August 2008
IMF Country Report No. 08/272

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

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

- The staff report for the Seventh Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on December 21, 2007, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 28, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of May 6, 2008 updating information on recent developments.

- A Press Release summarizing the views of the Executive Board as expressed during its May 9, 2008 discussion of the staff report that completed the request and review.

- A statement by the Executive Director for Turkey.

The document listed below has been or will be separately released.

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

*Also included in Staff Report

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

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TURKEY

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

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Matthew Fisher

April 28, 2008

Executive Summary

Macroeconomic developments have become less favorable since the last review in May 2007. Supply-side shocks have slowed growth while stoking inflationary pressure. The unfolding global credit crunch is also weighing on the economic outlook and heightening risks, which stem mainly from a large current account deficit and the private sector's significant reliance on external financing.

Political developments have distracted attention from an ambitious economic agenda. As a result, performance under the Fund-supported program suffered, with fiscal policy imparting an unplanned stimulus in 2007 and structural reforms meeting with delays. (Program implementation is summarized in Table 1 and Annex A of the attached Supplementary Letter of Intent (LOI).)

Against this backdrop, the authorities have recently taken important actions to strengthen policies and bring the Stand-By Arrangement (SBA) back on track. The most important of these is passage of a revised social security law, a major step forward in strengthening the long-term sustainability of public finances. In the attached LOI, the authorities also note recent actions and future plans in the areas of energy pricing, tax administration, and financial regulation. To reverse the recent surge in inflation, the central bank has halted its easing cycle and moved to a clear tightening bias. On fiscal policy, the authorities now target an unchanged primary surplus for 2008, which they believe balances the need to promote disinflation and external adjustment against the objective of funding growth-inducing initiatives (infrastructure spending and labor tax cuts). To help anchor expectations about future fiscal policy, they will shortly announce a medium-term fiscal framework that targets continued debt reduction. In light of recent progress, the authorities request, and staff support, completion of the seventh review and the purchase of the associated outstanding amount (SDR 2.25 billion) under the SBA.

Completion of this review would bring closure to the current SBA, under which Turkey has dramatically reduced public debt and built international reserves. Nonetheless, steadfast policies and reforms are still needed to successfully navigate the weaker external environment and sustain high growth.

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Table 1. Turkey: Program Monitoring

Quantitative conditionality (performance criteria)	August 2007	December 2007 (controlling)
1. Floor on primary balance of consolidated government sector (CGS)	*Not observed*	*Not observed*
2. Floor on primary balance of CGS excluding State Economic Enterprises (SEEs)	*Not observed*	*Not observed*
3. Ceiling on consolidated primary spending of central government and social security institutions (SSIs)	*Not observed*	*Not observed*
4. Ceiling on new external public debt with maturities exceeding one year	Observed	Observed
5. Ceiling on new external public debt with maturities up to one year	Observed	Observed
6. Floor on net international reserves of CBT and Treasury combined	Observed	Observed
7. Floor on overall balance (before transfers) of SSIs	*Not observed*	*Not observed*

Inflation consultation clause	Comment
1. End-June 2007	Inner band *exceeded;* discussions with staff held
2. End-September 2007	Inner band *exceeded;* discussions with staff held
3. End-December 2007	Outer band *exceeded*; open letter issued (Attachment II)
Structural performance criteria	
1. No new amnesties of arrears on public sector receivables as defined in Annex F of the TMU (continuous, ¶19, MEP April 26, 2005)	Observed
Structural benchmarks 1/	
1. Replacement of at most 10 percent of those leaving through attrition in each state enterprise, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (continuous, ¶17, MEP April 26, 2005) 2/	Observed
2. Replacement of no more than 50 percent of civil servants leaving through attrition (quarterly, ¶14, LOI November 27, 2006) 2/	Observed
3. Maintaining excise taxes and SEE prices in line with 2007 program assumptions (continuous, ¶11) 2/	Observed
4. Publication of report that quantifies existing tax expenditures (end-June 2007, ¶17, LOI November 27, 2006)	*Observed with delay* (report was published October 10)
5. Parliamentary approval of the insurance law (end-June 2007, ¶22)	Observed
6. Adoption of a legal framework requiring large employers to pay salaries through bank accounts (end-June 2007, ¶15)	*Observed with delay* (passage in April 2008)
7. Extension of family medicine program to 22 regions (end-2007, ¶12)	*Partially observed with delay* (program expanded to 20 regions at end-April 2008)
8. Putting in place a unified tax declaration form for SSI and Revenue Administration (end-2007, ¶15)	*Not observed*; legal authority was created in April 2008, implementation expected by end-2008
9. Introduction of a risk-based audit system for VAT refunds (end-2007, ¶16)	*Observed with delay* (introduction in April 2008)
New prior actions 3/	
1. Adoption of a revised medium-term fiscal plan targeting a debt ratio of 30 percent of GDP (Maastricht definition) by 2012 (¶12)	Pending
2. Adoption of a legal framework requiring large employers to pay salaries through bank accounts (¶16)	Done
3. Introduction of a risk-based audit system for VAT refunds (¶17)	Done
4. Launch of the tender process for the privatization of four regional electricity distribution companies (¶20)	Pending

1/ Unless otherwise noted, ¶ refers to the relevant paragraph numbers in the May 1, 2007 Supplementary Letter of Intent.
2/ This benchmark expired at end-December 2007.
3/ ¶ refers to the relevant paragraph numbers in the attached Supplementary Letter of Intent.

I. INTRODUCTION

1. **Turkey's ruling AK party (AKP) was re-elected decisively in July 2007, but the resolution of political uncertainty proved short-lived**. Elections were brought forward from November to July due to a political crisis in the spring of 2007. The AKP won 47 percent of the vote and 62 percent of parliamentary seats on a business-friendly platform and a strong economic track record. The new parliament subsequently elected ex-Foreign Minister Gül as president in August 2007, while Prime Minister Erdoğan retained his post. Markets viewed this outcome as providing a mandate to renew market-oriented reforms amid political stability. However, domestic political tensions resurfaced in March 2008 when the chief prosecutor filed a court case against the AKP, accusing it of violating Turkey's secular principles and calling for its closure.

2. **Policy implementation flagged in the election year, resulting in slippages in program conditionality**. With the disappearance of favorable factors, which had temporarily boosted the 2006 fiscal position, and a moderation in growth, the authorities found it difficult to deliver the sharp programmed tightening of the underlying fiscal stance in 2007. Efforts to advance structural reforms, particularly when requiring legislation, also encountered resistance.

3. **Meanwhile, the global credit crunch and supply-side shocks have dampened the economic outlook and heightened Turkey's vulnerabilities**. Financial turbulence in industrial countries has reduced growth prospects in Turkey's main export markets and raised the risk that deteriorating external financing conditions may prompt a disorderly external adjustment. In addition, oil and food import prices have surged, creating further headwinds for growth and causing inflation to rise well above target. Meanwhile, domestic political tensions are weighing on investor and consumer confidence.

4. **Turkey's GDP level was revised upward by some 30 percent in March 2008 to reflect improved coverage of both formal and informal sectors**. The revision naturally improves a number of key economic ratios (Box 1). However, it does not fundamentally alter staff's assessment of Turkey's vulnerabilities, which stem mostly from its large gross external financing requirements. Consistent with this, market reaction to the announcement was muted, especially since a large upward revision had been expected for some time.

5. **Against this backdrop, discussions for the seventh review focused on ways to reinvigorate reform and reduce risks**.[1] The authorities agreed on the need to regain momentum through a number of strong, upfront actions. In particular, they recently:

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[1] Discussions were held in Istanbul, Ankara, and Washington during October 3-17 and December 17-20, 2007 and April 3-14, 2008. The team comprised Messrs. Giorgianni (head), Benelli, Fletcher, Kannan, Meier (all EUR), McGrew (PDR), Barnett (FAD), Josefsson and Ms. Mitchell Casselle (both MCM), and Messrs. Samiei

(continued…)

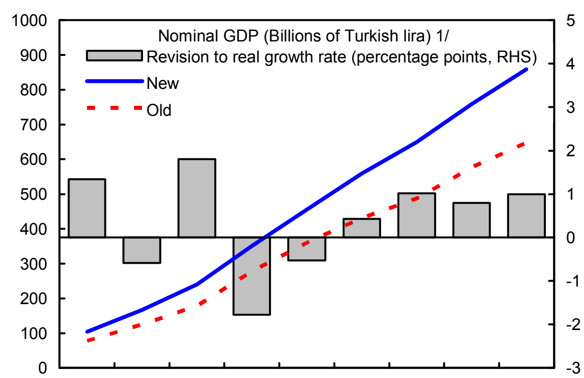
Box 1. National Accounts Revision

In March 2008, the Turkish Statistical Institute released revised national accounts data for the period 1998 to 2007. The revision, which completes a four-year exercise that involved technical assistance from the IMF and Eurostat, largely aligns standards and methodologies with the European System of Accounts 1995 and introduces a more recent base year (1998 instead of 1987).

The revised national accounts data are now based on sources that have a broader coverage of formal and informal economic activity. The new Census of Industry and Business Establishment, in particular, represents a marked improvement in the coverage of economic activity in manufacturing (surveying 28,000 establishments versus 11,000 for previous annual surveys), mining, and business and personal services. Similarly, the new Labor Force Survey provides a better yardstick to measure the extent of the informal sector due to its increased sample size and accuracy. The incorporation of the 2000 Building Census, which shows a significantly greater stock of housing than previously estimated, also resulted in a significant upward revision to the value of paid and imputed rental services. Meanwhile, the use of finer levels of statistical disaggregation of products resulted in a much more reasonable series for changes in inventories, which in the previous national accounting system had reached implausible levels.

The new national accounts data feature an upward revision of nominal GDP for the years 1998-2006 of between 26 and 32 percent. On the production side, the revisions imply, above all, a larger weight of the service sector. This is matched, on the expenditure side, by a large upward revision in private consumption with balancing reductions in the investment and export shares.

The revision also altered recent growth dynamics somewhat, due to changes in relative prices resulting from the updating of the base year and improvements in methodology and coverage. The revised data show a smoother overall growth profile since 1998, with less contraction during the 2001 crisis, a commensurately weaker rebound, and somewhat stronger growth since 2004. Average growth over the period 1998-2006 increased by 0.4 percentage points, from 3.7 percent to 4.1 percent per year.

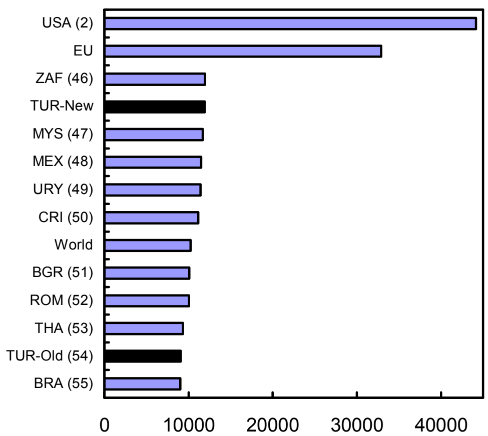


Source: Turkstat; and IMF staff calculations.
1/ Old 2007 data based on realizations for the first three quarters and projection for the fourth quarter.

(senior resident representative) and Lombardo (resident representative). Mr. Demirkol (OED) joined the discussions. Additional mission and Fund relations details are in the separate Fund Relations annex.

The data revisions naturally imply changes to several key economic indicators. The upward revision to GDP has allowed Turkey to climb the ladder of international rankings of per capita income. At the same time, public debt and the current account deficit are now much lower in relation to GDP. However, gross external financing requirements remain the same in dollar terms, and several commonly used indicators of solvency, such as the ratio of public revenue to public debt and the ratio of exports to external debt, also remain unchanged. Meanwhile, several other indicators have worsened. The decline in the ratio of tax receipts to GDP, for example, suggests even less efficient tax collection than previously thought.

GDP per Capita in Current International Dollars, 2006 1/



Sources: World Bank; and CIA World Factbook.
1/ Numbers in parentheses denote rankings.

Change in Selected Ratios (Percent of GDP)

	2006		2007 (Est.)	
	Old	New	Old	New
Nonfinancial public sector				
Primary balance	6.1	4.6	4.6	3.5
Overall balance	-0.7	-0.5	-1.8	-1.4
Debt of the public sector				
General gov. gross debt (EU def.)	60.6	46.1	51.3	38.8
Net debt 1/	45.0	34.2	38.5	29.1
External sector				
Current account balance	-7.9	-6.0	-7.5	-5.7
Gross external debt	50.5	38.4	44.6	33.7

Source: IMF staff estimates and projections.
1/ Authorities' definition. Subtracts net assets of the central bank from nonfinancial public sector debt.

- passed a major social security reform aimed at addressing the Constitutional Court's objections to the annulled 2006 reform while still generating significant savings (estimated by staff at around 75 percent of 2007 GDP in present value);[2]

- raised average end-user electricity prices by 16½ percent (the first increase in over five years) and are launching the privatization of several electricity distribution companies; both actions are part of a broader strategy to make state-owned energy companies viable and avert potential power shortages down the road;

- took several steps to enhance tax administration and reduce informality; and

- strengthened bank provisioning and liquidity requirements to build additional buffers in bank balance sheets.

6. **With these actions, the authorities bring closure to an SBA that, despite suffering some delays, has overperformed on several key objectives**. Economic growth, public debt reduction, and international reserve accumulation have all exceeded original program targets by wide margins. Social security reform, large privatizations, and new banking, mortgage, and insurance laws have mitigated macroeconomic risks while enhancing efficiency. Base-broadening tax policy and revenue administration measures have also protected the revenue base and allowed tax rate reductions (e.g., the corporate tax rate was cut from 30 to 20 percent in 2006).

Macroeconomic Performance Under the SBA, 2005–07

	Original Program 1/			Actual Outturn		
	2005	2006	2007	2005	2006	2007
GDP growth (percent)	5.0	5.0	5.0	8.4	6.9	4.5
CPI inflation (end-of-period, percent)	8.0	5.0	4.0	7.7	9.7	8.4
Current account deficit (percent of GDP)	-3.3	-2.7	-2.1	-4.6	-6.0	-5.7
Net FDI (percent of GDP)	0.8	0.8	0.6	1.9	3.6	3.0
Nonfinancial public sector primary balance (percent of GDP)	4.9	4.9	4.9	5.1	4.6	3.5
Nonfinancial public sector overall balance (percent of GDP)	-3.4	-1.7	-0.8	-0.2	-0.5	-1.4
Public sector net debt (percent of GDP)	45.0	43.5	40.4	41.7	34.2	29.1
Gross foreign reserves (billions of U.S. dollars)	39.7	39.5	40.2	52.2	63.3	76.5

Source: IMF staff.

1/ Projections in the original program request document, IMF Country Report No. 05/412; shares of GDP are adjusted based on the March 2008 national accounts revision.

[2] All references to GDP are based on the revised national accounts data released on March 8, 2008.

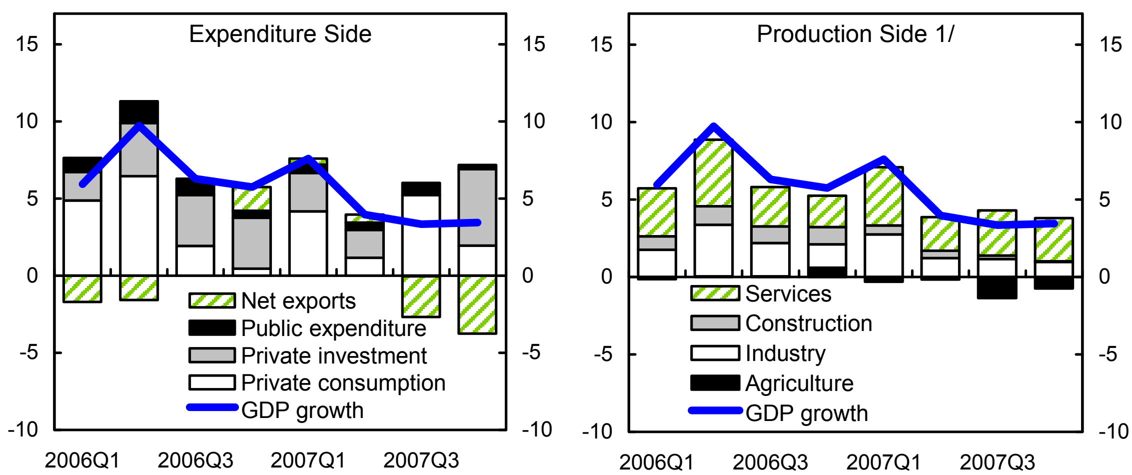
7. **Nonetheless, key economic challenges remain to be addressed**. In the near term, heightened global risks, domestic political tensions, and surging import prices amplify Turkey's external vulnerabilities and the challenge of reducing inflation to its target. Beyond this, Turkey faces a number of structural problems—including still high tax rates, a large informal economy, energy supply bottlenecks, and shallow financial intermediation—which need to be tackled to lift potential growth. Steadfast implementation of macroeconomic policies and structural reforms will help Turkey navigate the choppy waters, increase the resilience of the economy, and secure lasting prosperity.

II. Recent Developments

8. **Macroeconomic performance has become less favorable recently**:

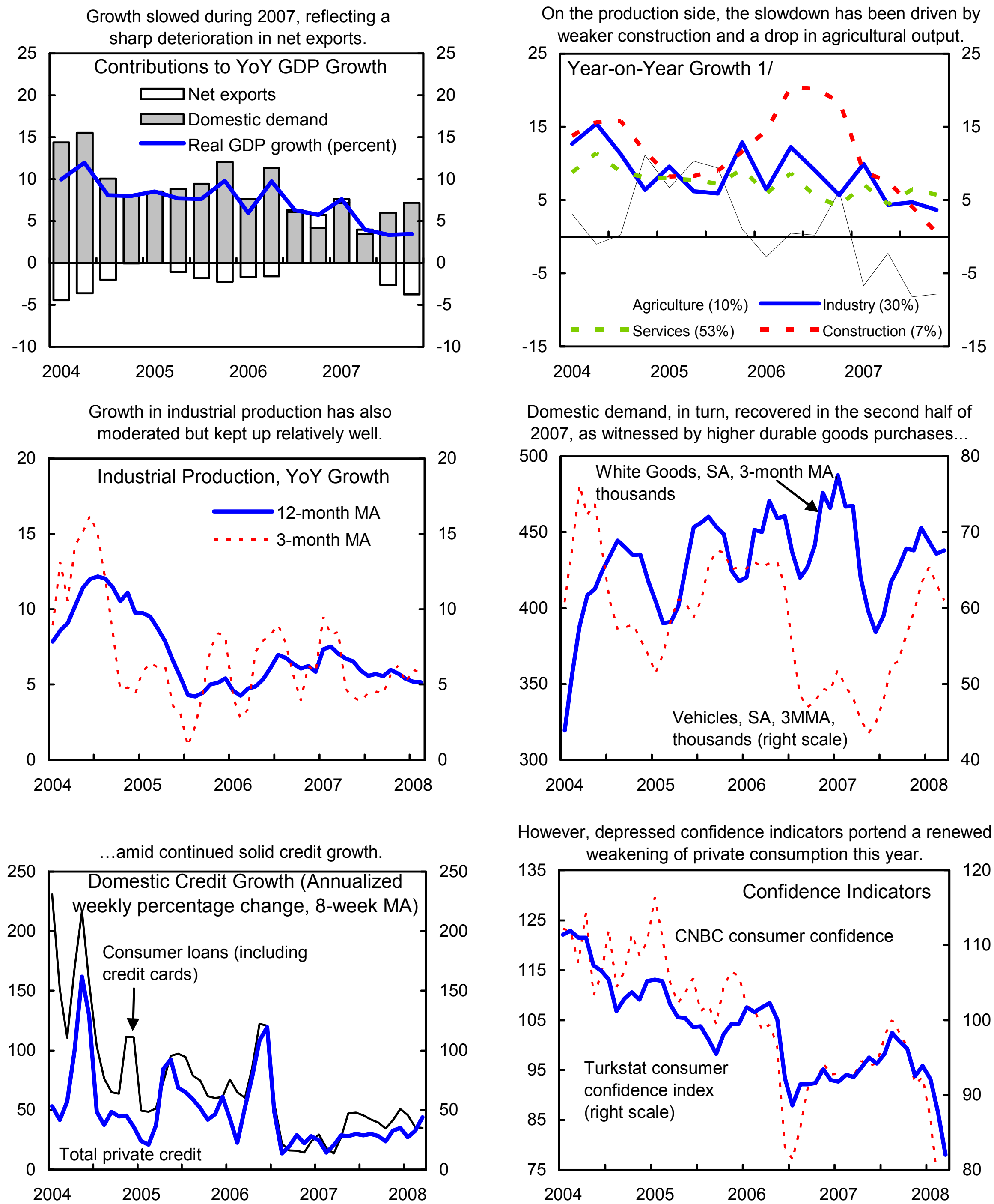
- **Growth slowed during 2007**, from an average annual rate of 5.7 percent in the first half to 3.4 percent in the second half (Figure 1). This slowdown was due to a combination of factors, notably a sharp drought-related drop in agricultural production (which subtracted ¾ percentage point from 2007 growth) and a deterioration in net exports, reflecting the strong lira in 2007 (up 19 percent in real effective terms—Table 11). These growth-depressing factors were partly mitigated by declining real interest rates and a temporary rise in sentiment after the July elections. Thus, average growth in 2007 reached 4.5 percent, one-half percentage point below the authorities' target. More recently, the flaring up of political tensions, higher prices of food and energy, and the worsening global outlook have weighed on consumer sentiment, portending continued weakness in economic activity into 2008.

Contribution to GDP Growth
(Percent; year-on-year)



Sources: Turkstat; and IMF staff calculations.
1/ Difference between GDP growth and sum of components accounted for by taxes minus subsidies.

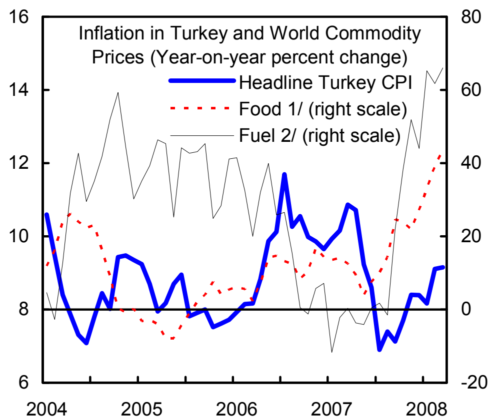
Figure 1. Turkey: Real Sector Indicators, 2004−08
(Percent, unless otherwise indicated)



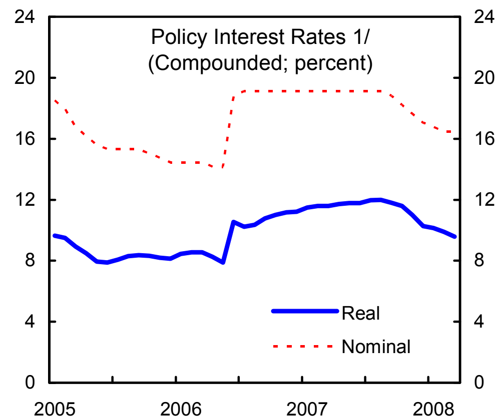
Sources: Turkstat; Central Bank of Turkey; CNBC; and IMF staff estimates.

1/ Values in parentheses denote shares of total value added in 2007.

- **Inflation fell through most of 2007, but has recently rebounded** (Figure 2 and Attachment II). Tight monetary policy (real policy rates above 10 percent for most of 2007) and the strong lira brought headline and core inflation down to historic lows (below 7 percent) by mid-2007. Taking comfort also from the moderate pace of domestic activity, the central bank started a gradual easing cycle, which brought the policy rate from 17.5 percent (simple) in September 2007 to 15.25 percent by February 2008. However, a series of supply-side shocks (surging food and oil prices, excise increases, and administered price hikes) pushed inflation up again to 9.2 percent by March 2008, just above the upper limit of the central bank's inflation band and, thus, requiring another open letter to the government (to be issued on April 30, 2008). Recently, lira weakness has further added to inflationary pressures. In response to these developments, the central bank has halted its easing cycle and introduced a tightening bias in its monetary policy stance.

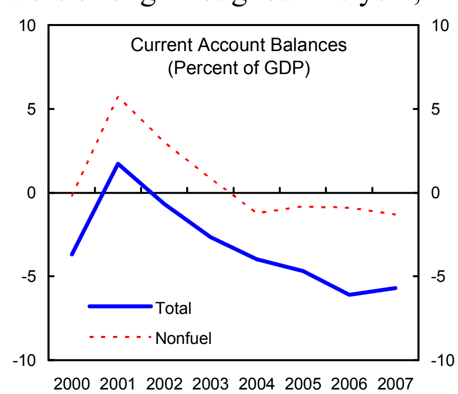


Sources: Central Bank of Turkey; and IMF, internal database.
1/ Index includes cereal, vegetable oils, meat, seafood, sugar, bananas, and oranges.
2/ Index includes crude oil, natural gas, and coal.



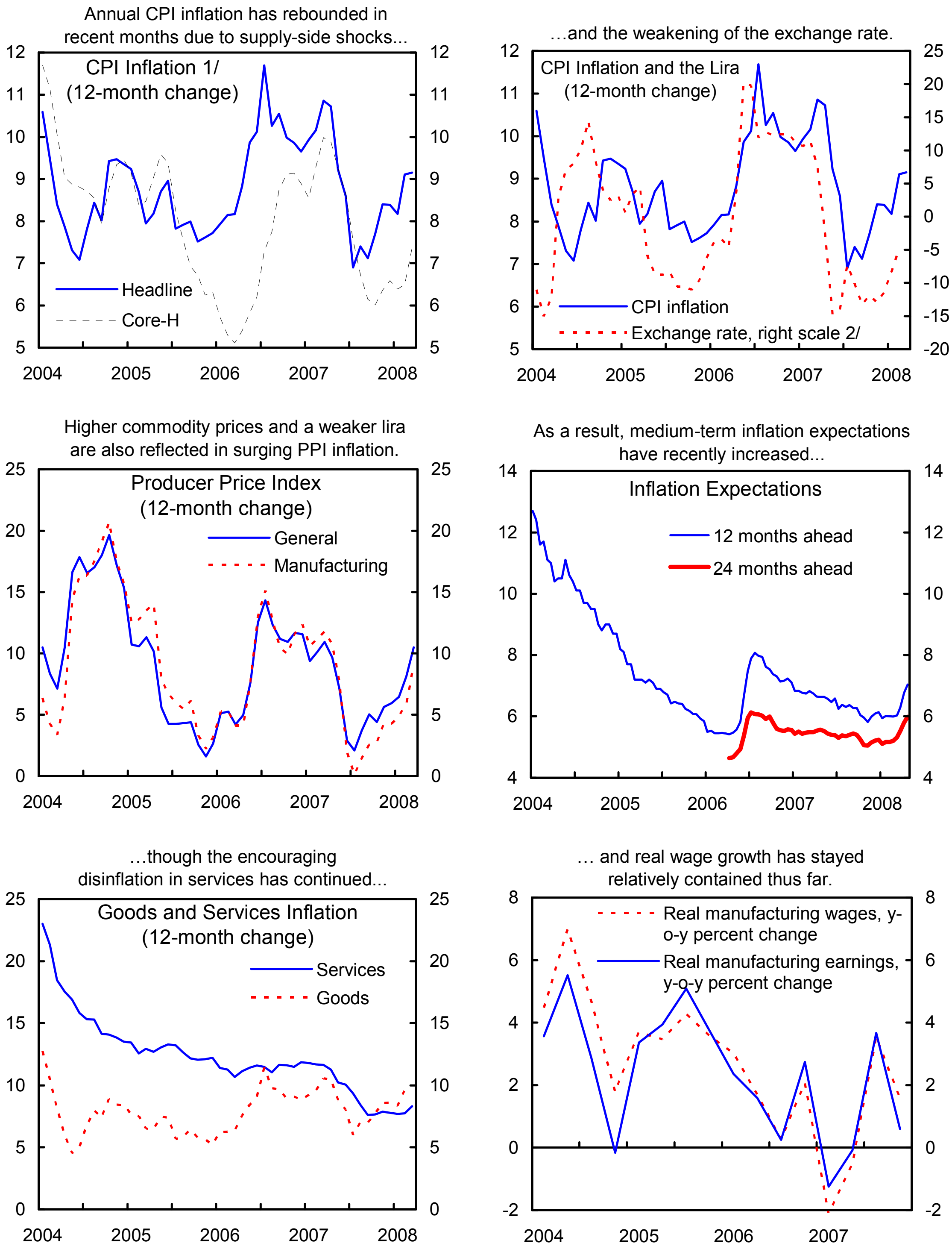
Sources: Central Bank of Turkey; and IMF staff calculations.
1/ Using survey-based inflation expectations.

