed budgets and other special revenues.

2/ Excluding recapitalization of state banks; including net lending to the private sector.

3/ Includes current and capital transfers (foreign and domestic) and contingency items.

4/ Excluding severance payments for retirees.

5/ Added to the public sector balance for 2002. Not included in the 2001 primary surplus calculation.

Table 7. Turkey: Banking System—Selected Indicators, 2001–04 1/
(In millions of new Turkish lira)

	2001 Dec. 1/	2002 Dec.	2003 Dec.	2004 Mar.	2004 June	2004 Sept.	2004 Dec.
Banking System							
Total assets	179,675	212,681	249,693	255,974	274,839	294,208	306,470
Cash and claims on CBT	12,558	13,872	14,962	14,941	17,616	19,543	20,819
Claims on other banks	19,871	15,401	15,141	12,159	15,264	19,450	21,044
Securities portfolio	70,026	86,105	106,844	113,159	114,081	120,449	123,683
Loans, net	41,058	52,932	67,210	72,407	88,243	93,984	100,112
Other assets	36,162	44,371	45,536	43,308	39,635	40,783	40,813
Total liabilities	179,675	212,680	249,693	255,974	274,839	294,208	306,470
Deposits	110,298	137,973	155,312	158,756	170,959	182,549	191,065
Borrowing from banks	23,798	21,967	25,918	25,508	32,543	34,201	33,762
Repos	10,776	6,161	11,241	10,698	12,062	13,397	10,596
Other liabilities	20,527	21,351	21,683	22,134	23,672	24,130	25,064
Shareholders' equity (incl. profits)	14,276	25,228	35,539	38,878	35,603	39,930	45,983
Memorandum items:							
Capital adequacy ratio (%)	15.3	25.3	30.9	32.1	25.4	26.6	28.8
NPLs (%) total loans	29.3	17.6	11.5	10.2	6.3	6.5	6.3
Provisions (%) NPLs	47.1	64.2	88.5	89.8	86.6	88.6	88.7
Net profit (loss) after tax	-9,910	2,336	5,678	921	2,402.6	4,626.5	6,336.5
ROA (%)	-5.5	1.1	2.3	0.4	1.0	1.9	2.5
ROE (%)	-69.4	9.3	16.0	2.4	6.7	13.6	17.4
Share in assets (%)	100	100	100	100	100	100	100
Share in deposits and repos (%)	100	100	100	100	100	100	100
Private Banks							
Total assets	97,930	119,471	142,270	142,621	157,643	169,816	175,916
Cash and claims on CBT	8,434	9,356	9,868	9,488	11,718	12,789	14,149
Claims on other banks	10,494	7,623	6,369	5,420	6,774	8,822	9,484
Securities portfolio	27,146	39,819	51,485	50,174	51,937	55,780	56,447
Loans, net	26,506	35,752	46,402	49,759	60,991	65,729	69,021
Other assets	25,350	26,921	28,146	27,781	26,223	26,696	26,816
Total liabilities	97,930	119,471	142,270	142,621	157,643	169,816	175,916
Deposits	67,223	80,629	88,180	85,518	95,386	101,225	105,195
Borrowing from banks	15,585	13,703	18,158	18,141	22,152	23,651	23,917
Repos	1,803	4,074	8,103	7,870	8,714	10,336	8,954
Other liabilities	5,779	5,871	6,872	7,902	8,690	9,259	10,440
Shareholders' equity (incl. profits)	7,540	15,194	20,958	23,191	22,700	25,346	27,410
Memorandum items:							
Capital adequacy ratio (%)	9.0	19.64	23.5	24.7	21.1	22.1	22.3
NPLs (%) total loans	27.6	8.9	6.5	6.2	4.6	4.5	4.8
Provisions (%) NPLs	31.0	53.0	80.0	81.1	80.3	83.6	84.5
Net profit (loss) after tax	-7,382.6	2409.6	2917.0	772.3	1370.6	2319.5	2836.5
ROA (%)	-7.5	2.0	2.1	0.5	0.9	1.7	1.9
ROE (%)	-97.9	15.9	13.9	3.3	6.0	11.2	12.8
Share in assets (%)	54.5	56.2	57.0	55.7	57.4	57.7	57.4
Share in deposits and repos (%)	57.0	58.8	57.8	55.1	56.9	56.9	56.6

Table 7 (Continued). Turkey: Banking System—Selected Indicators, 2001–04 1/
(In millions of new Turkish lira)

	2001 Dec. 1/	2002 Dec.	2003 Dec.	2004 Mar.	2004 June	2004 Sept.	2004 Dec.
State Banks /2							
Total assets	57,583	67,831	83,134	89,335	89,954	96,710	108,872
Cash and claims on CBT	3,544	4,000	4,589	4,912	5,264	6,130	6,000
Claims on other banks	5,096	3,996	5,365	3,894	4,614	6,000	6,689
Securities portfolio	32,756	39,245	47,716	55,104	54,126	56,366	63,333
Loans, net	9,177	8,804	12,202	14,325	17,439	18,060	21,057
Other assets	7,011	11,786	13,263	11,099	8,511	10,153	11,793
Total liabilities	57,583	67,831	83,134	89,335	89,954	96,710	108,872
Deposits	37,258	48,489	59,862	66,098	67,659	72,759	81,156
Borrowing from banks	2,381	2,230	2,338	2,103	2,982	3,123	4,249
Repos	3,844	1,022	1,018	897	1,308	1,471	1,231
Other liabilities	9,707	9,343	10,342	9,825	10,360	10,600	10,888
Shareholders' equity (incl. profits)	4,393	6,747	9,574	10,411	7,646	8,756	11,348
Memorandum items:							
Capital adequacy ratio (%)	34.0	50.2	56.3	56.2	34.9	37.9	41.4
NPLs (%) total loans	37.3	37.4	26.2	23.5	12.4	12.0	10.7
Provisions (%) NPLs	63	74	98	98	96	96	95
Net profit (loss) after tax	-681	1,056	1,790	182	916	2,000	2,943
ROA (%)	-1.2	1.6	2.2	0.2	1.0	2.4	3.2
ROE (%)	-15.5	15.7	18.7	1.7	12.0	23.6	36.1
Share in assets (%)	32.0	31.9	33.3	34.9	32.7	32.9	35.5
Share in deposits and repos (%)	33.9	34.4	36.6	39.5	37.7	37.9	40.9
SDIF Banks /2							
Total assets	11,035	9,310	7,075	6,825	7,146	6,048	-
Cash and claims on CBT	45	62	52	35	35	35	-
Claims on other banks	874	619	456	545	762	403	-
Securities portfolio	8,451	4,655	4,964	4,942	4,904	4,287	-
Loans, net	602	1,889	910	655	614	523	-
Other assets	1,064	2,085	693	647	831	800	-
Total liabilities	11,035	9,310	7,075	6,825	7,146	6,048	-
Deposits	3,566	5,770	4,133	3,994	4,019	4,082	-
Borrowing from banks	2,020	1,274	837	837	1,133	1,010	-
Repos	5,023	1,024	2,025	1,896	1,980	1,063	-
Other liabilities	814	2,338	927	995	957	1,036	-
Shareholders' equity (incl. profits)	-388	-1,096	-847	-897	-943	-1,144	-
Memorandum items:							
Capital adequacy ratio (%)	-17.8	-7.6	-21.6	-25.6	-27.0	-42.0	-
NPLs (%) total loans	67.3	69.4	53.8	28.6	27.5	31.8	-
Provisions (%) NPLs	89.1	60.5	75.4	67.9	67.5	78.3	-
Net profit (loss) after tax	-2,344	-1,677	272	6	-28	-219	-
ROA (%)	-21.2	-18.0	3.8	0.1	-0.4	-3.6	-
ROE (%)	...	-153.0	-32.1	-0.7	3.0	19.1	-
Share in assets (%)	6.1	4.4	2.8	2.7	2.6	2.1	-
Share in deposits and repos (%)	7.1	4.7	3.7	3.5	3.3	2.6	-

Table 7 (Continued). Turkey: Banking System—Selected Indicators, 2001–04 1/
(In millions of new Turkish lira)

	2001	2002	2003	2004	2004	2004	2004
	Dec. 1/	Dec.	Dec.	Mar.	June	Sept.	Dec.
Foreign and Investment Banks							
Total assets	13,126	16,068	17,213	17,194	20,097	21,484	21,682
Cash and claims on CBT	535	454	454	506	600	589	670
Claims on other banks	3,408	3,164	2,951	2,300	3,113	4,224	4,871
Securities portfolio	1,673	2,386	2,680	2,939	3,114	4,015	3,903
Loans, net	4,773	6,487	7,695	7,668	9,200	9,672	10,034
Other assets	2,738	3,577	3,434	3,781	4,070	2,984	2,204
Total liabilities	13,126	16,068	17,213	17,194	20,097	21,484	21,682
Deposits	2,252	3,086	3,137	3,145	3,895	4,483	4,714
Borrowing from banks	3,812	4,761	4,585	4,427	6,276	6,417	5,596
Repos	105	40	95	36	61	527	411
Other liabilities	4,227	3,798	3,542	3,412	3,665	3,248	3,736
Shareholders' equity (incl. profits)	2,730	4,383	5,854	6,173	6,200	6,810	7,225
Memorandum items:							
Capital adequacy ratio (%)	41.0	48.37	60.8	63.1	53.8	52.4	55.9
NPLs (%) total loans	9.3	4.3	3.8	3.8	3.1	3.0	3.2
Provisions (%) NPLs	81.2	69.3	85.5	86.0	85.5	85.9	81.5
Net profit (loss) after tax	498	548	698	-39	144	525.9	556.6
ROA (%)	3.8	3.4	4.1	-0.2	0.7	3.1	3.1
ROE (%)	18.2	12.5	11.9	-0.6	2.3	9.2	9.3
Share in assets (%)	7.3	7.6	6.9	6.7	7.3	7.3	7.1
Share in deposits and repos (%)	1.9	2.2	1.9	1.9	2.2	2.6	2.5

Sources: Data provided by Turkish authorities; and Fund staff estimates

1/ Data for December 2001 onward reflect the results of the audits conducted during the first half of 2002.

2/ SDIF banks group consist of only one bank and Bayındırbank is added to the State Banks group due to Banks Act.

Table 8. Turkey: Proposed Access

	Original Arrangement (as of 2/4/2002)	High-Access Cases 1/ (Ratio)				Normal Access Cases (Ratio)			
		Proposed Arrangement (Percentile)	20th Percentile	80th Percentile	Average	Proposed Arrangement (Percentile)	20th Percentile	80th Percentile	Average
Access									
In millions of SDRs	12,821	6,662	33	3,343	15,168	100	34	406	369
Average annual access	456	230	54	133	399	100	21	51	40
Total access in percent of: 2/									
Actual quota	1,330	691	67	307	840	100	30	75	64
Calculated 11th review quota	441	229	58	105	396	100	13	42	32
Gross domestic product	...	2.9	24	2.8	7.7	82	0.7	2.8	1.8
Gross international reserves	79	25	13	27	109	64	5	45	43
Exports of goods and nonfactor services	31	6	4	11.4	46.3	74	1.9	7.4	5.7
Imports of goods and nonfactor services	34	6	4	15.1	62.4	73	1.7	6.5	4.9
Total debt stock									
Of which: Public	13	11	50	6	17	...	...	...	...
External	15	4	13	6	15	68	2	6	5
Short-term	48	20	25	19	51	...	...	...	...
M2	...	6	25	5	24	61	1	12	107
Total financing package	100	100	29	58	100	...	...	...	...

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include all available data at approval and on augmentation for the 23 requests to the Board since 1994 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables.

3/ Phasing is based on program years.

Table 9. Turkey: External Financing Requirements and Sources, 2003 -10
(In billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009	2010
Gross financing requirements	47.4	62.0	67.3	70.5	74.2	78.1	79.7	83.5
Current account deficit (excluding official transfers)	8.3	15.7	15.8	13.3	11.6	11.0	9.9	8.5
Amortization on debt securities	3.9	3.8	3.6	2.8	3.7	3.7	2.0	2.7
Of which:								
Public sector	3.8	3.8	3.2	2.8	3.7	3.7	2.0	2.7
Medium and long-term debt amortization	15.0	14.8	15.8	17.4	18.0	18.9	19.7	20.2
Of which:								
Public sector 1/	3.2	3.2	4.1	3.9	3.4	3.3	3.1	3.0
Private sector	10.4	10.5	10.5	12.0	13.0	14.0	14.8	15.3
Deposit money banks	1.4	1.2	1.2	1.5	1.6	1.7	1.8	1.9
Short-term debt amortization	20.1	27.7	32.2	37.0	40.9	44.5	48.1	52.1
Public sector (net)1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade credits 2/	22.4	31.4	35.1	39.3	42.9	46.5	50.2	54.1
Banks and other private (net)	-2.3	-3.7	-2.9	-2.3	-2.0	-2.0	-2.0	-2.0
Available financing	47.4	62.0	67.3	70.5	74.2	78.1	79.7	83.5
Foreign direct investment (net)	1.2	1.7	3.9	4.0	3.9	3.3	3.0	3.5
Portfolio flows	7.9	13.2	11.4	8.7	7.4	7.6	7.8	8.0
Public sector	5.3	5.8	5.5	5.5	5.5	5.8	5.8	5.8
Deposit money banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector (net)	2.6	7.5	5.9	3.2	1.9	1.9	2.1	2.3
Medium and long-term debt financing	14.1	20.9	19.3	19.8	20.8	20.8	20.9	21.8
Of which:								
Public sector 1/	0.7	1.7	3.3	3.2	3.0	2.1	2.2	2.3
Short-term trade credits, currency and deposits	23.0	27.5	38.5	41.5	45.3	48.7	51.2	55.1
Official transfers	0.3	0.3	0.4	0.6	0.6	0.6	0.6	0.6
Other 3/	5.0	2.8	0.4	0.0	0.0	0.0	0.0	0.0
Net reserves (+/- = decrease/increase)	-4.1	-4.3	-6.6	-4.1	-3.8	-2.9	-3.9	-5.5
Accumulation of gross reserves	-4.0	-0.8	-2.1	0.2	-0.7	-1.1	-0.7	-2.9
IMF (net)	-0.1	-3.5	-4.5	-4.4	-3.1	-1.9	-3.3	-2.6
Purchases	1.7	1.2	3.4	3.4	2.5	0.8	0.0	0.0
Repurchases	-1.7	-4.7	-7.9	-7.7	-5.6	-2.7	-3.3	-2.6
Memorandum item:								
Net public sector financing (incl. IMF, excl. reserves)	-0.7	-2.7	-2.6	-1.8	-1.1	-0.3	0.2	0.4

1/ General government and Central Bank of Turkey.

2/ Series reflects gross flows of short term trade credits, and stocks of credits to the banking sector.

3/ Errors and omissions.

Table 10. 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	10.9	8.0	6.0	4.8	2.6	0.9
In percent of quota	1,685	1,682	1,436	1,132	835	625	498	273	93
In percent of exports of G&NFS	37	32	22	15	10	7	5	3	1
In percent of GNP	12	10	7	5	3	2	2	1	0
In percent of public sector external debt	25	24	22	18	14	10	8	5	2
In percent of overall external debt	16	16	13	10	7	5	4	2	1
In percent of end-period foreign reserves	75	65	54	42	31	23	18	10	3
Repurchases of Fund Credit									
In billions of SDRs	4.9	1.2	3.2	5.2	5.1	3.7	1.8	2.2	1.7
In percent of quota	510	127	328	535	528	383	185	223	180
In percent of exports of G&NFS	11	2	5	7	6	4	2	2	2
In percent of GNP	3	1	2	2	2	1	1	1	1
In percent of public sector external debt service	37	11	27	38	38	30	18	23	19
In percent of overall MLT external debt service	22	6	16	23	21	16	8	10	8
In percent of start period foreign reserves	32	6	13	21	19	14	7	8	6
In percent gross public sector ext. financing 2/	21	7	16	18	21	16	10	12	8
Net Fund Resource Flows 3/									
In billions of SDRs	4.4	-0.7	-3.0	-3.6	-3.3	-2.3	-1.5	-2.3	-1.8
In percent of quota	455	-72	-312	-371	-346	-242	-152	-239	-186
In percent of exports of G&NFS	10	-1	-5	-5	-4	-3	-2	-2	-2
In percent of GNP	3	0	-1	-2	-1	-1	-1	-1	-1
In percent of public sector external debt service	33	-6	-26	-26	-25	-19	-15	-25	-19
In percent of overall MLT external debt service	20	-4	-15	-16	-14	-10	-7	-11	-8
In percent start period foreign reserves	29	-3	-13	-14	-13	-9	-6	-9	-7
In percent gross public sector ext. financing 2/	19	-4	-15	-13	-14	-10	-8	-13	-9

1/ Projected on an expectations basis, except repurchase expectations on purchases made between February 2002 and July 2003 falling due in 2004-2005, as well as all 2006 repurchase expectations, which are projected on an obligations basis.

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

3/ Net purchases less repurchases and charges.

TURKEY: FUND RELATIONS
(As of March 31, 2005)

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

II. General Resources Account:	Millions of SDRs	Percent of Quota
Quota	964.00	100.00
Fund holdings of currency	14,038.35	1,456.26
Reserve position in Fund	112.78	11.70

III. SDR Department:	Millions of SDRs	Percent of
Allocation		
Net cumulative allocation	112.31	100.00
Holdings	12.31	10.96

IV. Outstanding Purchases and Loans:	Millions of SDRs	Percent of Quota
Stand-by Arrangements	13,187.12	1,367.96

V. Latest Financial Arrangements:				
Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
In millions of SDRs				
Stand-By	02/04/02	02/03/05	12,821.20	11,914.00
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00
Stand-By	07/08/94	03/07/96	610.50	460.50

VI. **Projected Payments to Fund (Expectations Basis)**⁷
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	4,496.85	7,612.90	822.23	255.15	
Charges/Interest	442.84	251.58	28.58	6.63	2.48
Total	4,939.69	7,864.48	850.80	261.78	2.48

⁷This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk (see repayment schedules and IMF lending for details).

Projected Payments to Fund (Obligations Basis)⁸

(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	3,264.35	6,324.75	2,520.65	822.23	255.15
Charges/Interest	461.67	374.11	87.74	28.09	6.66
Total	3,726.01	6,698.86	2,608.39	850.31	261.81

VII. Safeguard Assessments:

Under the Fund's safeguards policy, the CBT is subject to a full safeguards assessment with respect to the new SBA. The staff's findings and recommendations for the assessment conducted under the previous SBA (completed on April 4, 2002) were reported in Section IV of Country Report No.02/136. The authorities have implemented all of the measures recommended following the 2002 assessment. The new assessment has largely been completed and no new material vulnerabilities have been uncovered.

VIII. Exchange Rate Arrangement:

For the period January 1, 2000–June 30, 2001, the lira was to have depreciated against a basket comprising US\$1 and €0.77 along a daily path pre-announced by the central bank. The preannouncement was for the 12-month period, and was updated quarterly. There would not be an exchange rate band around the pre-announced path during the first 18 months of the program. Thereafter—that is, from July 1, 2001—a symmetrical intervention band was to have been introduced around the central parity rate, with the total width of the band increasing gradually at a rate of 15 percentage points per year. This exchange rate arrangement was in place until February 22, 2001, when the government decided to float the currency.

IX. Article IV Consultations:

The 2004 Article IV staff report (Country Report No.05/163) was issued on July 9, 2004, and the accompanying Selected Issues paper (Occasional Paper No.242) was issued on July 15, 2004. Board discussion took place on July 30, 2004.

⁸This schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations—except for SRF repayment expectations—would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country (see repayment schedules and IMF lending for details). SRF repayment expectations are shown on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

X. **ROSCs**

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 27, 2000	Report on the Observance Of Standards and Codes
Corporate Governance (prepared by the World Bank)	December 11, 2000	
Data ROSC	March 14, 2002	Country Report No. 02/55

XI. **Technical Assistance:** (1993–present)

Department	Timing	Purpose
MAE	July 1994	Banking sector reform
MAE	July 1995	Inflation accounting
FAD	September 1995	Taxation of petroleum products
FAD	October 1995	Assistance to IBRD Public Financial Managing Project; 8 FAD missions since 1994, assignment of 5 resident experts, mainly focused on customs modernization
STA	February 1997	Balance of payments compilation
PDR/EU1/ MAE	December 1998	Short-term debt monitoring
MAE	June 1999	Basel Core Principles
MAE	August 1999	Debt management policies
MAE	October 1999	Banking sector reform
MAE	March 2000	Banking sector reform
FAD	April 2000	Fiscal transparency
FAD	April 2000	Tax policy

Department	Timing	Purpose
MAE	April 2000	Banking sector reform
MAE	May 2000	Banking sector reform
MAE	July 2000	Inflation targeting
STA	September 2000	Balance of payments statistics
MAE	Sept. 2000– April 2001	Banking sector reform
MAE	April 2001	Debt management
FAD/STA	May 2001	Fiscal accounting and reporting
MAE/RES	September 2001	Inflation targeting
STA	October 2001	Data ROSC
STA	April 2002	National accounts statistics
MAE/RES	April/May 2002	Inflation targeting
STA	July 2002	Public finance statistics
FAD	July 2003	Social security contribution collections
FAD/MFD	September 2003	Taxation of Financial Intermediation Direct Tax Reform
MFD	December 2003	Banking reform
FAD	December 2003	Informal sector and tax administration reform
MFD	March 2004	Currency reform
STA	April 2004	Consumer and wholesale price indices
STA	May 2004	National account statistics

Department	Timing	Purpose
FAD	May 2004	Public expenditure analysis
FAD	June 2004	Tax reform strategy
MFD	October 2004	Currency reform
FAD/MFD	February 2005	Treasury cash management and state bank reform

TURKEY: IMF–WORLD BANK RELATIONS

Partnership in support of Turkey's Development Strategy

1. Turkey's vision is of a modern and secular participatory democracy, fully integrated into the European community, playing a critical role in the regional context, with an export-oriented, highly competitive production structure. The priorities of the government are spelled out in the program presented to parliament in March 2003 and in the associated Urgent Action Plan.
2. The IMF and World Bank teams have collaborated closely in Turkey, and standard working arrangements already broadly follow the guidelines for enhanced Bank-Fund collaboration. This has included regular participation of Bank staff in the meetings with government of the Fund's program review missions, and IMF staff invited to Bank review meetings and meetings with government. The IMF has taken the lead in macroeconomic stabilization and the World Bank in social and structural areas, with close collaboration in structural areas that have a particular impact on macroeconomic stability. The Bank's dialogue and conditionality has maintained consistency with the macroeconomic framework endorsed by the IMF.

World Bank Country Assistance Strategy

3. The objectives of the CAS, discussed by the Executive Directors on November 6, 2003, are to help Turkey reduce economic vulnerability and achieve high and stable growth, and continue the process of addressing some long neglected social and environmental problems. The last CAS focused heavily on crisis management. This CAS aims at reducing the risk of reemergence of crises and helping Turkey address the many economic challenges of preparing for EU membership. The planned assistance program for FY04–06 is structured around four development themes: (i) sound macroeconomics and governance; (ii) equitable human and social development; (iii) attractive business climate and knowledge; and (iv) strong environmental management and disaster prevention.
4. Under the program to promote sound macroeconomics and governance, the first priority has been the final loan in the Programmatic Financial and Public Sector Adjustment Loan (PFPSAL) series, PFPSAL III. Going forward, programmatic lending will be split between public sector and financial sector components reflecting the more specialized nature of the second generation of reforms. These will include fiscally sustainable reform of the social security system, continued support for the ongoing agenda of public sector reforms, and beginning to shift the emphasis from reforms to measurable improvements in public service delivery. The Bank will support the Government's activities in the legal and judicial reform area initiated under the Urgent Action Plan through improvements in the legal framework and in judicial reform. Finally, under this heading, the Bank will help Government to develop a local government reform strategy with the objective of providing

better local infrastructure services (water, roads, transport, solid waste management etc.) to the urban population that represents about 70 percent of the population. Analytical support under the sound macroeconomics and governance heading include development of a Computable General Equilibrium (CGE) model to study impact of the financial sector on growth and employment; a Country Economic Memorandum on EU accession; and a new Public Expenditure and Institutional Review, Country Financial Accountability Assessment, and Country Procurement Assessment Report.

5. Bank support for equitable human and social development will focus on secondary education, a radical reform of the health sector and assistance for social protection. Under the previous CAS, support had begun on primary education. Work will now begin on secondary education reform, in close coordination with EU-financed activities. Significant reforms are planned in the health sector to streamline service provision, do away with arbitrary differences in the provision of health care, and extend health insurance to the entire population in a fiscally responsible manner. Health insurance is only part of a planned reform of the entire social protection system including pensions, health insurance, social assistance and unemployment insurance. The Bank is providing intensive support for this process including analytical support through a Poverty Assessment, Labor Market Study, and projections on pensions, health insurance and unemployment insurance.

6. To help improve the business climate, the Bank will continue to support financial sector reform with a focus on the legal and regulatory framework for banking, the privatization of state banks, and regulatory issues related to capital markets, insurance and other nonbank financial institutions. A knowledge economy project will help position Turkey in the global economy. The real sector will be supported through an export finance loan. IFC will continue to finance viable private sector export-oriented projects including small and medium enterprises, and MIGA will offer guarantees to Turkish firms. Bank assistance in agriculture will focus on increasing productivity by addressing issues of human capital and through diversification in rural areas. A renewable energy project and railway restructuring project are planned. Analytical work will be on financial sector reform, a recently completed knowledge economy assessment, and a rural development strategy.

7. Environmental management is a high priority since Turkey is seeking to adopt European Union environmental standards. Bank lending support will focus on micro-watershed management and a contribution to a regional effort to reduce chemical run-off into the Black Sea. The Bank will also continue to support disaster management through a project to mitigate seismic risks.

8. As of March 31, 2005, the portfolio of World Bank financed projects in Turkey comprises 16 operations, including one adjustment loan and three grant-financed projects, with total net commitments of about US\$4.3 billion. The International Finance Corporation (IFC) has been active in the financial sector, manufacturing, oil and gas, infrastructure and health and education. As of November 30, 2004, IFC's total portfolio in Turkey was US\$1,013 million. With a gross exposure of US\$214 million as of June 2003, Turkey is an

important country for MIGA. The total amount of foreign direct investment facilitated by MIGA is estimated at approximately US\$1 billion.

IMF-World Bank collaboration

9. **Areas where the Fund leads.** The Fund takes the lead in macroeconomic stabilization including macro-fiscal policy, monetary policy, exchange rate policy and financial stability and risk management.

10. **Areas in which the World Bank leads.** The Bank has taken the lead in structural areas where both institutions have conditionality including bankruptcy reform, corporate sector restructuring, social security reform, regulatory and market reforms in telecommunications and energy, agriculture reform, and privatization. The Bank is also in the lead in areas such as health, education, infrastructure, governance and environmental management.

11. **Areas of shared responsibility.** The work on public sector management and governance has focused on strengthening public expenditure management system while maintaining fiscal discipline. The Fund has taken the lead in the short-term measures needed for the fiscal adjustment such as incomes policy, urgent revenue and expenditure measures, and budget monitoring and reporting. The Bank has taken the lead in assisting government on the medium-term public expenditure management strategy, rationalization of the public investment program, public procurement reform, accounting reform, and public liability management. Public employment policy, medium-term tax strategy, anti-corruption strategy and civil service reform are further areas of Bank involvement.

12. The challenge facing Turkey in the financial sector has been to address the banking crisis and putting in place an appropriate legal and regulatory framework that would minimize the risk of future crises. The Bank has taken the lead in reform of the legal framework and regulations for bank supervision, the institutional development of the Banking Regulatory and Supervisory Agency (BRSA) and Saving Deposit Insurance Fund (SDIF), and the structural reforms required to guide the restructuring and improve the governance of the state banks, as well as work on Non-Bank Financial Institutions (NBFI). The Fund has taken the lead in assessing the soundness of the banking system and where there was an immediate fiscal impact such as the re-capitalization of the state banks, the closing of insolvent banks, and the private bank recapitalization scheme. On the state banks agenda and resolution of private banks the Fund and Bank have worked closely as a team. The Bank intends to continue its support for financial sector reform in Turkey including the development of the NBFI for which a major study has recently been concluded.

REPORT ON EXCEPTIONAL ACCESS FOR REQUEST OF STAND-BY ARRANGEMENT

A. Introduction

1. **As part of their strategy to exit from Fund financial support, the Turkish authorities have requested a new three-year stand-by arrangement in the amount of SDR 6.7 billion (691 percent of quota).** Given the level of Turkey's outstanding use of Fund resources and the size of the proposed SBA, the proposed program qualifies as exceptional access.

2. **As set out in the framework for exceptional access cases, this separate report evaluates the case for exceptional access under the proposed SBA, based on the four substantive exceptional access criteria in capital account crises.** In cases where one or several of the four criteria are not met, exceptional access can be granted based on the exceptional circumstances clause and the considerations that apply to members that had exceptional access and need further access as part of their exit strategy.⁹

B. Exceptional Access Criteria in Capital Account Crises

3. **The staff's evaluation of Turkey's compliance with the four exceptional access criteria is as follows:**

- ***The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within the normal limits.*** Turkey is not in a capital account crisis, but it has substantial balance of payments needs over the next three years. Magnified by the worsening of the underlying current account position, Turkey's gross external financing requirement is in the order of US\$65–70 billion annually (and roughly half that excluding trade credit), leaving it vulnerable to shifts in market sentiment. Moreover, its projected reserves position is precarious. With reserves to short-term debt by remaining maturity declining to about 43 percent without a Fund-supported program, the cushion to absorb external shocks is limited.

These vulnerabilities are exacerbated by the composition of Turkey's public debt, half of which consists of floating rate debt and half of which is linked to the exchange rate. This in turn, could further fuel pressures on the capital account. Accordingly, Turkey's financing needs remain very challenging.

⁹ See Acting Chairman's Summing Up of: "Review of Exceptional Access Policy," BUFF/04/81, April 23, 2004.

- ***A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable.***

Public debt. Even under conservative baseline assumptions, the staff's debt sustainability analysis shows that Turkey's public debt ratio is on a downward path (Annex A). Under a baseline scenario that assumes high effective real interest rates of about 11 percent (to provide a safety margin), a primary surplus of 6.5 percent of GNP, a broadly constant real exchange rate, modest privatization receipts, and 5 percent real growth, the net public debt ratio would decline from about 70 percent of GNP at end-2003 to below 60 percent of GNP by end-2007.

However, staff analysis, which includes standardized tests and tests tailored to Turkey's circumstances, shows that Turkey's public debt outlook is vulnerable to shocks and that a combination of large negative shocks would jeopardize sustainability. These tests underline the fact that Turkey's debt outlook is critically dependent on the continuation of good policies.

External debt. Under baseline assumptions, the staff's external debt sustainability analysis shows that Turkey's external debt burden is also on a declining path (Annex B). Under a baseline scenario that assumes a gradual decline in the external current account balance, a pickup in foreign direct investment, and the same macroeconomic assumptions as in the public debt sustainability analysis, the external debt burden is projected to decline by around 10 percentage points, to 43 percent of GNP, by end-2007. However, external debt too remains vulnerable to the more extreme standardized shocks.

- ***The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge.*** Turkey has retained its market access. Treasury raised some US\$5¾ billion last year on the international bond market and has already raised US\$ 3.2 billion in the first few months of 2005, covering close to two-thirds of its annual issuance target. As such, Turkey remains among the top five emerging market borrowers from international bond markets.

Turkey has also seen strong foreign investor interest in its domestic sovereign bond market, with foreign holdings of domestic government paper having increased by US\$9 billion since early 2004.

Gross Eurobond Issuance (millions of US dollars) - Top Five Emerging Markets

Country	2000	Rank	Country	2001	Rank	Country	2002	Rank	Country	2003	Rank	Country	2004	Rank
Argentina	9,248	1	Brazil	6,683	1	Mexico	4,000	1	Mexico	7,382	1	Mexico	7,719	1
Turkey	7,537	2	Mexico	4,702	2	Brazil	3,942	2	Brazil	5,833	2	Turkey	5,741	2
Brazil	6,839	3	Colombia	4,243	3	Turkey	3,260	3	Turkey	5,254	3	Brazil	5,208	3
Mexico	4,928	4	Lebanon	3,100	4	Philippines	2,850	4	Poland	4,301	4	Hungary	4,639	4
Russia	4,660	5	Turkey	2,159	5	Poland	2,680	5	Venezuela	3,670	5	Philippines	3,874	5

Source: Bondware database

Discussions with market participants suggest a market consensus that the authorities will issue at least as much international bonds as last year, although this is contingent on continuation of the currently favorable external environment. Market participants noted that the prospects for a Fund program and for the commencement of talks on EU accession provide two important anchors for investor sentiment. Furthermore, vulnerability indicators—most notably debt ratios—continue to improve. However, participants cautioned that the economic environment in the period ahead may not be as favorable, with European growth, rising interest rates and persistently high oil prices cited as concerns. Investors also worried about a possible real exchange rate appreciation undermining competitiveness and export growth, and the still high current account deficit.

- ***The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.*** Turkey's performance under the previous Fund-supported program has been strong, delivering impressive financial and macroeconomic results. The Turkish authorities have reiterated their commitment to continue with their ambitious macroeconomic and structural reform agenda, to further lower the economy's vulnerability to crises and promote strong and durable growth over the medium term. To this end, they have developed a comprehensive reform agenda. The government's commanding majority in parliament puts it in a strong position to implement its reform program.

C. Overall Assessment

4. **Staff supports the authorities' request for a new three-year arrangement.**

Turkey's macroeconomic performance under the current program has been impressive. The authorities are committed to continuing prudent macroeconomic policies, and removing impediments to sustainable long-run growth. However, maintaining this success will require further progress on structural reforms, particularly in fiscal and financial areas where a large unfinished agenda remains.

5. **This successor arrangement should play a role in facilitating the needed reforms.**

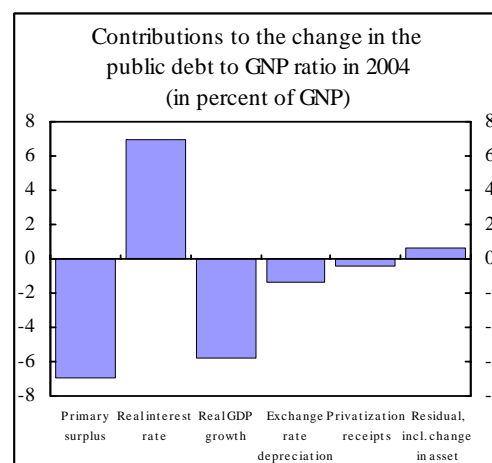
A three-year program would allow sufficient time to fully elaborate an exit strategy, facilitate implementation of a substantial structural reform agenda, help smooth the repayment profile to the Fund, and provide an anchor during the run up to the next general elections (to be held by November 2007). The authorities have also provided assurances for early repayment and exit, should conditions prove more favorable than expected.

6. **Turkey is not facing an acute capital account crisis and, as such, does not meet all of the criteria governing exceptional access. Hence, it is proposed to approve the proposed exceptional access by invoking the exceptional circumstances clause.** The authorities have formulated a strong policy framework that staff supports. By providing financial support at a time when financing needs are large, the Fund can help Turkey buffer its reserves and secure its successful graduation from Fund financial assistance.

ASSESSING PUBLIC DEBT SUSTAINABILITY

This Annex analyzes Turkey's public sector debt sustainability and considers the impact of a range of shocks. Although sustainability can be achieved under several plausible shocks, a combination of shocks could jeopardize sustainability. Additional tests tailored to Turkey's specific circumstances show how negative external events or complacency could negatively affect debt dynamics. These tailored tests bring out clearly the importance of maintaining fiscal discipline.

7. **Turkey's public sector net debt ratio has declined substantially under the current program.** Over the past three years net public sector debt has declined by more than 25 percentage points, from its peak of over 90 percent of GNP at end-2001 to less than 64 percent in end-2004 (Table 1). This was achieved by a strong fiscal performance, high economic growth, a decline in domestic interest rates and an appreciation of the currency, although the contribution from latter was relatively small in 2004.



8. **Under baseline assumptions, Turkey's public sector debt burden should decline substantially over the medium term.** With a primary surplus of 6.5 percent of GNP, privatization receipts of less than ½ percent of GNP each year, an annual real growth of 5 percent, and a moderate decline in the average real interest rate to 10 percent, the net public debt is expected to fall by about 10 percentage points over the program period, to slightly above 53 percent of GNP by end-2007. Without any change in the underlying assumptions, it would further decline to close to 40 percent of GNP by the end of the decade. (Figure 1).

9. **Public debt dynamics remain sustainable under most of the standard *alternative scenarios*, but become unsustainable when setting all key variables at their historical averages** (Table 1, panel A). Under the growth shock scenario (A3), debt still falls to less than 44 percent of GNP by 2010. The market forecast (A4) scenario yields a similar result under the assumption that the primary surplus would be reduced in the absence of an IMF program in the outer years of the projection. The no policy change (A2) scenario is identical to the baseline, which assumes that the key parameters remain unchanged. In sharp contrast, where key variables return to historical averages (A1), debt increases to over 108 percent of GNP by 2010.

10. **The standardized *bound tests* show that Turkey could cope with most of the isolated shocks, but a combination of large shocks would undermine sustainability** (Table 1, panel B). Isolated shocks on the exchange rate (B5) and contingent liabilities (B6) would create one-time increases in debt followed by a decline back to the initial ratio after two to three years. When imposing a shock to real growth (B2) or the primary balance (B3)

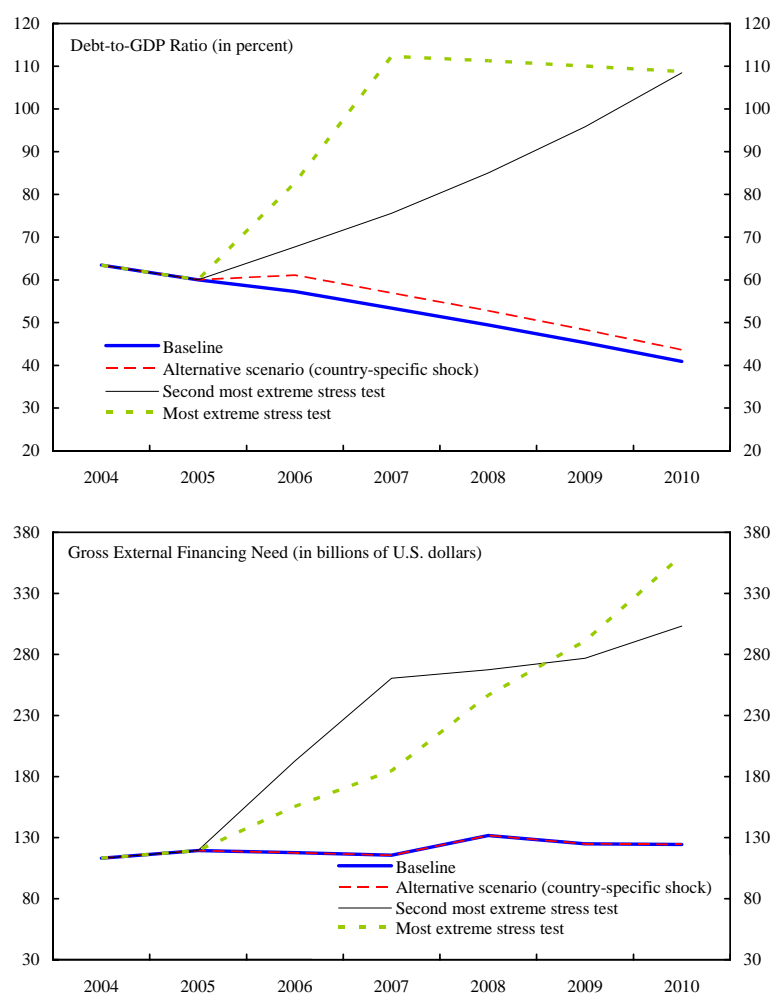
the debt ratio rises rapidly over the first two years, peaking at more than 74 percent, but then returns back to a declining path. While the interest rate shock (B1) and the combination shock (B4) result in a similar path, the debt ratios under these scenarios would peak at close to 100 and 112 percent, and the subsequent decline would be much slower. The sustainability of the debt burden under such circumstances would be clearly at risk.