- **The current account deficit stabilized temporarily in 2007** (Figure 3). Despite an appreciating lira, export and tourism performance were strong throughout the year, supported by past productivity gains. Import growth was weak in early 2007—reflecting sluggish domestic demand and the lagged effects of the mid-2006 depreciation—but gradually regained strength as these factors dissipated and oil prices surged. The current account deficit was 5.7 percent of GDP for the full 2007, down from 6.0 percent in 2006, but has widened again in recent months. The external debt-to-GDP ratio still fell to 34 percent of GDP by end-2007 due to the lira's sharp appreciation and strong nondebt-creating inflows (Appendix I).



Source: Turkstat.

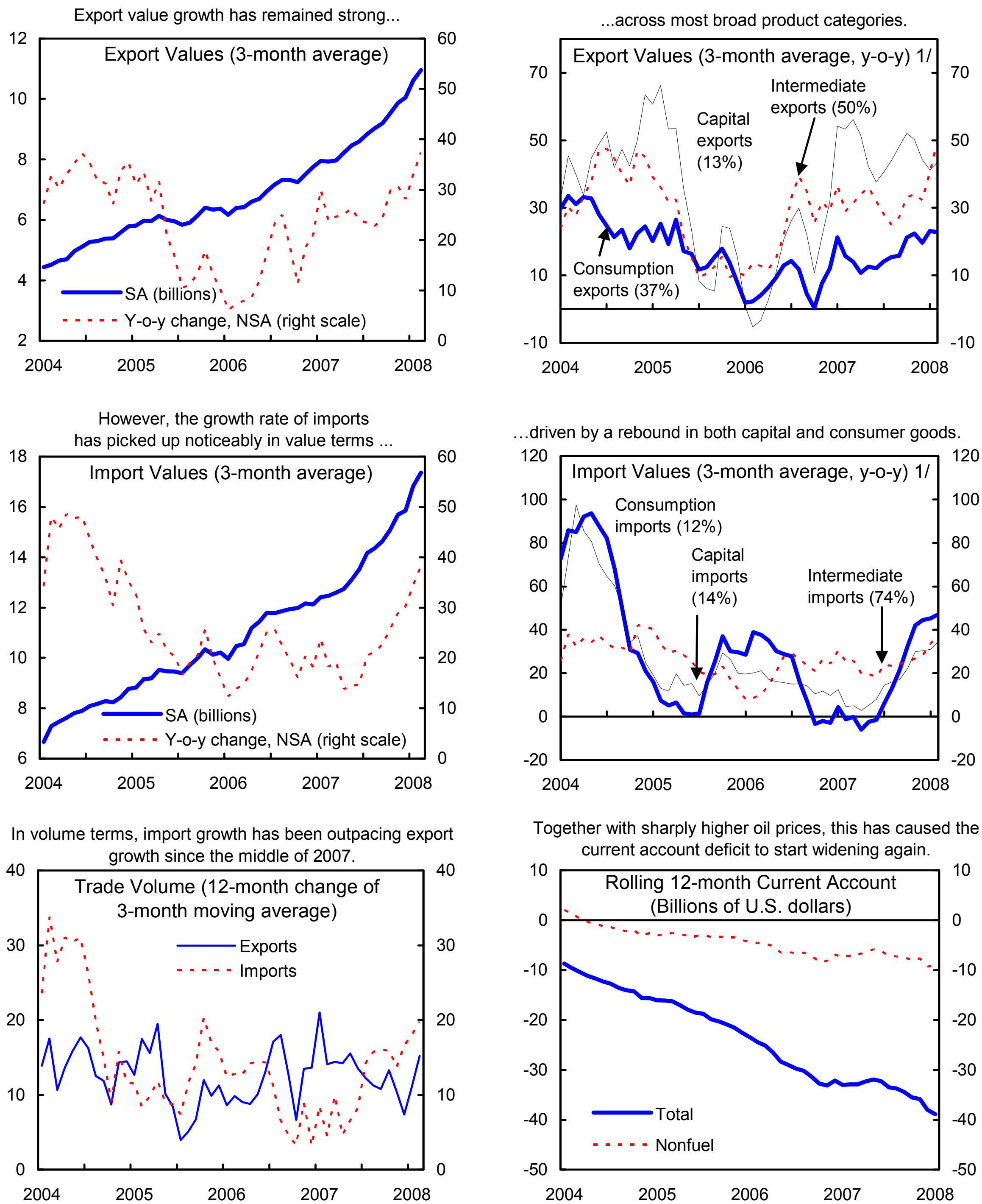
Figure 2. Turkey: Inflation Developments, 2004–08
(Percent, unless otherwise indicated)



Sources: Turkstat; and Central Bank of Turkey.

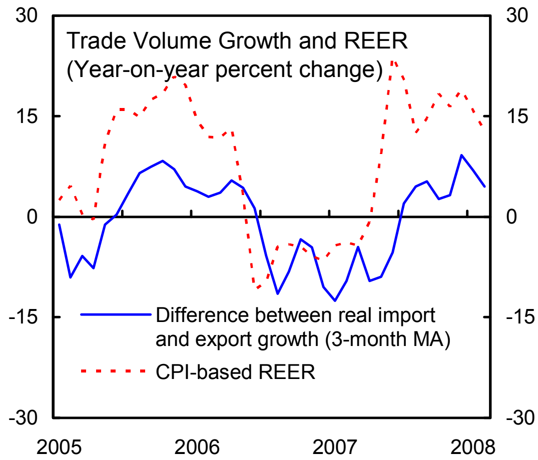
1/ Index "H" excludes energy, alcohol, tobacco, unprocessed foods, and gold.
2/ Exchange rate index computed as 0.5 x YTL/Euro + 0.5 x YTL/USD.

Figure 3. Turkey: External Sector Indicators, 2004−08

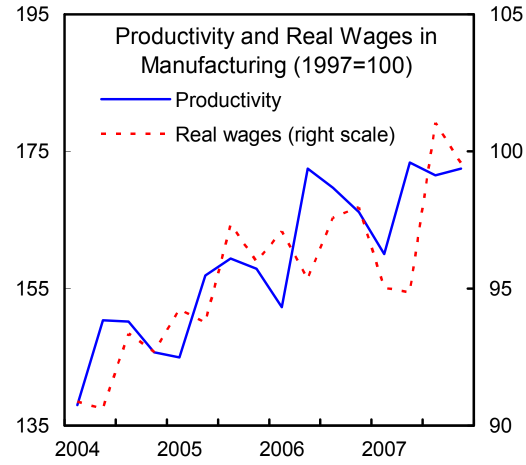


Sources: Turkstat; and IMF staff estimates.

1/ Values in parentheses denote shares of total in 2007.

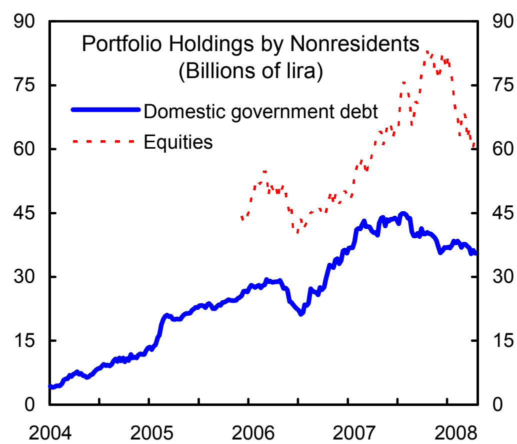


Sources: Turkstat; and IMF staff calculations.

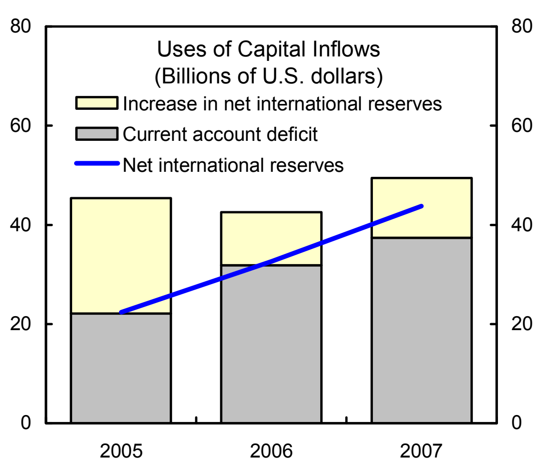


Sources: Turkstat; and IMF staff calculations.

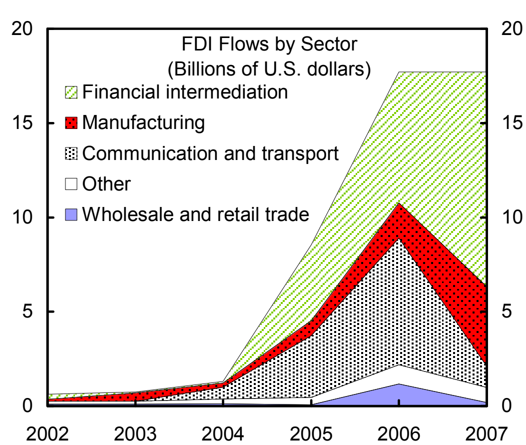
- **External financing was ample during 2007, but turmoil in global markets has since tightened financing conditions.** FDI inflows were buoyant in 2007, driven by mergers and acquisitions in the financial sector, and covered half of last year's current account deficit. Equity market inflows and long-term corporate loans also were robust. This abundance of external financing allowed the central bank to increase international reserves well above the 2007 program floor. More recently, however, external financing conditions have tightened in many areas—foreign investors have scaled back their portfolio holdings, securitized bank lending has ground to a halt, and spreads on syndicated loans have widened.



Sources: Central Bank of Turkey; and Central Registry Agency.



Source: Turkstat.



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

9. **Fiscal resolve weakened considerably in 2007**. Stripping out one-off factors, which had buoyed fiscal performance in 2006, fiscal policy was programmed to tighten by over 1 percent of GDP in 2007 (IMF Country Report No. 07/363). In the event, the envisaged discretionary tightening did not materialize: the 2007 nonfinancial public sector primary surplus was 1½ percent of GDP less than programmed, largely due to policy-induced factors (text table). In particular, with growth moderating, it proved difficult to enforce the envisaged spending restraint in an election year. On the revenue side, the main problem was weakness in tax collections linked to consumption, reflecting slow spending for durable goods, as well as a drop in compliance and tax arrears (of around ¼ percent of GDP) from an ailing state energy enterprise, underscoring the need for reform in this area (Section III.D). Even so, debt ratios continued to decline rapidly in 2007, helped by lira appreciation and privatization receipts.

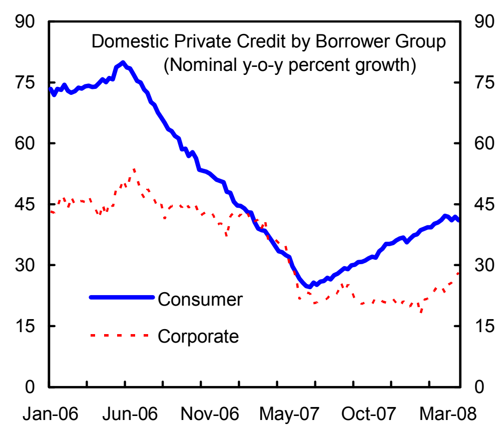
Turkey: Fiscal Peformance, 2007

	Deviation from Program (Percent of GDP)	Comment
Nonfinancial public sector primary balance	-1.5	Fiscal performance was weaker than programmed…
General government	-1.5	
Central government and social security	-1.3	...mainly due to central government and social security.
Primary revenue	-0.6	Large revenue shortfalls reflect…
Tax revenue	-0.6	...softness in tax revenue...
VAT and excises	-0.5	...as collections linked to consumption were weak due to a slowdown in consumption, compliance issues, and arrears from state energy enterprises…
Income and other	-0.1	…although income taxes held up well.
Nontax revenue	-0.1	Revolving Funds transferred less than expected.
Social security	0.1	Social security revenue was broadly in line with program.
Primary expenditure	0.7	Spending in many categories was higher than programmed…
Central government current	0.3	...led by capital transfers...
Central government capital	0.3	...and capital expenditure due to budget articles allowing for some automatic increases in appropriations.
Social security 1/	0.2	H2 pension increase was above expectations; health spending overruns continued (though less than in previous years).
Other general government	-0.2	Local government projections hampered by data shortcomings.
State economic enterprises (SEEs)	0.0	Performance would have been weaker if state energy enterprises had not run tax arrears.

Sources: Turkish authorities; and IMF staff estimates.

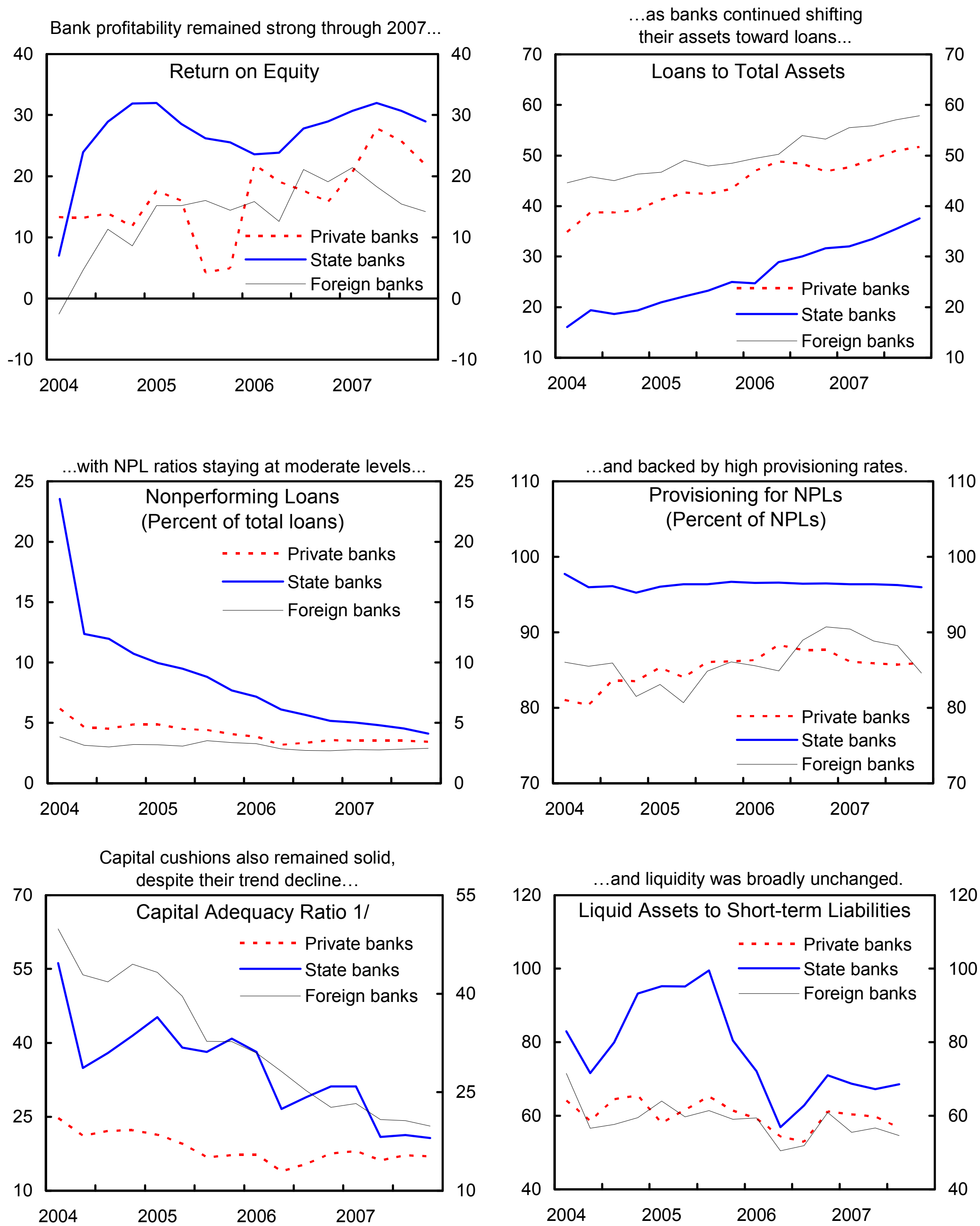
1/ Includes Social Security Institution expenditure as well as central government spending on health.

10. **While Turkish banks have so far weathered the global credit crunch, there are signs pointing to slower credit growth in the period ahead** (Figure 4). Enjoying ample capital buffers, strong profitability, sound liquidity, and no known direct exposure to the U.S. subprime mortgage market, banks have been able to expand their loan portfolios at an annual rate of over 30 percent in recent months. Consumer lending has grown the fastest, though still well below the record rates observed in Turkey until mid-2006 or elsewhere



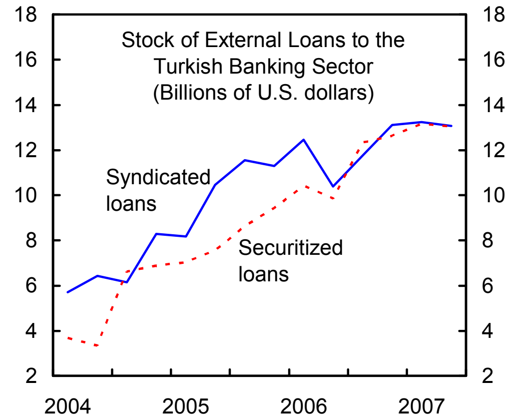
Sources: Central Bank of Turkey; and IMF staff calculations.

Figure 4. Turkey: Banking System, 2004–07
(Percent, unless otherwise indicated)

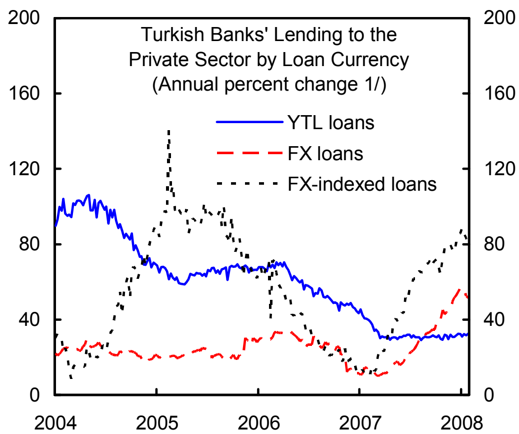


Sources: BRSA; Banks Association of Turkey; and IMF staff calculations.
1/ From June 2007 onward, capital requirements also take into account operational risk.

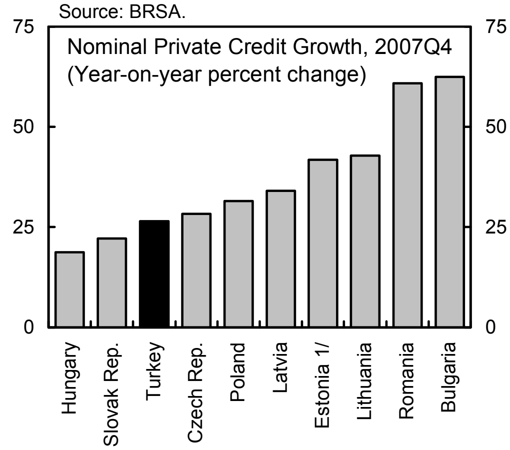
in the region. A noteworthy feature is the recent surge in foreign-currency (FX)-linked loans, which may indicate high demand from corporates faced with a decline in external borrowing sources. Meanwhile, tighter global credit conditions have also begun to reduce Turkish banks' access to external funding (notably through securitized loans), which is likely to slow credit growth going forward.



Source: BRSA.

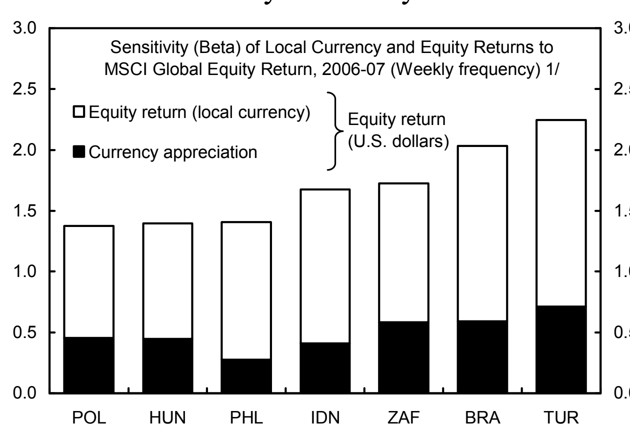


Sources: BRSA; and IMF staff calculations.
1/ Computed in YTL for YTL loans, and in U.S. dollars for all fx (-indexed) loans. As such, the latter are affected by cross exchange rate movements.



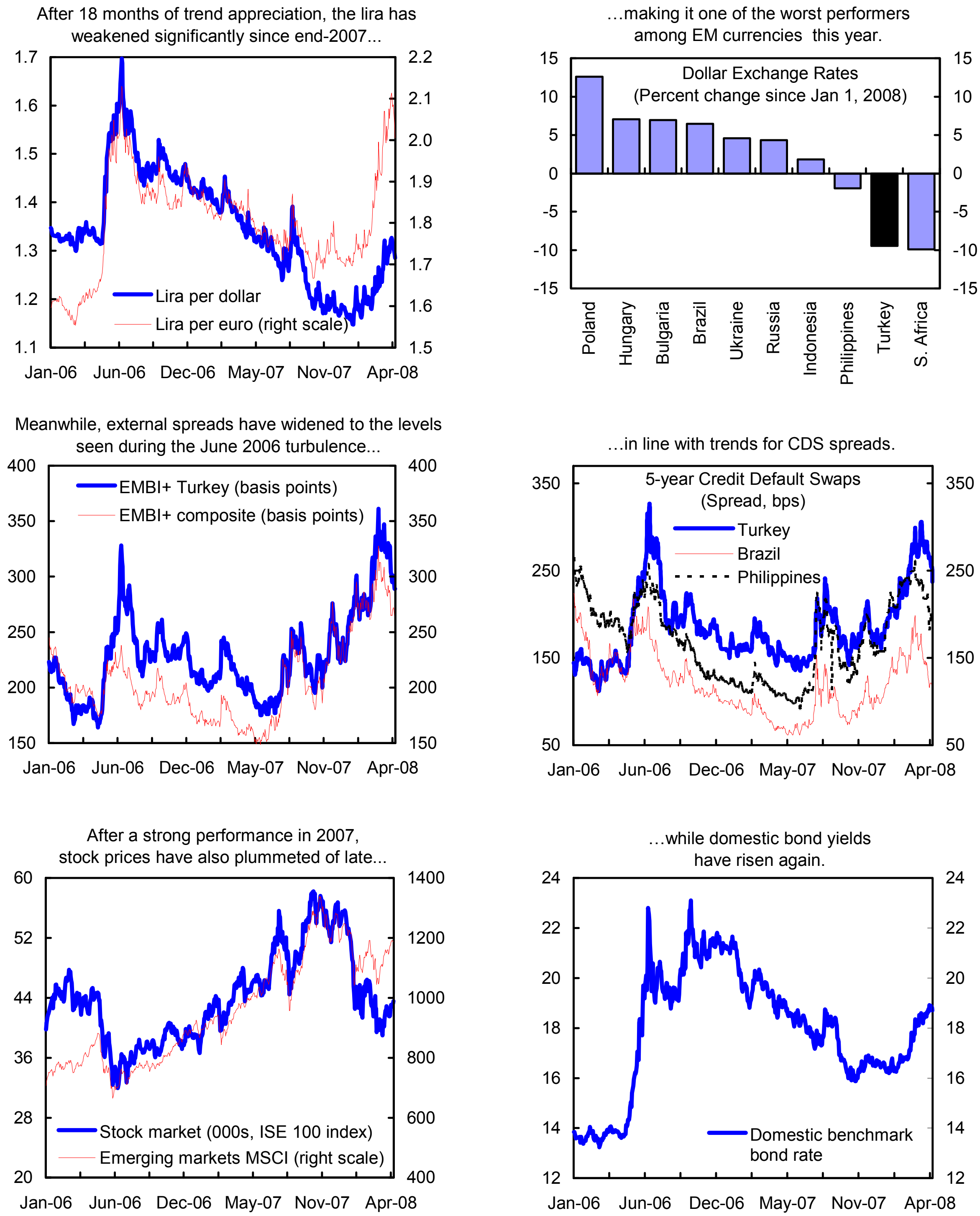
Source: IMF, *International Financial Statistics*.
1/ Data for Estonia pertain to 2007Q3.

11. **Turkish financial markets outperformed most comparators in 2007, but have fallen back significantly this year in the latest bout of volatility** (Figure 5). Equities rose 42 percent in local currency last year, while the benchmark bond yield fell by 460 basis points. Moreover, high interest rates and an appreciating currency made Turkey perhaps the most profitable "carry trade" destination throughout the year. The flip side has been strong exposure to global investor sentiment, as witnessed during the market turmoil in August 2007 and more recently in 2008, when Turkey was again among the hardest-hit emerging markets. Indeed, equities have fallen 22 percent this year, bond yields and



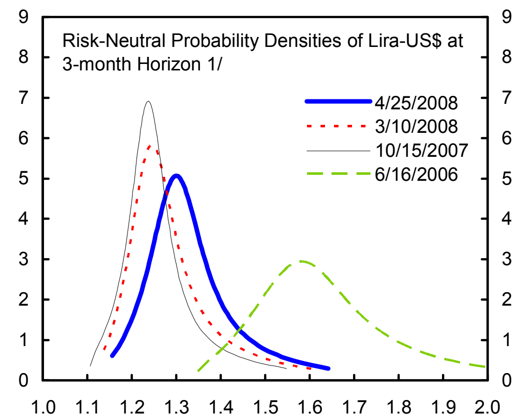
Sources: Bloomberg; and IMF staff calculations.
1/ Beta measures the local asset's volatility relative to global market movements. A beta of 1.5, for example, indicates that the local asset tends to increase by 1.5 percent in response to a 1 percent increase in the global index.