11. ***Tailored tests help analyze particular risks to Turkey's debt dynamics*** (Table 1, panel C).

- **Stronger-than-expected global liquidity tightening.** This test assumes that interest rates in advanced markets rise much stronger than currently anticipated, for a period of three years (2006–08), sharply reducing the amount of international capital flowing into emerging markets and also slowing world demand for emerging market exports. This would weaken the currency and at the same time cause higher real interest rates and lower growth in those three years. As a result, the debt ratio no longer declines but increases in the first two years of the shock. Assuming an unchanged fiscal policy, however, this increase would be contained to about 3½ percentage points and the ratio quickly falls to its original level when interest rates and growth return to their baseline in 2009–2010.
- **A sudden Turkey-related shift in investor sentiment.** Triggered by an adverse Turkey-specific event, investors would rush out of Turkish assets, causing a sudden sharp exchange rate depreciation. In the initial year of the shock (2006) growth is zero, interest rates return to their high historic average and the public debt ratio jumps by almost 15 percentage points of GNP. Assuming an unchanged fiscal policy and the restoration of confidence, interest rates then gradually return to the baseline over the next two years, accompanied by a strong rebound in economic activity. Although not reaching its original level by the end of the projection period, the debt ratio is back on a firmly declining trend in the outer years of the projection.
- **Domestic policy complacency.** In the final test, it is assumed that the primary surplus is lowered to 4 percent of GNP each year and that structural reforms are no longer pursued. This causes a permanent increase in the real interest rate. Although growth is not affected negatively in the initial year, because of the fiscal stimulus, it falls to a lower trend rate in the following years. Taken together, this sets debt dynamics on a steadily increasing path, raising the debt ratio by almost 12 percentage points by the end of the decade.

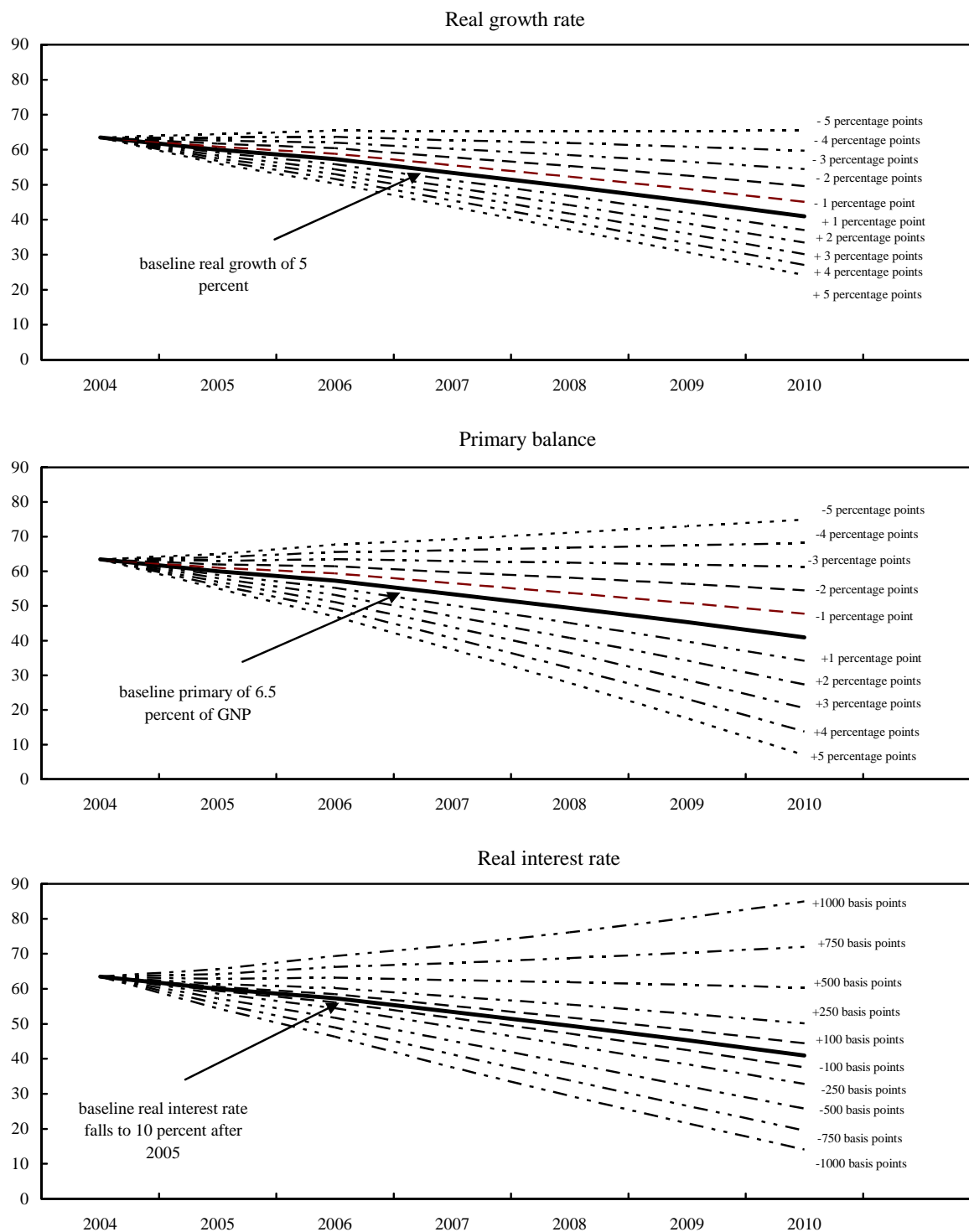
12. **The tailored tests highlight Turkey's vulnerability to shifts in global liquidity conditions and investor sentiment, but they also point to the critical role of domestic policy in preserving debt sustainability.** The first two tests illustrate how maintaining fiscal discipline under adverse external changes can help prevent a deterioration of debt dynamics to an unsustainable path by stabilizing expectations and helping to lower interest rates. By the same token, a loosening of fiscal policy in response to these shocks would put debt dynamics on a rapidly deteriorating path. Indeed, the third tailored test shows how policy complacency by itself could set in motion an adverse scenario of higher interest rates and lower growth that would place public debt on an unsustainable path.

Turkey: Debt Ratio and Gross External Financing Need, 2002–08



Source: IMF staff calculations.

Figure 1. Turkey: Sensitivity of Public Debt to Changes in Key Variables
(in percent of GNP)



Source: Based on DSA exercise.

Table 1. Turkey: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1 Public sector debt 1/ o/w foreign-currency denominated	90.5	78.5	70.4	63.5	60.0	57.3	53.4	49.5	45.3	40.9
2 Change in public sector debt	36.2	39.3	32.7	26.3	24.6	21.8	19.2	16.8	13.6	12.3
3 Identified debt-creating flows (4+7+12)	33.4	-12.0	-8.2	-6.9	-3.4	-2.7	-3.9	-3.9	-4.2	-4.4
4 Primary deficit	35.7	-16.7	-13.9	-7.5	-2.7	-4.2	-4.4	-4.1	-4.2	-4.4
5 Revenue and grants	-5.5	-4.1	-6.2	-6.9	-6.5	-6.5	-6.5	-6.5	-6.5	-6.5
6 Primary (noninterest) expenditure	26.1	24.8	26.6	26.9	28.2	27.7	27.7	27.7	27.7	27.7
7 Automatic (debt) dynamics 2/	20.6	20.6	20.3	19.9	21.7	21.2	21.2	21.2	21.2	21.2
8 Contribution from interest rate/growth differential 3/	41.2	-12.3	-7.6	-0.2	4.2	2.7	2.5	2.4	2.3	2.1
9 Of which contribution from real interest rate	10.2	-16.2	-1.8	1.2	4.2	2.7	2.5	2.4	2.3	2.1
10 Of which contribution from real GDP growth	6.3	-11.6	1.7	7.0	7.1	5.4	5.1	4.9	4.5	4.2
11 Contribution from exchange rate depreciation 4/	3.9	-4.6	-3.6	-5.8	-2.8	-2.7	-2.6	-2.5	-2.3	-2.1
12 Other identified debt-creating flows	31.0	4.0	-5.8	-1.4	...	...	...	...	...	...
13 Privatization receipts (negative)	0.0	-0.3	-0.1	-0.4	-0.4	-0.4	-0.4	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3) 5/	-2.3	4.7	5.7	0.6	-0.8	1.5	0.4	0.2	0.1	0.1
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	-9.5	7.9	5.9	9.9	5.0	5.0	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 7/	65.6	27.9	26.7	22.3	19.6	16.3	14.5	13.5	13.1	13.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	21.2	5.4	17.2	15.5	12.8	10.3	10.1	10.1	10.1	10.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	-53.6	-11.8	17.7	4.3	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	55.3	44.4	22.5	9.5	6.8	6.0	4.5	3.5	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-15.3	8.1	4.3	7.3	14.6	2.9	5.0	5.0	5.0	5.0
Primary deficit	-5.5	-4.1	-6.2	-6.9	-6.5	-6.5	-6.5	-6.5	-6.5	-6.5
II. Stress Tests for Public Debt Ratio										
A. Alternative Scenarios										
A1. Key variables are at their historical averages in 2006-10 7/	60.0	67.7	75.6	85.0	60.0	67.7	75.6	85.0	95.9	108.4
A2. No policy change (constant primary balance) in 2006-10	60.0	57.3	53.4	49.5	60.0	57.3	53.4	49.5	45.3	40.9
A3. Country-specific shock in 2006, with reduction in GDP growth (relative to baseline) of one standard deviation 8/	60.0	61.1	56.9	52.8	60.0	61.1	56.9	52.8	48.3	43.7
A4. Selected variables are consistent with market forecast in 2006-10	60.0	57.3	53.4	50.0	60.0	57.3	53.4	50.0	46.8	44.0
B. Bond Tests										
B1. Real interest rate is at historical average plus two standard deviations in 2006 and 2007	60.0	76.5	98.0	96.3	60.0	76.5	98.0	96.3	94.3	92.3
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007	60.0	67.1	74.4	71.5	60.0	67.1	74.4	71.5	68.3	65.1
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007	60.0	67.5	74.2	71.3	60.0	67.5	74.2	71.3	68.2	64.9
B4. Combination of B1-B3 using one standard deviation shocks	60.0	82.7	112.3	110.0	60.0	82.7	112.3	110.0	108.7	106.7
B5. One time 30 percent real depreciation in 2006 9/	60.0	68.8	65.5	62.2	60.0	68.8	65.5	62.2	58.6	54.9
B6. 10 percent of GDP increase in other debt-creating flows in 2006	60.0	67.3	63.9	60.5	60.0	67.3	63.9	60.5	56.9	53.0
C. Tailored Tests										
C1. Stronger-than-expected global liquidity tightening/ 10	60.0	63.3	62.8	62.5	60.0	63.3	62.8	62.5	59.0	55.3
C2. Sudden Turkey-related shift in investor sentiment/ 11	60.0	74.6	73.5	69.3	60.0	74.6	73.5	69.3	66.0	62.6
C2. Domestic policy complacency/ 12	60.0	61.5	63.6	66.1	60.0	61.5	63.6	66.1	68.8	71.7

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g)) - g + \alpha\pi(1+g)] / (1+g+\pi+g\pi)$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\pi(1+g)$.

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

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

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

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

10/ Assumes 10 percent real depreciation in 2006, an increase in real interest rates by 3 percentage points in 2006-2008 and reduced annual GNP growth of 3 percent in 2006-2008. Baseline assumptions for 2009-2010.

11/ Assumes a 20 percent real depreciation, an increase in interest rates to historical average and zero growth in 2006; in 2007-2008 interest fall gradually back to baseline, and growth rebounds with 8 percent annually. Baseline assumptions for 2009-2010.

12/ Assumes that starting in 2006 the primary fiscal balance is permanently reduced to 4 percent, and real interest rates permanently rise by 2 percentage points. In 2007, annual growth drops permanently to 2.5 percent.

EXTERNAL DEBT SUSTAINABILITY

13. **Turkey's projected external debt ratios have worsened somewhat since the 2004 Article IV consultation, primarily reflecting a deterioration in the current account balance.** The external debt-to-GNP ratio is now projected to decline from around 53 percent of GNP in 2004 to around 43 percent in 2009, roughly 1½ percentage points above staff's July projections. Higher current account deficits are projected to add roughly 15 percent of GNP to the external debt stock over the projection period (compared to around 12 percent of GNP at the time of the last Article IV), but the overall deterioration is mitigated by higher levels of FDI and a downward revision in projected interest payments (Table 1).

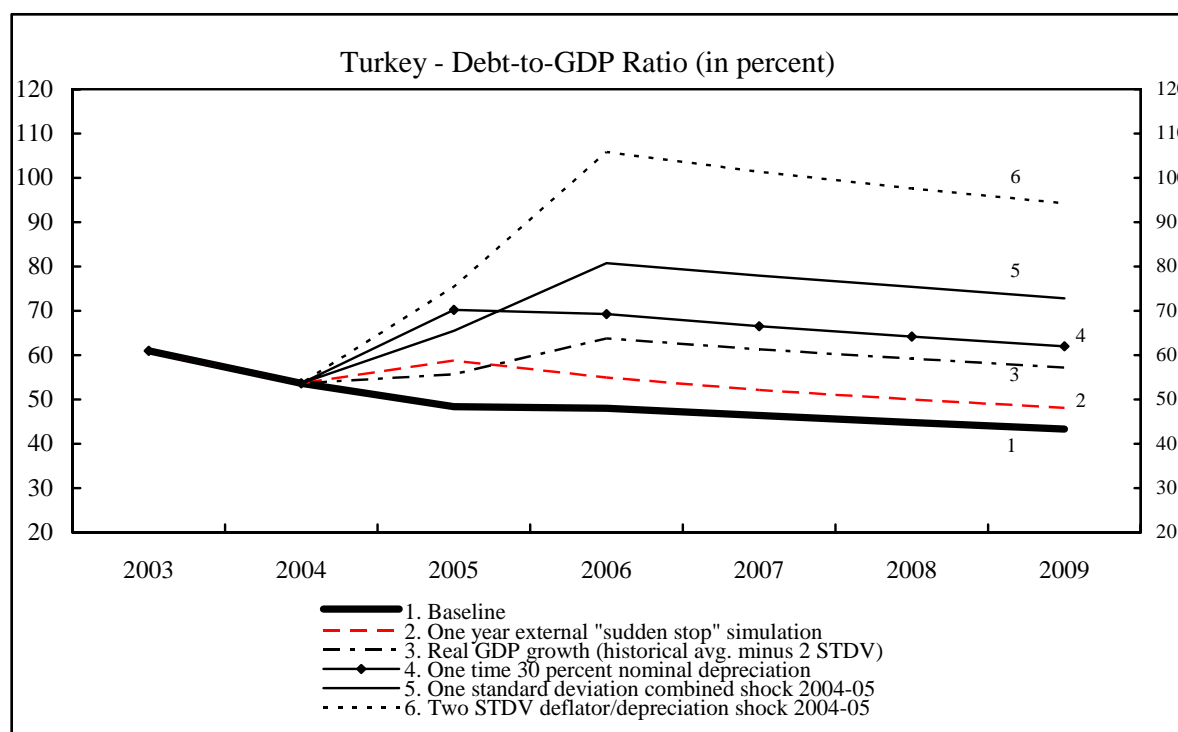
14. **The most notable change in the revised DSA is the sharp increase in Turkey's projected gross borrowing requirements.** These are now projected in the range of \$65–70 billion a year, about \$5 billion higher than at the time of the Article IV. This is caused by an increase in short-term debt flows, which continue to comprise a large share of capital inflows. The increase in short-term debt is also projected to exacerbate the already sharp decline in Turkey's reserve-to-short-term debt ratios, which fall to around 43 percent in 2006 (absent further Fund financing and on a residual maturity basis).

15. **External debt remains vulnerable to extreme standardized shocks.** Turkey's history of macroeconomic volatility implies that the “standardized” bound debt sustainability tests are particularly demanding in comparison to most countries. Notwithstanding this record of vulnerability, the debt ratio is fairly robust over the medium term to two-year standard deviation shocks to the current account balance, interest rates and GNP growth, and to a one-off permanent 30 percent nominal depreciation. However, more extreme combined shocks, and the two standard deviation shock to the exchange rate, would significantly test debt sustainability (Figure 1).

16. **Using the revised baseline, we have updated the tailored test presented in the Article IV to illustrate the effect of a temporary closure of international capital markets to Turkey.** In such a scenario, it is assumed that adverse global liquidity developments result in the temporary closure of public international bond borrowing in 2005, a net outflow of short-term bank credit, and reduced levels of foreign direct investment, foreign purchases of domestic bonds and equities due to confidence effects. Assuming that much of the high frequency trade financing remains in place, this would reduce total external financing by close to one-third.

17. **Such a shock would affect the economy through multiple channels.** The exchange rate would weaken, reflecting reduced demand for domestic currency assets, and pass-through effects would raise domestic inflation. Domestic interest rates (both nominal and real) would increase, and growth would slow significantly. On the assumption that growth falls to zero, and the real exchange rate depreciates by 15 percent (and higher nominal depreciation to offset higher inflation), imports would decline substantially. This would lead to a sharp adjustment in the current account balance—improving by as much as 4–5 percent GNP—to offset the reduction in external financing. In subsequent years, growth recovers

quickly, narrowing the output gap, financing flows return to the baseline scenario, and the exchange rate depreciation is reversed.



18. **The impact of this shock on external debt dynamics is relatively modest.** This reflects the sharp current account adjustment that is associated with the sudden shock itself, and the associated drop-off in debt creating financing flows, as well as assumed domestic adjustment and a quick reversal of the initial real exchange rate depreciation. Such an outcome depends crucially on both the parameters of the scenario and the authorities' policy reaction. Notably, if short-term financing were to weaken even further, in a re-run of the 2001 crisis when net bank financing was cut by around US\$10 billion, the required exchange rate adjustment would be even larger and the impact on debt sustainability greater. However, providing that the exchange rate adjusts promptly—in contrast to earlier crises—and does not overshoot, it seems reasonable to assume a much weaker reaction from private creditors, as the external financing situation would be relatively quickly brought into balance.