Figure 5. Turkey: Financial Indicators, 2006–08
(Percent, unless otherwise indicated)



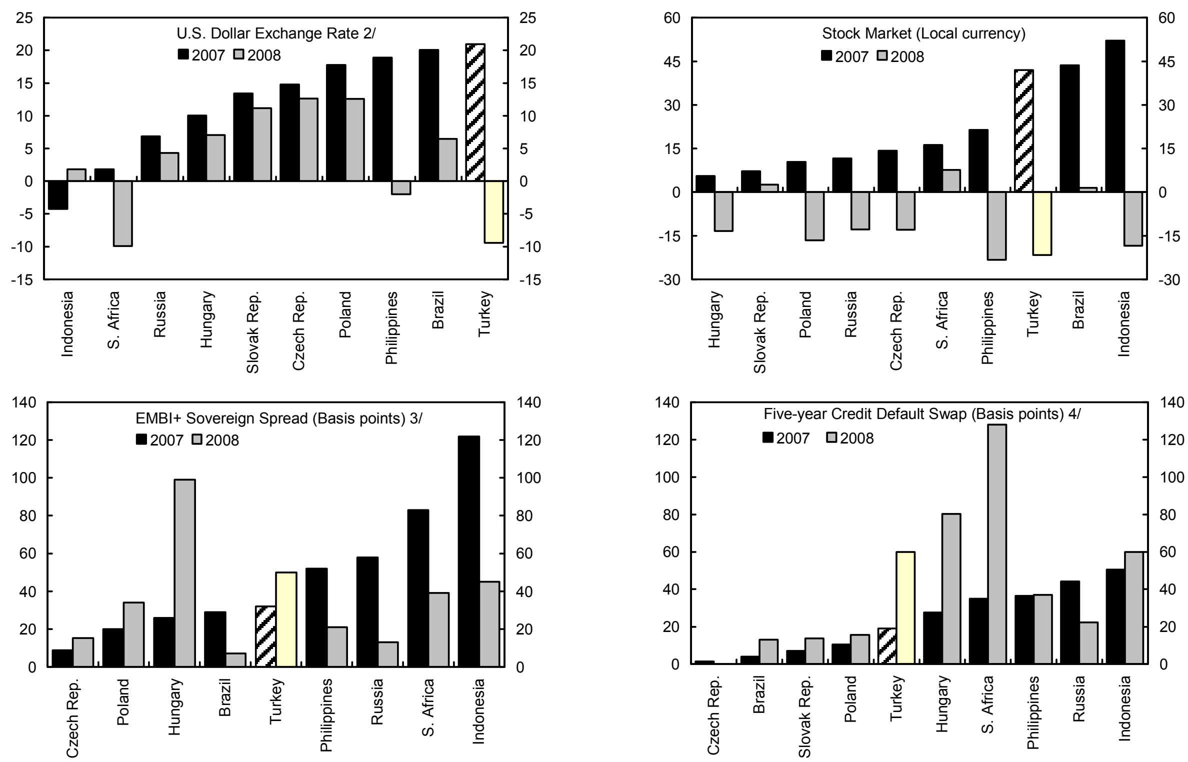
Source: Bloomberg.

external spreads are up 210 and 55 basis points, respectively, and the lira is down 12.5 percent against a euro-dollar basket (with markets pricing additional depreciation), reflecting Turkey's status as a "high-beta" investment destination, as well as growing concerns over domestic political tensions. Facing rising spreads, a steepening yield curve, and reduced participation of foreign investors in domestic debt markets, public debt managers have recently temporarily shortened maturities of new borrowing (the average maturity of domestic debt remains short at around 2 years).



Sources: Deutsche Bank; and IMF staff estimates.
1/ The implied risk-neutral probability densities are extracted from 3-month options on the lira-US$ exchange rate.

Financial Market Performance, 2007–08 1/
(Cumulative changes, percent, unless otherwise indicated)



Source: Bloomberg.
1/ Change for 2007 from Dec. 29, 2006 to Dec. 31, 2007. Change for 2008 from Dec. 31, 2007 to Apr. 25, 2008.
2/ Positive sign denotes appreciation; negative sign denotes depreciation.
3/ Where EMBI+ sovereign spreads are not available, the graph reports the spread between the domestic benchmark bond and a German bond of the same maturity.
4/ An increase in the spread of the credit default swap corresponds to a decrease in the credit quality of bonds.

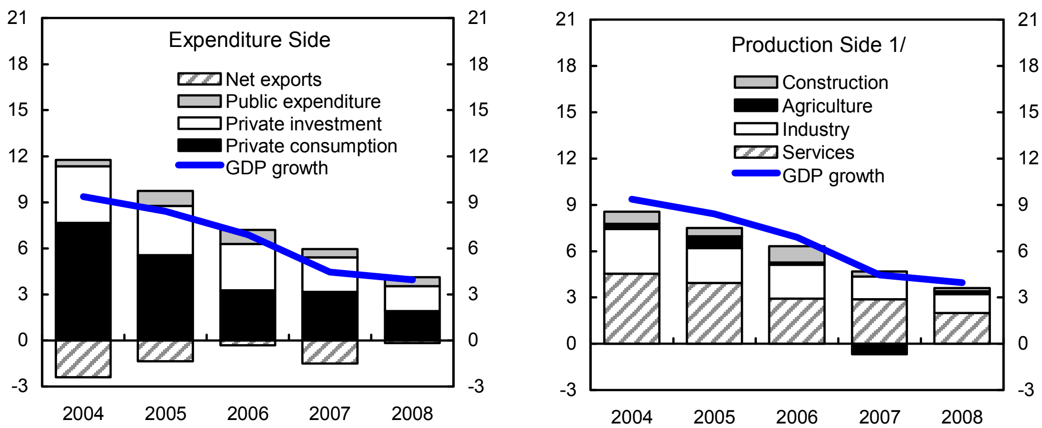
III. Policy Discussions

A. Macroeconomic Framework

12. **Economic growth is expected to continue at a moderate pace** (¶4–5).[3] The somewhat subdued outlook reflects a less supportive external environment, with further downside risks if the global credit crunch were to *sharply* contract external demand and financing (Box 2). Domestic political events could also weigh significantly on sentiment.

- **For 2008, the authorities have revised their growth forecast down from 5.5 percent to 4.5 percent**. Economic activity is expected to benefit from recoveries in agricultural production and net export volume growth, although the latter hinges on the weaker lira and at least modest growth among major trading partners. At the same time, the outlook for private domestic demand has dimmed significantly on the back of the sharp recent weakening in consumer confidence. Indeed, the combination of difficult domestic and external conditions has led staff to lower its growth projection to 4 percent (Table 2), in line with the latest market consensus. Risks around this forecast are slightly tilted to the downside.

Contribution to GDP Growth
(Percent; year-on-year)



Sources: Turkstat; and IMF staff projections (for 2008).
1/ Difference between GDP growth and sum of components accounted for by taxes minus subsidies.

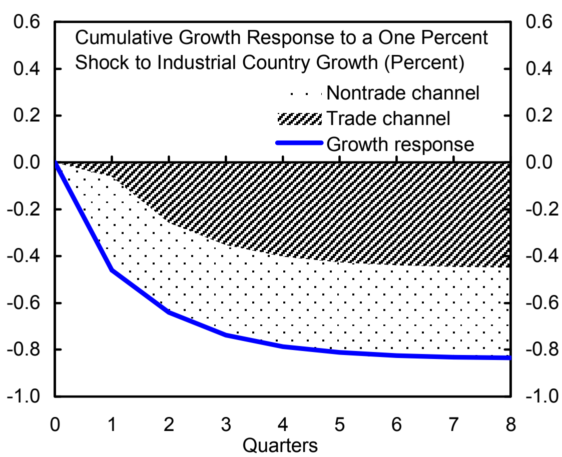
- **The inflation outlook is quite challenging**. *Core* inflation (i.e., stripping out surging food and energy prices) has remained well below headline inflation so far, but has recently started picking up (Box 3). Medium-term inflation expectations have also

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

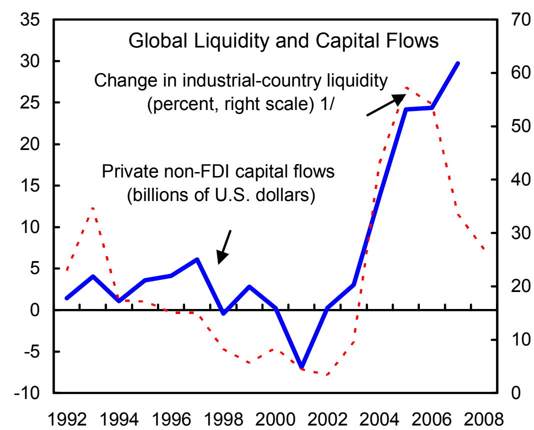
Box 2. How Will the Global Growth Slowdown Affect Turkey?

Spillover effects on Turkey from tighter credit conditions and slower growth in industrial countries may be large. Staff estimates that each 1 percentage point reduction in industrial country growth reduces Turkey's growth by a cumulative 0.8 percentage points. The projected slowdown in industrial country growth in 2008 and 2009 has consequently led to a corresponding decrease in staff's projections for Turkey's growth. A decomposition of the different channels of growth spillovers shows that the trade channel only accounts for about half of the cumulative growth response, suggesting a significant role for financial factors, especially in the first quarter after the shock.

Historically, measures of industrial country liquidity have been strong leading indicators of private non-FDI flows into Turkey. Over the last two years, however, industrial country liquidity has contracted while private capital flows into Turkey have remained strong. It remains to be seen whether the current episode marks a "decoupling" of Turkey's capital inflows from industrial country liquidity conditions or whether 2007 was anomalous, in which case external financing may recede significantly going forward, possibly imposing a disorderly adjustment.



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

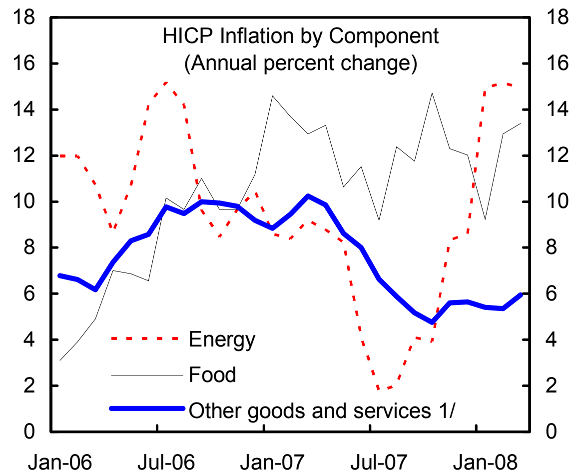


Source: IMF, *World Economic Outlook*.

1/ 3-year rolling growth rate of narrow money (moved forward one year) in the U.S., U.K., Canada, and the euro area, measured in U.S. dollars.

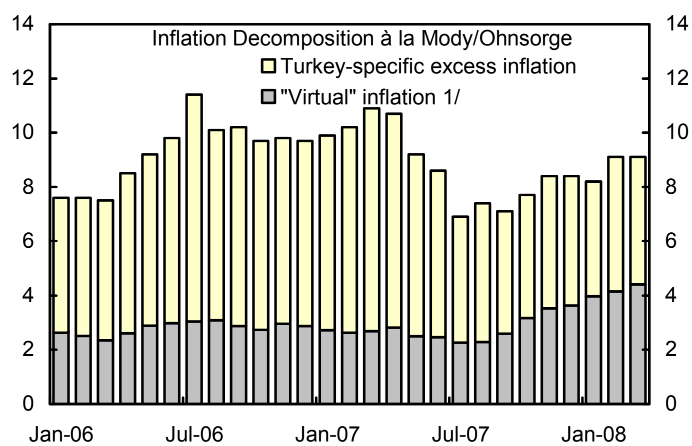
Box 3. Inflation Dynamics: Second-Round Effects

An encouraging decline in core inflation in 2007 has been overshadowed by recent adverse shocks to energy and food prices. Annual HICP (Harmonized Index of Consumer Prices) inflation excluding energy and food has exhibited a broad downward trend since March 2007, reaching 5.9 percent in March this year. This trend has reflected both the dampening effect of high real interest rates on domestic demand and the concomitant appreciation of the lira until late 2007. Energy items—representing 11½ percent of the HICP basket—were also supportive of disinflation during the first half of 2007, as lira strength and the administrative freeze of utility prices temporarily shielded consumers from rising world market prices. More recently, however, the surge in oil prices has become manifest in domestic inflation. In addition, food prices—28½ percent of the basket—have continued to exert upward pressure.



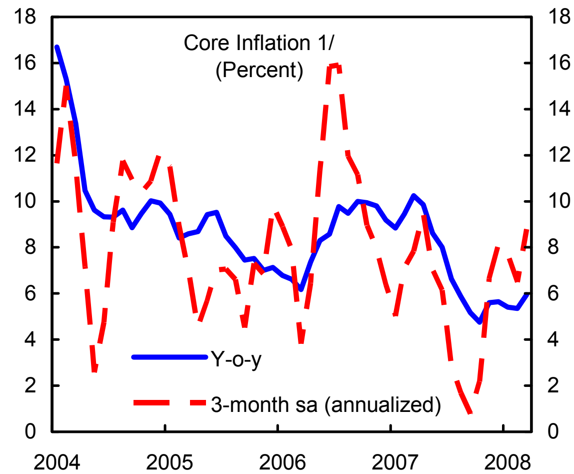
Source: Eurostat.
1/ Also excludes alcohol and tobacco.

Although these supply shocks point to global forces behind recent inflation trends, Turkey's inflation rate remains essentially a domestic phenomenon. Following Mody and Ohnsorge (2007), a "virtual" inflation series was computed by applying Turkey's basket weights to average EU-27 inflation rates for detailed HICP components. This virtual rate is meant to capture the impact of pan-European price trends, which in the case of Turkey are magnified by the relatively high weight of key items (especially food) in the national basket. Indeed, EU-wide trends explain most of Turkey's very recent inflation *dynamics*. However, the general level of inflation clearly remains a domestic phenomenon.



Sources: Eurostat; and IMF staff calculations.
1/ Inflation that would prevail if inflation at the level of detailed subitems of Turkey's HICP basket were the same as the respective EU-27 average.

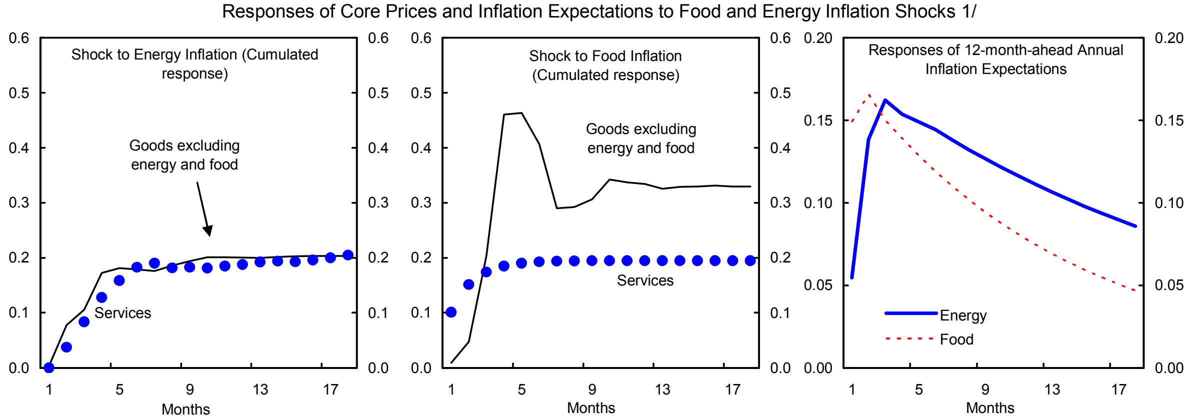
The key risk for the inflation outlook is that the recent supply-side shocks will produce lasting second-round effects. Inflation expectations have long followed a gentle downward path but have risen sharply again in recent weeks. Moreover, the latest monthly numbers on core inflation do point to a problematic broadening of price pressures, also related to the lira depreciation early this year.



Source: Eurostat; and IMF staff calculations.
1/ HICP excluding energy, food, alcohol, and tobacco.

Indeed, staff research suggests that shocks to energy and food prices have fed through to core prices and inflation expectations in the past. Illustratively, in simple bivariate models an initial one percentage point shock to energy or food inflation tends to increase core inflation by around 0.2–0.25 percentage points. As a result, headline inflation rises by 0.3–0.4 percentage points—or by a factor of 1½ (for food) and 2 (for energy) times the mechanical impact of the shocks on headline inflation. The adjustment has typically been fast, unfolding on average within one year from the original shock. Moreover, the shocks have had a relatively persistent, if contained, effect on inflation *expectations*. Taken together, these findings suggest that second-round effects represent a significant risk, highlighting the need for very close monitoring and prompt policy responses to adverse price developments following exogenous shocks.

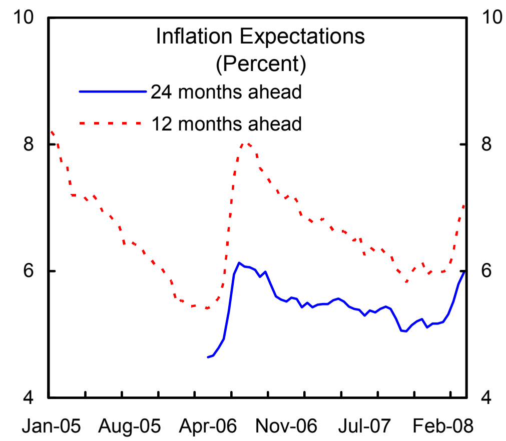
Responses of Core Prices and Inflation Expectations to Food and Energy Inflation Shocks 1/



Source: IMF staff estimates.

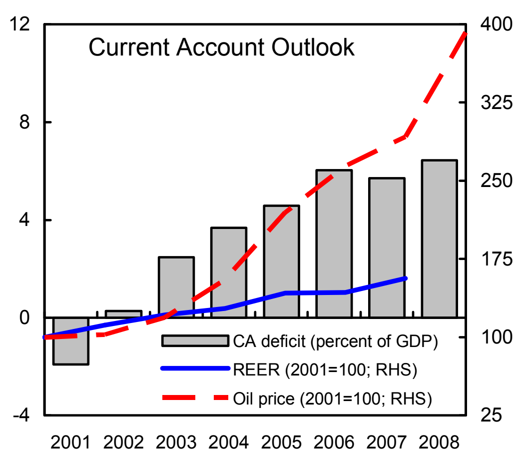
1/ Energy/food inflation shocks are one-percentage point increases in energy/food prices. Responses are estimated from impulse response functions in bivariate VAR models on monthly, seasonallly adjusted inflation rates (starting in January, 2003).

increased sharply in recent weeks, underscoring the emergence of second-round effects from the various shocks. Thus, the central bank now expects that it will take much longer than previously envisaged to bring inflation down to target, foreshadowing an upward revision of its inflation forecasts. Staff currently projects end-year inflation at 9¼ percent with risks somewhat tilted to the upside (Section B).

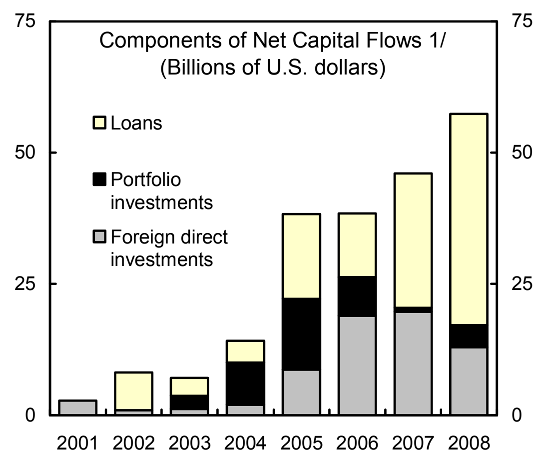


Source: Central Bank of Turkey.

- **The current account deficit is projected to widen again in 2008** (Table 3). The lagged effects of 2007's strong lira and surging oil prices have continued to weigh on net export values in early 2008. The lira's recent reversal should help improve performance in the second half of the year in volume terms, but the current account deficit will still widen for the full year in value terms, due to unfavorable terms of trade movements. Uncertain prospects for growth in major trading partners pose a downside risk for exports, which is balanced by the risk that the lira may weaken and boost net exports.



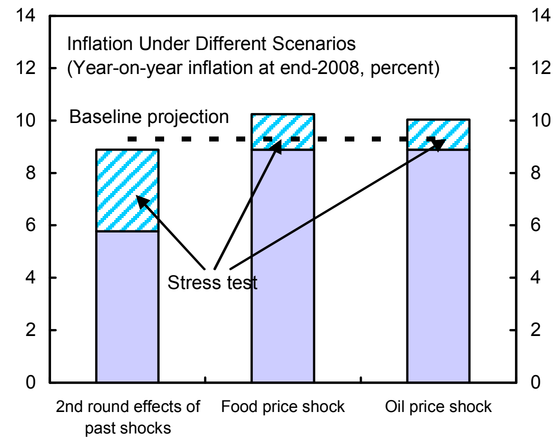
Sources: Turkstat; Central Bank of Turkey; IMF, *World Economic Outlook*; IMF, internal database; and IMF staff projections.



Sources: Turkstat; and IMF staff projections.
1/ Projection for 2008. Loans include trade credits and currency and deposits.

- **External financing conditions are expected to remain adequate, but risks have increased considerably** (Table 4). FDI is projected to cover one-quarter of the current account shortfall in 2008, as privatization transactions (tobacco, petrochemicals) and a pipeline of private sector merger and acquisition deals are finalized. However, tight global credit conditions and political uncertainty in Turkey pose significant risks to external financing. The considerable reliance of banks and especially corporates on external loans and the substantial stock of portfolio investment by nonresidents represent key risks in this regard.

B. Monetary and Exchange Rate Policies



Source: IMF staff estimates.
1/ These stress tests assume modest electricity price adjustments in mid-2008. (i) "Second round effects of past shocks" focuses on *past* shocks only and compares a scenario with no second round effects of past shocks with one with full second round effects. Assuming full second round effects of *past* shocks, (ii) "Food" compares a scenario with high food price inflation (15 percent) to one with moderate food price inflation; and (iii) "Oil" considers the effect of a 20 percent shock to baseline oil prices. Simulations are based on a small-scale macroeconomic model (IMF Working Paper 06/81).

13. **In response to the recent surge in inflation, the central bank has adopted a tightening bias in its interest rate policy** (¶6). In its view, the recent rise in inflation largely reflects adverse developments in food, energy, and administered prices as well as a weakening currency in a more uncertain global environment. These shocks—with a significant global component and greater persistence than earlier anticipated—have more than offset the moderating effects of weaker demand and pose upward risks to the inflation outlook. This assessment is in line with staff simulations, which foreshadow a significant overshooting of the 4-percent target by end-2008 even in the absence of new major shocks. Recognizing these risks, the central bank has halted its easing cycle and announced a tightening bias whereby monetary policy will be more responsive to adverse developments than favorable developments in the inflation outlook. Staff concur with this approach and advise the central bank to consider raising interest rates in the period ahead to anchor inflation expectations and ensure progress in reducing inflation to target over the medium term. Supporting fiscal and income policies will also be key to achieving further disinflation without aggravating external imbalances.

14. **The central bank remains committed to building international reserves for prudential reasons** (¶7). It took advantage of favorable market conditions to double its daily foreign currency auction purchases in October 2007 (to a minimum US$30 million plus an additional optional amount of up to US$60 million). However, it reduced the purchase amounts back to the previous level in March 2008 in the face of greater exchange market volatility. The central bank is prepared to adjust its pace of predictable and moderate reserve accumulation as conditions permit to meet its goal of building reserves without adding to market volatility.

C. Fiscal Policy

15. **The authorities target a neutral fiscal stance for 2008** (Tables 5-6; ¶10). Staff and the authorities agree that the primary surplus target of the last five years (5 percent of GDP)

has been a cornerstone of past macroeconomic success. However, with gross public debt down to 39 percent of GDP (Appendix II), a primary surplus of 5 percent is no longer necessary from a debt dynamics perspective. In any case, the authorities now view such a target as neither feasible (given the slippage in 2007), nor desirable, given pressing needs for infrastructure investment and labor tax cuts. On the other hand, high real interest rates, above-target inflation, the large current account deficit, and Turkey's still below-investment-grade rating all argue for some tightening of fiscal policy from the 2007 outturn (3.5 percent of GDP). The authorities thus targeted a higher primary surplus of 4.2 percent of GDP in their original 2008 budget, with the adjustment relying in part on a significant compression of investment spending. In the event, the authorities came to view this adjustment as untenable and therefore reduced the target back to 3.5 percent of GDP to create additional fiscal space for infrastructure investment (including major projects in poorer southeast areas), labor market reform (paragraph 23), and higher transfers to subnational governments (paragraph 20). The authorities view this stance as appropriately balancing macroeconomic concerns against microeconomic needs. It also implies a slight tightening of the structural balance, given the disappearance of some one-off revenue and below-potential GDP growth.

Structural Fiscal Balance, 2004–08

(Percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	Change, 2007–08
I. Reported balance						
Nonfinancial public sector primary balance	5.5	5.0	4.6	3.5	3.5	0.0
CG and SSI consolidated	4.0	4.1	4.4	2.6	2.7	0.1
Revenue	25.5	26.0	26.8	25.5	25.1	-0.4
Expenditure	21.5	21.9	22.5	22.9	22.4	-0.5
Rest of public sector	1.5	0.9	0.2	0.9	0.8	-0.1
II. Underlying balance 1/						
Nonfinancial public sector primary balance	5.5	5.0	3.3	3.2	3.4	0.1
CG and SSI consolidated	4.0	4.1	3.1	2.4	2.6	0.3
Revenue	25.5	26.0	25.7	25.2	25.0	-0.2
Expenditure	21.5	21.9	22.6	22.9	22.4	-0.5
Rest of public sector	1.5	0.9	0.2	0.9	0.8	-0.1
III. Structural balance (percent of potential GDP) 2/						
Nonfinancial public sector primary balance	6.2	5.2	3.3	3.4	3.6	0.3
CG and SSI consolidated	4.7	4.3	3.1	2.5	2.9	0.4
Revenue	25.5	26.0	25.7	25.2	25.0	-0.2
Expenditure	20.8	21.7	22.6	22.7	22.1	-0.6
Rest of public sector	1.4	0.9	0.2	0.9	0.8	-0.1
Memorandum items:						
Potential GDP (billions of lira)	577.3	655.2	759.4	862.0	989.9	...
Output gap (percent of potential)	3.2	1.0	0.1	0.7	1.2	0.5

Sources: Turkish authorities; and IMF staff estimates.