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

Ankara, April 26, 2005

Dear Mr. de Rato,

1. This letter comes after the completion of the second year of our government. In the short time since taking office, our government has decisively transformed the performance of the Turkish economy. Output has grown significantly while inflation has fallen to single digits, the best performance in more than a generation. By bringing order to economic policymaking and to the management of the public finances, the confidence of our citizens and of investors has been restored, allowing interest rates to drop to their lowest levels in decades.

2. Although the achievements of the last two years have been considerable, over the next three years we aim to build on these and provide the basis for strong and sustained growth, low inflation, and employment generation. To this end, we have developed our own comprehensive program of economic reform. These policies are aimed at fulfilling our next and most ambitious challenge—securing convergence with the economies of the European Union:

- First, the strict control of public finances and debt reduction will continue to be the cornerstone of our economic strategy. Within a debt reduction framework that seeks to reduce the net public debt ratio by about 10 percent of GNP by the end of the program period, we will continue to aim at achieving a primary surplus of 6½ percent of GNP. This should help bring the overall budget position close to balance by the end of the program period. Continued tight fiscal policy will keep the current account deficit under control, and generate the resources needed for investment and growth. Importantly, it will also help ensure that interest rates continue to fall.
- Second, with macroeconomic stability successfully established, we can now focus on improving the quality of government spending and taxation to make our fiscal adjustment sustainable and easier to implement. To achieve this, we will embark on a wide-ranging structural reform agenda to redirect resources toward more growth-enhancing public investment. We will also introduce reforms that will broaden the tax base and reduce the size of the unregistered economy, to generate sustained improvements in revenue performance.
- Third, the government and the central bank are determined to safeguard the success in reducing inflation and indeed to bring it down to the low single digits during the program period. To achieve this, we remain committed to fiscal discipline and

preserving the independence of the Central Bank, in line with European Union standards, and to introducing formal inflation targeting by January 2006.

- Fourth, to maintain financial sector stability we will introduce a new Banking Law that further improves the supervisory and regulatory framework, restructure the state banks, and accelerate asset recovery.
- Fifth, we will introduce a comprehensive agenda of reform to enhance the investment climate, improve Turkey's medium-term growth prospects, and lower unemployment.
- Finally, we will continue to strengthen our international reserve position, as part of our strategy for increasing resilience to external shocks and exiting from the financial support of the Fund.

3. The attached Memorandum of Economic and Financial Policies (MEFP) presents the details of the reforms we will adopt in pursuit of these goals. To support this reform program, we request a new three-year stand-by arrangement with the Fund (May 2005–May 2008). Based on our balance of payments and financing framework, and our strengthened policies described below, we are requesting access in an amount equivalent to SDR 6,662.04 million, to be spread across 12 equally sized purchases (Annex A).

4. To smooth our debt service profile, we also request that the repurchase expectations falling due in 2006 be extended to an obligations basis. Moreover, should macroeconomic conditions prove significantly more favorable than envisaged in the macroeconomic framework underlying the request for this arrangement, we would forgo further purchases and treat any remaining access under the program as precautionary.

5. The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks. The phasing of purchases under the arrangement and the review schedule are set out in Annex A. Annex B summarizes the quantitative performance criteria and indicative targets, while Annex C lists the structural conditions and prior actions for approval of the arrangement.

6. We will enhance the transparent reporting of performance under the program described in the attached memorandum. We are committed to publishing key relevant data, all updates to the memorandum and associated Letters of Intent, as well as all staff reports for the request and reviews for this program. Accurate and timely data will be provided as required for the monitoring of the program described in the attached memorandum.

7. We believe that the policies set forth in the attached Memorandum of Economic and Financial Policies are adequate to achieve the objectives of our program, but we will take any further measures that may become appropriate for this purpose. We will consult with the

Fund on the adoption of these measures and in advance of revisions to policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

Very truly yours,

/s/

Ali Babacan

Minister of State for Economic Affairs

/s/

Süreyya Serdengeçti

Governor of the Central Bank of Turkey

Attachments

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES OF THE GOVERNMENT OF THE REPUBLIC OF TURKEY

April 26, 2005

1. **Since taking office in November 2002, our government's reform program has delivered a sustained improvement in economic performance.** Despite outside shocks, financial market confidence has strengthened. Interest rates have declined significantly and the lira has remained strong. The strength of the real economy has exceeded our projections, while, backed by prudent fiscal and monetary policies, inflation has fallen sharply to single digits. After rising significantly following the banking crisis of 2000–01, net public debt has been put on a steadily declining path, falling by some 30 percentage points to 63.5 percent of GNP at the end of 2004, which has helped address concerns over debt sustainability.

2. **Over the next three years we intend to build on this record of success and strengthen our convergence with the economies of the European Union.** To achieve these goals, we will: (i) secure further declines in government debt through continued primary surpluses, guided by a medium-term debt reduction strategy; (ii) reduce inflation to low single digits, through the introduction of formal inflation targeting, and maintaining the independence of the central bank; (iii) enhance the strength and preserve the stability of the financial system; (iv) introduce structural reforms that will put the social security system on a sound footing, reduce the size of the unregistered economy, lower unemployment, and improve the investment climate; and (v) strengthen our international reserve position to prepare for exit from Fund financial support (Annexes A–C). This memorandum outlines the reform agenda in detail.

A. Macroeconomic Framework

3. **Our macroeconomic program aims to place Turkey firmly on a path of robust growth, with a sustainable external current account and low inflation.** The recovery from the economic crisis has been very strong, with growth in 2004 exceeding program projections by a wide margin. The new economic reform program assumes that growth moderates to around 5 percent. With our tight fiscal policy, we expect growth to be led by increased investment and exports. This should lower the current account deficit to around 4½ percent of GNP in 2005 and then to 3 percent for the remainder of the program. This cooling of the economy will also help sustain our successful disinflation program, gradually reducing inflation rates further towards EU levels. The target is to reach 8 percent inflation in 2005 and to move to levels below 5 percent by the end of the program.

B. Monetary Policy

4. **The main objective of monetary policy over the course of the program will be to reduce inflation towards EU levels.** In just three years, inflation has fallen from 70 percent to less than 10 percent, well below our program targets. To reduce inflation further, we will maintain our prudent fiscal policies and protect the independence of the Central Bank of Turkey (CBT), both of which have been central to the success achieved so far. Given the recent success in reducing inflation, the strength of the Turkish lira, and the decline in inflation expectations, this year's 8 percent inflation target is clearly achievable. This will set the stage for further reductions during the new program period. In the initial stages of the transition to formal inflation targeting, we will retain the existing framework of base money targets, accompanied by indicative targets on net domestic assets (Annex D). These targets will continue to be kept under close review and modifications would be proposed if there is strong evidence of a shift in base money demand. To mark our success in disinflation and strengthened confidence in the Turkish lira, in January we introduced a new redenominated currency (dropping six zeros). The introduction of the new Turkish lira was extremely smooth, further enhancing policy credibility.

5. **The CBT has announced a detailed plan to move to formal inflation targeting by January 2006.** With inflation already in single digits, a declining public debt burden, and a strengthened financial system, we believe the right time is approaching to introduce formal inflation targeting. The first part of the plan concerns the timing of monetary policy decisions. In this respect, regular monthly meetings of the Monetary Policy Committee (MPC), which was formed in May 2001, are being held on preannounced dates of each month starting January 2005, with the MPC playing an advisory role initially. After each meeting, the CBT will explain its decision and publish a report summarizing the inflation outlook and the deliberations of the MPC. Monetary policy decisions will continue to be made according to the existing practice during the 12-month transition stage. During the year the CBT's views on the transmission mechanism will be explained and core inflation measures introduced. Marking the final stage in the transition to formal inflation targeting, the MPC will assume full responsibility for setting interest rates in early 2006 and a summary of MPC minutes will be released after each meeting. As for program conditionality, once the MPC assumes full responsibility for setting interest rates in early 2006, base money and net domestic asset targets will be replaced with an inflation consultation clause.

6. **Working within the floating exchange rate regime, the CBT plans to strengthen its net international reserves during the program** (Annex E). The CBT has restarted its daily foreign exchange purchase auctions with fixed daily minimum purchase amounts for the year 2005. Daily minimum purchase amounts have been fixed in advance at US\$15 million, with winning banks given the option to sell additional foreign exchange to the CBT at the average auction price. To provide greater predictability in the auction mechanism, these daily minimum amounts will remain unchanged throughout the year, although there will be provisions to allow temporary suspension of the auctions in extreme circumstances. As shown in our response to capital inflows in January and March this year,

the CBT will also retain the option of using strictly limited discretionary intervention, outside the auction mechanism, to help prevent excessive exchange rate volatility.

C. Fiscal Policy

Program objectives

7. **Our new program remains focused on debt reduction through high primary surpluses.** High primary surpluses have helped reduce public debt and lower interest rates, and sent a clear signal of our policy determination to financial markets. We will continue this successful strategy under the new program and reduce the net debt ratio by around 10 percentage points of GNP.

8. **Our new program will also improve the composition and quality of the budget to ensure sustainability of the adjustment and an enhanced impact on the economy.** We will broaden the tax base and improve tax administration, so as to reduce our reliance on high tax rates, distortionary tax instruments, and one-off measures. We will introduce social security and civil service reforms to enhance budget flexibility, and improve the efficiency of spending on health and education. Expenditure management and fiscal policy transparency will also be advanced further.

Fiscal performance in 2004

9. **Reflecting strong growth and buoyant revenues, fiscal performance in 2004 exceeded program targets.** Expenditures were kept in line with the budget, and tax collections were robust, particularly from the corporate income tax and the VAT. Outside of the central government, fiscal performance was also strong with a minor shortfall in the position of the social security institutions (SSIs) being more than offset by the higher primary surplus of the state economic enterprises (SEEs), despite higher international oil prices and grain purchases. In sum, the primary surplus for 2004 reached close to 7 percent of GNP. Both the 6½ percent of GNP target for the consolidated public sector, and the 5 percent target for the central government were exceeded.

10. **To address the current account deficit and strengthen the revenue base for 2005, we introduced a series of targeted measures in the fourth quarter of 2004.** These include adjustments in petroleum product and natural gas prices as well as higher excises on motor vehicles. For 2005, excise taxes and SEE prices will be kept in line with 2005 program assumptions (structural benchmark).

2005 Budget framework

11. **Our 2005 budget targets a primary surplus of 6½ percent of GNP for the consolidated public sector (5 percent for central government) (Annex F).** With interest rates declining steadily, we expect the overall public sector deficit to fall from over 6 percent of GNP in 2004 to about 4½ percent in 2005 (Annex F). The budget was approved by

parliament in December and includes a number of first steps toward improving the composition of revenues and expenditures:

- On the expenditure side, we are shifting resources toward outlays for public investment and scientific research. This not only underwrites critical progress on key infrastructure and social projects, but allow us to make greater use of bilateral and multilateral foreign financing. We will also contain social security expenditures by curbing the sharp growth of recent years in spending on pharmaceuticals and other medical supplies. Measures include lower procurement prices for drugs and medical services. To help ensure that the program's fiscal targets are met, the new program incorporates quarterly indicative targets on the combined balance of the three SSIs (Annex F).
- The budget lowers the corporate income tax rate as well as the top rate of the personal income tax. If revenues outperform projections in 2005, we will consider reducing financial intermediation taxes. This would encourage intermediation back into the domestic banking system at a modest revenue cost.

We stand ready to take additional revenue and expenditure measures, if needed, to achieve the 2005 fiscal targets, and we will continue to allow any revenue overperformance to be saved, in order to provide a cushion to help ensure that the 2005 budget targets are met, and to help contain pressures on the current account deficit.

Medium-term budgetary framework

12. **To facilitate debt and interest rate reduction we intend to retain our 6½ percent of GNP primary surplus target for the program period.** Within this envelope we seek to improve expenditure composition further in particular by rationalizing current expenditures, transfers to the SSIs, SEEs and other institutions, and subsidies. Tax policy changes will be consistent with the primary surplus target, while improved tax administration to capture Turkey's large informal economy offers prospects for revenue gains. Through these measures, we expect that the overall public sector deficit will be close to balance by 2007.

D. Structural Fiscal Reforms

13. **The new program will extend the success of our current program in implementing fiscal structural reforms.** Over the last two years we have made major improvements to budgetary transparency and the tax system, and we have initiated reforms in social security and tax administration. Continued implementation of these reforms is essential to place Turkey's public finances on a fully sustainable path and bring its fiscal institutions more into line with those in the EU.

14. **A key element in our efforts to entrench a lasting improvement of public finances is comprehensive social security reform, supplemented by short-term safeguards.** Without reform, the additional costs associated with demographic trends and

technological advances in medicine would make it very difficult to maintain prudent fiscal policies, especially in the longer run. Following an extensive consultative process, we have prepared a package of three reform laws. A draft pension and health reform law introduces parametric changes while harmonizing the pension formula across occupational groups, and establishes universal health insurance with the additional costs largely offset through measures under the health transformation program. The reform also reorganizes the fragmented system into one unified pension fund and one unified health fund. Legislation on social aid consolidates a multitude of existing programs. Finally, an administrative reform law unifies the governance structure of pensions, health and social assistance programs. With the focus of social security reform on long-run savings, we are guarding against near-term pressures by capping the overall balance (before transfers) of the three social security institutions (SSK, Bağ-Kur, and Emekli Sandığı) at 4.5 percent of GNP, the same ratio as in 2004, for the program period (indicative target).

15. The pension reform aims to reduce the pension deficit to less than 1 percent of GNP over the long term. Savings will come from a unified pension formula that bases all pensions on life-time earnings, modification of key pension parameters, a broadening of the contribution base, and adjustments of the statutory retirement age to lengthening life expectancy. Annual savings will build gradually over time and are expected to reach around 1 percent of GNP in ten years' time. The draft pension reform law has been submitted to Parliament (prior action). Parliamentary passage of the pension reform law is expected by end-June, a structural performance criterion under the program. The passage of the administrative reform law is also expected by end-June 2005 (structural benchmark).

16. We intend to begin implementing universal health insurance starting from 2006. Although there will be initial transition costs, sectoral reforms connected with universal coverage, including hospital restructuring and a refocusing on primary care, aim at reducing costs over the medium term below the pre-reform baseline trend. The measures we are taking in 2005 to reduce the growth of pharmaceutical spending will be a critical start to our efforts to defray the additional costs of universal coverage and, more generally, reduce the growth of health spending. In light of the potential additional burden of health care reforms on the budget, we stand ready to take compensatory fiscal measures, as needed. After the passage of the health reform law, we will develop a quantitative framework (benchmark for end-September, 2005) for monitoring health expenditures and assessing medium-term trends to ensure that health outlays are kept under control and in line with the baseline projected after the implementation of the reforms.

17. We are introducing other expenditure policy reforms to reduce the rigidity of budget spending and improve the quality of public services. This year we started work with the World Bank on a full public expenditure review (PER), to elaborate medium-term spending priorities. The PER will target efficiency gains in public employment, health, education, agriculture, and investment. Our personnel outlays absorb a much larger share of primary expenditure than in EU countries. Moreover, our public employment policies have overly complex compensation schemes, wage compression, and contracts that impede

medium-term planning. To address these problems, a comprehensive review of civil and public service wage and employment structures has been initiated, and will be completed by end-year (structural benchmark). We will also continue our policy of strictly limiting new hiring in SEEs. At most, 10 percent of those leaving through attrition will be replaced at each state enterprise, with limited exceptions for specialist positions and overperforming enterprises (structural benchmark).

18. Further tax reforms are key to improving efficiency, reducing incentives to remain in the informal economy, and offsetting the expected structural decline in revenues, as interest rates and revenues from financial intermediation taxes decline:

- By September 2005, we will submit to Parliament legislation to reform the **personal income tax** (PIT), with an aim to improving coverage and compliance, and enhancing revenues (structural benchmark). In particular, we intend to broaden the PIT base, combine the wage and non-wage schedules, reduce the number of brackets, and streamline the system of expenditure credits to ease the compliance burden for taxpayers and the revenue administration.
- We have introduced **VAT** coverage at reduced rates in 2005 for private health care and education services and a narrow range of food items, in line with EU directives. Beyond this, we do not intend to change the VAT rates or coverage during the program period.
- We will review the **corporate income tax** regime by September 2005, with a view to simplification, greater efficiency and base broadening. Our aim is to bring the CIT more in line with practices in the EU.
- **Financial intermediation taxes** will be phased out during the program period. We intend to eliminate the BITT by 2006 and, conditions permitting, eliminate the RUSF during the program period.
- Finally, to reduce distortions and harmonize tax treatment across financial instruments, starting from 2006 we will introduce a unified tax rate on individuals' earnings from government and other securities, bank deposits, and other financial assets.

19. Legislation to restructure and strengthen Turkey's tax administration has been approved by parliament, a prior action under the program. The legislation establishes the Revenue Administration (RA) under the Ministry of Finance as a semi-autonomous entity, structured along functional lines and with local tax offices directly under its control. Responsibility for tax policy will be retained by the Ministry of Finance, allowing the new RA to focus on tax administration. Additionally, RA is setting up a large taxpayers unit by end-2005 (structural benchmark) and is expected to take increasing responsibility for collecting social security contributions in 2006. We will also continue to examine the scope for improving tax audit activities. Over the medium-term we will increase the number of

auditors from 5 percent of GDR staff to the international standard of 20 percent or more. As in the previous program, we will continue to refrain from introducing **amnesties for public sector receivables** (continuous structural performance criterion).

20. **The Public Financial Management and Control Law (PFMCL) will come fully into force by 2006 and provide a framework for further improvements in expenditure management.** Two areas where implementation will be critical are medium-term and performance-based budgeting and improved financial accountability at the municipal and provincial level. Secondary legislation will be in place by end-September, 2005 (structural benchmark). To help identify key issues in these areas, as well as in audit and control, budget preparation and execution, debt and cash management, and Treasury operations and coverage, we have requested the Fund staff to prepare an updated Report on the Observance of Standards and Codes in the area of fiscal policy transparency.

21. **The government remains committed to seeking a greater degree of decentralization, within a legislative framework that promotes enhanced transparency and strict budgetary discipline.** We will submit to parliament draft legislation that will ensure that new spending mandates of the local administrations are adequately matched by local tax instruments and revenue capabilities and supported by a stable and transparent system for revenue sharing. New laws on local administrations will put in place strict borrowing and debt limits for special provincial administrations and municipalities. The debt stock of municipalities and special provincial administrations will be limited to no more than annual revenue, while the debt stock of metropolitan municipalities will be limited to 1.5 times annual revenue. New borrowing by all local administrations in excess of 10 percent of annual revenues will require central government authorization. These limits will be closely monitored during the program period and will be tightened if necessary. We will complete and publish by end-September 2005 a comprehensive report on the debt level of municipalities and metropolitan municipalities, including enterprises under their control. Arrears of municipalities and metropolitan municipalities will continue to be dealt with on a case-by-case basis, with formal settlements to be made public and guided by ability to pay. Adequate safeguards will ensure repayment through claw back of central government transfers.

22. **New legislation strengthening state enterprise governance will further improve fiscal transparency.** The governance legislation will cover performance targets, accountability and disclosure requirements, budgeting and planning arrangements, procurement requirements and provisions for external audits. The legislation is expected to be submitted to parliament by the end of September 2005 (structural benchmark).

E. Debt Management

23. **Our debt management strategy will further reduce the vulnerability of public debt (Annexes H and I).** We plan to lower the public debt stock's roll-over risk by further lengthening the maturity of new domestic debt issues and by increasing the Treasury's cash position. In October 2004, we launched successfully a lira-denominated fixed-coupon

government bond with a maturity of three years, which is significantly longer than previous issues of this type. We followed this by issuing a five year bond in February this year. We plan similar issuances in the future as market conditions permit in order to extend the yield curve for local currency denominated government bonds and create a more liquid market for these instruments. This will not only facilitate debt management but also help foster the development of the domestic capital market, thereby enabling financial intermediaries to better manage their interest rate and liquidity exposure. Finally, we will continue our efforts to broaden the investor base for government paper, exploring avenues to raise the demand among pension and insurance funds, corporations, retail investors and foreign investors.

24. **We will also improve our contacts with markets, by strengthening our Investor Relations office in Treasury.** Such an upgraded office (supported by a dedicated website) helps enhance our dialogue and information exchange with market participants, contributing to the stability of foreign financing flows. In addition to general information on the government's macroeconomic position, its objectives and policies (legal framework, etc.), this office will make available updated forecasts, insight on financing plans, and other forthcoming events that are of particular interest to investors in the country's debt and equity instruments.

F. Financial Sector Reform

25. **Reforms in recent years have brought the banking regulatory framework closer to international standards.** State banks have been recapitalized and restructured, and private banks have been restored to profitability. The new program will build on these reforms by addressing the remaining vulnerabilities in the legal and supervisory regime; accelerating asset resolution; and further restructuring state banks and preparing them for eventual privatization. As input to our reform plans, we are requesting the Fund and the World Bank to initiate a Financial Sector Assessment Program in early 2006.

26. **We have submitted a new Banking Law, with the elements outlined below, to parliament (prior action), and passage is expected by end-June (structural performance criterion).** The draft law will bring the legal framework more closely in line with EU standards. Notably, the new law will enhance banking supervision and regulation in the following areas: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections (by allowing the BRSA to engage off-site supervisory personnel and bring in other experts in this process); (iii) lending to related parties (by establishing prudential safeguards such as non-preferential terms and special approval requirements); (iv) legal protection for BRSA and SDIF board members and staff for actions taken in good faith during the course of their duties; (v) delineating better the responsibilities of BRSA and SDIF and providing for their effective coordination; and (vi) granting SDIF the power to determine deposit insurance premiums in coordination with the BRSA, the CBT, and the Treasury. We are committed to maintaining the operational and financial independence of the BRSA and the SDIF in the new Banking Law and other relevant legislation. Implementing regulations will be completed by end-June 2006 (structural benchmark).

27. **We will further strengthen BRSA's supervision, bringing it closer to best international practices.** By end-September 2005, taking into account the findings of the Imar inquiry, the BRSA will publish a list of actions it will take to strengthen its organizational structure, coordinate onsite and offsite supervision, and improve the effectiveness of its staff, together with a timetable for their implementation (structural benchmark).

28. **We are planning to consolidate further the supervision of our financial markets.** Regulation and supervision of non-bank financial institutions will be transferred from the Treasury to the BRSA as soon as the new Banking Law has been passed. We will also set up a committee to assess whether integrated financial sector supervision in Turkey is warranted. The committee is expected to present its findings by end-March 2006 (structural benchmark).

29. **We are determined to bring state bank restructuring and privatization to a decisive stage over the next three years.** While substantial progress has been made in restructuring and rationalizing the state banks, their privatization has proved difficult because of their large government bond holdings and their extensive rural branch network. Bank specific strategies are being prepared and will be adopted by both the government and the boards of the state banks by end-June 2005 (structural benchmark). In this context, the government is determined to also level the playing field in the banking system to ensure efficiency and competitiveness. As part of this effort, we will adopt a timetable for phasing out special privileges and obligations of the state banks by end-June 2005 (structural benchmark).

30. **A number of intermediary steps have been taken and further actions are planned in preparation for adoption of bank specific strategies:**

- The integration of **Pamukbank** into **Halkbank** was completed on November 17, 2004.
- Effective April 12, both **Ziraat** and **Halkbank** have separate boards of directors in which a majority of the members are non-executive directors (prior action). The banks are drawing up plans for restructuring their balance sheets, including assessing the feasibility of reducing their holdings of government bonds. The timetable for implementation will be included in the strategic plans. Until the strategic plans have been adopted, these banks will not increase the size of their balance sheets and will be cautious in their lending operations.
- Our aim is to ensure that the managements of **Ziraat** and **Halkbank** have the necessary expertise, and are given the mandate and held accountable for implementation of restructuring and privatization plans.
- With regard to **Vakifbank**, on April 1, 2005 the bank's General Assembly adopted a plan for its restructuring and for increasing private participation in the bank. By end-

2005, the first IPO of Vakifbank will be launched (structural benchmark) to enhance private ownership in the bank and increase the capital base.

31. **We will accelerate the resolution of bad assets in banks previously taken over by the SDIF.** To this end, the SDIF has prepared and published a sales strategy whereby the bulk of asset recoveries will be completed before end-2007 and the government is removing legal obstacles that complicate the sale of certain assets. Publication of the strategy fulfills a prior action for the program. The SDIF estimates that it will be able to recover about US\$6.2 billion. It expects to complete about 90 percent of the recoveries (US\$5.5 billion) before end-2007. The strategy has the following key components:

- Protocols have already been signed with 11 former owners of failed banks on how they will settle their debts to SDIF. SDIF will immediately exercise remedies upon default.
- All cases of recalcitrant owners of failed banks will be turned over to prosecutors in 2005.
- Encouraged by the successful completion of its first loan auction, SDIF will auction off all remaining non-related party loans by end-2005 (structural benchmark). Such loans have a face value of about US\$1 billion in total. SDIF has announced the details of its auction plans.
- The SDIF will dispose holdings of shares in companies and other assets taken over through competitive bidding of the assets by end-2007. The strategy will include a plan for operational restructuring of SDIF as assets are sold. The resolution of Bayindirbank will be concluded by end-2007.
- The Treasury will by end-September 2005 resolve its receivables from the SDIF that arise from the earlier costs of restructuring the banking system.

G. Enhancing the Investment Climate

32. **To further improve medium-term growth and employment prospects, we are taking a range of measures aimed at improving the investment climate and expanding foreign direct investment.** In this regard, we will continue to build on the recommendations from the Investment Advisory Council, focusing on accelerating privatization, streamlining administrative procedures, improving the efficiency of the judicial system and adopting EU standards and regulations. Various legislative changes have been made in key areas with a view to raising the efficiency and transparency of government services and rationalizing the application and processing procedures for necessary permits and approvals.

- A key achievement has been to reduce the time required to register a company to less than one week, and in many cases less than a day—well below the OECD average. We

have also eliminated minimum capital requirements and drastically shortened the time needed to obtain environmental impact assessments from 6–7 months to 33 days.

- A regulation streamlining procedures for obtaining an operating license from the Ministry of Labor and Social Security has been drafted, which will reduce the number of required documents from 18 to 3, and set a maximum approval period of 30 days.
- We have prepared legislation for the creation of a “one-stop-shop” system for obtaining business permits. The new system will make procedures for start-up permits easier by enabling investors to apply through a single agency. The legislation would also eliminate duplication of documents and make more transparent the approval periods for various permits.
- We are preparing a new Commercial Code that will further align Turkey’s corporate law with the EU directives.
- To reduce transaction costs for traders, customs controls and import procedures have been simplified, and the processing of customs declarations is increasingly automated. As of mid-2004, 96 percent of export and 77 percent of import declarations were processed within 24 hours.

33. **Following the good progress realized in 2004, we intend to further advance our privatization program.** A good start was made during 2004, with the privatization of over 30 companies, including a block sale of TEKEL’s Alcoholic Beverages Unit and a 23 percent public offering of TURKISH AIRLINES. Looking ahead, our aim is to bring several of the larger state enterprises to the point of sale as soon as feasible, and we have set ambitious, but realistic, targets for privatization receipts under the program (indicative targets). In particular:

- The privatization process for the sale of 55 percent of TURK TELEKOM was initiated on November 25, 2004 and 13 bidders were pre-qualified during January 2005. The bidding deadline for the transaction is May 31, 2005. The privatization of TURK TELEKOM marks a milestone in our privatization program, and will contribute to further enhancing competition in the telecommunications sector, lowering costs for businesses and consumers alike.
- In March 2005, about 15 percent of TUPRAS shares were sold to investment funds through the Istanbul Stock Exchange, raising US\$ 440 million dollars. We plan to sell the remaining 51 percent of shares in a block sale during 2005.
- A public offering process for 34.5 percent of PETKIM shares was completed in mid-April, raising US\$288 million.
- We envisage 46 percent of ERDEMIR shares to be privatized via block sale during 2005.

- Finally, we will continue to privatize some of the smaller state-owned enterprises and the associated real estate assets. For the year as a whole, we are confident that we can comfortably surpass the level of privatization revenues achieved in 2004.

Turkey : Proposed Schedule of Purchases

Review 1/ 2005	Purchase		Test Dates Quantitative PCs	Earliest Possible Purchase Date
	(SDR millions)	Percent of Quota		
Approval	555.17	57.59		
2005				
1 st Review	555.17	57.59	May 31, 2005 2/	June 15, 2005
2 nd Review	555.17	57.59	June 30, 2005	Sep. 1, 2005
3 rd Review	555.17	57.59	Sep. 30, 2005	Dec. 1, 2005
2006				
4 th Review	555.17	57.59	Dec. 31, 2005	Mar. 1, 2006
5 th Review	555.17	57.59	Mar. 31, 2006	June 1, 2006
6 th Review	555.17	57.59	June 30, 2006	Sep. 1, 2006
7 th Review	555.17	57.59	Sep. 30, 2006	Dec. 1, 2006
2007				
8 th Review	555.17	57.59	Dec. 31, 2006	Mar. 1, 2007
9 th Review	555.17	57.59	Apr. 30, 2007	July 1, 2007
10 th Review	555.17	57.59	Aug. 30, 2007	Dec. 1, 2007
2008				
11 th Review	555.17	57.59	Dec. 31, 2007	Mar. 1, 2008
Total	6662.04	691.09		

1/ The frequency of reviews after the first year of the arrangement will be reassessed at the end of 2005.

2/ Fiscal PCs will be for end-April 2005.

Turkey: Quantitative Performance Criteria and Indicative Targets for 2004-05

	Target Under Old Arrangement	Outcome (Preliminary)	Ceiling / Floor May 31, 2005 2/	Ceiling / Floor June 30, 2005	Ceiling / Floor Sep. 30, 2005	Ceiling / Floor Dec. 31, 2005
	Dec. 31, 2004					
I. Quantitative performance criteria 1/ (In trillions of TL for 2004 and millions of YTL for 2005, unless otherwise stated)						
1. Floor on the cumulative primary balance of the consolidated government sector	26,200	27,723	8,720	15,730	25,995	30,460
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector	22,900	23,803	8,020	14,130	23,295	26,660
3. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US\$)	17,500	8,928	7,000	10,000	13,000	16,000
4. 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	1,000	1,000	1,000
5. Floor on level of net international reserves of CBT and Treasury combined (in billions of US\$)	-2.00	0.23 3/	2.00	2.00	2.75	3.80
6. Ceiling on base money (in quadrillions of TL for 2004 and billions of YTL for 2005)	20.9	20.2	23.6	23.6	24.7	25.0
II. Indicative targets						
1. Floor on the cumulative overall balance of the consolidated government sector	-35,440	-22,593	-8,180	-8,770	-10,205	-19,590
2. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in quadrillions of TL for 2004 and billions of YTL for 2005)	35.0	31.2 3/	37.7	37.7	37.8	36.4
3. Privatization proceeds (in millions of US\$)	3,000	1,282	...	300	1,250	1,500
4. Number of employees hired at non-financial state enterprises	4,000	1,612	...	...	...	...
5. Ceiling on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES)	-19,185	-19,123	-7,200	-10,500	-16,500	-21,500

1/ Cumulative targets are set from January 1, 2005. The targets through September 30, 2005 are performance criteria; the remaining targets are indicative.

2/ End-April for floor on the cumulative primary balance of the consolidated government sector and for floor on the cumulative primary balance of the consolidated government excluding SEEs, and for fiscal indicative targets (1 and 5).

3/ Outturns at new, end-September 2004 program exchange rates are US\$1.29 billion for net international reserves, and TL35.5 quadrillion for net domestic assets.

Turkey: Structural Conditionality 2005 1/

Action	Timing
Prior Actions	
1. Parliamentary submission of Banking Law. (¶26)	Done.
2. Separation of board in Ziraat and Halk. (¶30)	Done.
3. Publication of SDIF's strategy to complete bulk of asset recoveries by end-2007. (¶31)	Done.
4. Parliamentary submission of pension reform legislation. (¶15)	Done.
5. Parliamentary approval of tax administration legislation. (¶19)	Done.
Fiscal Measures	
6. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19)	Continuous PC.
7. 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)	BM.
8. Maintain excise taxes and SEE prices in line with 2005 program assumptions. (¶10)	BM. End-June 2005.
9. Parliamentary approval of pension reform legislation. (¶15)	PC. End-June 2005.
10. Parliamentary approval of the administrative social security reform law. (¶14)	BM. End-June 2005.
11. Put in place secondary legislation required under the Public Financial Management and Control Law. (¶20)	BM. End-September 2005.
12. Parliamentary submission of legislation strengthening state enterprise governance. (¶22)	BM. End-September 2005.
13. Develop a quantitative framework for monitoring health expenditure and assessing medium-term trends. (¶16)	BM. End-September 2005.
14. Prepare legislation to reform the personal income tax. (¶18)	BM. End-September 2005.
15. Establish a large-taxpayers unit within the Revenue Administration. (¶19)	BM. End-December 2005.
16. Complete comprehensive review of civil service wage and employment structure. (¶17)	BM. End-December 2005.
Financial Sector Measures	
17. Parliamentary approval of Banking Law. (¶26)	PC. End-June 2005.
18. Adoption of state bank specific strategies by both the government and the boards of the state banks. (¶29)	BM. End-June 2005.
19. Adopt a timetable for the phasing out of special privileges and obligations of the state banks. (¶29)	BM. End-June 2005.
20. Publication by BRSA of its planned reforms taking into account the findings of the Imar inquiry. (¶27)	BM. End-September 2005.
21. SDIF to sell all remaining non-related party loans by auction. (¶31)	BM. End-December 2005.
22. Launch of first IPO for Vakifbank. (¶30)	BM. End-December 2005.
23. Set up a committee to assess whether integrated financial sector supervision is warranted, with findings to be presented by end-March 2006. (¶28)	BM. End-March 2006.
24. Completion of implementing regulations for the Banking Law. (¶26)	BM. End-June 2006.

1/ PA=prior action, PC=structural performance criterion, BM= structural benchmark. Paragraph numbers refer to the Memorandum of Economic and Financial Policies.

MONETARY TARGETS

Table 1. Turkey: Performance Criteria and Indicative Targets for Base Money of the Central Bank of Turkey 1/

(In quadrillions of TL for 2004 and billions of YTL for 2005)

	Ceilings	Actual
Outstanding base money as of December 31, 2004		20.2 2/
May 31, 2005 (performance criterion)	23.6	
June 30, 2005 (performance criterion)	23.6	
September 30, 2005 (performance criterion)	24.7	
December 31, 2005 (indicative target)	25.0	

1/ These ceilings are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

2/ Base money outturn at December 31, 2004.

1. This Annex sets out performance criteria for base money, and indicative targets for net domestic assets of the Central Bank of Turkey (CBT) and Treasury combined.
2. Base money is defined as currency issued by the CBT, plus the banking sector's deposits in Turkish lira with the CBT. The net domestic assets (NDA) of the CBT are defined as base money less net foreign assets of the CBT. The net domestic assets of the CBT and Treasury combined are defined as net domestic assets of the CBT plus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.
3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex E), medium- and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange). As of December 31, 2004, net foreign assets of the CBT amounted to TL11.03 quadrillion, net domestic assets of the CBT TL9.16 quadrillion, and base money TL20.19 quadrillion.
4. Net domestic assets of the Treasury are equal to Treasury liabilities to the International Monetary Fund and Treasury foreign exchange denominated borrowing with an original maturity of less than one year. As of December 31, 2004, these amounted to US\$17.59 billion, or TL26.34 quadrillion (evaluated at program exchange rates).
5. All assets and liabilities denominated in foreign currencies will be converted into Turkish lira at program exchange rates (Annex J).

6. NDA ceilings will be adjusted for any change in the definition of the aggregate to which the reserve requirement applies according to the following formula:

$$\Delta NDA = R * \Delta B,$$

where: R denotes the 6 percent reserve requirement and ΔB denotes the change in base generated by a change in the definition of the reserve aggregate, or due to any change in the averaging period. Base money ceilings will also be adjusted to reflect these changes.

7. NDA ceilings will be adjusted for any change in the reserve requirement coefficient according to the following formula:

$$\Delta NDA = B * \Delta R$$

where: B is the level of the base to which the reserve requirement applies on the test date and ΔR is the change in the reserve requirement coefficient and the liquidity requirement coefficient. Base money ceilings will also be adjusted to reflect these changes.

8. The NDA and base money ceilings will be adjusted downward for any waiver of reserve requirements for any additional bank intervened by the BRSA. The adjustment will be equal to the existing reserve requirement coefficient times the amount of liabilities at these banks subject to reserve requirements.

Table 2. Turkey: Indicative Targets on the Net Domestic Assets
of the Central Bank of Turkey and Treasury Combined 1/

(In quadrillions of TL for 2004 and billions of YTL for 2005)

	Ceilings	Actual
Outstanding NDA as of December 31, 2004:		35.5
May 31, 2005	37.7	
June 30, 2005	37.7	
September 30, 2005	37.8	
December 31, 2005	36.4	

1/ These targets are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

TARGETS FOR NET INTERNATIONAL RESERVES

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

(In billions of U.S. dollars)

	Floor on level of NIR	Actual	Memo item: NIR of the CBT
Outstanding stock as of December 31, 2004:		1.29	18.87
May 31, 2005 (performance criterion)	2.00		...
June 30, 2005 (performance criterion)	2.00		...
September 30, 2005 (performance criterion)	2.75		...
December 31, 2005 (indicative target)	3.80		...

1/ The end-December NIR outcome (US\$1,293 million) corresponds to a level of US\$229 million when measured using program exchange rates under the previous arrangement.

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\$0.33 billion on December 31, 2004). Reserve assets as of December 31, 2004 amounted to US\$35.08 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 31, 2004 reserve liabilities thus defined amounted to US\$16.20 billion (evaluated at program exchange rates).

6. 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 31, 2004 these amounts were zero.
7. As of December 31, 2004 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\$17.59 billion.
8. 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).

FISCAL TARGETS

A. Primary Balance of the Consolidated Government Sector

Table 1. Turkey: Performance Criteria and Indicative Targets 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, 2005, to:	
April 30, 2005 (performance criterion)	8,720
June 30, 2005 (performance criterion)	15,730
September 30, 2005 (performance criterion)	25,995
December 31, 2005 (indicative target)	30,460
Cumulative primary balance (excluding SEEs) from January 1, 2005, to:	
April 30, 2005 (performance criterion)	8,020
June 30, 2005 (performance criterion)	14,130
September 30, 2005 (performance criterion)	23,295
December 31, 2005 (indicative target)	26,660

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the 3 extra budgetary funds (EBFs) identified below, the 26 state economic enterprises (SEEs) identified below, the social security institutions (SSIs), and the unemployment insurance fund. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

- For the central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported transfers to social security institutions are reconciled with cash transfers reported by the social security institutions.
- 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.
- For the SSIs, and the unemployment insurance fund from above the line on a cash basis;
- For the SEEs, from below the line as described in paragraph 6.