1/ Adjusts for non-recurring items.

2/ Cyclically adjusts the underlying balance, using elasticity of 1 for revenue and 0 for spending.

16. **The unchanged fiscal stance masks some changes in the composition of the budget** (¶10). A supplementary budget has not yet been submitted to finalize the allocation of additional resources among the various initiatives. However, a tentative distribution is

shown in the "staff projection" column, which also incorporates potential effects of recent upward inflation revisions on revenue and on wage and pension increases. In this scenario, revenue is projected to fall somewhat as a share of GDP (relative to 2007), in part due to an expected revenue loss of 0.2 percent of GDP from a reduction in the VAT rate on tourism (hotels and restaurants) from 18 to 8 percent in the original budget. Staff's view is that this sector should not be given preferential treatment, as a lower VAT rate would complicate administration, erode the revenue base, create opportunities for fraud, and artificially distort economic activity. However, the authorities note that tourism receives preferential VAT treatment in several other European countries and believe that similar preferences are needed to keep Turkey's tourism sector competitive and help narrow the current account deficit. On the expenditure side, current spending is compressed to safeguard capital spending.

17. **Risks to the budget are broadly balanced, provided there are no new unbudgeted initiatives**. On the downside, further electricity price increases may be insufficient to ensure state enterprises' targeted contribution to the primary surplus (see paragraph 25), and the VAT reduction on tourism could prove more costly than expected. These risks are broadly offset by nominal revenue projections that are now otherwise somewhat conservative relative to the recent upward adjustment to the inflation outlook and in light of improved revenue compliance in the first quarter.

Turkey: Fiscal Program, 2008

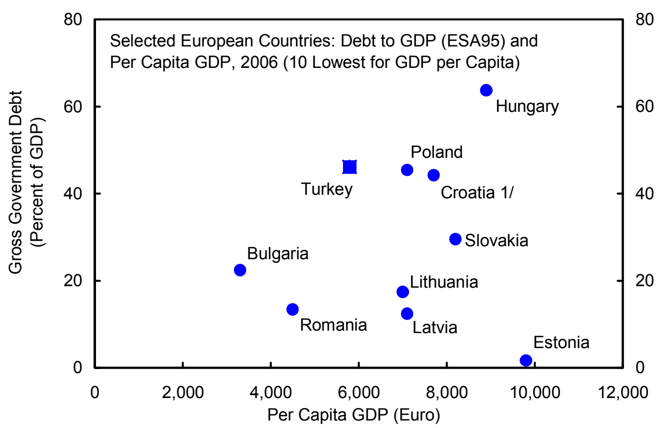
(Percent of GDP, unless otherwise indicated)

	2007 Est.	2008 Staff proj.	Change 2007-08	Comments
Nonfinancial public sector primary balance	3.5	3.5	0.0	Headline balance stays at 2007 ratio
General government	3.1	3.2	0.0	
Central government and social security	2.6	2.7	0.1	.... also broadly the same for consolidated central government and social security.
Primary revenue	25.5	25.1	-0.4	Revenue ratio declines somewhat
Tax revenue	17.8	17.7	-0.1	
VAT and excises	9.6	9.4	-0.2	... in part due to the VAT cut on tourism.
Income and other	8.2	8.3	0.1	
Nontax revenue	2.7	2.6	-0.1	
Social security	4.9	4.7	-0.2	... employer social security contribution rate cut by 5 pps in Q4 as part of proposed labor market reform.
Primary expenditure	22.9	22.4	-0.5	Spending is tightened as a share of GDP
Central government current	11.2	10.8	-0.4	... in particular, current spending is restrained
Central government capital	1.5	1.5	0.0	... while capex is held constant as a share of GDP.
Social security 1/	10.1	10.0	-0.1	Pension increase is limited to inflation and health spending overruns are eliminated.
Other general government	0.5	0.5	-0.1	All broadly similar to 2007.
Local government	-0.1	0.0	0.0	
Unemployment insurance fund	0.3	0.3	0.0	Somewhat lower due to labor market reform.
Extrabudgetary and revolving funds	0.3	0.2	-0.1	
State economic enterprises (SEEs)	0.4	0.3	-0.1	Assumes SEE prices adjust as needed.
Memorandum item: GDP (millions of lira)	856,387	978,331	...	

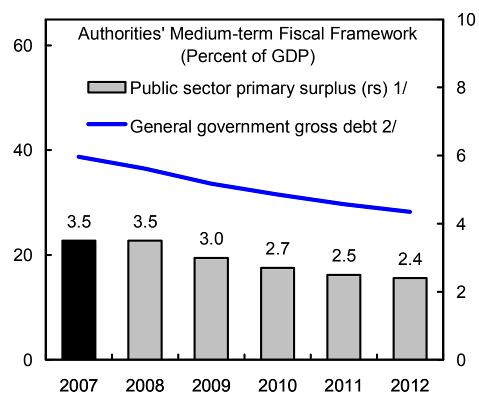
Sources: Turkish authorities; and IMF staff estimates.

1/ Includes Social Security Institution expenditure as well as central government spending on health.

18. **The authorities will soon announce a medium-term fiscal framework to help guide policies and expectations going forward** (¶12). The authorities' main fiscal policy objective over the medium term is to lower debt further to safer levels (Turkey's gross debt-to-GDP ratio is still high relative to European countries with similar levels of per capita income) while using fiscal space to ease the tax burden and increase infrastructure spending. This will require restraint of current spending. To anchor expectations around these objectives, the authorities have prepared a medium-term fiscal framework targeting 2012 gross debt at 30 percent of GDP (general government, Maastricht definition) and paths for key fiscal variables that support this objective (likely outcomes and risks under this fiscal framework and staff's medium-term macroeconomic assumptions are in Appendix II and Table 13). In this scenario, a gradual reduction in the primary surplus plus some mild restraint of the growth of personnel costs (supported by civil service reform) should make room for increased infrastructure spending and cuts in labor and financial transaction taxes. The authorities are studying ways to underpin the framework with a strengthened institutional setup (such as a fiscal rule embedded in a fiscal responsibility law) and expect to make a decision in this regard prior to the 2009 budget.



Sources: Eurostat; Turkish authorities; and IMF staff estimates.
1/ Data for Croatia as of 2005.



Source:Turkish Treasury.
1/ IMF definition.
2/ Maastricht definition.

19. **The government is considering using fiscal space to increase transfers to provincial and local governments by enacting legislation as early as mid-2008**. This reform would empower subnational governments to increase their own-revenue from property taxes and other sources. However, under some proposals, the reform would also increase the share of central government revenue transferred to subnational governments by 0.4 percent of GDP, without a corresponding transfer of spending responsibilities or an attempt to claw back subnational governments' substantial tax and other arrears to the rest of the public sector. Staff recommends including such safeguards so as to implement the proposal in a broadly deficit-neutral and gradual manner. Otherwise, it could significantly reduce budget flexibility, rapidly transfer resources to localities with limited absorptive capacity, and reduce space for other pressing priorities.

D. Structural Fiscal Reform

Social security

20. **Parliament passed a major reform on April 17, 2008 to place social security finances on a sustainable path** (¶15). Among other changes, the reform gradually raises the retirement age to 65 and reduces replacement rates closer to internationally standard levels. Even though the law was adjusted in the final stages of parliamentary approval to broaden its support among unions, the reform still retains the bulk of the savings of the original 2006 law struck down by the Constitutional Court (Box 4). The reform also officially adopts a universal health insurance system that, among other things, allows flexibility in setting medical copayments in order to reorient demand for health services toward primary care physicians in the first instance and away from direct use of costly tertiary services.

Tax administration

21. **Strengthening tax administration is a key part of the authorities' reform agenda** (¶16–17). A priority is to strengthen VAT compliance, as highlighted by weak VAT collections in 2007, including from a spike in refunds. The authorities have thus taken measures to combat refund fraud and move toward a risk-based refund system, which will also reduce the compliance burden for low-risk taxpayers. Staff also recommends consolidating all tax auditing under the Revenue Administration (RA) to promote efficiency and coordination and bring Turkey in line with international good practice (currently, auditing responsibilities are fragmented across several agencies). However, the authorities, taking into account the organizational challenges, are currently evaluating the option of merging all tax auditing bodies under the Ministry of Finance instead. Staff advises against this move, as it would actually move audit resources out of the RA, further hampering coordination between auditing and other revenue administration responsibilities. Regarding social security contributions, the authorities have adopted legislation requiring large employers to pay wages through bank accounts and introducing a unified tax declaration form that covers taxes due to both the RA and the Social Security Institution, which will facilitate better cross-checking and ease the administrative burden on taxpayers.

Labor market reform

22. **The authorities are preparing a package of labor market reforms** (¶11). Their aim is to encourage employment and reduce labor market rigidities. Reforms being considered include the following:

- reducing employer social security contributions by 5 percentage points (total social security contributions are currently 33.5–39 percent of wages);
- providing additional targeted incentives for youth employment;

Box 4. Social Security Reform

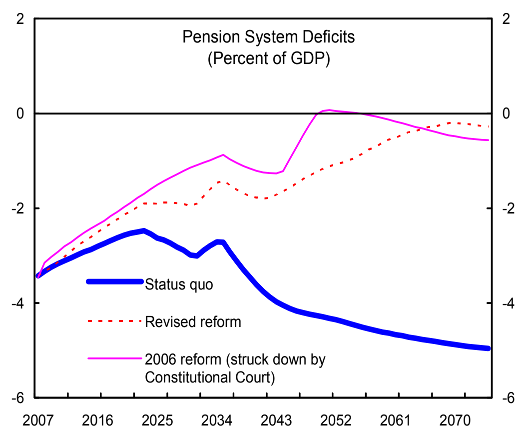
Parliament passed a landmark social security reform in 2006, but the Constitutional Court struck down key elements. The Court's main objections were to (i) all provisions relating to civil servants, on the grounds that they did not respect the different "legal status" of civil servants and (ii) the reform's index for bringing wage histories into present value (which is needed to calculate the average lifetime wage on which pensions are based), on the grounds that the "the share of prosperity per individual arising from the growing economy had not been taken into consideration" (though the index consisted of 50 percent average economy-wide wages plus 50 percent consumer prices).

In April 2008, parliament passed a revised reform that aims to address the Court's concerns. The revised reform addresses the first objection above by fully grandfathering all current civil servants. It addresses the second objection by changing the relevant index to 30 percent real GDP growth (to more explicitly link to economic growth) plus 100 percent consumer prices.

The revised reform retains most of the other key elements of the 2006 reform. In particular, it

- gradually raises the retirement age, which will eventually reach 65 for most new retirees around 2060−70 (an individual's exact retirement age will depend on several factors other than age; preexisting law has the retirement age gradually rising to 60 for men and 58 for women by 2036; currently, individuals can retire in their mid-40s);
- indexes pension increases to consumer prices (in recent years, pension increases have been discretionary and have typically exceeded inflation);
- brings replacement rates (an individual's pension relative to their preretirement earnings) down closer to international standards, though Turkey will still have some of the highest replacement rates among OECD-member countries; and
- creates a unified system once all grandfathering is phased out (currently, private sector employees, the self-employed, and civil servants are covered by separate systems, hindering labor mobility).

As a result, the reform achieves most of the savings and efficiency gains of the original reform. World Bank staff estimate that the reform will bring the pension system close to balance in the long run, compared to deficits in excess of 4.5 percent of GDP in the absence of reform. In present value, staff estimate savings over the next 75 years to be around 75 percent of 2007 GDP. However, there is inherently a large amount of uncertainty surrounding such long-run estimates of a quite complex system. Uncertainty also arises from the opposition's recent announcement that it will again challenge the reform in the courts. Depending on the outcome and other developments, further adjustments to the system may be needed.



Source: World Bank staff estimates.

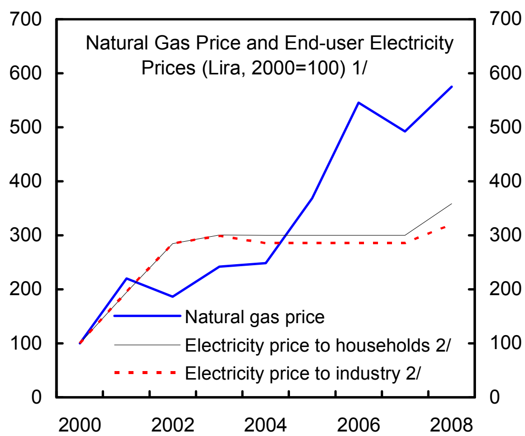
- raising spending on active labor market policies; and
- increasing the flexibility of labor regulations.

The reform is expected to cost around 0.4 percent of GDP on an annual basis (mainly from lower social security contributions) and become effective in the last quarter of 2008. The authorities expect that this reform will facilitate employment generation and, together with efforts to enforce compliance of social security contributions, reduce the incidence of unregistered employment.

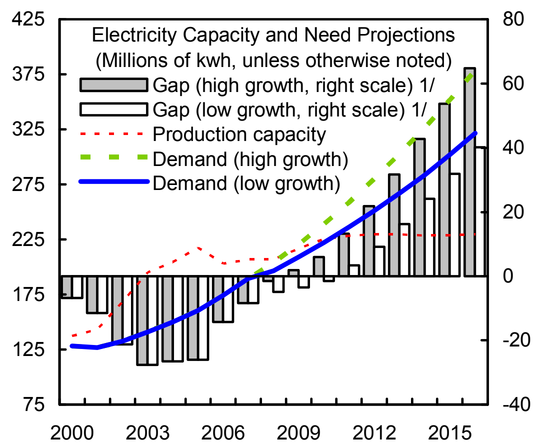
Energy sector

23. **Energy sector reform has become increasingly urgent as rising input costs and existing structural inefficiencies have led to large financial losses in the sector**. Losses in the state-owned electricity distribution company, TEDAŞ, are estimated at 0.14 percent of GDP in 2007, as end-user electricity tariffs were not raised between 2002−07 despite substantial increases in international energy prices. The sector is also plagued with high rates of electricity theft, loss, and nonpayment. The sector's growing financial losses have been a significant drag on public finances.

24. **Of equal concern is the impact of losses on the sector's infrastructure**. TEDAŞ's financial problems have led to sustained underinvestment in the distribution network, compounding technical problems and electricity losses. Moreover, the absence of a financially solid distribution company has discouraged upstream private investment in new generation capacity. Combined with other supply problems—recent droughts have impaired hydroelectric power generation—and the fast growth of electricity demand (8.5 percent per year over the last five years), this has created a serious risk of near-term electricity shortages (IMF Country Report No. 07/362, Box 4).



Sources: Turkish authorities; and IMF, *World Economic Outlook*.
1/ Natural gas accounted for one half of electricity generation in 2007.
2/ 2008 prices refer to the first quarter only.



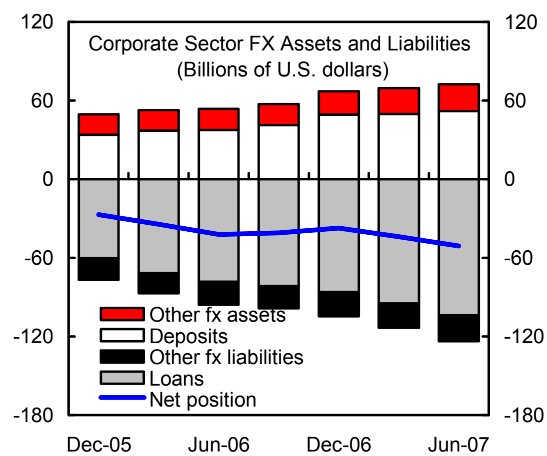
Source: TEIAS; and IMF staff calculations.
1/ In percent. Positive value indicates demand greater than installed supply capacity.

25. **The authorities are undertaking a comprehensive strategy that aims to restore financial viability of the energy sector and encourage much-needed investment** (¶19). The plan aims to implement cost-recovery pricing, reduce arrears (including from municipalities), and restart privatization, which is needed to generate investment and enhance efficiency and bill collection. In line with the proposed strategy, tariffs were increased by 12.2 percent for industrial users and 19.4 percent for households and retail businesses on January 1, 2008. However, this price adjustment alone will not achieve the programmed contribution to the public sector primary surplus, given current projections for international energy prices and the exchange rate.[4] This highlights the importance of the authorities' plan to make effective, by July 1, 2008, an automatic cost-based pricing mechanism that will adjust tariffs based on realized costs and revised end-year macroeconomics assumptions. If implemented as planned, such a mechanism should improve the sector's finances and help attract private investment into the sector.

E. Financial Sector Reform

26. **The authorities have published the Financial System Stability Assessment and adopted some of its recommendations** (¶21). Of note, the authorities passed a new law modernizing the institutional framework for the insurance sector. They also strengthened loan provisioning requirements by distinguishing fully performing loans (classified as "standard") from those showing potential impairment (classified as "special mention"), thereby encouraging banks to recognize risks more accurately and build additional buffers. Moreover, the BRSA recently raised liquidity requirements for banks.

27. **The corporate sector's large FX indebtedness is a potential risk for the banking sector and the economy at large**. A scarcity of data on hedging hampers the assessment of FX risk in the corporate sector. However, there are indications that the open FX position may have widened considerably in recent years (IMF Country Report No. 07/361) and that borrowing is predominantly at variable rates. Moreover, Turkey's history of exchange rate volatility suggests that FX loans are likely to be a significant source of credit risk. Staff advises the authorities to monitor risks closely and ensure that banks' loan policies and practices take FX



Sources: Central Bank of Turkey, Financial Stability Report; and IMF staff calculations.

[4] Under current projections, a mid-year price increase of nearly 15 percent is needed to restore prices to a cost-recovery level going forward.

and other market risks fully into account. In this regard, the central bank's new survey of corporate FX exposure, the authorities' plans to encourage banks to enhance their oversight of corporates' FX borrowing, and the plan to enhance corporate governance and transparency by introducing a new Commercial Code are all welcome steps (¶21–22).

28. **The authorities intend to advance state bank privatization, a key element of their strategy to strengthen the financial sector under the Fund-supported program**. Following the successful IPO of Halkbank last year, the authorities intend to sell another 24 percent of Halkbank shares through a secondary equity offering later this year (¶24). The authorities also remain committed to privatizing other state-owned banks (notably Ziraat) in the years ahead.

IV. Program Modalities

29. **This will be the final review under the current Stand-By Arrangement, which ends on May 10, 2008**. Completion of this review will enable Turkey to draw all remaining purchases under the current arrangement (SDR 2.25 billion, or about US$3.7 billion, ¶2–3).

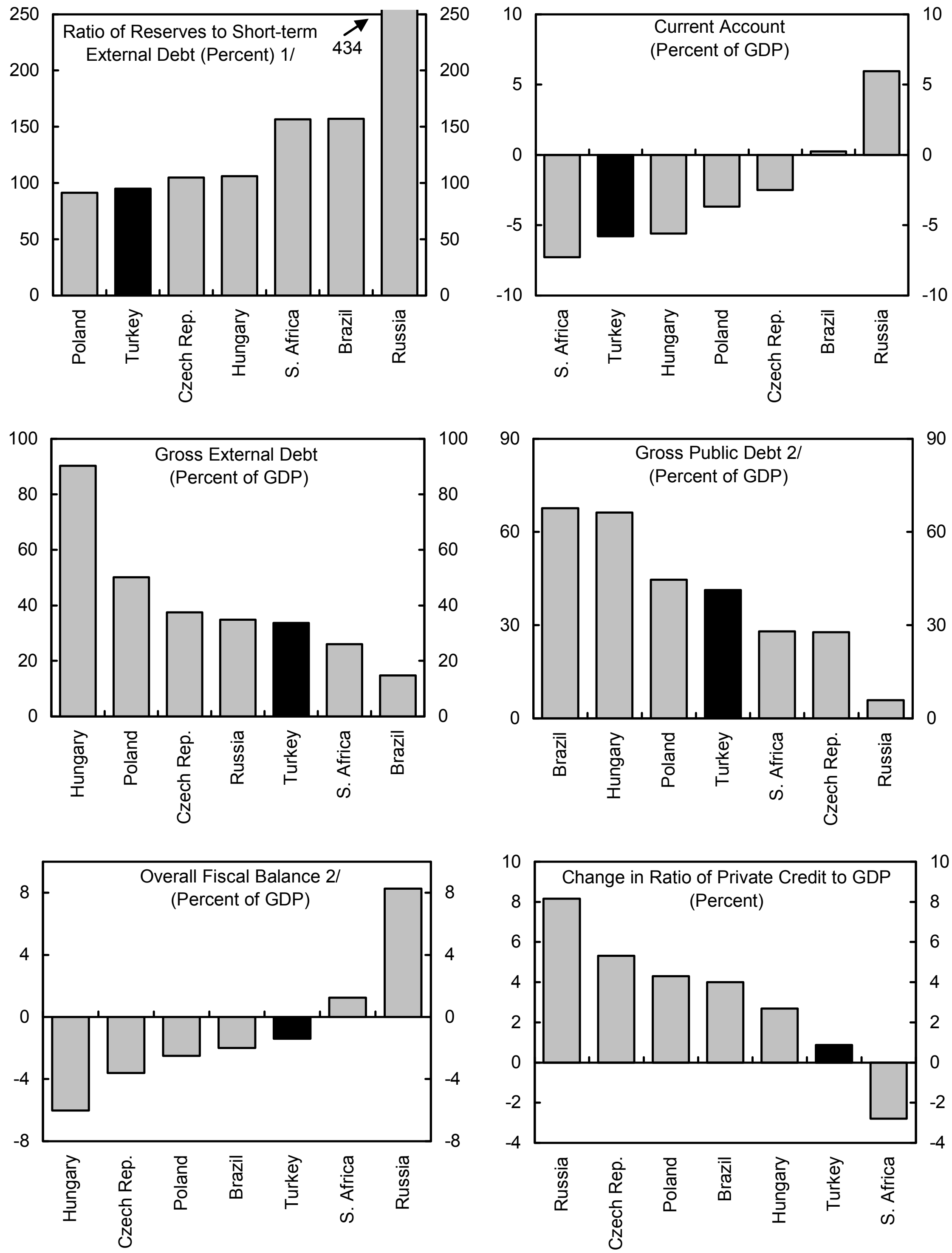
30. **Turkey's capacity to repay the Fund remains strong**. External vulnerabilities have risen significantly since the last review due to the global credit crunch, surging import prices, higher projected current account deficits and external debt over the medium term, and rising risk perceptions due to heightened domestic political tensions. Nonetheless, indicators of Fund credit still suggest a strong capacity to repay the Fund (Table 10). While Turkey's current account deficit remains relatively high, several other vulnerability indicators remain broadly in line with other emerging economies (Figure 6).

V. Staff Appraisal

31. **Economic performance and policy implementation have been mixed since the last review**. Supply-side shocks have weighed on growth while fueling inflationary pressure. The 2007 presidential and parliamentary elections also distracted attention from implementing an ambitious economic policy agenda.

32. **The global credit crunch has dampened the economic outlook and heightened Turkey's vulnerabilities**. While improvements in public and private sector balance sheets over the last five years have increased Turkey's resilience to shocks, external risks remain considerable and need to be monitored closely. In particular, high and rising current account deficits worsen the external debt outlook over the medium term, increase Turkey's dependence on external financing flows, and make the private sector more exposed to abrupt changes in the exchange rate. These risks are exacerbated by the still strong lira, the substantial stock of volatile portfolio investment by nonresidents, and the potentially significant component of unhedged foreign-currency liabilities in the corporate sector.

Figure 6. Vulnerability Indicators of Selected Emerging Market Countries, 2007



Source: IMF staff estimates.

1/ Debt falling due in 2007. Gross international reserves are end-2007 stocks.
2/ Consolidated public sector for Turkey and Brazil, general government for all others.

33. **Steadfast implementation of the authorities' reform strategy is necessary for Turkey to navigate the choppy waters ahead and increase the resilience of the economy**. This strategy continues to center on (i) adapting monetary policy to the need to achieve low, stable inflation; (ii) strengthening public sector balance sheets by lengthening debt maturities, adhering to a medium-term fiscal framework geared toward continued debt reduction, and implementing broad-ranging fiscal reforms; (iii) increasing the resilience of the banking system by building cushions in balance sheets and stepping up oversight; (iv) fostering private-sector led growth through structural reforms, including privatization, tax and energy reforms, and labor market liberalization; and (v) maintaining a floating exchange rate to act as a flexible shock absorber and to encourage hedging against exchange rate risk.

34. **The authorities have made significant progress in this regard in recent months**. The recently adopted social security law is a major reform that substantially strengthens long-term fiscal sustainability and should be implemented without further delays. Other recent signals of the government's commitment to reform include significant hikes in end-user electricity prices, the resumption of the privatization process for electricity distribution companies, the adoption of key tax administration reforms (requiring large firms to pay salaries through bank accounts, passage of legislation allowing a unified tax declaration form, and introduction of a risk-based system to address VAT refund fraud), and the tightening of bank provisioning and liquidity requirements.

35. **To preserve the credibility of the inflation targeting regime, monetary policy should respond promptly to broadening price pressures**. In response to the recent supply shocks to inflation, the central bank has halted its easing cycle and adopted a clear tightening bias. With mounting signs that these shocks are starting to exert second-round effects on broader price-setting behavior, monetary policy will need to be tightened in the coming months to restart disinflation and avoid lasting damage to credibility.

36. **Achieving the fiscal targets would underpin investor confidence and further strengthen public sector balance sheets**. Indeed, a somewhat tighter fiscal stance in 2008 would have been preferable in light of macroeconomic imbalances and to provide a larger cushion against heightened risks. While the current targets provide more space for worthy initiatives (labor tax cuts and infrastructure investment), they also leave little room for slippage. It is therefore imperative to secure the fiscal targets by keeping spending to budgeted levels and avoiding erosion of the tax base through measures such as the VAT rate cut for tourism, a regrettable step that will further complicate administration and distort economic activity.

37. **Staff welcomes the adoption of a medium-term fiscal framework to guide future policy and encourages the authorities to strengthen its institutional underpinnings**. Fulfilling the authorities' goal of lowering gross debt to 30 percent of GDP by 2012, while restraining nonessential current spending to make room for priority infrastructure spending

and tax cuts, would help reduce vulnerabilities and boost growth. The challenge is to turn these plans into reality, including by sticking to the announced primary surplus target for 2009 (3 percent of GDP) and beyond and by adjusting policies when needed to preserve the attainability of the debt target. A stronger institutional framework (e.g., a fiscal responsibility law) would help realize the envisaged restraint of current spending and reduce risk premia by bolstering fiscal policy credibility.

38. **Rapid progress on fiscal structural reforms is needed to achieve the authorities' medium-term fiscal policy goals**. Efficiency improvements in revenue administration, social security contribution collection, health spending, and the civil service are essential to creating much-needed fiscal space to ease Turkey's heavy tax burden and increase high-priority spending, while sustaining debt reduction. As outlined in their LOI, the authorities have a significant program of structural reforms in these areas, which should be implemented expeditiously. In this regard, amalgamating tax auditing capability under the Revenue Administration should be a key priority to reduce tax evasion and widespread informality. Staff is also concerned about the large costs of the authorities' plans to increase transfers to subnational governments, which would likely further aggravate budget rigidity. The authorities are therefore urged to consider ways to make this reform fiscally neutral or to implement it gradually to give subnational governments time to strengthen their financial management and control capacity.

39. **Energy sector reform has become especially critical in light of looming electricity shortages and mounting quasi-fiscal losses at state-owned energy enterprises**. The recent end-user price increase was a critical first step to reduce losses, expand resources for investment, and provide stronger incentives for conservation. The resumption of the privatization of electricity distribution companies will also facilitate investment and efficiency improvements in the sector. These steps should be followed by the timely implementation of (i) an automatic pricing mechanism that ensures full pass-through of input costs, (ii) measures to improve collections (including from municipalities), and (iii) further privatization of electricity distribution and generation.

40. **Financial sector reforms are essential to mitigate vulnerabilities and create an environment conducive to sustained growth**. Staff welcomes the recent strengthening of provisioning and liquidity requirements, as well as initiatives to enhance monitoring of corporate FX borrowing—a key indirect risk to the banking system. Advancing state bank privatization as market conditions permit could also improve efficiency in this sector.

41. **Staff recommends completing the seventh review and inflation consultation and approving the authorities' request for waivers (**¶2-3). Despite slippages in 2007, the authorities' renewed reform momentum of recent months and forward-looking policy commitments deserve the support of the international community. Staff supports requests for waivers of nonobservance of fiscal performance criteria for end-December 2007 in light of

the authorities' restraint of current spending in the 2008 budget and the adoption of key fiscal reforms, which together are envisaged to strengthen the fiscal outlook.

42. **The current SBA has overachieved on many key objectives—sustaining this success will require unwavering commitment to reform**. Under the current SBA, strong policies (especially in the first half of the arrangement) and a favorable external environment helped Turkey dramatically reduce public debt and bolster international reserves. Turkey remains, however, exposed to external and domestic-political shocks, which leave limited scope for policy error. Important structural challenges also remain which constrain Turkey's growth potential. Staff encourages the authorities to capitalize on recent economic successes and secure durable improvements in living standards by staying the course of disciplined macroeconomic policies and pursuing structural reforms with vigor.

Table 2. Turkey: Selected Economic Indicators, 2003−08

	2003	2004	2005	2006	2007		2008
					Old GDP 1/	Est.	Proj.
				(Percent)			
Real sector							
Real GDP growth rate	5.3	9.4	8.4	6.9	4.0	4.5	4.0
Private consumption growth rate	10.2	11.0	7.9	4.6	2.8	4.6	2.7
Private gross fixed investment growth rate	23.7	36.1	16.2	15.0	5.5	2.7	7.5
Contributions to GDP growth							
Private domestic demand	9.5	11.4	8.8	6.3	3.9	5.4	3.6
Public spending	-0.9	0.4	1.0	0.9	1.2	0.5	0.6
Net exports	-3.3	-2.4	-1.4	-0.3	-1.1	-1.5	-0.2
GDP deflator growth rate	23.3	12.4	7.1	9.3	8.1	8.1	9.9
Nominal GDP growth rate	29.8	22.9	16.1	16.9	12.4	12.9	14.2
CPI inflation (12-month; end-of period)	18.4	9.4	7.7	9.7	8.4	8.4	9.3
PPI inflation (12-month; end-of-period)	13.9	15.3	2.7	11.6	5.9	5.9	11.9
Unemployment rate	10.5	10.3	10.2	9.9	9.9	9.9	…
Average nominal treasury bill interest rate	45.1	24.7	16.2	18.1	18.1	18.1	...
Average ex-ante real interest rate	33.9	15.3	6.0	8.6	7.5	7.5	...
Central government budget							
Primary balance	3.8	4.1	4.1	4.3	3.3	2.5	2.7
Net interest payments	12.5	9.4	5.7	5.5	6.9	5.2	5.5
Overall balance	-8.7	-5.3	-1.6	-1.2	-3.6	-2.7	-2.8
Nonfinancial public sector							
Primary balance	4.8	5.5	5.0	4.6	4.6	3.5	3.5
Net interest payments	12.0	9.1	5.3	5.1	6.5	4.9	5.2
Overall balance	-7.2	-3.6	-0.3	-0.5	-1.8	-1.4	-1.8
Debt of the public sector							
General government gross debt (EU definition)	67.4	59.2	52.3	46.1	51.3	38.8	…
Net debt 2/	55.2	49.1	41.7	34.2	38.5	29.1	…
Net external debt	17.2	13.4	6.5	4.0	2.9	2.2	…
Net domestic debt	37.9	35.7	35.2	30.2	35.6	26.9	…
Share of FX debt (percent of gross public debt)	46.5	41.4	37.1	36.3	36.0	36.0	…
External sector							
Current account balance	-2.5	-3.7	-4.6	-6.0	-7.5	-5.7	-6.4
Nonfuel current account balance	1.0	-0.9	-0.7	-0.8	-1.8	-1.3	-1.2
Exports of goods and nonfactor services	23.2	23.3	21.8	22.5	29.0	21.9	23.6
Volume growth (goods only; percent)	19.1	15.0	10.1	12.0	10.9	10.9	13.3
Imports of goods and nonfactor services	24.2	25.9	25.4	27.6	35.6	26.9	28.9
Volume growth (goods only; percent)	24.6	22.2	11.8	9.8	11.1	11.1	8.4
Trade balance	-4.5	-5.8	-6.8	-7.7	-9.4	-7.1	-7.7
Gross financing requirement	14.9	16.4	15.8	20.8	23.8	18.0	17.4
Foreign direct investment (net)	0.4	0.5	1.9	3.6	4.0	3.0	1.7
Gross external debt	44.2	38.4	35.0	38.4	44.6	33.7	41.1
Net external debt	29.5	24.6	20.4	20.2	24.0	18.2	23.8
Short-term external debt (by remaining maturity)	12.6	12.5	12.4	13.6	14.5	11.0	12.3
Monetary aggregates							
Nominal growth of M2Y broad money (percent)	13.0	22.1	24.5	24.1	10.4	10.4	…
GDP (billions of U.S. dollars)	303.1	392.2	482.7	529.3	496.4	656.5	…
GDP (billions of new Turkish lira)	454.8	559.0	648.9	758.4	647.5	856.4	978.3
Per capita GDP (2007): $9,333	Poverty Rate (2003): 26 percent (WB poverty line estimate)						

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

1/ Reported data through Q3 and estimates for Q4. All other columns refer to revised national accounts data released in March 2008.
2/ Authorities' definition. Subtracts net assets of the central bank from nonfinancial public sector debt.

Table 3. Turkey: Balance of Payments, 2003–09

(Billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009
						Proj.	
Current account balance	-7.5	-14.4	-22.1	-31.9	-37.4	-47.9	-46.8
Trade balance	-13.5	-22.7	-33.0	-40.9	-46.8	-57.1	-55.3
Exports (f.o.b.)	52.4	68.5	78.4	93.6	115.3	139.7	156.1
Of which:							
Exports (f.o.b.) in trade returns	47.3	63.2	73.5	85.5	107.2	133.0	149.1
Shuttle trade	4.0	3.9	3.5	6.4	6.0	6.6	6.9
Imports (f.o.b.)	-65.9	-91.3	-111.4	-134.6	-162.1	-196.8	-211.4
Of which:							
Imports (c.i.f.), incl. non-monetary gold	-69.3	-97.5	-116.8	-139.6	-170.1	-205.7	-221.4
Fuel imports (c.i.f.)	-11.6	-14.4	-21.3	-28.9	-33.9	-46.3	-48.6
Services and Income (net)	5.0	7.2	9.4	7.1	7.1	6.8	6.0
Services and Income (credit)	20.2	25.6	30.2	29.6	35.1	38.4	40.4
Of which:							
Tourism receipts	13.2	15.9	18.2	16.9	18.5	19.6	20.8
Services and Income (debit)	-15.2	-18.4	-20.9	-22.5	-27.9	-31.6	-34.3
Of which:							
Interest	-7.2	-7.2	-8.3	-9.8	-11.2	-13.2	-15.1
Private transfers (net) 1/	0.7	0.8	0.9	1.3	1.6	1.7	1.7
Official transfers (net)	0.3	0.3	0.6	0.6	0.7	0.8	0.8
Capital account balance	7.2	17.7	43.5	42.7	48.4	56.3	52.2
Including errors and omissions	11.6	18.8	45.3	42.5	49.4	56.3	52.2
Direct investment 2/	1.3	2.0	9.0	19.0	19.9	13.0	12.9
Portfolio investment in securities	1.1	6.1	10.4	4.0	-0.2	2.0	4.7
Public sector (central and local governments and EBFs)	-0.7	0.8	1.3	2.6	1.0	3.9	3.3
Bonds (net)	1.5	2.0	3.4	3.3	0.9	2.1	3.5
Eurobond drawings	5.3	5.8	6.5	5.8	4.6	5.5	5.5
Eurobond repayments	-3.8	-3.8	-3.1	-2.5	-3.7	-3.4	-2.0
Loans (net)	-2.2	-1.2	-2.2	-0.7	0.1	1.7	-0.3
Loan disbursements	1.0	2.0	1.1	2.5	3.4	5.2	3.0
Loan repayments	-3.2	-3.2	-3.3	-3.2	-3.3	-3.4	-3.3
Central Bank of Turkey (excl. reserve assets, liabilties)	0.6	-0.1	-0.5	-1.0	-1.1	-1.8	-1.1
Deposit money banks (net)	3.0	1.2	10.0	0.7	0.4	8.4	5.7
FX deposits abroad (- denotes accumulation)	0.7	-6.0	-0.3	-10.3	-3.5	2.2	-0.7
Other (net)	2.3	7.2	10.4	11.0	3.9	6.2	6.4
Medium and long-term (net)	-0.2	2.4	6.2	9.8	7.3	5.4	4.9
Short-term (net)	2.5	4.8	4.2	1.2	-3.4	0.8	1.5
Interbank credit lines from foreign commercial banks	2.0	3.3	2.7	-4.0	-1.7	-1.0	1.0
Other private sector (net)	1.9	7.7	13.4	17.3	28.5	30.8	26.8
Medium and long term (net)	1.7	5.3	9.6	18.6	25.6	24.9	20.3
Short term (net)	0.2	2.4	3.8	-1.3	2.9	5.9	6.4
Errors and omissions	4.4	1.0	1.8	-0.2	1.0	0.0	0.0
Overall balance	4.1	4.3	23.2	10.6	12.0	8.4	5.4
Overall financing (NIR change excl. ST liabilities, + denotes decline)	-4.1	-4.3	-23.2	-10.6	-12.0	-8.4	-5.4
Change in net international reserves (+ denotes decline)	-4.1	-4.3	-23.2	-10.6	-12.0	-8.4	-5.4
Change in gross official reserve assets (+ denotes decline)	-4.0	-0.8	-17.8	-6.1	-8.0	-9.9	-2.6
Change in reserve liabilities (IMF)	-0.1	-3.5	-5.4	-4.5	-4.0	1.5	-2.8
Purchases	1.7	1.2	2.4	3.0	1.1	3.4	0.0
Repurchases 3/	-1.7	-4.7	-7.8	-7.5	-5.1	-1.9	-2.8

Table 3. Turkey: Balance of Payments, 2003–09 (concluded)

(Billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009
						Proj.	
Memorandum items:							
Trade in goods and services							
Percent of GDP							
Current account balance (incl. shuttle trade)	-2.5	-3.7	-4.6	-6.0	-5.7	-6.4	-6.1
Nonfuel current account balance	1.0	-0.9	-0.7	-0.8	-1.3	-1.2	-0.7
Trade account balance (incl. shuttle trade)	-4.5	-5.8	-6.8	-7.7	-7.1	-7.7	-7.2
Exports of goods and nonfactor services	23.7	23.8	22.3	23.0	22.6	23.6	25.5
Imports of goods and nonfactor services	24.4	26.1	25.7	27.8	27.2	28.9	30.2
Percent change							
Value growth in exports of goods (incl. shuttle trade)	28.7	30.8	14.3	19.5	23.2	21.1	11.8
Value growth in exports of goods (excl. shuttle trade)	32.2	33.5	15.8	16.4	25.3	21.7	12.1
Value growth in imports of goods	39.9	38.5	22.0	20.8	20.5	21.4	7.4
Volume growth in exports of goods	19.1	15.0	10.1	12.0	10.9	13.3	10.8
Volume growth in imports of goods	24.6	22.2	11.8	9.8	11.1	8.4	6.4
Volume growth in imports of goods exluding fuel	19.8	28.0	15.4	9.1	11.3	10.4	7.1
Terms of trade	2.0	1.0	-1.3	-4.5	3.1	-1.8	0.1
Reserve and debt indicators							
Gross foreign reserves (Central Bank of Turkey) 4/							
Billions of U.S. dollars	35.2	37.6	52.2	63.3	76.5	86.4	88.9
Months of goods and nonfactor service imports	5.2	4.1	4.7	4.8	4.8	4.5	4.3
Net international reserves (Central Bank of Turkey)	-0.5	1.3	22.4	32.6	43.8	52.7	58.5
External debt (end-of-period)							
Billions of U.S. dollars	144.3	160.8	168.7	205.5	247.2	287.5	319.8
Percent of GDP	44.2	38.4	35.0	38.4	33.7	41.1	42.9
Percent of exports of goods and nonfactor services	200.5	172.1	156.8	168.8	166.8	163.5	164.3
Net external debt (end-of-period) 5/							
Billions of U.S. dollars	96.4	102.8	98.5	108.1	133.3	166.5	195.5
Percent of GDP	29.5	24.6	20.4	20.2	18.2	23.8	26.2
Short-term debt (end-of-period)							
Billions of U.S. dollars	23.0	31.9	37.1	40.4	41.8	47.7	55.3
Reserves to short-term debt ratio	152.8	118.1	140.6	156.8	183.0	181.2	160.8
Short-term debt plus medium- and long-term repayments							
Billions of U.S. dollars	41.1	52.2	59.8	72.9	80.7	85.7	103.9
Reserves to short-term debt ratio	85.5	72.1	87.2	86.9	94.8	100.8	85.6
Debt service ratio 6/	35.2	26.7	26.2	26.1	28.8	29.0	26.8

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

1/ Until 2003, remittances include tourism receipts from foreign citizens. These are now classified under the services account.
2/ Including privatization receipts.
3/ 2008–09 repurchases on an expectations basis.
4/ Changes in stocks may not equal balance of payments flows due to valuation effects of exchange rate changes.
5/ Non-bank external debt minus the net foreign assets of the banking sector and the central bank.
6/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).

Table 4. Turkey: External Financing Requirements and Sources, 2003–09

(Billions of U.S. dollars)

	2003	2004	2005	2006	2007	2008	2009
						Proj.	
Gross financing requirements	45.3	64.4	76.1	109.9	118.0	129.5	135.0
Current account deficit (excluding official transfers)	7.8	14.7	22.7	32.5	38.1	48.6	47.6
Amortization on debt securities	3.9	3.8	3.4	2.5	3.7	3.4	2.0
Government Eurobonds	3.8	3.8	3.1	2.5	3.7	3.4	2.0
Medium- and long-term debt amortization	14.8	14.5	17.0	20.3	28.9	35.7	36.2
Public sector 1/	3.2	3.2	3.3	3.2	3.3	3.4	3.3
Private non-bank sector	10.1	10.1	11.4	14.6	22.5	26.7	25.6
Banks	1.4	1.2	2.4	2.6	3.1	5.6	7.3
Short-term debt amortization	16.4	23.0	31.9	37.1	40.4	41.8	47.7
Public sector (net) 1/	1.7	2.9	3.3	3.2	2.8	2.3	1.7
Trade credits 2/	7.1	8.9	12.6	14.6	16.3	21.2	27.3
Banks	6.3	9.7	14.5	17.7	19.8	16.8	17.2
Other private	1.3	1.6	1.5	1.6	1.5	1.5	1.5
Increase in portfolio and other investment assets	2.4	8.3	1.0	17.5	6.8	0.0	1.6
Available financing	45.3	64.4	76.1	109.9	118.0	129.5	135.0
Foreign direct investment (net)	1.3	2.0	9.0	19.0	19.9	13.0	12.9
Portfolio flows	7.8	13.2	18.1	13.9	6.5	9.5	11.0
Government Eurobonds	5.3	5.8	6.5	5.8	4.6	5.5	5.5
Private non-bank sector (net) 3/	2.5	7.5	11.6	8.1	1.9	4.0	5.5
Medium and long-term debt financing	14.0	20.6	30.4	47.2	61.0	66.5	60.1
Public sector 1/	0.7	1.7	0.5	1.6	2.5	4.0	2.0
Private non-bank sector	11.8	15.4	21.0	33.2	48.1	51.5	45.9
Banks	1.4	3.5	8.9	12.3	10.4	11.0	12.2
Short-term financing	21.7	31.5	39.4	40.0	40.6	48.1	55.3
Public sector 1/	2.8	3.3	2.8	2.6	2.3	1.7	1.3
Trade credits	8.9	12.6	14.6	16.4	21.1	27.3	33.8
Banks	10.0	15.7	22.0	21.2	17.1	19.1	20.2
Other private	1.6	1.5	1.6	1.5	1.5	1.5	1.5
Official transfers	0.3	0.3	0.6	0.6	0.7	0.8	0.8
Other 4/	4.4	1.0	1.8	-0.2	1.4	0.0	0.3
NIR change (excl. short-term liabilities, - denotes increase	-4.1	-4.3	-23.2	-10.6	-12.0	-8.4	-5.4
Accumulation of gross reserves	-4.0	-0.8	-17.8	-6.1	-8.0	-9.9	-2.6
IMF (net)	-0.1	-3.5	-5.4	-4.5	-4.0	1.5	-2.8
Purchases	1.7	1.2	2.4	3.0	1.1	3.4	0.0
Repurchases 5/	-1.7	-4.7	-7.8	-7.5	-5.1	-1.9	-2.8
Memorandum item:							
Net public sector financing (incl. IMF, excl. reserves)	2.1	0.6	-1.4	0.4	-1.0	6.6	1.5

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

1/ General government and Central Bank of Turkey (excludes IMF purchases and repurchases) and (for short-term debt) nonfinancial SEEs.

2/ Series reflects stock of short term trade credits at end of previous year.

3/ Portfolio equity and domestic government debt (net).

4/ Errors and omissions and other liabilities.

5/ Repurchases in 2008–09 are on an expectations basis.

Table 5. Turkey: Consolidated Fiscal Presentation, 2004–08 1/

	2004	2005	2006	2007		2008	
				Prog.	Est.	Budget	Proj. 2/
	(Millions of new Turkish lira)						
Nonfinancial public sector primary balance	30,855	32,632	35,064	43,043	30,077	39,470	33,967
General government	26,312	31,021	33,609	39,923	26,912	36,411	30,907
Central govt. and social security	22,538	26,647	33,243	33,518	22,441	31,742	26,406
Primary revenue	142,705	168,915	203,587	223,253	218,429	243,217	245,231
Tax revenue	100,342	119,627	137,480	157,854	152,832	171,989	173,614
Nontax revenue	17,551	20,975	26,870	24,010	23,464	24,946	25,481
Social security	24,812	28,312	39,237	41,389	42,134	46,282	46,136
Primary expenditure	120,167	142,268	170,344	189,735	195,988	211,475	218,825
Central government current	59,610	69,970	84,736	94,074	96,234	103,241	105,722
Central government capital	8,265	10,340	12,098	10,523	12,915	11,775	14,881
Social security 3/	52,292	61,959	73,511	85,139	86,840	96,459	98,222
Other general government	3,774	4,374	366	6,405	4,471	4,669	4,501
State economic enterprises	4,543	1,611	1,455	3,120	3,165	3,059	3,059
Memorandum items:							
Primary spending (less revenue transfers) 4/	109,719	129,450	156,220	172,772	178,830	192,084	197,682
Current	101,454	119,110	144,123	162,250	165,915	180,309	182,801
Capital	8,265	10,340	12,098	10,523	12,915	11,775	14,881
Pension spending	32,620	39,591	46,241	53,953	55,771	61,930	62,789
Health spending 5/	15,695	17,967	23,459	25,583	26,669	29,837	30,741
GDP	559,033	648,932	758,391	856,387	856,387	978,331	978,331
	(Percent of GDP)						
Nonfinancial public sector primary balance	5.5	5.0	4.6	5.0	3.5	4.0	3.5
General government	4.7	4.8	4.4	4.7	3.1	3.7	3.2
Central govt. and social security	4.0	4.1	4.4	3.9	2.6	3.2	2.7
Primary revenue	25.5	26.0	26.8	26.1	25.5	24.9	25.1
Tax revenue	17.9	18.4	18.1	18.4	17.8	17.6	17.7
Nontax revenue	3.1	3.2	3.5	2.8	2.7	2.5	2.6
Social security	4.4	4.4	5.2	4.8	4.9	4.7	4.7
Primary expenditure	21.5	21.9	22.5	22.2	22.9	21.6	22.4
Central government current	10.7	10.8	11.2	11.0	11.2	10.6	10.8
Central government capital	1.5	1.6	1.6	1.2	1.5	1.2	1.5
Social security 3/	9.4	9.5	9.7	9.9	10.1	9.9	10.0
Other general government	0.7	0.7	0.0	0.7	0.5	0.5	0.5
State economic enterprises	0.8	0.2	0.2	0.4	0.4	0.3	0.3
Memorandum items:							
Primary spending (less revenue transfers) 4/	19.6	19.9	20.6	20.2	20.9	19.6	20.2
Current	18.1	18.4	19.0	18.9	19.4	18.4	18.7
Capital	1.5	1.6	1.6	1.2	1.5	1.2	1.5
Pension spending	5.8	6.1	6.1	6.3	6.5	6.3	6.4
Health spending 5/	2.8	2.8	3.1	3.0	3.1	3.0	3.1

Sources: Turkish authorities; and IMF staff estimates.

1/ Data for 2004–06 are based on the final accounts, which differ from data used for program monitoring.
2/ Includes impact of five percentage point cut in employer social security contributions starting in Q4, a quarter percent of GDP increase in capital expenditure, and some adjustments for the impact of inflation on revenue and expenditure (wages, pensions, and
3/ Social Security Institutions plus budget spending on social security (such as civil servants' health and Green Card).
4/ Consolidated central government and social security spending (corresponds to program monitored spending).
5/ Measured as health spending by the Social Security Institution and budget for Green Card and civil servants. This is not a comprehensive measure of health spending, and underestimates spending as it excludes some items (such as Ministry of Health spending on medical personnel salaries).

Table 6. Turkey: Public Sector Finances, 2003−08 1/

(Millions of new Turkish lira)

	2003	2004	2005	2006	2007		2008	
					Prog.	Est.	Budget	Proj. 2/
Nonfinancial public sector primary balance	21,922	30,855	32,632	35,064	43,043	30,077	39,470	33,967
Central government	17,377	22,831	26,725	32,353	33,519	21,661	31,742	26,303
Primary revenue	99,479	117,894	140,602	164,350	181,864	176,295	196,935	199,095
Tax revenue	82,484	100,342	119,627	137,480	157,854	152,832	171,989	173,614
Personal income taxes	16,861	21,244	24,490	28,983	35,115	34,447	39,201	40,377
Corporate income taxes	9,472	10,521	12,048	11,158	12,672	13,751	15,462	15,705
VAT	23,456	30,591	34,326	41,337	48,047	43,285	47,742	47,873
SCT	22,283	26,648	33,345	36,926	40,297	39,111	44,571	44,054
Other	10,412	11,338	15,419	19,077	21,723	22,239	25,012	25,606
Nontax revenue 3/	16,995	17,551	20,975	26,870	24,010	23,464	24,946	25,481
Primary expenditure	82,102	95,063	113,878	131,997	148,345	154,634	165,193	172,792
Personnel	28,833	33,663	37,389	42,887	49,769	49,356	55,078	55,904
Goods and services, *of which:*	11,874	13,604	15,186	19,001	20,182	22,154	22,135	22,316
Defense and security	5,700	5,998	6,498	7,630	7,236	7,576	7,641	7,641
Transfers, *of which:*	33,507	39,531	50,963	58,010	67,872	70,209	76,205	79,692
Social security institutions	15,922	19,333	23,762	24,738	31,506	33,063	37,031	38,766
Agricultural subsidies	2,805	3,084	3,707	4,747	5,100	5,555	5,400	5,400
Transfers of revenue shares	7,108	10,448	12,819	14,124	16,963	17,158	19,391	21,143
Capital transfers	92	465	1,384	2,637	3,122	3,543	2,084	2,084
Capital expenditure	7,888	8,265	10,340	12,098	10,523	12,915	11,775	14,881
Rest of the public sector	4,545	8,024	5,907	2,710	9,524	8,416	7,728	7,664
Extrabudgetary funds	594	551	917	-1,988	1,102	1,345	807	807
Revolving funds 4/	933	976	966	944	1,128	963	1,162	1,162
Social security institutions	53	-293	-78	890	-1	780	0	103
Unemployment insurance fund	1,228	1,557	1,681	2,278	2,800	2,879	3,150	2,982
Local governments 4/	-567	690	810	-868	1,375	-716	-450	-450
State economic enterprises 5/	2,304	4,543	1,611	1,455	3,120	3,165	3,059	3,059
Nonfinancial public sector overall balance	-32,848	-20,009	-1,791	-3,832	43	-11,866	-11,814	-17,318
Interest expenditure (net)	54,771	50,865	34,423	38,896	43,000	41,942	51,284	51,284
Domestic	50,547	44,283	…	…	…	…	…	…
External	4,224	6,582	…	…	…	…	…	…
Nonfinancial public sector financing	32,848	20,009	1,791	3,832	-43	11,866	11,814	17,318
Amortization	113,949	137,486	145,058	…	…	…	…	…
External	11,519	12,655	14,847	…	…	…	…	…
Domestic	102,430	124,830	130,211	…	…	…	…	…
Borrowing	146,268	159,421	165,149	…	…	…	…	…
External	11,706	11,293	13,619	…	…	…	…	…
Domestic	134,562	148,127	151,529	…	…	…	…	…
Deposits decrease 6/	230	-3,774	-23,499	…	…	…	…	…
Privatization	299	1,848	5,200	…	…	…	…	…
Memorandum items:								
Central govt. overall balance (auth. def.)	-40,210	-29,173	-6,903	-4,643	-14,773	-13,883	-17,997	-23,435
Total revenue	101,037	122,919	152,784	173,483	187,673	189,617	204,557	206,716
Primary revenue (from above)	99,479	117,894	140,602	164,350	181,864	176,295	196,935	199,095
Interest revenue	1,519	3,786	8,638	4,430	2,259	3,923	1,926	1,926
Program adjustments	39	1,240	3,543	4,703	3,550	9,399	5,696	5,696
Total expenditure	141,248	152,093	159,687	178,126	202,446	203,501	222,553	230,152
Primary expenditure (from above)	82,102	95,063	113,878	131,997	148,345	154,634	165,193	172,792
Interest expenditure	58,527	56,491	45,680	45,963	52,946	48,732	56,000	56,000
Program adjustments	619	539	129	166	1,155	135	1,360	1,360