2. For the purposes of the program, the primary revenues will exclude interest receipts of the consolidated central government (including on tax arrears), SEEs, and of the unemployment insurance fund, 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 state bank dividend payments. Revenues of the CGS from sales of immovables below YTL500 million will be included. 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.

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 26 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), Türk Telekom (telecommunications), 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, THY, TÜPRAŞ, TİGEM, KIYEM, TDİ, TÜGSAŞ, 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, 2004 the stock of net banking claims on SEEs as defined above stood at TL499 trillion, 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, 2004 the stock of external loans stood at TL8,207 trillion, 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 are SSK, Bağ-Kur, and Emekli Sandığı. The deficits of the SSIs 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 Bag Kur they exclude the arrears to the common retirement fund. The stock of arrears for Bag Kur stood at TL104 trillion; for SSK stood at TL54 trillion; and for ES stood at TL0 trillion on December 31, 2004. 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:

- 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;
- For any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).
- For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 100 million.

13. The floor on the primary surplus of the CGS will be adjusted upwards (downwards) 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, 2004.

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 the primary surplus of the CGS excluding SEEs.

B. 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, 2005 to:	
April 30, 2005	-8,180
June 30, 2005	-8,770
September 30, 2005	-10,205
December 31, 2005	-19,590

15. 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, the UIF, and the SEEs, (iii) the interest payments of SSIs and EBFs, (iv) transfers of profits from the CBT and net special revenues of the Turkish Mint to the consolidated central government, and (v) state bank dividends payments, expenditures under the risk account (net lending) and carry over at current expenditures.

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

17. 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, 2004.

C. Overall Balance (before transfers) of the Social Security Institutions

Table 1. Turkey: Indicative Floor on the Cumulative Overall
Balance (before transfers) of the Social Security Institutions

	Floor (In millions of YTL)
Cumulative overall balance (before transfers) from January 1, 2005 to:	
April 30, 2005	-7,200
June 30, 2005	-10,500
September 30, 2005	-16,500
December 31, 2005	-21,500

18. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı.

D. Amnesties and Public Sector Receivables

19. 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.

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, 2005 to:		
April 30, 2005	270	360
June 30, 2005	450	600
September 30, 2005	580	800
December 31, 2005	770	1,100

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.

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\$)
May 31, 2005 (performance criterion)	1,000
June 30, 2005 (performance criterion)	1,000
September 30, 2005 (performance criterion)	1,000
December 31, 2005 (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).

MEDIUM- AND LONG-TERM 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	
May 31, 2005 (performance criterion)	7,000
June 30, 2005 (performance criterion)	10,000
September 30, 2005 (performance criterion)	13,000
December 31, 2005 (indicative target)	16,000

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. 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. 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.

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.

INTERNATIONAL MONETARY FUND

Turkey—Assessment of the Risks to the Fund and the Fund’s Liquidity Position

Prepared by the Finance and Policy Development and Review Departments

In consultation with other Departments

Approved by Michael G. Kuhn and Liam P. Ebrill

April 28, 2005

1. In accordance with the policy on exceptional access, this note assesses the risks to the Fund and the effect on the Fund’s liquidity position arising from the proposed new Stand-By Arrangement (SBA) for Turkey, also taking into account the requested extension of repurchase expectations.¹ The authorities are requesting a three-year SBA with access of about SDR 6.7 billion (equivalent to US\$10 billion or about 691 percent of quota) to follow the three-year SBA that expired in February 2005. The new SBA would run from May 2005 to May 2008. The arrangement would be phased with 12 equally-sized purchases of SDR 555 million (58 percent of quota): an initial purchase would be available upon approval and 11 subsequent purchases would be linked to approximately quarterly reviews.² The authorities have also requested an extension of the repurchase expectations arising in 2006 amounting to SDR 2.5 billion (US\$3.8 billion) to an obligations basis. The paper discusses the impact on Fund finances of the proposed new arrangement against the backdrop of Turkey’s large use of Fund credit and the objective of securing Turkey’s successful exit from Fund support.

Background

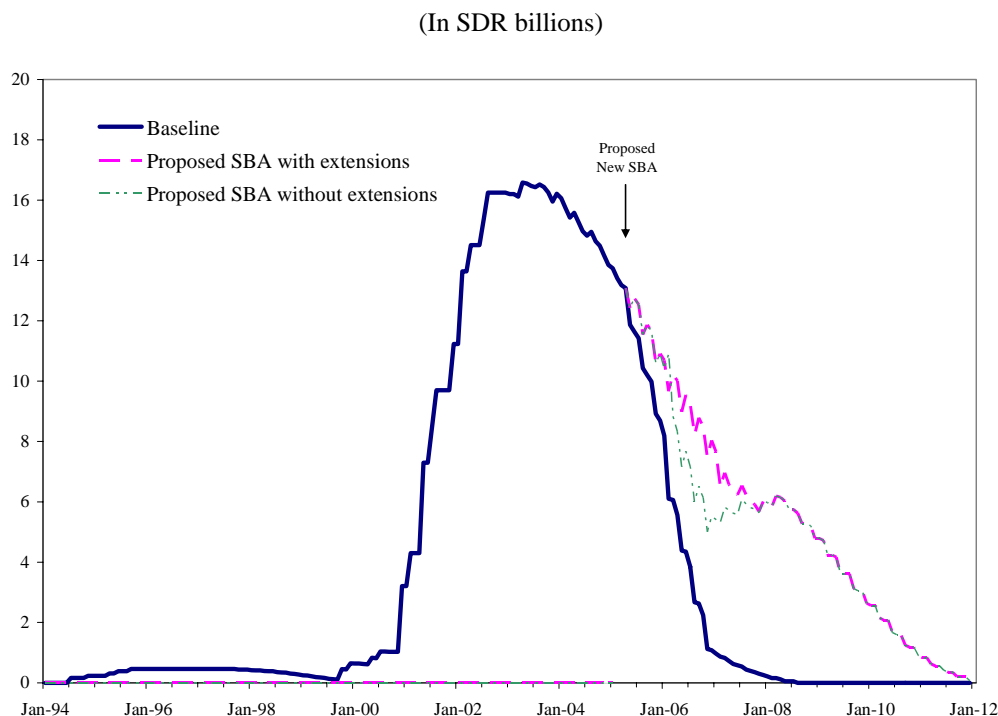
2. **Turkey has had a long and extensive financial relationship with the Fund; recent large-scale use of Fund resources began in 1999 and in particular with the arrangements and augmentations approved in 2000–02** (Table 1 and Figure 1). Turkey has been among the five largest users of Fund credit from 1980 to 1984; and again from 2000

¹See *The Acting Chair’s Summing Up of the Review of Access Policy under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy*, issued on 3/5/03.

²*Turkey—Requests for Stand-By Arrangement and Extension of Repurchase Expectations*, issued on 4/27/05.

to date.³ The profile of recent Fund exposure to Turkey is similar to that of most Fund members facing capital account crises and where access was exceptional: Fund credit rose steeply from low levels to a substantial multiple of the member's quota (Figure 2). A three-year SBA with access of SDR 2.9 billion (300 percent of quota) was approved in 1999 in support of Turkey's disinflation and fiscal adjustment program. In December 2000, after a liquidity and currency crisis, the SBA was augmented by SDR 5.8 billion under the Supplemental Reserve Facility (SRF). In May 2001, following a worsening of the currency crisis, the SBA was augmented again by SDR 6.4 billion, but this time using credit tranche resources, effectively replacing the SRF credit. In February 2002, the SBA was replaced with a new three-year SBA with access of SDR 12.8 billion (see Table 1).⁴ As of end-March 2005, Fund exposure to Turkey was SDR 13.2 billion, or 1,368 percent of quota, and 26 percent of total Fund credit outstanding.⁵ A key issue going forward is the pace at which that exposure can be reduced.

Figure 1. Turkey: Fund Credit Outstanding, 1994–2011



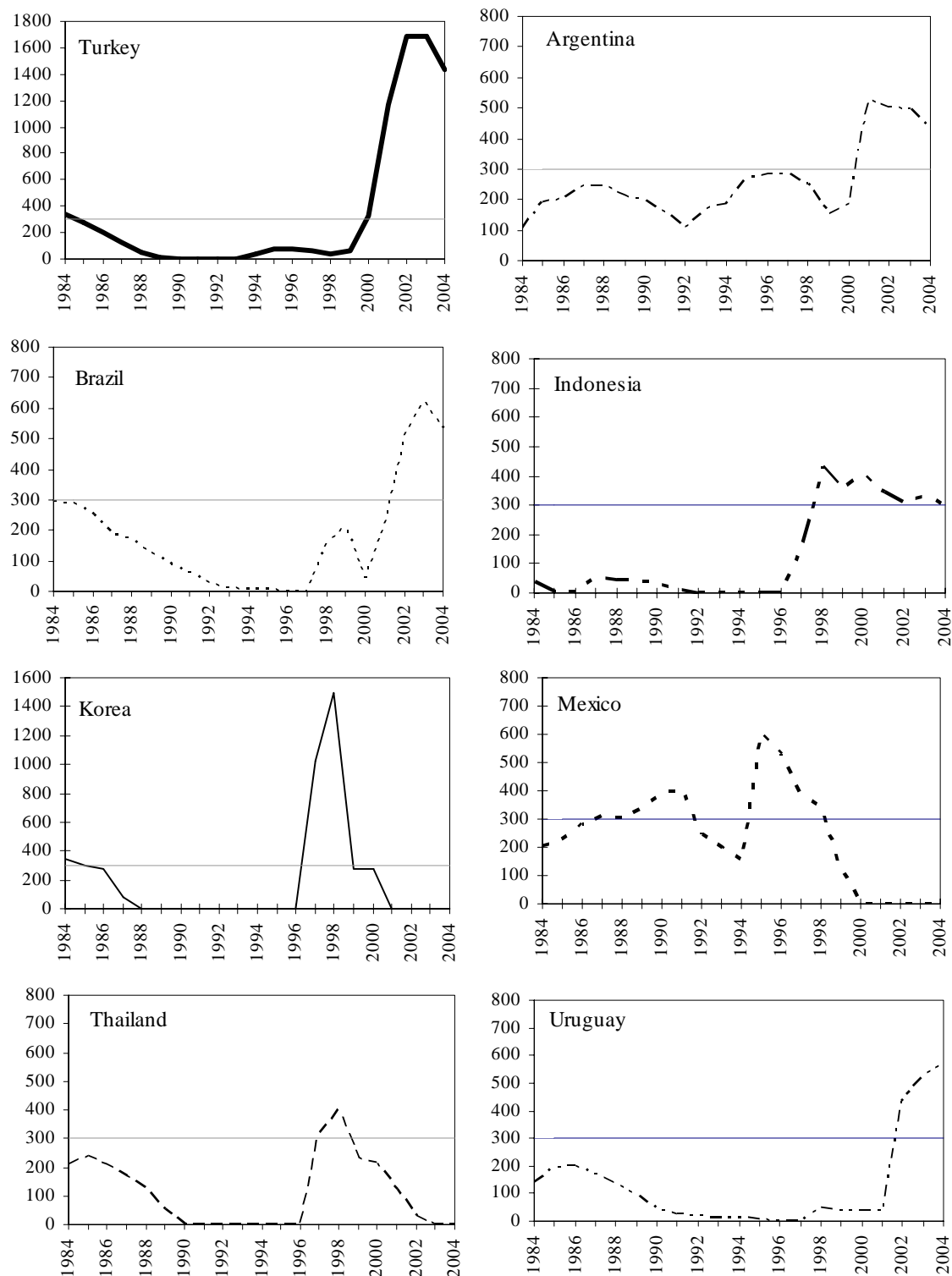
³Turkey had several SBAs before 1999, including one with access of about SDR 1.3 billion (625 percent of quota).

⁴Outstanding amounts under the SRF were repaid in February 2002.

⁵Fund credit outstanding refers to the General Resources Account only.

Figure 2. Fund Credit Outstanding in Exceptional Access Cases, 1984–2004

(In percent of quota)



Source: International Financial Statistics.

Table 1. Turkey: Approved Arrangements, Purchases and Repurchases, 1984–2008

(In millions of SDRs)

Year	Type of New Arrangement	Date of Approval	Date of Expiration or Cancellation	Amount of New Arrangement	Purchases	Repurchases	Fund Exposure
1984	SBA	4-Apr-84	3-Apr-85	225.0	169	160	1,455
1985 1/					0	248	1,208
1986					0	320	887
1987					0	344	543
1988					0	321	222
1989					0	186	36
1990					0	36	0
1991					0	0	0
1992					0	0	0
1993					0	0	0
1994	SBA	8-Jul-94	7-Mar-96	509.3	236	0	236
1995	SBA Augmentation	25-Apr-95	7-Mar-96	101.2	225	0	461
1996 2/					0	0	461
1997					0	20	440
1998					0	165	276
1999	SBA	22-Dec-99	4-Feb-02	2,892.0	583	210	649
2000	SRF Augmentation	21-Dec-00	20-Dec-01	5,784.0	2,622	66	3,205
2001	SBA Augmentation	15-May-01	21-Dec-02	6,362.4	8,895	868	11,233
2002 3/	SBA	4-Feb-02	3-Feb-05 4/	12,821.2	9,929	4,916	16,246
2003					1,191	1,224	16,213
2004					793.8	3,158	13,848
2005 5/ 6/	SBA	May-05	May-08	6,662.1	2,221	5,158	10,911
2006					2,221	5,092	8,039
2007					1,666	3,690	6,015
2008					555	1,782	4,788

Source: Finance Department.

1/ Expiration of SBA with SDR 56.3 million undrawn.

2/ Expiration of SBA with SDR 150.0 million undrawn.

3/ Cancellation of undrawn balances of SDR 3,299.4 million upon approval of the 2002–05 SBA.

4/ On April 16, 2004 the initial date of expiration, December 31, 2004 was extended to February 3, 2005.

5/ Expiration of 2002–05 SBA with SDR 907.2 million undrawn.

6/ Proposed SBA with total access of SDR 6.7 billion. Repurchase expectations arising in 2006 are extended to obligations. Phasing is based on *Turkey—Requests for Stand-By Arrangement and Extension of Repurchase Expectation issued on 4/27/05*.

3. The recent rise in Turkey's share in Fund credit has coincided with a marked increase in the overall concentration of the use of the Fund's resources in the GRA.⁶

The share of the top five users of Fund resources in total Fund credit outstanding has risen

⁶ It is important to note that high concentration does not necessarily embody the same overall risk for the Fund as for other financial institutions.

from 51 percent in 1994 to 89 percent at end-March 2005. Turkey's share of total Fund credit outstanding has also risen quickly from 8 percent at end-2000 to 26 percent at end-March 2005, representing 7.8 percent of the total quotas of participants in the Financial Transactions Plan. In absolute terms, at end-March 2005, Turkey's Fund credit outstanding (SDR 13.2 billion) was second only to Brazil's (SDR 15.4 billion) and almost 60 percent higher than Argentina's exposure (SDR 8.4 billion). Fund exposure to Turkey is also very large when scaled by measures reflecting economic size such as GDP and quota. When measured as a percent of GDP, Turkey's Fund credit outstanding is broadly comparable to that of Argentina and about double the ratio for Brazil. As a percent of quota, Turkey's Fund credit outstanding surpasses that of any other member by a large margin, and is more than double the exposures of Brazil and Argentina, but this partly reflects the fact that Turkey's quota is relatively low compared with its economic size.⁷

4. **As is the case for several other large users of Fund resources, Fund credit constitutes a large share of Turkey's external debt and debt service** (Table 2). At the end of 2004, Turkey's outstanding Fund credit is estimated to account for over one-fifth of public external debt and 9 percent of total public debt. In terms of payment flows, Turkey's debt service to the Fund in 2004 accounted for one-third of public external debt service and almost one-fifth of total external debt service.

Table 2. Fund Share in Debt of Large Borrowers, 2004

	Public External Debt	Total Public Debt	Public External Debt Service
Argentina	15	7	26
Brazil	22	6	28
Turkey	22	9	33
Uruguay	26	20	37

Source: Staff estimates.

⁷Turkey is one of a small group of members whose actual quota shares are consistently among the lowest relative to their calculated quota shares (see *Alternative Quota Formulas—Further Considerations*, issued on 5/6/02).

5. **After several years of heavy reliance on Fund financing, Turkey began making net repurchases in 2003.** Purchases rose to high levels in 2001 and 2002 (SDR 8.9 billion and SDR 9.9 billion, respectively) and then declined to SDR 1.2 billion in 2003. At the same time, Turkey has met about half of the repurchase expectations arising between January 2003 and end-March 2005.⁸ In the absence of a successor arrangement and extension of repurchase expectations arising in 2006, net repurchases would rise sharply in 2006 and continue through 2009. Even with the proposed successor arrangement, and if all purchases are made, Turkey will continue to make very significant net repurchases to the Fund in the coming years.

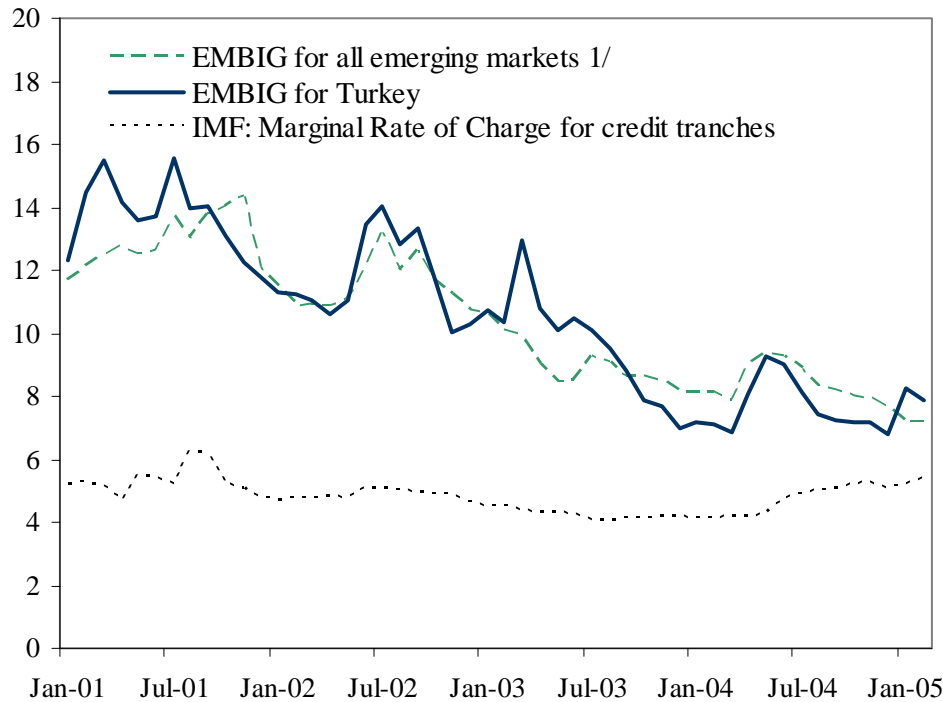
6. **Turkey's capacity to make net repurchases to the Fund reflects its improved access to international capital markets, which in turn reflects strengthened confidence in the Turkish economy and policy making as well as improved global conditions in those markets.** The mixed record on policy implementation that characterized past Fund-supported programs and the first years under the 2002–05 SBA has been followed by a clear improvement in policy implementation. This improvement has contributed to a strengthened macroeconomic situation and a substantial decline in bond spreads. The difference between Turkey's actual cost of borrowing from markets and from the Fund has narrowed significantly, though a gap still remains (Figure 3). While Turkey enjoys quite good market access, a problem in the past has been its inability to fund itself entirely in capital markets. In 2004, Turkey was one of the largest emerging market borrowers (in absolute terms) in international capital markets (see Appendix III of the Staff Report). Notwithstanding more favorable borrowing conditions from private markets, the authorities and staff believe that Fund exposure to Turkey cannot be unwound quickly given its large size, both in absolute terms and as a share in Turkey's total debt.⁹

⁸In 2003, Turkey met all arising expectations, in the amount of SDR 0.8 billion. In 2004, Turkey met repurchase expectations of SDR 2.7 billion (out of SDR 5.8 billion), with the remainder extended to an obligations basis. In January–March 2005, Turkey met repurchase expectations of SDR 0.6 billion (out of SDR 1.8 billion), with the remainder extended to an obligations basis.