Table 6. Turkey: Public Sector Finances, 2003−08 (concluded) 1/

(Percent of GDP)

	2003	2004	2005	2006	2007		2008	
					Prog.	Est.	Budget	Proj. 2/
Nonfinancial public sector primary balance	4.8	5.5	5.0	4.6	5.0	3.5	4.0	3.5
Central government	3.8	4.1	4.1	4.3	3.9	2.5	3.2	2.7
Primary revenue	21.9	21.1	21.7	21.7	21.2	20.6	20.1	20.4
Tax revenue	18.1	17.9	18.4	18.1	18.4	17.8	17.6	17.7
Personal income taxes	3.7	3.8	3.8	3.8	4.1	4.0	4.0	4.1
Corporate income taxes	2.1	1.9	1.9	1.5	1.5	1.6	1.6	1.6
VAT	5.2	5.5	5.3	5.5	5.6	5.1	4.9	4.9
SCT	4.9	4.8	5.1	4.9	4.7	4.6	4.6	4.5
Other	2.3	2.0	2.4	2.5	2.5	2.6	2.6	2.6
Nontax revenue 3/	3.7	3.1	3.2	3.5	2.8	2.7	2.5	2.6
Primary expenditure	18.1	17.0	17.5	17.4	17.3	18.1	16.9	17.7
Personnel	6.3	6.0	5.8	5.7	5.8	5.8	5.6	5.7
Goods and services, *of which*:	2.6	2.4	2.3	2.5	2.4	2.6	2.3	2.3
Defense and security	1.3	1.1	1.0	1.0	0.8	0.9	0.8	0.8
Transfers, *of which*:	7.4	7.1	7.9	7.6	7.9	8.2	7.8	8.1
Social security institutions	3.5	3.5	3.7	3.3	3.7	3.9	3.8	4.0
Agricultural subsidies	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Transfers of revenue shares	1.6	1.9	2.0	1.9	2.0	2.0	2.0	2.2
Capital transfers	0.0	0.1	0.2	0.3	0.4	0.4	0.2	0.2
Capital expenditure	1.7	1.5	1.6	1.6	1.2	1.5	1.2	1.5
Rest of the public sector	1.0	1.4	0.9	0.4	1.1	1.0	0.8	0.8
Extrabudgetary funds	0.1	0.1	0.1	-0.3	0.1	0.2	0.1	0.1
Revolving funds 4/	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Social security institutions	0.0	-0.1	0.0	0.1	0.0	0.1	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Local governments 4/	-0.1	0.1	0.1	-0.1	0.2	-0.1	0.0	0.0
State economic enterprises 5/	0.5	0.8	0.2	0.2	0.4	0.4	0.3	0.3
Nonfinancial public sector overall balance	-7.2	-3.6	-0.3	-0.5	0.0	-1.4	-1.2	-1.8
Interest expenditure (net)	12.0	9.1	5.3	5.1	5.0	4.9	5.2	5.2
Domestic	11.1	7.9	…	…	…	…	…	…
External	0.9	1.2	…	…	…	…	…	…
Nonfinancial public sector financing	7.2	3.6	0.3	0.5	0.0	1.4	1.2	1.8
Amortization	25.1	24.6	22.4	…	…	…	…	…
External	2.5	2.3	2.3	…	…	…	…	…
Domestic	22.5	22.3	20.1	…	…	…	…	…
Borrowing	32.2	28.5	25.4	…	…	…	…	…
External	2.6	2.0	2.1	…	…	…	…	…
Domestic	29.6	26.5	23.4	…	…	…	…	…
Deposits decrease 6/	0.1	-0.7	-3.6	…	…	…	…	…
Privatization	0.1	0.3	0.8	…	…	…	…	…
Memorandum items:								
Central govt. overall balance (auth. def.)	-8.8	-5.2	-1.1	-0.6	-1.7	-1.6	-1.8	-2.4
Total revenue	22.2	22.0	23.5	22.9	21.9	22.1	20.9	21.1
Primary revenue (from above)	21.9	21.1	21.7	21.7	21.2	20.6	20.1	20.4
Interest revenue	0.3	0.7	1.3	0.6	0.3	0.5	0.2	0.2
Program adjustments	0.0	0.2	0.5	0.6	0.4	1.1	0.6	0.6
Total expenditure	31.1	27.2	24.6	23.5	23.6	23.8	22.7	23.5
Primary expenditure (from above)	18.1	17.0	17.5	17.4	17.3	18.1	16.9	17.7
Interest expenditure	12.9	10.1	7.0	6.1	6.2	5.7	5.7	5.7
Program adjustments	0.1	0.1	0.0	0.0	0.1	0.0	0.1	0.1
Nominal GDP (millions of new Turkish lira)	454,781	559,033	648,932	758,391	856,387	856,387	978,331	978,331

Sources: Turkish authorities; and IMF staff estimates.

1/ Data for 2002–06 are based on the final accounts, which differ from data used for program monitoring.
2/ Includes impact of five percentage point cut in employer social security contributions starting in Q4, a quarter percent of GDP increase in capital expenditure, and some adjustments for the impact of inflation on revenue and expenditure (wages, pensions, and medicine).
3/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figures for 2006-07 exclude TÜPRAŞ and Türk Telekom.
4/ Excluded from consolidated government sector subject to quantitative conditionality.
5/ Excluding severance payments for retirees. Some minor SEEs excluded from consolidated government sector subject to quantitative conditionality. Figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).
6/ Calculated as a residual.

Table 7. Turkey: Monetary Aggregates, 2005–08

	2005	2006				2007				2008
		Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
	(Billions of new Turkish lira)									
Broad money (M2Y)	229.5	237.4	267.0	270.2	284.9	279.0	293.7	300.7	314.6	330.7
Lira broad money (M2)	153.5	162.1	177.3	177.8	185.1	191.3	204.0	212.8	225.9	237.3
Foreign exchange deposits 1/	76.1	75.4	89.7	92.4	99.8	87.8	89.7	87.9	88.7	93.4
Repos	1.5	2.1	2.6	2.3	2.2	1.9	3.3	2.1	2.7	2.6
Broad liquidity	231.0	239.6	269.6	272.5	287.1	281.0	297.0	302.8	317.3	333.3
Base money	32.5	32.6	36.6	34.8	41.2	35.6	40.9	39.4	46.3	43.0
Net foreign assets 1/	18.0	24.7	30.3	36.3	44.3	54.2	57.9	56.0	53.5	60.0
Billions of U.S. dollars	13.4	18.4	18.9	24.7	31.3	39.1	44.0	46.3	46.0	46.9
Net domestic assets	211.5	212.7	236.7	233.9	240.7	224.9	235.9	244.6	261.0	270.7
Central government	152.2	151.1	151.9	149.2	150.1	138.9	140.3	144.0	147.0	146.8
Other government 2/	1.2	1.2	1.5	1.4	2.0	2.6	2.1	2.7	3.2	3.3
Private sector 3/	128.8	139.9	161.9	167.3	176.3	217.2	231.0	245.5	268.8	279.6
Turkish lira claims	109.0	119.2	135.6	142.7	153.2	193.3	207.6	222.9	244.5	253.7
Foreign exchange claims 1/	19.8	20.7	26.3	24.6	23.1	23.9	23.4	22.6	24.3	25.9
Other items (net)	-70.6	-79.3	-78.6	-83.9	-87.7	-133.9	-137.4	-147.6	-158.0	-159.0
Memorandum items:	(Annual percent change)									
Broad money (M2Y)	24.5	28.1	35.1	26.0	24.1	17.5	10.0	11.3	10.4	18.5
Lira broad money (M2)	41.4	42.5	40.3	28.3	20.6	18.0	15.0	19.7	22.0	24.1
Foreign exchange deposits 1/	0.3	5.3	26.1	21.6	31.2	16.5	0.1	-4.9	-11.2	6.4
Net domestic assets	14.6	11.5	22.2	12.1	19.2	-3.7	3.4	4.0	16.6	14.8
Central government	0.5	-2.8	2.5	-3.7	-1.2	-10.7	-5.0	-2.5	5.6	4.6
Other government 2/	80.8	95.8	110.1	117.4	94.2	107.6	61.0	38.9	121.4	61.4
Private sector 3/	43.7	39.3	45.7	37.7	36.8	38.5	40.3	41.9	24.8	21.0
Other items (net)	23.5	20.9	18.3	22.7	40.7	47.1	47.9	50.0	27.8	22.2
	(Billions of U.S. dollars)									
Broad money (M2Y)	170.9	176.8	166.6	183.8	201.6	201.3	223.4	248.5	270.1	258.5
Lira broad money (M2)	114.3	120.7	110.6	120.9	131.0	138.0	155.2	175.9	193.9	185.5
Foreign exchange deposits 1/	56.7	56.1	55.9	62.8	70.6	63.3	68.3	72.6	76.1	73.0
Net domestic assets	157.5	158.4	147.7	159.1	170.3	162.2	179.4	202.2	224.1	211.6
Central government	113.3	112.5	94.8	101.5	106.2	100.2	106.7	119.0	126.3	114.7
Other government 2/	0.9	0.9	0.9	1.0	1.4	1.9	1.6	2.2	2.8	2.6
Private sector 3/	95.9	104.2	101.0	113.8	124.8	156.7	175.7	202.9	230.7	218.5
Other items (net)	-52.6	-59.1	-49.0	-57.1	-62.0	-96.6	-104.5	-122.0	-135.6	-124.2
	(Percent of GDP, unless otherwise indicated) 4/									
Base money	5.0	4.9	5.2	4.8	5.4	4.5	5.0	4.7	5.4	5.0
Broad money (M2Y)	35.4	35.5	38.3	37.0	37.6	35.5	36.1	35.9	36.7	38.6
Lira broad money (M2)	23.6	24.3	25.4	24.4	24.4	24.3	25.1	25.4	26.4	27.7
Foreign exchange deposits (percent of broad money)	33.1	31.7	33.6	34.2	35.0	31.5	30.6	29.2	28.2	28.2
Net domestic assets	32.6	28.1	31.2	30.8	31.7	26.3	27.5	28.6	30.5	31.6
Central government	23.5	19.9	20.0	19.7	19.8	16.2	16.4	16.8	17.2	17.1
Other government 2/	0.2	0.2	0.2	0.2	0.3	0.3	0.2	0.3	0.4	0.4
Private sector 3/	19.8	18.4	21.3	22.1	23.2	25.4	27.0	28.7	31.4	32.6
Other items (net)	-10.9	-10.5	-10.4	-11.1	-11.6	-15.6	-16.0	-17.2	-18.4	-18.6
Money multiplier (percent of base money)										
Broad money (M2Y)	7.1	7.3	7.3	7.8	6.9	7.8	7.2	7.6	6.8	7.7
Lira broad money (M2)	4.7	5.0	4.8	5.1	4.5	5.4	5.0	5.4	4.9	5.5

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

1/ Evaluated at current exchange rates, monetary authorities and deposit money banks.
2/ Includes claims to local governments and nonfinancial public enterprises.
3/ Includes claims to the private sector, investment banks, development banks, and nonbank financial institutions.
4/ Evaluated as percent of nominal GDP over previous four quarters.

Table 8. Turkey: Central Bank Balance Sheet, 2001–08

	2001	2002	2003	2004	2005	2006	2007				2008
							Mar.	Jun.	Sep.	Dec.	Mar.
	(Billions of new Turkish lira, program exchange rate)										
Net foreign assets	-12.7	3.9	8.8	11.0	38.6	48.6	58.8	58.7	60.7	60.6	59.7
Gross foreign assets	28.6	37.7	42.5	53.0	80.0	90.2	99.3	99.9	101.9	102.2	103.1
Gross foreign liabilities	41.2	33.8	33.6	42.0	41.4	41.6	40.5	41.1	41.2	41.6	43.4
International reserve liabilities	20.7	11.5	9.8	5.7	2.1	1.9	1.7	1.5	1.4	1.3	1.2
Other reserve liabilities 1/	10.1	13.2	14.5	22.3	22.3	20.3	20.0	19.6	18.7	18.2	17.9
Banks' FX deposits with CBT	10.4	9.1	9.3	14.0	17.0	19.5	18.8	20.0	21.0	22.0	24.3
Net domestic assets	20.6	6.5	6.0	9.2	-6.2	-7.3	-23.2	-17.9	-21.3	-14.3	-16.7
Base money	7.8	10.4	14.9	20.2	32.5	41.2	35.6	40.9	39.4	46.3	43.0
Currency issued	5.3	7.6	10.7	13.5	19.6	26.8	22.2	24.7	26.1	27.4	28.3
Banks' lira deposits at the CBT	2.5	2.8	4.2	6.7	12.9	14.4	13.4	16.2	13.3	18.9	14.7
Net foreign assets (Treasury)	-1.8	-21.1	-20.4	-26.3	-22.7	-15.8	-12.4	-12.5	-11.0	-10.0	-9.3
Net foreign assets (Treasury plus CBT)	-14.5	-17.2	-11.6	-15.3	15.9	32.8	46.4	46.2	49.7	50.6	50.4
Net domestic assets (Treasury) 3/	1.8	21.1	20.4	26.3	22.7	15.8	12.4	12.5	11.0	10.0	9.3
Net domestic assets (Treasury plus CBT)	22.4	27.6	26.4	35.5	16.5	8.5	-10.7	-5.4	-10.3	-4.2	-7.4
Base money (Treasury plus CBT)	7.9	10.4	14.9	20.2	32.4	41.3	35.6	40.9	39.4	46.3	43.0
	(Billions of U.S. dollars, at program exchange rates)										
CBT gross international reserves	19.8	26.2	29.5	35.4	53.4	60.3	66.3	66.7	68.1	68.2	68.8
At current cross rates:	19.8	28.1	35.2	37.7	52.5	63.3	70.0	70.7	74.6	76.5	80.1
CBT gross international liabilities	28.6	23.5	23.4	28.1	27.7	27.8	27.0	27.5	27.5	27.8	29.0
CBT net foreign assets	-8.8	2.7	6.1	7.3	25.8	32.5	39.3	39.2	40.5	40.5	39.9
Plus CBT forward position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Plus other reserve liabilities	7.1	9.2	10.1	14.9	14.9	13.5	13.4	13.1	12.5	12.2	11.9
Minus Dresdner one year deposits	0.7	1.4	2.1	3.0	2.9	2.4	2.3	2.3	2.1	2.0	1.9
Minus defense fund	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
CBT net international reserves	-2.9	10.0	13.6	18.9	37.5	43.2	50.0	49.7	50.7	50.4	49.6
Treasury net international reserves 2/	-1.3	-14.7	-14.2	-17.6	-15.1	-10.6	-8.3	-8.3	-7.4	-6.7	-6.2
Net international reserves (Treasury plus CBT)	-3.5	-4.6	-0.5	1.3	22.4	32.6	41.7	41.4	43.3	43.7	43.4
Memorandum items:											
Exchange rate (new Turkish lira per U.S. dollar)	1.44	1.63	1.40	1.34	1.34	1.41	1.39	1.31	1.21	1.16	1.28
Program exchange rate (new Turkish lira per U.S. dollar)	1.44	1.44	1.44	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50

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

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

Table 9. Turkey: Banking System—Selected Indicators, 2001–07 1/

(Millions of new Turkish lira, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007			
	Dec. 1/	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.
					Banking system					
Total assets	179,675	212,681	249,693	306,448	396,963	485,970	500,403	516,916	526,050	562,158
Cash and claims on CBT	12,558	13,872	14,962	20,819	29,498	37,129	34,445	36,519	34,027	40,911
Claims on other banks	19,871	15,401	15,141	21,044	25,842	38,424	33,406	33,989	29,202	30,510
Securities portfolio	70,026	86,105	106,844	123,681	143,016	158,935	166,858	165,537	166,455	164,712
Loans, net	41,058	52,932	67,210	100,101	150,701	210,411	220,837	235,784	248,862	272,682
Other assets	36,162	44,371	45,536	40,803	47,906	41,070	44,857	45,086	47,503	53,343
Total liabilities	179,675	212,680	249,693	306,448	396,963	485,970	500,403	516,916	526,050	562,158
Deposits	110,298	137,973	155,312	191,065	243,121	296,495	307,984	319,042	322,967	342,031
Borrowing from banks	23,798	21,967	25,918	33,765	54,310	70,372	66,376	66,806	64,893	70,468
Repos	10,776	6,161	11,241	10,596	17,414	25,786	25,133	26,874	25,985	27,753
Other liabilities	20,527	21,351	21,683	25,055	28,383	35,340	38,353	39,803	42,842	48,422
Shareholders' equity (incl. profits)	14,276	25,228	35,539	45,966	53,736	57,978	62,556	64,392	69,363	73,484
Memorandum items:										
Capital adequacy ratio (percent)	15.3	25.3	30.9	28.8	24.2	22.1	22.4	18.8	19.5	19.0
NPLs (percent of total loans)	29.3	17.6	11.5	6.0	4.8	3.8	3.7	3.7	3.6	3.5
Provisions (percent of NPLs)	47.1	64.2	88.5	88.1	89.8	90.8	89.8	89.4	89.1	88.4
Net profit (loss) after tax	-9,910	2,336	5,678	6,451.1	5,714.7	10,973.0	3,325.3	7,870.1	11,410.0	14,329.4
ROA (percent) 2/	-5.5	1.1	2.3	2.3	1.7	2.5	2.9	3.3	3.1	2.8
ROE (percent) 2/	-69.4	9.3	16.0	16.4	11.8	19.8	23.4	26.5	24.4	21.6
					Private banks					
Total assets	97,930	119,471	142,270	175,924	237,043	265,783	274,651	283,585	285,724	306,445
Cash and claims on CBT	8,434	9,356	9,868	14,149	20,760	22,285	20,496	21,269	20,750	24,502
Claims on other banks	10,494	7,623	6,369	9,483	13,425	15,235	14,170	14,246	13,887	14,633
Securities portfolio	27,146	39,819	51,485	56,445	71,013	79,692	83,710	83,109	80,243	80,579
Loans, net	26,506	35,752	46,402	69,011	102,916	124,562	130,946	139,692	145,498	158,256
Other assets	25,350	26,921	28,146	26,836	28,928	24,010	25,330	25,269	25,345	28,475
Total liabilities	97,930	119,471	142,270	175,924	237,043	265,783	274,651	283,585	285,724	306,445
Deposits	67,223	80,629	88,180	105,195	138,669	156,882	162,179	167,799	167,908	179,486
Borrowing from banks	15,585	13,703	18,158	23,920	40,243	42,458	42,732	43,100	40,046	41,528
Repos	1,803	4,074	8,103	8,954	15,692	20,766	19,189	18,426	19,266	21,830
Other liabilities	5,779	5,871	6,872	10,455	13,043	18,091	20,338	21,439	23,101	26,431
Shareholders' equity (incl. profits)	7,540	15,194	20,958	27,399	29,396	27,586	30,214	32,821	35,403	37,171
Memorandum items:										
Capital adequacy ratio (percent)	9.0	19.64	23.5	22.3	17.2	17.5	18.0	16.2	17.2	17.0
NPLs (percent of total loans)	27.6	8.9	6.5	4.9	4.1	3.6	3.5	3.5	3.5	3.5
Provisions (percent of NPLs)	31.0	53.0	80.0	83.5	86.1	87.7	86.1	85.9	85.7	85.9
Net profit (loss) after tax	-7,382.6	2409.6	2917.0	2825.4	1,391.0	4,657.3	1,520.1	4,152.6	6,012.7	7,290.0
ROA (percent) 2/	-7.5	2.0	2.1	1.8	0.7	1.8	2.3	3.1	2.9	2.6
ROE (percent) 2/	-97.9	15.9	13.9	11.8	5.0	15.7	20.6	27.8	25.7	21.8

Table 9. Turkey: Banking System—Selected Indicators, 2001–07 1/ (concluded)

(Millions of new Turkish lira, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007			
	Dec. 1/	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.
					State banks 2/					
Total assets	57,583	67,831	83,134	108,841	126,344	145,458	150,701	153,366	156,278	164,833
Cash and claims on CBT	3,544	4,000	4,589	6,000	7,351	10,321	9,444	10,207	9,065	11,413
Claims on other banks	5,096	3,996	5,365	6,689	5,995	9,331	8,679	9,451	6,108	7,520
Securities portfolio	32,756	39,245	47,716	63,333	65,444	68,956	71,884	70,561	72,559	69,325
Loans, net	9,177	8,804	12,202	21,057	31,518	46,050	48,266	51,388	55,401	61,883
Other assets	7,011	11,786	13,263	11,763	16,037	10,801	12,428	11,758	13,144	14,692
Total liabilities	57,583	67,831	83,134	108,841	126,344	145,458	150,701	153,366	156,278	164,833
Deposits	37,258	48,489	59,862	81,156	94,472	109,051	113,761	117,167	119,474	124,559
Borrowing from banks	2,381	2,230	2,338	4,249	5,357	7,940	7,617	7,055	7,296	7,926
Repos	3,844	1,022	1,018	1,231	653	3,026	2,424	4,607	3,522	3,848
Other liabilities	9,707	9,343	10,342	10,865	11,077	9,733	10,585	9,691	9,922	11,008
Shareholders' equity (incl. profits)	4,393	6,747	9,574	11,340	14,786	15,709	16,315	14,845	16,064	17,493
Memorandum items:										
Capital adequacy ratio (percent)	34.0	50.2	56.3	41.5	40.9	31.2	31.2	20.9	21.3	20.6
NPLs (percent of total loans)	37.3	37.4	26.2	10.7	7.7	5.2	5.0	4.8	4.5	4.1
Provisions (percent of NPLs)	63	74	98	95.2	96.7	96.5	96.4	96.4	96.3	96.0
Net profit (loss) after tax	-681	1,056	1,790	3,068.7	3,128.5	4,124.7	1,114.6	2,389.7	3,558.2	4,617.0
ROA (percent) 2/	-1.2	1.6	2.2	3.2	2.8	3.1	3.2	3.3	3.2	3.0
ROE (percent) 2/	-15.5	15.7	18.7	31.9	25.5	29.0	30.7	32.0	30.7	29.0
					Foreign and investment banks					
Total assets	13,126	16,068	17,213	21,683	33,576	74,728	75,051	79,965	84,048	90,879
Cash and claims on CBT	535	454	454	629	1,236	4,524	4,505	5,043	4,211	4,996
Claims on other banks	3,408	3,164	2,951	4,871	6,422	13,859	10,557	10,293	9,207	8,357
Securities portfolio	1,673	2,386	2,680	3,903	6,559	10,287	11,264	11,867	13,653	14,807
Loans, net	4,773	6,487	7,695	10,034	16,267	39,799	41,625	44,705	47,962	52,543
Other assets	2,738	3,577	3,434	2,246	3,092	6,259	7,100	8,059	9,014	10,176
Total liabilities	13,126	16,068	17,213	21,683	33,576	74,728	75,051	79,965	84,048	90,879
Deposits	2,252	3,086	3,137	4,714	9,980	30,562	32,045	34,076	35,584	37,986
Borrowing from banks	3,812	4,761	4,585	5,596	8,710	19,974	16,027	16,650	17,552	21,014
Repos	105	40	95	411	1,069	1,994	3,521	3,841	3,198	2,076
Other liabilities	4,227	3,798	3,542	3,735	4,263	7,516	7,431	8,672	9,819	10,984
Shareholders' equity (incl. profits)	2,730	4,383	5,854	7,226	9,554	14,682	16,028	16,726	17,895	18,820
Memorandum items:										
Capital adequacy ratio (percent)	41.0	48.37	60.8	56.0	40.25	26.93	27.68	24.45	24.22	23.08
NPLs (percent of total loans)	9.3	4.3	3.8	3.2	3.37	2.69	2.77	2.75	2.83	2.89
Provisions (percent of NPLs)	81.2	69.3	85.5	81.5	86.07	90.71	90.42	88.85	88.23	84.63
Net profit (loss) after tax	498	548	698	557	1,196	2,191	691	1,328	1,839	2,422
ROA (percent) 2/	3.8	3.4	4.1	2.9	4.3	4.3	4.6	3.8	3.2	3.0
ROE (percent) 2/	18.2	12.5	11.9	8.6	14.4	19.1	21.4	18.3	15.5	14.2

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

1/ Does not include participation banks. Data for December 2001 onward reflect the results of the audits conducted during the first half of 2002.
2/ Data for 2007 are annualized.

Table 10. Turkey: Indicators of Fund Credit, 2004–12 1/

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Outstanding Fund credit (end of period)									
Billions of SDRs	13.8	10.2	7.2	4.5	5.5	3.7	1.9	0.6	0.0
Percent of quota	1437	1063	600	380	465	307	157	47	0
Percent of exports of goods and nonfactor services	22	14	9	5	5	3	1	0	0
Percent of GDP	5	3	2	1	1	1	0	0	0
Percent of public sector external debt	22	18	13	8	9	6	3	1	0
Percent of overall external debt	13	9	5	3	3	2	1	0	0
Percent of end-period foreign reserves	57	28	17	9	10	6	3	1	0
Repurchases of Fund Credit									
Billions of SDRs	3.2	5.3	5.1	3.4	1.2	1.9	1.8	1.3	0.6
Percent of quota	328	546	427	283	104	158	149	110	26
Percent of exports of goods and nonfactor services	5	7	6	3	1	1	1	1	0
Percent of GDP	1	2	1	1	0	0	0	0	0
Percent of public sector external debt service	23	33	34	25	11	18	17	15	7
Percent of overall medium- and long-term external debt servic	16	22	19	11	4	5	4	3	1
Percent of start period foreign reserves	13	21	14	8	2	3	3	2	1
Percent gross public sector external financing 2/	35	23	34	24	8	20	18	11	5
Net Fund Resource Flows 3/									
Billions of SDRs	-3.0	-4.2	-3.6	-3.0	0.8	-2.1	-1.9	-1.4	-0.6
Percent of quota	-312	-440	-305	-252	65	-175	-158	-114	-26
Percent of exports of goods and nonfactor services	-5	-6	-4	-3	1	-2	-1	-1	0
Percent of GDP	-1	-1	-1	-1	0	0	0	0	0
Percent of public sector external debt service	-22	-27	-24	-22	7	-20	-18	-15	-7
Percent of overall medium- and long-term external debt servic	-15	-17	-14	-10	2	-6	-4	-3	-1
Percent start period foreign reserves	-13	-17	-10	-7	2	-4	-3	-2	-1
Percent gross public sector external financing 2/	-15	-9	-11	-9	2	-10	-8	-5	-2

Source: IMF staff estimates and projections.

1/ Projected on an expectations basis. Quota was increased effective November 1, 2006 from SDR964 million to SDR 1191.3 million.
2/ Consolidated govt. and CBT. Includes reserve accumulation before repurchases.
3/ Net purchases less repurchases and charges.

Table 11. Turkey: Indicators of External Vulnerability, 2001–08

	2001	2002	2003	2004	2005	2006	2007	2008 Proj.
CPI inflation (end year)	68.5	29.7	18.4	9.4	7.7	9.7	8.4	9.3
Overall balance public sector (percent of GDP)	-17.1	-10.6	-7.2	-3.6	-0.3	-0.5	-1.4	-1.8
Net debt of the public sector (percent of GDP)	65.4	60.9	55.2	49.1	41.7	34.2	29.1	26.2
Export volume of goods (percent change)	15.7	17.2	19.1	15.0	10.1	12.0	10.9	13.3
Import volume of goods (percent change)	-23.8	26.1	24.6	22.2	11.8	9.8	11.1	8.4
Current account balance (percent of GDP)	1.9	-0.3	-2.5	-3.7	-4.6	-6.0	-5.7	-6.4
Capital account balance (billions of U.S. dollars)	-14.6	1.2	7.2	17.7	43.5	42.7	48.4	56.3
Of which: foreign direct investment	2.9	1.0	1.3	2.0	9.0	19.0	19.9	13.0
foreign portfolio investment	-4.6	-1.2	1.1	6.1	10.4	4.0	-0.2	2.0
Gross official reserves (billions of U.S. dollars)	19.8	28.1	35.2	37.6	52.5	63.3	76.5	86.4
Months of imports of goods and nonfactor services	4.6	5.6	5.2	4.1	4.7	4.8	4.8	4.5
Percent of broad money	26.7	34.3	32.5	27.4	30.5	31.4	28.3	31.9
Gross total external debt (billions U.S. dollars)	113.6	129.7	144.3	160.8	168.7	205.5	247.2	287.5
Percent of GDP	68.4	60.7	44.2	38.4	35.0	38.4	33.7	41.1
Percent of exports of goods and nonfactor services	220.4	229.7	200.5	172.1	156.8	168.8	166.8	163.5
Gross short-term external debt (billions of U.S. dollars) 1/	32.5	35.0	41.1	52.2	59.8	72.9	80.7	85.7
Percent of gross total external debt	28.6	27.0	28.5	32.5	35.4	35.4	32.6	29.8
Percent of gross official reserves	164.0	124.9	117.0	138.7	114.7	115.1	105.5	99.2
Debt service ratio (percent) 2/	42.8	38.4	35.2	26.7	26.2	26.1	28.8	29.0
REER appreciation (CPI based, period average)	-17.6	11.4	8.9	5.1	11.5	0.4	9.5	...
REER appreciation (CPI based, end of period)	-21.2	7.8	12.1	1.8	19.7	-6.6	18.9	...
Capital adequacy ratio (percent)	15.3	25.3	30.9	28.8	24.2	22.1	19.0	...
State banks	34.0	50.2	56.3	41.5	40.9	31.2	20.6	...
Private banks	9.0	19.6	23.5	22.3	17.2	17.5	17.0	...
Foreign banks	41.0	48.4	60.8	56.0	40.2	26.9	23.1	...
Nonperforming loans (percent of total)	29.3	17.6	11.5	6.0	4.8	3.8	3.5	...
Real broad money (percent change) 3/	11.3	-3.3	-4.6	11.7	15.3	13.5	6.2	...
Real credit to the private sector (percent change) 3/	-40.6	-21.2	27.4	47.8	44.7	28.6	16.2	...
Banks' net foreign asset position (billions of U.S. dollars)	-0.1	-0.4	0.3	-0.1	-0.1	0.2	-0.3	...
EMBI Global bonds spread (basis points)	707	693	309	265	223	207	239	...

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

1/ By residual maturity.
2/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).
3/ Deflated by the CPI.

Table 12. Turkey: Purchases and Proposed Schedule of Purchases, 2005–08

	SDR Millions	Percent of Quota 1/	Test Date 2/	Earliest Possible Purchase Date	Date of Board Approval
Approval	555.2	57.6			11-May-05
2005					
1st & 2nd Reviews	1,110.3	115.2	30-Sep-05		9-Dec-05
2006					
3rd Review 3/	624.6	64.8	31-Dec-05	1-Mar-06	28-Jul-06
4th Review 3/	624.6	64.8	31-Mar-06	1-Jun-06	28-Jul-06
5th Review	749.5	62.9	30-Sep-06	1-Dec-06	13-Dec-06
2007					
6th Review	749.5	62.9	31-Dec-06	1-Mar-07	18-May-07
2008					
7th Review	2,248.4	188.7	31-Dec-07	1-Apr-08	
Total 4/	6,662.0	559.2			

Source: IMF staff.

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

Table 13. Turkey: Medium-Term Scenario, 2003–13

(Percent change, unless otherwise indicated)

						Projections						Average	Average
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2003–07	2008–13
Real GDP	5.3	9.4	8.4	6.9	4.5	4.0	4.3	5.0	5.0	5.0	5.0	6.9	4.7
Real domestic demand	8.8	11.7	9.5	7.0	5.7	3.9	3.8	4.5	4.7	4.7	4.7	8.5	4.4
Private consumption	10.2	11.0	7.9	4.6	4.6	2.7	3.9	4.6	4.7	4.7	4.7	7.6	4.2
Private investment	23.7	36.1	16.2	15.0	2.7	7.5	4.1	5.0	5.0	5.0	5.0	18.7	5.2
Public spending	-6.0	2.9	7.5	6.9	4.0	4.3	3.5	4.0	4.5	4.5	5.0	3.1	4.3
Exports	6.9	11.2	7.9	6.6	6.7	8.7	9.0	10.3	9.7	9.7	9.7	7.8	9.5
Imports	23.5	20.8	12.2	6.9	11.1	7.8	6.7	8.0	8.1	8.2	8.4	14.9	7.9
Contributions to GDP growth (percent)													
Real domestic demand	8.5	11.8	9.8	7.2	5.9	4.1	4.0	4.7	4.8	4.8	4.9	8.6	4.6
Private consumption	6.8	7.7	5.6	3.3	3.2	1.9	2.6	3.1	3.2	3.1	3.1	5.3	2.8
Private investment	3.1	5.6	3.1	3.1	0.6	1.7	0.9	1.1	1.1	1.1	1.1	3.1	1.2
Public spending	-0.9	0.4	1.0	0.9	0.5	0.6	0.5	0.5	0.6	0.6	0.6	0.4	0.6
Net exports	-3.3	-2.4	-1.4	-0.3	-1.5	-0.2	0.3	0.3	0.2	0.2	0.1	-1.8	0.1
Exports	1.6	2.7	1.9	1.6	1.6	2.2	2.3	2.8	2.8	2.9	3.0	1.9	2.7
Imports	-4.9	-5.1	-3.3	-1.9	-3.1	-2.3	-2.1	-2.5	-2.6	-2.7	-2.9	-3.7	-2.5
Saving and investment (percent of GDP)													
Domestic saving	15.1	15.7	15.4	16.0	16.5	16.6	17.3	17.9	18.4	18.9	19.4	15.7	18.1
Gross investment	17.6	19.4	20.0	22.1	22.2	23.0	23.4	23.4	23.5	23.6	23.8	20.2	23.5
Employment rate	43.2	43.7	43.7	44.2	44.4	...	...	...	...	...	...	43.8	...
Unemployment rate (percent)	10.5	10.3	10.2	9.9	9.9	...	...	...	...	...	...	10.1	...
GDP deflator	23.3	12.4	7.1	9.3	8.1	9.9	6.9	5.9	4.4	4.0	4.0	12.0	5.8
Consumer prices													
Period average	25.3	8.6	8.2	9.6	8.8	9.8	6.9	6.0	4.4	4.0	4.0	12.1	5.9
End-period	18.4	9.4	7.7	9.7	8.4	9.3	6.7	4.9	4.0	4.0	4.0	10.7	5.5
Nonfinancial public sector (percent of GDP)													
Primary surplus	4.9	5.5	5.1	4.6	3.5	3.5	3.0	2.7	2.5	2.4	2.3	4.7	2.7
Overall balance	-7.2	-3.6	-0.2	-0.5	-1.4	-1.8	-1.1	-0.7	-0.5	-0.3	-0.3	-2.6	-0.8
General government gross debt (EU definition)	67.4	59.2	52.3	46.1	38.8	37.3	34.8	33.1	31.5	30.2	29.2	52.8	32.7
External indicators													
Current account (percent of GDP)	-2.5	-3.7	-4.6	-6.0	-5.7	-6.4	-6.1	-5.5	-5.0	-4.7	-4.4	-4.5	-5.4
Trade balance (percent of GDP)	-4.5	-5.8	-6.8	-7.7	-7.1	-7.7	-7.2	-6.7	-6.2	-5.9	-5.6	-6.4	-6.5
Net FDI (percent of GDP)	0.4	0.5	1.9	3.6	3.0	1.7	1.7	1.5	1.3	1.3	1.4	1.9	1.5
Gross external debt (percent of GDP)	44.2	38.4	35.0	38.4	33.7	41.1	42.9	44.1	45.9	47.2	48.7	37.9	45.0
Real Effective Exchange Rate (CPI-based, end-period percent change)	12.1	1.8	19.7	-6.6	18.9	...	...	...	...	...	...	9.2	...
Nominal GDP (billions of Turkish lira)	455	559	649	758	856	978	1,090	1,212	1,329	1,451	1,585	656	1,274
Nominal GDP (billions of U.S. dollars)	303	392	483	529	657	...	...	...	...	...	...	473	...

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

Appendix Table I.1. Turkey: External Debt Sustainability Framework, 2002–13

(Percent of GDP, unless otherwise indicated)

		Actual 7/						Projections						
		2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Debt-stabilizing non-interest current account 6/
1	Baseline: External debt	60.7	44.2	38.4	35.0	38.4	33.7	41.1	42.9	44.1	45.9	47.2	48.7	-1.8
2	Change in external debt	-7.7	-16.5	-5.8	-3.4	3.4	-4.7	7.4	1.8	1.1	1.9	1.3	1.5	
3	Identified external debt-creating flows (4+8+9)	-15.2	-19.0	-7.1	-3.5	-1.4	0.4	3.3	2.5	1.6	1.3	0.9	0.4	
4	Current account deficit, excluding interest payments	-2.8	0.1	1.7	2.9	4.1	3.6	5.0	4.3	3.5	3.0	2.6	2.2	
5	Deficit in balance of goods and services	1.4	2.6	3.7	4.9	6.3	5.4	7.2	6.6	5.9	5.5	5.1	4.8	
6	Exports	26.8	22.2	22.5	22.5	23.0	20.5	25.5	26.4	27.6	29.1	30.4	32.3	
7	Imports	28.2	24.9	26.2	27.4	29.3	25.9	32.7	33.0	33.5	34.5	35.5	37.1	
8	Net non-debt creating capital inflows (negative)	-0.2	-0.4	-0.8	-3.0	-3.9	-3.4	-2.1	-2.1	-2.0	-1.7	-1.7	-1.8	
9	Automatic debt dynamics 1/	-12.1	-18.7	-8.0	-3.3	-1.7	0.3	0.5	0.4	0.1	0.1	0.0	0.0	
10	Contribution from nominal interest rate	3.1	2.2	1.7	1.7	1.8	1.5	1.9	2.0	2.1	2.2	2.2	2.2	
11	Contribution from real GDP growth	-3.3	-2.1	-3.2	-2.8	-2.2	-1.2	-1.4	-1.7	-2.0	-2.1	-2.2	-2.2	
12	Contribution from price and exchange rate changes 2/	-12.0	-18.9	-6.5	-2.3	-1.3	-9.1	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	7.4	2.5	1.3	0.1	4.8	-5.1	4.1	-0.7	-0.5	0.5	0.4	1.0	
	External debt-to-exports ratio (percent)	226.6	198.7	170.8	155.3	166.8	164.4	161.5	162.8	159.7	157.9	155.0	150.6	
	Gross external financing need (billions of U.S. dollars) 4/	38.9	44.2	60.4	81.9	99.3	115.6	130.6	135.5	151.3	164.3	178.7	192.5	
	Percent of GDP	18.2	13.5	14.4	17.0	18.6	15.8	18.7	18.2	19.0	19.5	20.0	20.5	
	Scenario with key variables at their historical averages 5/						33.7	31.7	29.0	26.6	24.5	22.6	20.9	-1.8
	Key Macroeconomic Assumptions Underlying Baseline													
	Real GDP growth (in percent)	6.2	5.3	9.4	8.4	6.9	4.5	4.0	4.3	5.0	5.0	5.0	5.0	
	GDP deflator in U.S. dollars (change in percent)	21.2	45.1	17.2	6.3	3.9	31.2	-8.4	2.2	2.0	0.5	1.2	0.1	
	Nominal external interest rate (in percent)	5.9	5.5	5.0	5.2	5.8	5.5	5.3	5.3	5.3	5.2	5.1	5.0	
	Growth of exports (U.S. dollar terms, in percent)	8.6	26.8	29.7	15.4	13.5	22.0	18.4	10.3	12.1	11.2	11.2	11.6	
	Growth of imports (U.S. dollar terms, in percent)	16.1	34.6	35.2	20.5	18.8	21.0	20.2	7.6	8.8	8.8	9.3	9.8	
	Current account balance, excluding interest payments	2.8	-0.1	-1.7	-2.9	-4.1	-3.6	-5.0	-4.3	-3.5	-3.0	-2.6	-2.2	
	Net non-debt creating capital inflows	0.2	0.4	0.8	3.0	3.9	3.4	2.1	2.1	2.0	1.7	1.7	1.8	

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

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

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

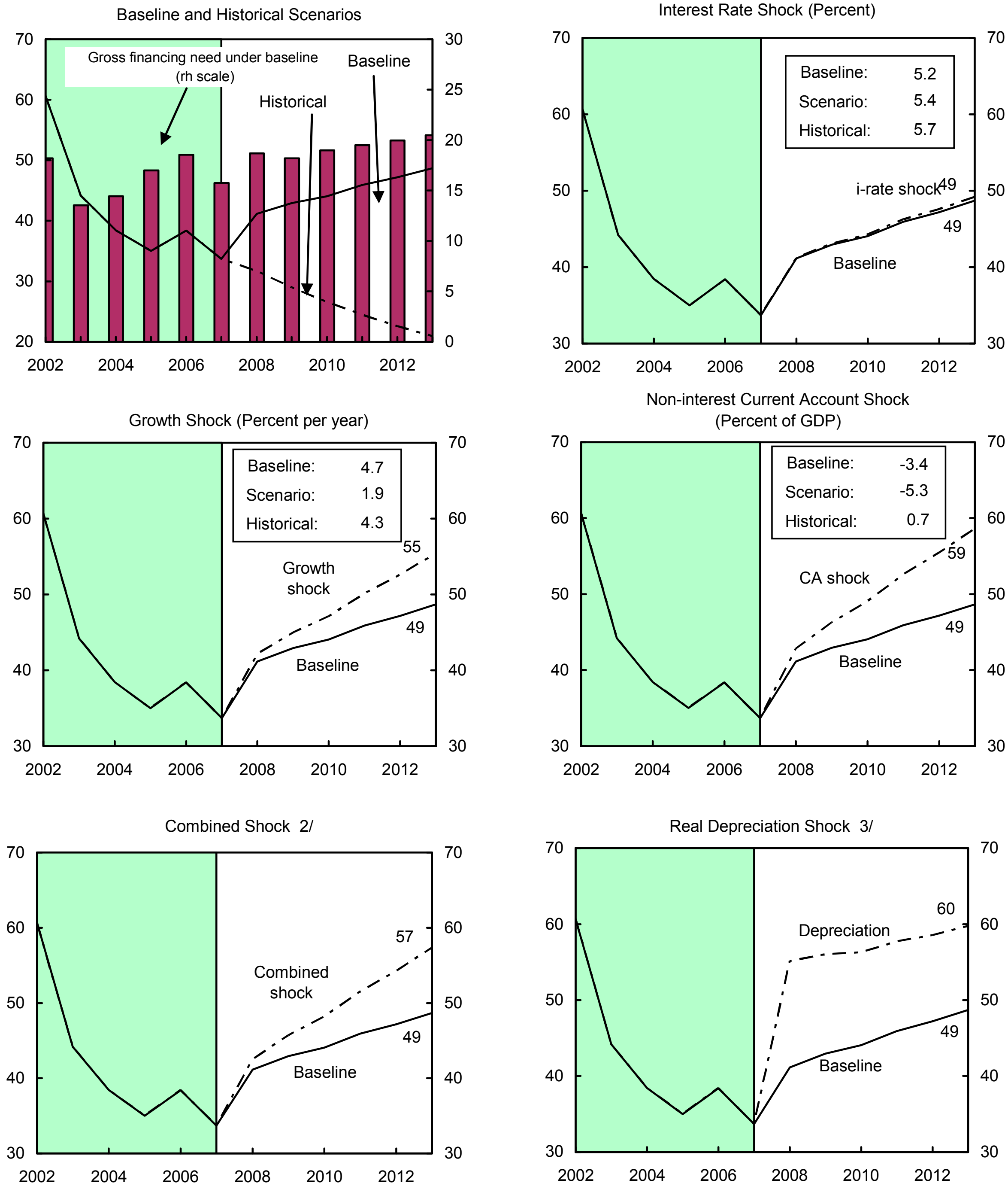
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. Differs slightly from external financing requirement in Staff Report because includes official transfers and IMF repurchases but excludes increase in portfolio and other investment assets.

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

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

7/ 2007 data are estimates.

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



Source: IMF staff estimates.

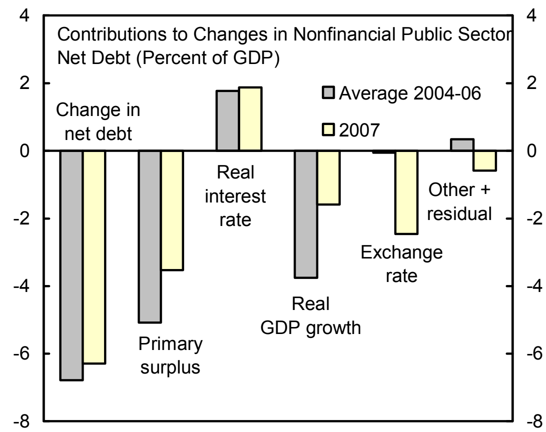
1/ Shaded areas represent actual data (estimated for 2007). Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

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

Appendix II: Public Debt Sustainability Analysis

1. **Ratios of net debt to GDP continued to fall in 2007 at a rapid pace**. Net debt of the public sector fell 5 percentage points of GDP to 29 percent. Sizable declines were also recorded in the net debt of the nonfinancial public sector (NFPS) and in gross measures of debt. The reduction in debt levels since 2001 has been impressive: net debt more than halved during this period. A strong appreciation of the lira was a powerful driver for debt consolidation in 2007, accounting for 2½ percentage points of NFPS debt reduction (Table II.1); this was in contrast to the previous three years, when the exchange rate had, on average, a negligible impact on debt dynamics. On the other hand, the contributions of fiscal policy and growth, while still positive, were smaller than their average contributions during the previous three years.



Source: IMF staff estimates.

Public Debt (Percent of GDP)

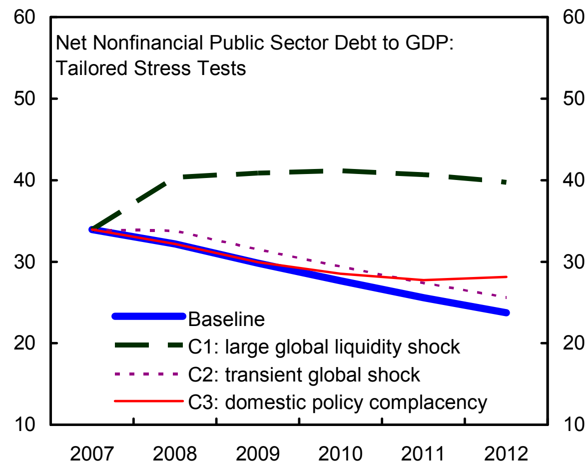
	2001	2002	2003	2004	2005	2006	2007
Net debt							
Public sector 1/	66.4	61.5	55.2	49.1	41.7	34.2	29.1
Nonfinancial public sector	75.9	68.8	60.6	54.1	46.4	40.2	33.9
General government	74.2	67.5	59.8	53.2	45.5	39.0	32.8
Central government	73.7	67.8	61.1	55.2	48.2	42.2	36.6
Other	0.5	-0.4	-1.4	-2.1	-2.7	-3.2	-3.8
SEEs	1.7	1.3	0.8	0.9	1.0	1.2	1.1
Gross debt							
Public sector	78.8	73.3	65.3	59.4	53.9	48.1	41.3
Nonfinancial public sector	78.8	73.3	65.3	59.4	53.9	48.1	41.3
General government	76.0	70.8	63.4	57.6	51.9	46.3	39.6
Central government	74.1	69.2	62.2	56.6	51.1	45.5	38.9
Other	2.0	1.5	1.2	0.9	0.9	0.8	0.7
SEEs	2.8	2.5	1.9	1.8	2.0	1.8	1.7
Memorandum item							
General government gross debt (EU def.)	77.6	73.7	67.4	59.2	52.3	46.1	38.8

Sources: Turkish Treasury; and IMF staff calculations.

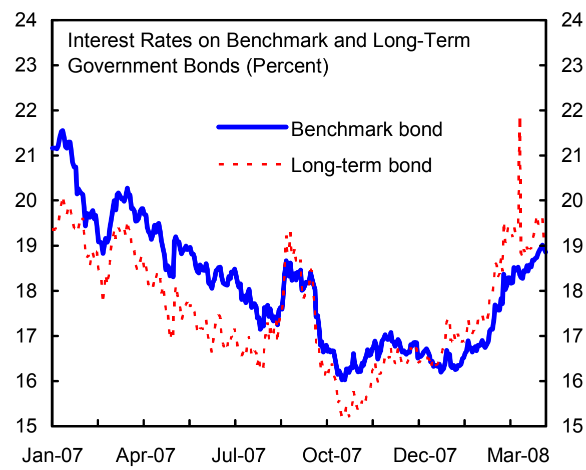
1/ Authorities' definition. Subtracts net assets of the central bank from nonfinancial public sector debt.

2. **To anchor fiscal policy and achieve further debt reduction, the authorities will soon announce a new medium-term fiscal framework (MTFF)**. The objective of the MTFF is to reduce general government gross debt (GGGD) under the European Union definition to 30 percent of GDP by 2012 (from 39 percent of GDP at end-2007). This target is

underpinned by a combination of gradually declining primary surpluses (from 3½ percent of GDP in 2008 to 2½ percent of GDP in 2012) and continued momentum in the implementation of the authorities' privatization agenda, which is projected to yield cumulative receipts of 3½ percent during 2008-12. Using conservative macroeconomic assumptions (with growth averaging 4.7 percent during 2008-12), staff projections indicate that gross debt would decline gradually to 30 percent of GDP by 2012 (Table II.1).



Source: IMF staff estimates and projections.



Source: Bloomberg.

3. **Stress tests show that debt dynamics could become unsustainable if fiscal discipline is abandoned or very large shocks occur**. More specifically, the following tailored stress tests were considered (Table II.1)[1]:

- ***Persistent deterioration in the global environment (C1)***. The onset of global financial volatility in the second half of 2007 has already contributed to a weakening of the lira and a significant increase in government bond yields (by more than 250 and 400 basis points on the benchmark and long-term bonds, respectively, from their 2007 lows). Scenario C1 assumes that the recent increase in risk aversion intensifies during 2008-09; compared with the baseline scenario, increased risk aversion is assumed to lead to a sharp lira depreciation (by 30 percent), an increase in real interest rates (by 500 basis points during 2008-09), and slower growth (to 2½ percent during 2008-09). The economy then returns to its baseline path in the following years. This scenario results in debt rising in the near term by 8 percentage points and a very slow decline in debt ratios afterwards.

[1] The stress tests and sensitivity analysis are carried out in terms of NFPS net debt.

- ***Transient deterioration in the global environment (C2)***. This scenario envisages a milder, temporary version of the shock delineated in the previous scenario (C1), with the exchange rate depreciating by only 10 percentage points over the baseline, interest rates increasing by 200 basis points over the baseline, and growth slowing temporarily to 2½ percent. In this scenario, debt increases by some 2 percentage points of GDP in the near term but resumes its decline afterwards.

- ***Domestic policy complacency (C3)***. This scenario assumes a loss of fiscal discipline through a combination of revenue-reducing tax changes, large net increases in transfers to subnational governments, and ambitious capital expenditure plans from 2009 onwards without offsetting measures. This results in a faster decline in the primary surplus (to ½ percent of GDP in 2012). In this scenario, which also assumes that structural reforms stall, real interest rates creep upward (by 250 basis points at the end of the projection period), and potential growth slows (to 4 percent during the projection period). As a result, debt ratios plateau at 4 percentage points above the 2012 baseline level.

4. **The scenarios underscore the importance of preserving fiscal discipline to safeguard debt sustainability**. The debt-stabilizing primary surplus is currently around 2 percent of GDP, which is not far below the primary surplus of the central government for 2009 envisaged in the authorities' MTFF (2.3 percent of GDP). Thus, it will be important to continue to build cushions against future shocks.