⁹*Turkey—Requests for Stand-By Arrangement and Extension of Repurchase Expectations, issued on 4/27/05.*

Figure 3. Turkey: EMBI Bond Yields and Marginal IMF Charges

(In percent)



Source: IMF and J. P. Morgan.

1/ J. P. Morgan's EMBI Global index (EMBIG), stripped of collateralized debt.

Risks and impact on Fund finances of new SBA

7. **Access under the proposed SBA would imply that the Fund's exposure to Turkey, although declining, will remain very high for several years, representing a substantial risk to the Fund.** The main risks to Turkey's capacity to repay the Fund are:

- **Turkey's large public debt and its short maturity and currency composition.** Although the government has gradually lengthened new debt maturities, average maturity remains short, so that rollover risk and vulnerability to exchange rate fluctuations and increases in short-term interest rates remain significant. The debt sustainability assessment is quite sensitive to various shocks.¹⁰
- **The uncertain outlook for the balance of payments and, in particular, the current account.** The current account deficit, which has widened very rapidly in the

¹⁰Turkey—Requests for Stand-By Arrangement and Extension of Repurchase Expectations, issued on 4/27/05, Appendix III, Annex A.

last two years to 5.1 percent of GNP in 2004—a key deviation from past projections—is assumed to narrow during the course of the new program, but this improvement is far from assured. A wider current account deficit would add to the external debt burden if the deficit is financed by debt-creating flows as has been the case so far, thereby increasing vulnerability. Also, an important external vulnerability relates to the fact that, under the program, the reserve coverage of short-term debt is envisaged to decline markedly.

- **Implementation risk associated with the demanding fiscal reforms and structural reforms in the banking sector and the legal system.** While Turkey's implementation record has been quite good recently, reform implementation in the past was more episodic. Aside from the direct negative effects from slippages on macroeconomic performance, slippages can also quickly lead to an erosion in market confidence.
- **There is also a risk associated with the fact that purchases are made by the Treasury rather than the central bank.** As explained in the staff report, repurchases become dependent on the Treasury's ability to purchase foreign exchange from the central bank, which in turn depends on the level of liquid government deposits or its ability to borrow from the market.¹¹

8. **The key safeguard against these risks is the determined implementation of the program by the authorities, as well as their readiness to take measures as needed in case the current account deficit does not decline as projected or other key variables deviate from program assumptions.** Sustained policy implementation through the next electoral cycle will be critical. Any hesitancy with respect to program implementation—including in the run-up to the November 2007 elections—can quickly translate into higher interest rates and lower capital inflows (and a deterioration in their composition)—undermining the rollover process and sustainability of the public debt, and jeopardizing the prospects for an orderly reduction in the current account deficit. Furthermore, to reduce the liquidity risk associated with the very large rollover requirement on public debt, it is important for the government to build up larger deposits at the central bank and lengthen the maturity of its debt.

9. **At the same time, Turkey has an impeccable track record in meeting financial obligations to the Fund.** The authorities have also indicated that, should macroeconomic conditions turn out substantially stronger than expected, they intend to treat the arrangement as precautionary and forgo further purchases (see the authorities' Letter of Intent).

10. **Furthermore, while the authorities are also requesting an extension of credit tranche repurchase expectations arising in 2006 to an obligations basis, they intend to**

¹¹ Ibid, paragraph 68.

make all other repurchases on an expectations basis. Extending the expectations coming due in 2006 to an obligations basis would achieve some smoothing of the hump in repayments in that year. For the remainder of 2005 and for 2007 and beyond, however, the authorities are planning to meet repurchases on an expectations basis. To this end, contrary to what is common for programs supported by purchases in the credit tranches, the program is designed to allow repurchases on an expectations basis.

11. The proposed successor arrangement and extension of repurchases would result in outstanding use of Fund resources potentially through 2012, though the Fund's exposure is projected to decline steadily (see Figure 1). Fund exposure would exceed SDR 6 billion through end-2007 and the Fund's share in Turkey's public external debt would also remain sizeable (exceeding 10 percent through 2007). Since Turkey has been in an almost continuous program relationship with the Fund since 1999, Turkey would become a prolonged user of Fund resources in March 2007.¹²

12. The proposed SBA would reduce the one-year forward commitment capacity (FCC)¹³ by SDR 6.7 billion (Table 3).¹⁴ This reduction reflects the total amount of Fund resources committed under the new SBA and is more than three times total new commitments (of SDR 2.1 billion) in the GRA made by the Fund between January 2004 and end-March 2005. This commitment could be accommodated by the present level of the Fund's FCC—SDR 94 billion as of end-March 2005.

13. Turkey's exposure to the Fund would exceed the Fund's current level of precautionary balances through 2006.¹⁵ In the event that Turkey incurred arrears to the

¹²Based on the start date for the program engagement with the Fund of December 22, 1999. See *The Acting Chair's Summing Up, Conclusions of the Task Force on Prolonged Use of Fund Resources*, issued on 4/8/03.

¹³The FCC, introduced in December 2002, is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months. See *The Fund's Liquidity Position—Review and Outlook*, issued on 4/8/05.

¹⁴This compares with the current impact of Turkey's exposure on the FCC (SDR 6.1 billion) measured as credit outstanding as of end-May 2005, less repurchases one-year forward on an obligations basis.

¹⁵In February 2004, Directors reconfirmed as broadly appropriate the decision taken in 2002 for a target level of precautionary balances of some SDR 10 billion (see the *Acting Chair's Summing Up on Financial Risk in the Fund and the Level of Precautionary Balances*, issued on 3/2/04). See also *Financial Risk in the Fund and the Level of Precautionary Balance*, issued on 2/4/04 and the accompanying background paper (Supplement 1), Chapters II and III.

Fund on repurchase obligations, the Board could decide to augment the accumulation of precautionary balances. The burden-sharing mechanism could be amended by the Board to facilitate augmentation.¹⁶

14. **Turkey is projected to pay charges to the Fund equal to about SDR 0.5 billion a year in the coming years, about three times the Fund's residual burden-sharing capacity.**¹⁷ Thus, in the event of nonpayment of charges, there would not be room for additional accumulation of precautionary balances.¹⁸ Any income losses to the Fund not covered by burden sharing would need to be recouped through an increase in the rate of charge or a reduction in precautionary balances, or both.¹⁹

Assessment

15. **Turkey is presently the Fund's second largest debtor accounting for about 26 percent of Fund credit outstanding, and with the new SBA, Fund exposure to Turkey will remain very high for many years.** The level of access under the proposed SBA is set so that, even if fully drawn, Turkey's outstanding Fund credit would still continue to decline quite rapidly from its peak in 2003. At the end of the SBA, assuming all purchases are made, Fund credit outstanding would be SDR 6.0 billion (or 625 percent of quota). The proposed access would allow Turkey to reduce its Fund credit at a pace that seems more likely to be

¹⁶The burden-sharing mechanism shares costs of overdue obligations equally between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. Article V, Section 9 (a) of the Articles of Agreement sets a floor for remuneration at 80 percent of the SDR interest rate (Article XX, Section 3) and presently there is an 85 percent limit set by the Executive Board. No corresponding ceiling applies to the rate of charge.

¹⁷Residual burden sharing represents "free capacity" and is equal to total burden-sharing capacity under current rules minus the amount currently being utilized to offset unpaid charges and build balances in the SCA-1. For more information on the burden-sharing mechanism, see *Review of the Fund's Income Position for FY 2005 and FY 2006, issued on 4/11/05*.

¹⁸Since the burden-sharing mechanism is limited by the floor on the rate of remuneration, Turkey's basic charges would exceed the current burden-sharing capacity (based on the floor for remuneration at 85 percent of the SDR interest rate; see Table 3). As a result, there would be no room for recovery of surcharges paid by Turkey nor for use of the burden-sharing capacity to accumulate additional contributions to SCA-1.

¹⁹If the full capacity of the burden-sharing mechanism were used applying the maximum flexibility under the existing rules, creditors would face a maximum reduction in the rate of remuneration of 49 basis points, while debtors would face an increase in the basic rate of charge of 57 basis points. This assumes an 80 percent floor on the rate of remuneration, which requires a special majority of 70 percent of the voting power; the current SDR interest rate of about 2.45 percent; and total credit outstanding in the GRA at its current level of SDR 50 billion. The capacity of the burden-sharing mechanism would decline if credit falls, but would increase with increases in the SDR interest rate. Although creditors and debtors pay equal amounts in level terms, a larger increase in the rate of charge would be required since the calculations are based on credit in good standing.

sustainable; though it also means that Fund exposure will remain high, even if declining, for a long time. Furthermore, since all outstanding Fund credit to Turkey and commitments under the requested SBA are in the credit tranches (rather than on SRF terms) and thus at rates considerably lower than the cost of market financing, Turkey could have an incentive to hold on to relatively inexpensive Fund financing for a long period. In this regard, the authorities' explicit statement, that they would forgo further purchases if macroeconomic conditions prove significantly more favorable than envisaged in the macroeconomic framework, is welcome.

16. **Turkey has an unblemished record of repayments to the Fund, and the main risks to Fund resources relate to the authorities' capacity to sustain implementation of the program and their readiness to take additional measures as needed to achieve the objectives of the program.** The proposed SBA can play a role in facilitating the needed policy reforms, placing Turkey firmly on a path toward convergence with European Union economies while ensuring an orderly exit from use of Fund resources. The main macroeconomic risks relate to the large current account deficit, the sustainability of the public debt, and the very substantial monthly rollover requirements caused by the short maturity of this debt. These risks can be mitigated only by a determined implementation by the authorities of all elements of the program. To this end, the strengthened policy implementation during the 2002–05 SBA is most welcome.

Table 3. Turkey: Impact on Fund Finances
(In billions of SDRs and end of period, unless otherwise indicated)

	2003	2004	5/31/05	2005	2006	2007	2008
Exposure							
Fund credit outstanding to Turkey							
Baseline scenario 1/	16.2	13.8	11.9	8.7	1.1	0.3	0.0
Staff proposal 2/	n.a.	n.a.	12.4	10.9	8.0	6.0	4.8
Staff proposal without extensions 3/	n.a.	n.a.	12.4	10.9	5.5	6.0	4.8
Fund credit outstanding to Turkey (percent of total outstanding credit)	24.9	25.0	...	...	...	...	...
Fund credit outstanding to 5 largest debtors (percent of total outstanding credit)	86.2	85.9	...	...	...	...	...
Liquidity							
One-year Forward Commitment Capacity (FCC)	54.2	71.9	...	...	...	...	...
Turkey's impact on FCC 4/							
Baseline scenario 1/	-11.3	-11.4	-6.1	...	...	...	...
Staff proposal 2/	n.a.	n.a.	-12.8	...	...	...	...
Staff proposal without extensions 3/	n.a.	n.a.	-12.8	...	...	...	...
Prudential Measures							
Fund credit outstanding to Turkey as a percent of current precautionary balances 5/							
Baseline scenario 1/	270	202	...	127	16	4	0
Staff proposal 2/	n.a.	n.a.	...	170	126	94	75
Staff proposal without extensions 3/	n.a.	n.a.	...	170	86	94	75
Turkey's annual charges as a percent of the Fund's residual burden-sharing capacity 6/							
Baseline scenario 1/	417	425	...	...	...	...	...
Staff proposal 2/	n.a.	n.a.	...	...	...	...	...
Staff proposal without extensions 3/	n.a.	n.a.	...	...	...	...	...
Memorandum items:							
Turkey's debt to the Fund as a percent of its total public external debt							
Baseline scenario 1/	23.9	21.9	...	14.6	2.0	0.5	0.0
Staff proposal 2/	n.a.	n.a.	...	17.6	13.5	10.4	8.4
Staff proposal without extensions 3/	n.a.	n.a.	...	17.6	9.3	10.4	8.4
Turkey's debt to the Fund as a percent of its total public debt-no purchases	11.3	8.7	...	5.4	0.6	0.2	0.0
Turkey's debt to multilaterals as a percent of its total public debt-no purchases 7/	15.5	12.9	...	9.8	4.6	3.8	3.2
Fund's precautionary balances 5/	6.0	6.9	...	...	...	...	...
Fund's residual burden-sharing capacity 6/	0.2	0.2	...	...	...	...	...
Undrawn commitments to Turkey							
Baseline scenario 1/	1.7	0.9	0.0	0.0	0.0	0.0	0.0
Staff proposal 2/	n.a.	n.a.	6.1	4.4	2.2	0.6	0.0
Staff proposal without extensions 3/	n.a.	n.a.	6.1	4.4	2.2	0.6	0.0
Repurchases of Turkey 8/							
Baseline scenario 1/	1.2	3.2	n.a.	5.2	7.6	0.8	0.3
Staff proposal 2/	n.a.	n.a.	n.a.	5.2	5.1	3.7	1.8
Staff proposal without extensions 3/	n.a.	n.a.	n.a.	5.2	7.6	1.2	1.8
Annual charges 8/							
Baseline scenario 1/	0.6	0.7	n.a.	0.6	0.2	0.0	0.0
Staff proposal 2/	n.a.	n.a.	n.a.	0.7	0.5	0.3	0.3
Staff proposal without extensions 3/	n.a.	n.a.	n.a.	0.7	0.4	0.3	0.3

Source: Staff estimates.

1/ Assumes no new arrangement. No further repurchase extensions.

2/ Assumes new arrangement of SDR 6.7 billion with 12 equally sized purchases of SDR 555 million in 2005–08 and an extension of repurchase expectations arising in 2006.

3/ Assumes new arrangement of SDR 6.7 billion 12 equally sized purchases of SDR 555 million in 2005–08. No extensions of repurchase expectations.

4/ The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to uncommitted usable resources plus repurchases one-year forward minus the prudential balance. A single country's negative impact on the FCC is defined as the sum of outstanding Fund credit and undrawn commitments minus repurchases one-year forward falling due on obligations schedule.

5/ Figures reflect adjustments for the implementation of IAS 19. See *Review of the Fund's Income Position, the Rate of Charge, Precautionary Balances, and Burden Sharing for FY2005 and FY 2006*, pp. 9–10.

6/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate (see Decision No. 12989 (03/36), adopted 4/21/03). Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being currently utilized to offset deferred charges and to build SCA-1 balances.

7/ Debt to multilaterals includes a small amount of debt incurred by the private sector. For details see Table 4, which does not include debt incurred by the private sector.

8/ Flows during the period based on repurchases on effective schedule.

Table 4. Turkey: Public External Debt Outstanding, 1999–2004

	1999	2000	2001	2002	2003	2004
(In billions of U.S. dollars)						
(Long Term)						
Public and publicly guaranteed debt	52.7	61.1	69.8	84.0	91.1	91.9
Official creditors	15.1	18.3	28.2	37.5	39.8	37.6
Multilaterals	6.5	10.3	21.0	29.8	31.8	30.1
IMF	0.9	4.2	14.1	22.1	24.1	21.5
IBRD	2.9	3.6	4.7	5.4	5.2	6.2
IDA	0.1	0.1	0.1	0.1	0.1	0.1
Others	2.6	2.4	2.1	2.3	2.4	2.4
Bilaterals	8.6	8.0	7.2	7.7	7.9	7.4
Private sector creditors	37.6	42.8	41.5	46.5	51.4	54.3
(In percent)						
Public and publicly guaranteed debt	100.0	100.0	100.0	100.0	100.0	100.0
Official creditors	28.7	29.9	40.5	44.7	43.6	40.9
Multilaterals	12.4	16.9	30.1	35.5	34.9	32.8
IMF	1.7	6.8	20.2	26.3	26.4	23.4
IBRD	5.5	5.9	6.7	6.4	5.7	6.7
IDA	0.2	0.2	0.1	0.1	0.1	0.1
Others	5.0	3.9	3.0	2.7	2.7	2.6
Bilaterals	16.3	13.1	10.4	9.2	8.7	8.1
Private sector creditors	71.3	70.1	59.5	55.3	56.4	59.1

Source: World Bank Global Development Finance database, IFS, Turkish Treasury, and staff estimates.

INTERNATIONAL MONETARY FUND

TURKEY

Requests for Stand-By Arrangement and Extension of Repurchase Expectations

Prepared by the European Department in consultation with other departments

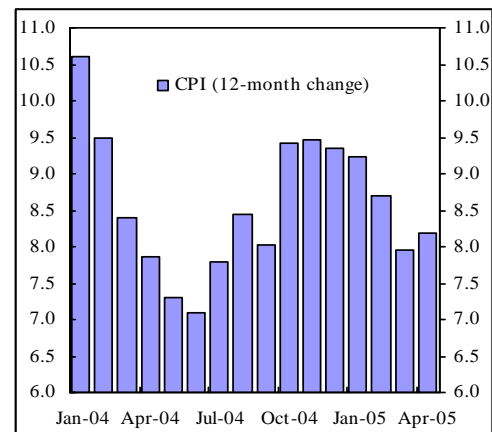
Approved by Michael Deppler and Liam P. Ebrill

May 6, 2005

This supplement provides an update on developments since the circulation of the staff report for the Requests for Stand-By Arrangement and Extension of Repurchase Expectations, issued on April 27, 2005. The staff appraisal remains unchanged.

Recent developments

1. **Annual CPI inflation in April came in at 8.2 percent, slightly up from March, but broadly in line with expectations.** As anticipated, high energy prices, recent hikes in administered prices and taxes, and the weaker lira put upward pressure on prices in April. This was partly offset by continued low food prices. For the CPI excluding energy, inflation was only 7.0 percent, and excluding administered prices and indirect taxes even lower, at 6.3 percent. With CPI inflation through April standing at only 1.5 percent, the 8 percent end-year target remains well within reach.



2. **Financial markets have weakened slightly compared to the strong performance in the first two months of the year.** Along with other emerging markets, conditions have proved sensitive to the stance of U.S. monetary policy and to global liquidity more generally. In Turkey, market concerns that the outcome of the French referendum on the EU constitution may affect accession prospects have created some additional volatility.

3. **March trade data is consistent with staff's end-year current account projections, although export and import growth were both higher than expected.** Exports in the first quarter were more than 25 percent higher than a year earlier, driven by continued strength in exports of cars, iron and steel products, electrical equipment and machinery. Despite the elimination of international textile quotas on January 1, 2005, textile exports have performed well, though this may reflect orders placed last year. Imports have increased by just under 25 percent, reflecting higher energy prices and further increases in intermediate goods imports. However, the growth rate of consumer goods imports has declined sharply, from near triple digit growth rates in mid-2004 to around 5 percent by March 2005. In particular, car imports and domestic car sales have fallen, following the phase out of tax incentives.

4. **Fiscal developments are on track:**

- **The central government primary surplus during the first quarter of 2005 exceeded the target by ¼ percent of GNP** (YTL 1,260 million). However, most of this overperformance came from expenditure compression, in each of the major categories, which is likely to be unwound later in the year.
- **The authorities increased the Special Consumption Tax (SCT), to keep the budget on target and help contain the current account deficit.** On April 26, the SCT was increased from 6.7 percent to 20 percent on 62 luxury goods (e.g. consumer electronics). The increase, which was largely in line with the program assumptions, is expected to generate approximately YTL 230 million during the remainder of 2005.

5. **On April 29, the President vetoed the Tax Administration Reform bill.**

Parliament had passed this law on April 14, a prior action for the new Stand-by Arrangement. The President objected to one Article of the law concerning his right to ratify senior appointments to the new Revenue Administration agency. According to the President, the Constitution gives him the right to approve all senior public sector appointments, including at quasi-independent institutions. These usually include the head of the agency, deputy heads, and top managers. However, for appointments to the newly created revenue administration agency, the law only gave the President power to ratify the agency head, not the levels below.

6. **The authorities have taken steps that ensure that the tax administration reform will be implemented.** On Thursday, May 5 Parliament re-approved the legislation in its original form, thereby overriding the President's veto. The contested article can still be referred to the Constitutional Court, but during this time the law still takes effect. If the Constitutional Court were to rule in favor of the President, the authorities are committed to amending the legislation in line with the ruling. The contested article does not have implications for the effectiveness of the law, regardless of how it is resolved. Nevertheless, the staff will continue to monitor the law's implementation and ensure its effectiveness, if needed through additional program conditionality.

7. **As envisaged in the LOI, the SDIF has announced a plan to auction off this year all remaining non-related party loans (with a face value of about US\$ 1 billion).** The SDIF will employ a profit sharing method, where the purchaser has to pay a certain amount upfront, while the final return to SDIF will be determined by the purchaser's success in collecting on the loans. The winning bid will be selected in mid-September. Also related to the SDIF's asset recovery efforts, the recent passage of legislation liberalizing media ownership will remove obstacles preventing the SDIF's sale of its holdings of such assets to foreign investors.

8. **The second Investment Advisory Council meeting took place in Istanbul on April 29.** Chaired by Prime Minister Erdoğan, the meeting was attended by the Managing Director, together with the heads of 19 international companies and other officials from international organizations. Participants reviewed progress in improving the investment climate since last year and made suggestions for further enhancing FDI prospects.



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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US\$10 Billion Stand-By Arrangement for Turkey

The Executive Board of the International Monetary Fund (IMF) today approved a three-year, SDR 6.66 billion (about US\$10 billion) Stand-By Arrangement to support Turkey's economic and financial program through May 2008. An amount equivalent to SDR 555.17 million (about US\$837.5 million) will be made available immediately, with the remaining balance distributed in eleven equal installments. The Board also approved a one-year extension of Turkey's repurchase expectations totaling SDR 2.52 billion (about US\$3.80 billion) arising in 2006.

Following the Executive Board's discussion on Turkey, Mr. Rodrigo de Rato, Managing Director and Chairman, made the following statement:

"Turkey's economic performance is at its strongest in a generation. Growth was 8 percent on average over the last three years, while inflation has fallen to single digits, its lowest level in more than 30 years. Strong policy implementation under the previous Fund-supported program has given rise to this impressive performance. Together with the EU's decision to open accession negotiations, this signals a sea change in Turkey's economic prospects.

"The authorities' new three-year program is designed to extend these gains in economic performance and reduce Turkey's remaining vulnerabilities. The government's commitment to maintain the primary surplus target at 6½ percent of GNP will steadily reduce the public debt and help contain the current account deficit. Continued independence of the central bank, together with next year's introduction of full inflation targeting, will help consolidate the reduction in inflation. These macroeconomic policies should facilitate further reductions in interest rates and generate sustained growth.

"Implementation of structural fiscal reform will be central to the success of the new program. The tax administration reform should be implemented in full to improve compliance and reduce the size of the underground economy. Tax reform needs to focus on raising revenues by simplifying the tax system and eliminating exemptions. Selective tax relief erodes the tax base, undermines compliance and should be avoided. Expenditure reform should gradually reduce the social security deficit, while improving the quality of spending.

"The authorities' structural reform agenda should also help sustain growth. Passage of the new Banking Law later this year should strengthen banking supervision, while the SDIF is making progress

towards resolving the stock of non-performing assets. Success in this year's privatizations and implementation of the recommendations of this year's Investment Advisory Council should help improve the business climate. Labor market flexibility will also need to be improved to ensure that Turkey's recent strong growth performance results in new job creation.

"Through their strong policies, the Turkish authorities have transformed Turkey's economic performance, while reforms associated with EU accession negotiations hold out the promise for further economic advance. Turkey deserves the support of the international community on the strength of its impressive track record under the last Fund-supported program and the policies proposed under the new arrangement. The challenge now for the authorities is to implement the new program in full in order to sustain and build on this recent success."

On the issue of the non-complying disbursement, Mr. de Rato said:

"The Executive Board reviewed a non-complying purchase made by Turkey under its previous Stand-By Arrangement. Revised data indicate that expenditure levels reported to assess the 2002 primary balance for the fourth review were slightly higher than reported to the Board at the time. The Executive Board took note of the improvements brought about in the collection and dissemination of the data in question and concluded that the deviation was minor (0.13 percent of GNP) and did not alter the assessment of the fiscal situation under the program. Accordingly, the Executive Board granted Turkey's request for a waiver of the noncomplying purchase."

Program Summary

Turkey has concluded the last Fund-supported program successfully and the impressive outcome has laid solid foundations for the new program. These reforms have delivered a decisive break with Turkey's history of high and variable inflation, and low and volatile growth. Output has recovered strongly from the 2001 recession, with annual growth rates averaging 8 percent over the last three years. Inflation is now well below 10 percent and government debt has declined to 63.5 percent of GNP.

The overriding goals of the new program are to create conditions for sustained growth that will raise living standards and reduce unemployment; facilitate convergence towards the EU economies; and bring about an orderly exit from Fund support. To achieve this, the program aims to:

- Deal effectively with short-term macroeconomic challenges and, in particular, reduce the current account deficit to more sustainable levels.
- Secure permanently lower inflation, by retaining the floating exchange rate, preserving central bank independence, and adopting formal inflation targeting.
- Make the government debt position more sustainable through continued sizable primary surpluses, shifting towards longer debt maturities, and underpinning the fiscal adjustment with structural fiscal reforms.

- Restore Turkey's net foreign exchange reserve position and strengthen its resilience to unexpected external developments.
- Maintain financial sector stability by further improving the supervisory and regulatory framework, accelerating asset recovery and restructuring state banks.
- Implement a structural reform agenda that enhances Turkey's growth prospects, lowers unemployment, and improves the investment climate.

The program's macroeconomic framework is centered on achieving high and sustained growth of around 5 percent each year. In 2005, slower domestic demand and continued export growth are expected to lower the current account deficit to 4.4 percent of GNP. Inflation is targeted at 8 percent this year, declining to the low single digits by the end of the program. The program also envisages a 5 percentage point decline in the overall fiscal deficit that should help reduce the government's net debt ratio by a further 10 percent of GNP.

Turkey became a member of the Fund on March 11, 1947; its quota is SDR 964 million (about US\$1.45 billion); and its outstanding use of IMF resources as of March 31, 2005 is SDR 13.19 billion (about US\$19.89 billion).

Table 1. Turkey: Selected Indicators, 2000–05

	2000	2001	2002	2003	2004	Projections 2005
	(In percent change)					
Real sector						
Real GNP growth rate	6.3	-9.5	7.9	5.9	9.9	5.0
GNP deflator	50.9	55.3	44.4	22.5	9.5	6.8
Nominal GNP growth rate	60.4	40.5	55.8	29.7	20.3	12.1
WPI (12-month, end-of-period)	32.7	88.6	30.8	13.9	15.3	8.0
CPI (12-month, end-of period)	39.0	68.5	29.7	18.4	9.3	8.0
Average nominal treasury bill interest rate	38.0	99.1	63.5	45.4	24.9	16.4
Average ex-ante real interest rate 1/	-9.5	35.5	38.2	34.8	16.6	9.4
	(In percent of GNP)					
Central government budget						
Primary balance 2/	4.6	4.8	2.4	5.0	5.1	5.1
Net interest payments 3/	15.8	26.4	15.9	15.9	13.2	11.3
Overall balance	-11.2	-21.6	-13.4	-10.9	-8.0	-6.2
Consolidated public sector						
Primary balance	3.0	5.5	4.2	6.2	6.9	6.5
Net interest payments	16.0	26.4	16.1	16.0	13.1	11.1
Overall balance	-13.0	-20.9	-11.9	-9.8	-6.2	-4.6
Operational balance	-6.9	-4.7	-4.4	-4.8	-2.9	-1.0
Net debt of public sector	58.3	90.5	78.5	70.4	63.5	60.0
Net external	19.0	37.7	32.3	22.1	17.5	16.4
Net domestic	39.3	52.8	46.2	48.3	46.0	43.6
External sector						
Current account balance	-4.9	2.4	-0.8	-3.4	-5.1	-4.4
Gross external debt	59.0	78.9	71.3	61.0	53.6	48.3
Net external debt	39.3	55.1	56.2	47.4	40.4	36.5
Short-term external debt (by remaining maturity)	21.7	22.7	17.9	17.6	16.7	16.4
Monetary aggregates						
Seignorage 4/	1.8	1.1	1.0	1.2	1.2	1.0
Nominal growth of M2Y broad money (in percent)	40.2	87.5	25.4	13.0	22.1	16.7
	(In billions of U.S. dollars, unless otherwise indicated)					
Privatization proceeds	3.3	2.8	0.5	0.2	1.3	1.5
Net external financing of central government	4.1	-2.3	-1.4	1.0	1.9	0.0
Amortization	6.2	6.7	11.4	7.0	7.0	12.2
Gross borrowing	10.3	15.0	18.1	8.0	8.9	12.2
Of which: Eurobond issues	7.5	2.2	3.3	5.3	5.8	5.5
GNP	201.3	144.0	182.7	238.5	301.7	349.0
GNP (in quadrillions of Turkish lira) 5/	125.6	176.5	275.0	356.7	428.9	481.0

Sources: Data provided by Turkish authorities; and IMF Staff estimates.

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation.

2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds

3/ Interest payments minus interest receipts plus profit transfers from the central bank.

4/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

5/ In billions of new Turkish lira from 2005 onwards.

**Statement by Willy Kiekens, Executive Director for Turkey
and Levent Veziroglu, Senior Advisor to Executive Director
May 11, 2005**

1. Encouraging results are the basis for continued progress

The implementation of ambitious and coherent policies over the last three years has decisively transformed the performance of the Turkish economy. During this period output grew by almost 26 percent; inflation fell below 10 percent; the net debt to GNP ratio declined by 25 percentage points to 63.5 at the end of 2004. Political stability, orderly economic policy making and responsible management of the public finances have restored confidence of economic agents, allowing interest rates to drop to their lowest levels in decades.

More progress is needed. The authorities are determined to build on their record of success to strengthen convergence with the economies of the European Union. To achieve this goal, the authorities firmly intend to further reduce inflation to low single digits; strengthen public finances; improve the quality of government spending and taxation; make the financial sector more robust and efficient; improve the climate for investment and employment creation; and make the economy more resilient to shocks by strengthening the international reserve position and the competitiveness of the Turkish economy.

To support their reform program, the Turkish authorities are requesting a three year Stand-By Arrangement with the Fund with an access of SDR 6.7 billion. This amount is justified by the balance of payments outlook and the objective of the authorities to substantially reduce the amount owed to the Fund by the end of the program. Since Turkey's balance of payments justifies continued financial support from the Fund, the authorities request that repurchases falling due in 2007 should not be advanced by one year, as was expected at the outset of the previous arrangement.

2. Reducing inflation to low single digits

Prudent fiscal policies, central bank independence and skillful implementation of monetary policy have been central in reducing annual inflation from 70 percent to below 10 percent. These features will be maintained. The redenomination of the currency by dropping six zeros last January marked the end of the era of high inflation and further enhanced policy credibility.

During the past several years, the Central Bank of Turkey (CBT) has carefully prepared for a formal inflation targeting regime. With inflation now in single digits, public debt burden further declining, and the financial sector substantially stronger, the CBT believes that formal inflation targeting can be successfully introduced in early 2006. The program projects that CPI inflation will drop to 4 percent by 2007.

3. Strengthening Public Finances

Strict control of public finances and debt reduction will continue to be the cornerstone of the strategy. The program aims at reducing the net public debt to GNP ratio by about 10 percentage points to 53.4 percent by the end of 2007. Achieving a primary surplus of 6.5 percent of GNP during the program period is a critical component of this strategy. With interest rates declining steadily, the overall public sector deficit is expected to fall to about 4.5 percent of GNP in 2005 and be well below 3 percent in 2006. By the end of the program, the overall public sector budget could approach a balanced position. Any revenue overperformance will be saved to help contain the current account deficit.

Continued tight fiscal policy will help ensure that interest rates continue to fall and generate the resources needed for investment and growth.

4. Improving the quality of government spending and taxation

Turkey not only needs to restore macroeconomic stability but such stability should also be lasting. In addition, the functioning of the public sector and the economy as a whole must be made more efficient. Enhancing productivity is required for high growth per capita and rapid real convergence with EU countries. Enhancing the quality of government spending and taxation is critical to achieve these objectives.

In 2004, expenditures for personnel and transfers, in particular to social security institutions, represented 78 percent of the non-interest outlays of the public sector. The program aims at reducing this share and correspondingly increased public investment in infrastructure and human capital. Therefore, the government has introduced in Parliament draft legislation reforming the pension and health care systems and the social security administration. Details of this legislation are well explained in the staff report. The pension law will correct the trend of increasing social security outlays by stabilizing the deficit to 4.5 percent of GNP during the program period. In the long run, the pension deficit would be reduced to 1 percent of GNP from 3.5 percent in 2004. In 2006, Turkey will introduce universal health insurance, taking care to ensure that, over the medium-term, its costs will fall below the pre-reform trend.

The government is working with the World Bank on a full review of public expenditures in order to set medium-term spending priorities and improve efficiency in public employment and other public services, including health care and education.

Improving the composition of expenditures is only one facet. Improving expenditure management is another critical requirement for achieving overall effectiveness of the public sector. To this end, secondary legislation to implement the recently enacted "Public Financial Management and Control Law" will soon be adopted. This legislation aims at improving public accountability, including at the local levels, budget preparation and execution, and debt and cash management. The authorities have requested the Fund to update the Fiscal Transparency ROSC for Turkey.

Turkey's tax system will be greatly improved under the program. At present the tax base is small because of many exceptions. And, because tax rates are high, a large informal economy has grown resulting in low tax receipts, distorted competition, and inhibiting efficiency gain throughout the economy.

The government's strategy to deal with these weaknesses is multi faceted and will be further developed in the course of the program. Part of the strategy is to strengthen tax administration, inter alia, by establishing a semi-autonomous Revenue Administration, including a large tax payers unit.

The other part is reform of the tax legislation itself, primarily by reducing exceptions, simplifying legislation and reducing the number of tax rates. The corporate income tax regime will be brought more in line with practices in the EU. Financial intermediation taxes will be phased out. The taxation of earnings from financial assets will be harmonized.

5. Making the financial sector more robust and efficient

Banking regulation and supervision has been greatly improved in the past several years. Insolvent private banks have been closed or restructured and recapitalized. There is now considerable interest on the part of foreign banks to invest in Turkish banks. We expect further consolidation in the banking sector, improved competition and financial deepening.

However, recent experience has revealed that several shortcomings remain in the legal and supervisory regime. To address them, a new banking law has been enacted which will bring the legal framework more closely in line with EU standards. The staff report provides the details.

Another key financial sector component of the program consists of actions to strengthen the organization and functioning of the supervisory authorities, including their onsite and offsite supervision.

Lastly, specific strategies will be adopted and implemented to further restructure state banks and prepare them for privatization. These strategies should level the playing field in the financial sector by phasing out special privileges and obligations of the state banks.

To support these reform plans, the authorities have requested a Financial Sector Assessment Program in early 2006.

6. Improving the climate for investment and employment creation

The staff's background study on Turkey's potential growth rate shows the huge potential for improving total factor productivity and increasing potential growth rate. The labor participation rate, annual gross fixed capital formation and the level of foreign direct investment in Turkey are lower than in any of the 10 countries that joined the EU last year. At the same time, the growth of Turkey's working age population is, by far, the highest as

compared to these 10 countries. Enhancing Turkey's fixed capital base and its human resources will unleash a dynamism which is likely to make the Turkish economy grow faster than any EU country over an extended period of time. Indeed, this is required to achieve meaningful real convergence during the next decade.

Enhancing the investment climate requires a comprehensive set of actions, many of which go beyond the core mandate of the Fund. But taken together, they are critical to ensure growth and lasting macrofinancial stability.

These include measures to improve the efficiency of the judicial system, streamlining administrative procedures, and adopting EU standards and regulation. There is no doubt that action in these fields will be greatly stimulated by the negotiations on EU accession in the coming years. It is heartening that since the decision of the EU council on December 17, 2004 to start these negotiations, the confidence of investors, both domestic and foreign, has indeed improved. The authorities are well aware that, in this area, efforts will have to be long lasting and comprehensive in nature. They are determined to conduct this process professionally, while seeking technical support from the European authorities, other EU member states, the Fund and the World Bank.

7. Making the economy more resilient to shocks

All the actions outlined above will greatly enhance the flexibility of the economy and the confidence of investors. By reducing the interest burden on both public and private debt, and by lengthening the maturities, the government and other economic agents will greatly reduce their roll-over risks. Most important, increased foreign direct investment and long-term portfolio investment will put the financing of the current account deficit on a much sounder footing.

In this climate of enhanced confidence and credibility, the central bank plans to strengthen its net international reserves during the program. In the same vein, the Treasury's public debt management will aim at further lengthening the maturity of new domestic debt issues, increasing the Treasury's cash position, help foster the development of a domestic capital market, and broaden the investor base for government paper in domestic currency. These developments will gradually reduce the vulnerability of the public finances to interest- and currency risk.

8. Financial Support by the Fund

The authorities are well aware that the level of financial support provided by the Fund has been exceptionally high. However, their determined implementation of the program and the intense cooperation with the staff has made this support highly effective and successful. The main cause of Turkey's high financial need, three years ago, was the extreme deterioration of its public finances. Reversing such a situation while remaining current on the existing debt requires a prolonged period of sustained fiscal discipline and comprehensive reform in the economy. For Turkey, this period clearly exceeds the normal repurchase period

of a Stand-By Arrangement. The authorities are, therefore, requesting a three year successor arrangement with an access level that enables Turkey to avoid a situation in which reserve coverage would fall to dangerously low levels and roll-over rates of domestic debt would become uncomfortably high. At the same time, the Fund's current exposure to Turkey will halve by the end of the three year program. Moreover, the strength of the program and Turkey's proven ability to implement an ambitious program, provide adequate safeguards to the Fund. The authorities are committed to treating the arrangement as precautionary, should the balance of payments turn out significantly stronger than expected.

In order to ensure robust access to financial markets, the authorities are committed to maintaining a high level of transparency about economic developments and policies, according to best practices. Turkey adheres to the SDDS and the Fund's standards for transparency of monetary and fiscal policies. The central bank will further enhance transparency of monetary policy as part of its inflation targeting framework. Finally, the authorities are committed to publish the letters of intent and memoranda of economic and financial policies in support of their SBA and consent to the publication of the staff reports.