Appendix Table II.1. Turkey: Public Sector Debt Sustainability Framework, 2002–13

(Percent of GDP, unless otherwise indicated)

	Actual								Projections					
	2002	2003	2004	2005	2006	2007			2008	2009	2010	2011	2012	2013
General government gross debt ~~/4~~ 1/	73.7	67.4	59.2	52.3	46.1	38.8			37.3	34.8	33.1	31.5	30.2	29.2
1 Nonfinancial (NFPS) public sector net debt	68.8	60.6	54.1	46.3	40.2	34.0			32.2	29.8	27.7	25.6	23.8	22.3
Of which: foreign-currency denominated	38.5	27.3	22.0	16.5	13.9	12.0			12.0	10.8	9.5	8.6	8.1	7.9
2 Change in NFPS net debt	-7.2	-8.2	-6.5	-7.8	-6.1	-6.3			-1.8	-2.3	-2.2	-2.1	-1.8	-1.5
3 Identified debt-creating flows	-11.7	-7.5	-8.2	-8.1	-7.9	-4.7			-3.5	-2.8	-2.5	-2.4	-2.0	-1.7
4 Primary deficit	-3.2	-4.9	-5.5	-5.1	-4.6	-3.5			-3.5	-3.0	-2.7	-2.5	-2.4	-2.4
7 Automatic debt dynamics	-8.1	-2.3	-2.2	-2.2	-1.6	0.3			1.0	1.2	0.9	0.7	0.7	0.7
8 Contribution from interest rate/growth differential	-8.1	-2.3	-2.2	-2.2	-1.6	0.3			1.0	1.2	0.9	0.7	0.7	0.7
9 *Of which:* contribution from real interest rate	-4.9	0.5	2.4	1.7	1.2	1.9			2.2	2.5	2.3	2.0	1.9	1.8
10 *Of which:* contribution from real GDP growth	-3.2	-2.8	-4.6	-3.9	-2.7	-1.6			-1.2	-1.3	-1.4	-1.3	-1.2	-1.1
11 Contribution from exchange rate depreciation	4.9	-4.9	-1.0	0.0	0.8	-2.5			...	...	...	...	...	...
12 Other identified debt-creating flows	-0.4	-0.4	-0.4	-0.8	-1.7	-1.5			-1.0	-0.9	-0.6	-0.5	-0.2	0.0
13 Privatization receipts (negative)	-0.2	-0.1	-0.3	-0.6	-1.6	-1.4			-1.2	-1.0	-0.7	-0.5	-0.2	0.0
15 Other	-0.1	-0.3	-0.1	-0.2	-0.1	-0.1			0.2	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes 2/	-0.4	4.2	2.7	0.3	1.0	0.9			1.7	0.4	0.3	0.3	0.1	0.2
Key Macroeconomic and Fiscal Assumptions							10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	6.2	5.3	9.4	8.4	6.9	4.5	4.7	5.1	4.0	4.3	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 3/	30.4	25.4	18.5	11.4	12.9	13.7	42.1	32.3	17.6	14.1	12.6	11.9	12.1	12.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	7.1	13.0	6.1	4.3	3.6	5.6	15.5	13.7	7.7	8.7	8.6	7.9	8.1	8.3
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-11.9	17.1	4.0	-0.1	-5.0	21.3	-12.4	24.9	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	37.4	23.3	12.4	7.1	9.3	8.1	33.0	24.3	9.9	5.4	4.0	4.0	4.0	4.0
Primary deficit	-3.2	-4.9	-5.5	-5.1	-4.6	-3.5	-3.5	1.9	-3.5	-3.0	-2.7	-2.5	-2.4	-2.4

Appendix Table II.1. Turkey: Public Sector Debt Sustainability Framework, 2002–13 (concluded)

(Percent of GDP, unless otherwise indicated)

	Actual						Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
A. Alternative Scenarios (based on nonfinancial public sector net debt)												
A1. Key variables are at their historical averages in 2008-13						34.0	33.3	32.3	31.5	30.7	30.1	29.8
A2. No policy change (constant primary balance) in 2008-13						34.0	31.1	27.9	24.7	21.4	18.2	15.3
A3. 2008 GDP growth is reduced (relative to baseline) by one standard deviation						34.0	32.8	29.4	26.5	23.8	21.7	20.1
B. Bound Tests												
B1. Real interest rate is at historical average plus one-half standard deviation						34.0	36.8	39.3	42.6	46.8	51.9	56.9
B2. Real GDP growth is at historical average minus one-half standard deviation						34.0	31.7	29.8	28.2	26.8	25.6	24.8
B3. Primary balance is at historical average minus one-half standard deviation						34.0	33.2	31.4	29.5	27.5	25.7	24.2
B4. Combination of B1-B3 using one-quarter standard deviation shocks						34.0	36.5	38.2	40.5	43.3	46.6	50.9
B5. One time 30 percent real depreciation in 2008 4/						34.0	37.9	35.9	34.0	32.2	30.6	29.4
B6. 10 percent of GDP increase in other debt-creating flows in 2006						34.0	41.3	39.4	37.7	36.0	34.6	33.5
C. Tailored Tests												
C1. Deterioration in global environment (liquidity tightening and low world growth) 5/						34.0	40.4	40.9	41.1	40.7	39.8	38.9
C1. Temporary deterioration in global environment 6/						34.0	33.8	31.5	29.4	27.4	25.6	24.2
C3. Domestic policy complacency 7/						34.0	32.2	29.9	28.5	27.8	28.1	29.2

1/ General government debt consistent with the Maastricht definition.

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

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

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

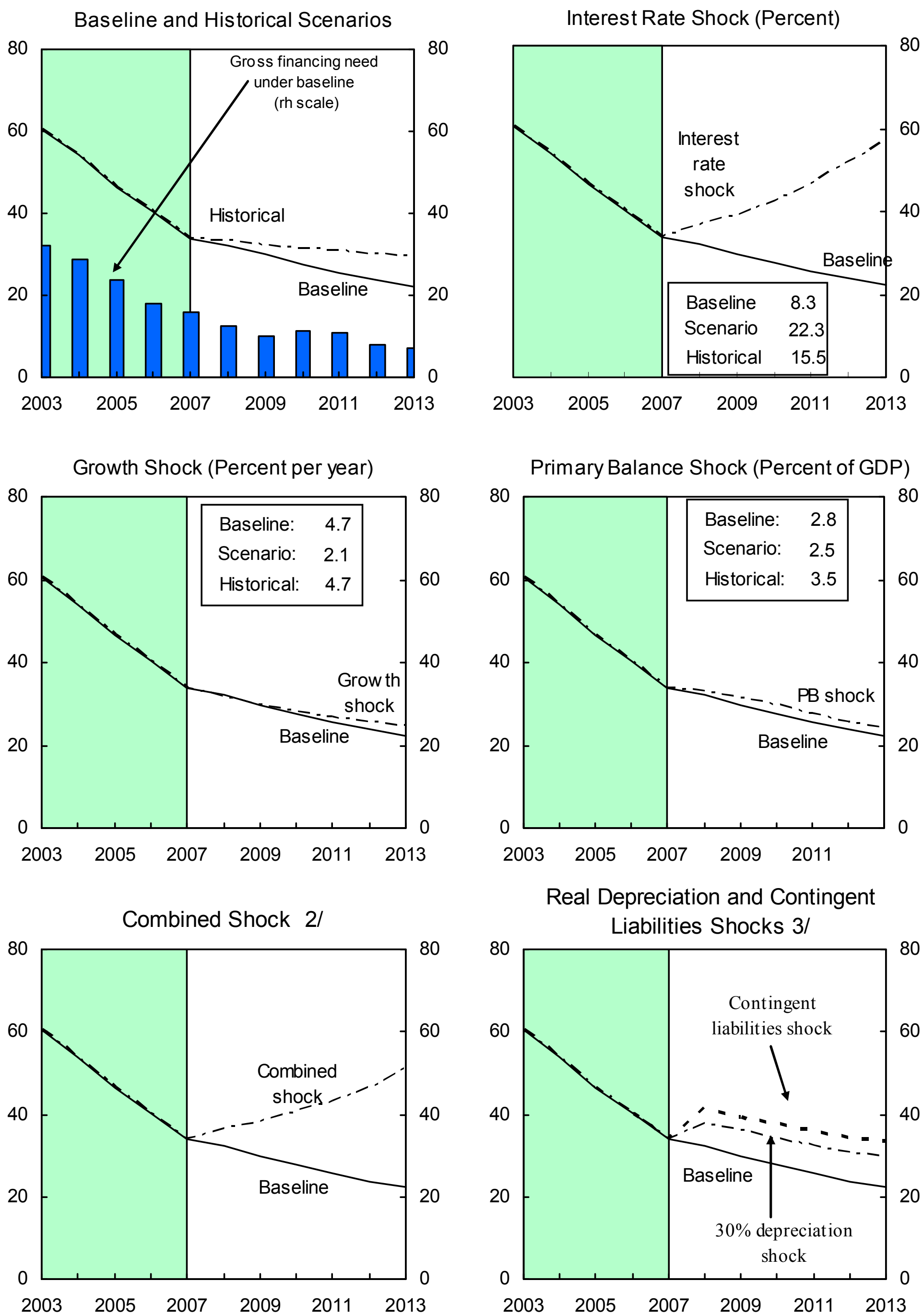
5/ Assumes a 30 percent depreciation in 2008 over the baseline, and a 500 bps increase in real interest rates in 2008−09, which reduces growth to 2.5 percent in these years. From 2010−13 interest rates will gradually ease 100 bps each year, while growth gradually accelerates to its 5 percent trend.

6/ Assumes a 10 percent depreciation, interest rates above baseline by 200 bps, and growth at 2.5 percent in 2008.

7/ Revenue-reducing reforms, local government reform, and ambititious capital expenditure plans are implemented without offsetting spending compression. No new structural reforms are implemented. This causes the real interest rate to creep up and growth to remain at 4 percent.

Appendix Figure II.1. Turkey: Public Debt Sustainability: Bound Tests 1/

(Net NFPS debt in percent of GDP)



Sources: IMF staff estimates.

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

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

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

Attachment I: Supplementary Letter of Intent

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Ankara, April 28, 2008

Dear Mr. Strauss-Kahn,

1. The Turkish economy continues to perform well overall, showing resilience in the face of severe turbulence in global financial markets—a testament to our prudent policies of the past five years. Growth is moderating, in line with global trends, but remains solid. The non-energy current account deficit has broadly stabilized as a percent of GDP, although record-high oil prices are widening the overall deficit. Headline inflation has remained above target, largely reflecting the global surge in energy and food prices, but core inflation has fallen markedly over the last twelve months. And, while the 2007 primary surplus outturn fell short of target, net public debt has dropped below 30 percent of GDP,[1] well ahead of the program's original objectives.

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

- *Quantitative performance criteria and inflation consultation clause* (Annex A). We met all the applicable external debt and net international reserve targets for end-August and end-December. Inflation at both end-June and end-September 2007 was within the outer bands, although it exceeded the inner bands, while end-December inflation exceeded the outer band. The central bank has discussed the reasons for the June and September results with Fund staff and reaffirmed its commitment to policies that will gradually reduce inflation to target levels. It has written a letter to the Government explaining the December deviation and its policy response, and it forwarded this letter to the Fund in accordance with the inflation consultation clause (Annex D of our May 1, 2007 Letter of Intent). The fiscal targets for end-April, end-August, and end-December were missed, as an acceleration of central government spending proved difficult to reverse, pension and health spending (especially at private hospitals) increased more than expected, and consumption-based tax revenue suffered from weak demand for some goods (notably autos and cigarettes). In addition, tax arrears from a large energy state economic enterprise (SEE) and some decline in compliance adversely affected the revenue outturn.

[1] All references to GDP are based on the revised national accounts data released on March 8, 2008.

- *Structural benchmarks.* The structural benchmarks on hiring in SEEs and the civil service were observed for June, September, and December 2007. The new insurance law was passed on June 3, 2007 (structural benchmark). The end-June structural benchmark on the creation of a legal framework for large employers to pay salaries through bank accounts was missed due to the early dissolution of Parliament, but this legislation was passed in April, 2008. The end-June structural benchmark associated with the publication of a report quantifying existing tax expenditure was met with a delay (the report was published on October 10), due to difficulties in compiling necessary data from related institutions. The end-December structural benchmark to introduce a risk-based audit system for VAT refunds was met with a delay (in April 2008, paragraph 17). The end-December structural benchmark to put in place a unified tax declaration form for taxes and social security contributions has not been met, but the relevant legislation was passed in April 2008 and is expected to be implemented by end-2008 (paragraph 16). The structural benchmark to extend the family medicine program to 22 regions by end-December was partially met with a delay, due to technical difficulties, with the program being extended to 20 regions by April 2008 (paragraph 13).

- *New policies*. We recently took a number of strong policy measures. In particular, we

    - adopted a prudent fiscal stance for 2008 that targets a public sector primary surplus of 3.5 percent GDP (paragraph 10);

    - passed a revised social security reform that will contribute decisively to fiscal sustainability (paragraph 15);

    - took several steps to strengthen tax administration (paragraph 17);

    - significantly raised average end-user electricity prices (the first increase in over five years) as part of our plan to bolster the energy sector (paragraph 19); and

    - strengthened bank provisioning requirements in line with international norms (paragraph 21).

3. In light of this recent progress, we request completion of the Seventh Review under the Stand-By Arrangement. In view of the corrective measures being taken (paragraphs 9–20), we request waivers for the end-December performance criteria on the primary surplus of the consolidated government sector, the primary surplus of the consolidated government sector excluding SEEs, the primary spending of the central government and social security institutions, and the balance of the social security institutions. This will be the final review under the current Stand-By Arrangement, which ends on May 10, 2008, and will enable Turkey to draw all remaining purchases under the current arrangement (SDR 2.25 billion, or about US$3.7 billion).

Macroeconomic framework for 2008

4. GDP growth in 2007 came in at 4½ percent, one-half percentage point below our original target. Economic activity has slowed on account of a drought-related shortfall of agricultural production and a weakening of net exports. Looking ahead, we expect activity to remain resilient to the global economic and financial headwinds. At the same time, we are mindful that the worsening global environment has increased uncertainty and reduced prospects for global growth. In this light, we have slightly revised downward our growth target for this year, to around 4½ percent.

5. On the external side, despite a strengthening of the exchange rate, export volumes grew by 10.9 percent in 2007, supported by robust growth in our main trading partners. Import growth accelerated during the course of 2007, reaching 11.1 percent for the year as a whole. Still, the current account deficit declined to 5.7 percent of GDP, from 6.0 percent of GDP in 2006. For 2008, in turn, the current account deficit is expected to increase slightly back to around 6½ percent of GDP, mainly on account of surging oil prices. Meanwhile, external financing remained favorable in 2007, with foreign direct investment covering more than half of the current account deficit (driven mainly by strong private merger and acquisition activity). Foreign direct investment is expected to exceed one-fourth of the current account deficit in 2008, supported by ongoing mergers and acquisitions and the resumption of privatization activity. In light of the recent credit crunch and repricing of risk in global markets, we are monitoring current and capital account developments closely and are prepared to adjust policies as needed.

Monetary policy

6. Low and stable inflation is a key foundation for sustained high growth. The tight monetary policy implemented by the central bank since the mid-2006 turbulence has allowed a marked decline in core inflation from early 2007, despite a recent pick-up in headline numbers, which largely reflects surging global commodity prices as well as necessary domestic price and tax adjustments. In particular, the November adjustment of specific excises on petroleum products and tobacco and the January increase in end-user energy prices to reflect higher input costs (paragraph 19) have exerted some temporary upward pressure on headline inflation. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy supply. Meanwhile, the continued easing of core inflation since early 2007 allowed a gradual reduction in interest rates during September 2007 to February 2008. In the period ahead, we expect macroeconomic policies to remain supportive of further disinflation, while volatile energy and food prices as well as the uncertainties related to international financial markets pose upward risks to the inflation outlook. Against this backdrop, the central bank's policy will be geared toward containing second-round effects of recent price

increases and bringing inflation down to the official target by being more responsive to adverse developments than favorable developments to the inflation outlook.

7. We remain committed to the floating exchange rate system, which helps to avoid undue build-up of risks in the financial system and provides flexibility to adjust to external developments. At the same time, accumulating international reserves for prudential reasons remains a key objective of the program. In light of increased volatility in global markets, we have recently reduced the daily minimum purchase amount to US$15 million (from the US$30 million announced in the central bank's yearly program for 2008), with the option for banks to sell up to US$30 million in additional foreign exchange to the central bank. As in the past, we retain the option to change the daily auction/optional selling amounts in either direction depending on market conditions, and to temporarily suspend the auctions in extreme circumstances. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

Fiscal policy

8. The high primary surpluses of the past several years have been the key force allowing the declines in the debt-to-GDP ratio, inflation, and real interest rates. Our public finances are now much stronger as a result. This provides us with latitude to replace the primary surplus target of 6.5 percent of (pre-revision) GNP, which has so far acted as a key guide to fiscal policy, with an explicit medium-term fiscal framework. The framework will be anchored to a debt reduction objective and include a strengthened institutional arrangement for achieving the desired expenditure restraint (paragraph 12). Expenditure restraint and improved tax administration are needed to make room to ease the tax burden on labor and financial transactions over time. In the short term, however, fiscal policy will continue to be geared toward supporting the central bank's disinflation efforts and reducing pressures on the external current account.

9. As pertains to 2007, a combination of higher-than-planned spending and weaker-than-expected revenue has resulted in a lower-than-targeted primary surplus. To strengthen public finances going forward, we have focused on making permanent improvements to tax administration (paragraph 17), including stepped-up collection efforts that have already begun to yield a recovery in revenue in late 2007 and early 2008.

10. Our revised 2008 budget targets a primary surplus of no less than 3½ percent of GDP, in line with the 2007 outturn. Against the backdrop of a slowing economy, the revisions were needed to accommodate an acceleration of labor market reforms (previously planned for 2009) and some priority investment projects, cumulatively amounting to no more than ½ percent of GDP in 2008. To promote achievement of this target:

- We have taken measures to boost revenue, including adjusting specific excises on petroleum products and tobacco, and strengthened tax administration. And, although we are confident that our revenue targets will be met, we stand ready to implement additional measures if revenues fall short of our baseline projections or if other assumptions underpinning the budget, including on state enterprise pricing, do not materialize.

- Expenditure as a share of GDP is expected to be slightly lower than in 2007. We have maintained hiring caps (limiting the replacement of civil servants leaving to attrition to 50 percent) to contain the wage bill.

- To help contain the Social Security Institution (SSI) deficit, we are implementing measures to improve health spending efficiency (paragraph 13).

- The recent price increases for electricity (paragraph 19) and natural gas are expected to improve SEEs' 2008 income by 0.4 percent of GDP (relative to what it would have been otherwise).

11. We have designed and plan to adopt soon a comprehensive reform package to reduce labor market rigidities and the financial burden on employment, which contribute to low employment ratios and a large informal sector, ultimately reducing growth. The package: (i) reduces nonfinancial burdens, including by easing special hiring and licensing requirements for private companies; (ii) expands active labor market programs; (iii) eases restrictions on temporary employment; and (iv) reduces employers' social security contributions by 5 percentage points, with additional targeted incentives for youth employment. We have ensured that the cost to this year's budget is contained to less than ¼ percent of GDP.

12. We plan to strengthen significantly our medium-term fiscal framework. For the time being, as a prior action for the review, we will soon announce a revised medium-term fiscal plan, including a debt reduction target (to 30 percent of GDP in gross terms as per the Maastricht definition by 2012) and a path for the primary surplus and primary spending consistent with meeting this target (details to be posted on www.hazine.gov.tr).We will preserve our primary surplus target in the near term (2009) even if debt falls below our projections. We will study alternative options to institutionalize this framework, with a view to taking a decision before the 2009 budget. To facilitate the monitoring of fiscal targets and to enhance fiscal transparency, we have started releasing fiscal statistics in line with a preannounced release calendar and publishing more data on sectors outside the central government, including the social security institution, SEEs, and revolving funds. We will also publish accounts that consolidate the central government and social security institution.

13. We are committed to improving the health system, enhancing its efficiency over time, and ensuring the system is adequately financed. We are confident that the budget for health

spending in 2008 is sufficient and have adopted safeguards to ensure the spending overruns of the last several years are not repeated. Specific measures include the following: (i) we have adopted tight global caps for state hospitals' 2008 budgets on a quarterly basis; (ii) we have used the "discount" system to legally settle all 2007 invoices and renewed this authority in March with a view to applying the same system in 2008; and (iii) we will shortly announce differentiated copayments for outpatient services with payments increasing with the level of service. Copayments will be between 0 and 2 YTL for primary care, between 5 and 10 YTL for secondary care, and between 8 and 10 YTL for tertiary care services, with a 100 percent discount for secondary and tertiary care with a physician referral. Technical preparations are now being made to put in place a referral system and facilitate the early adoption of differentiated copayments. To promote medium-term efficiency, we plan to publish an actuarial report on health finances by end-June 2008. We are also expanding the family medicine system, which was extended to 20 regions by April 2008.

14. To support our fiscal objectives, we will continue to replace no more than 10 percent of employees leaving SEEs and will maintain excise taxes and SEE prices (including energy prices) in line with program assumptions, or promptly take corrective measures. We will refrain from (i) introducing sectoral tax cuts that would undermine the structure of the VAT or income tax or (ii) creating any extrabudgetary fund that would prejudice fiscal transparency and financial discipline.

Structural fiscal reforms

15. Parliament has adopted a revised social security reform law, which addresses the objections raised by the Constitutional Court to Law 5510 while retaining most of the latter's savings. The reform will contribute enormously to entrenching fiscal sustainability over the medium and long run. The revised law also establishes a new universal health insurance framework. To promote efficiency in this area, the law authorizes the Social Security Institution to set copayment rates for outpatient services that are differentiated between primary, secondary, and tertiary levels. We expect to implement the law in its entirety starting from October 2008. In the interim period before the new law comes into force, we will ensure that pension increases do not exceed the growth rates implied by the indexation parameters in the new law.

16. In the meantime, we continue to press ahead with measures to improve the collection of social security contributions. In the context of the social security reform, we have adopted a legal framework requiring large employers to pay salaries through bank accounts (prior action), which had been delayed by the early dissolution of the previous parliament. In addition, we are strengthening and modernizing premium collection techniques. In this respect, we have established special departments focused on debt collection issues within the Social Security Institution, and we are working on establishing a separate subdivision within the Department of Premium Collection in Social Security Institution to deal with large

employers. We are also working on operationalizing Large Employer Offices in Istanbul, Ankara, and Izmir, which we expect to start operations by end-September 2008. We have also passed legislation enabling a unified tax declaration form, which we intend to implement by end-2008.

17. Continued progress in tax administration is essential to our objective of enabling lower taxes over the medium term without jeopardizing our fiscal objectives. We have expanded the number of auditors assigned to the Large Taxpayer Unit to 50 and will add more as we identify highly-qualified suitable candidates. To guard against VAT refund fraud, we (i) have eliminated the ability to offset third-party tax liabilities (thus limiting offsets to the claimant's own liabilities); (ii) introduced a risk-based audit system for VAT cash refunds with the introduction of a pilot system (prior action) that, with positive results, will be expanded by end-2008 to include more taxpayers; in the interim, post-refund audits of offsets will be introduced; (iii) will soon introduce monthly cross-matching of purchase and sales invoices for larger taxpayers; and (iv) will raise audit staff levels from 5 to 10 percent of total resources over the medium term. To improve compliance, we (i) will review the penalties for serious fraud and evasion with the goal of strengthening sanctions by end-2008; (ii) will remove the option to pay a fine to avoid custodial sentences by end-2008; and (iii) will enhance cash teams by introducing test purchasing backed up by verification.

18. We remain committed to reforming the civil service in such a way as to improve efficiency (through greater flexibility, better incentives for performance, and added emphasis on human capital development), eliminate discrepancies between pay for equal work (by consolidating the legal framework governing salary setting), and contain the weight of personnel costs in total public expenditure (through strengthened monitoring of employment and pay policy changes).

19. We have formulated a comprehensive plan to attain lasting financial viability of the SEEs operating in the energy sector. Our plan combines four key elements: (i) an upfront adjustment of end-user electricity tariffs; (ii) implementation of a reliable, automatic pass-through mechanism; (iii) a resolution of the nonpayment by municipalities; and (iv) a swift resumption of our sectoral privatization strategy. An upfront 16½ percent increase in average end-user tariffs for electricity was implemented on January 1, 2008. Consistent with our commitment to achieve the 2008 primary surplus target for the SEE sector, we have adopted, effective July 1, 2008, an automatic price adjustment mechanism that will ensure full pass-through and thus create a reliable basis for future private investment in the sector.

20. We are preparing a detailed action paper to resolve the issue of nonpayment by municipalities, including for street lighting, and reduce technical losses and theft, which weigh on the financial performance of the electricity sector. Moreover, we are committed to taking expeditious steps toward our strategic objective of increased private sector participation in both distribution and generation. In particular, we are soon launching the

tender process for the privatization of four regional electricity distribution companies (prior action). In this context, we will review carefully the possible need to adjust some of the performance targets and investment obligations for distribution companies stipulated under the original timetable. We also remain committed to privatizing generation companies in due course.

Financial sector reforms

21. We are continuing our efforts, most recently acknowledged in the Financial System Stability Assessment, toward ensuring that our supervisory and regulatory practices are fully in line with international best practices. To this end, the BRSA has recently tightened liquidity requirements and issued a new regulation setting specific provisioning rules for special mention loans in accordance with good prudential practices. As part of its examination of risk management in banks, the BRSA will further emphasize to banks their responsibilities to comprehensively monitor foreign exchange risks. In addition, the central bank has launched a new survey of corporate sector foreign exchange exposure to improve its oversight of these risks from the viewpoint of financial stability. The results will be published by end-2008. With respect to Basel II, the BRSA has postponed full implementation of the new rules until early 2009. To give banks sufficient time to prepare for the new capital requirements, however, the BRSA will soon announce risk weightings for banks' various assets.

22. Banks' prudent assessment of risks depends crucially on the availability of accurate and timely information about their borrowers' financial position. With this in mind, we are committed to ensure the parliamentary adoption of the new Commercial Code during 2008. The Commercial Code will require that corporate financial statements be prepared in line with International Financial Reporting Standards, thus ensuring a much improved coverage and timeliness.

23. We are also committed to completing all the requirements for an efficient and financially stable mortgage lending system. The Capital Markets Board (CMB) has already issued several important implementing regulations for the landmark February 2007 Mortgage Law. A draft regulation on asset-backed securities was recently disclosed for public comments and a draft regulation on mortgage finance corporations will be disclosed for public comments shortly. Both of these regulations will be issued in final form by end-June 2008. The BRSA plans to take appropriate measures for monitoring implementation of the new mortgage regulations by banks and their affiliates. Such supervisory actions would include requiring banks to have proper systems in place to identify all risks related to mortgage lending.

24. The initial public offering of 25 percent of Halkbank shares in May 2007 was highly successful. We are now making preparations for a secondary equity offering (SEO) of another

24 percent of shares in the period ahead, and depending on market conditions. This step could be followed by further block sale of the majority shares. We also remain committed to preparing a privatization strategy for Ziraat, once Halkbank is fully privatized.

25. The SDIF is now in a better position to focus on its role as a deposit insurance agency. It has recently taken a decision on the design of risk-based premiums that will further improve the functioning of the deposit insurance scheme. To assist the SDIF with its mission, we will continue to ensure high-quality cooperation and sharing of information among all relevant regulatory and supervisory agencies.

Investment climate

26. Foreign direct investment reached a new record in 2007, with net inflows of US$20 billion surpassing the previous year's record level of US$19 billion. Ongoing merger and acquisition activity across a range of sectors and the renewed privatization drive should continue to support foreign direct investment inflows this year and over the medium term. The main elements in the privatization agenda for 2008 include Tekel tobacco (tender completed in February), Türk Telecom (IPO for 15 percent) electricity distribution and generation, sugar refineries, toll roads and bridges, the national lottery, and the Halkbank share offering. We are committed to passing revised legislation as necessary to preserve the rights of foreign investors to own real estate in Turkey, as this is needed to ensure that Turkey continues to benefit from a robust flow of foreign direct investment.

27. We are committed to redoubling our efforts to improve Turkey's investment climate and continue to work closely with the private sector to identify and implement investment-friendly reforms. Notable areas of recent progress include the streamlining of business license requirements, and simplification of customs procedures. We expect parliamentary passage of the Commercial Code in the coming period (paragraph 22), which will strengthen corporate governance and transparency.

Stock-taking

28. As the current Stand-By Arrangement comes to an end, we consider that most of the key objectives set at the outset of the program have been achieved. First and foremost, continued discipline in fiscal and monetary policies (in the context of the recently adopted inflation targeting framework) has consolidated macroeconomic stability, affording three more years of strong and steady growth with comparatively low inflation, sharply rising FDI, and strengthened public balance sheets. These advances have allowed our economy to withstand even serious external shocks, including repeated bouts of financial market turbulence. Simultaneously, we have made important progress in a number of structural areas, notably on social security, tax administration, and banking supervision, as well as state bank restructuring and privatization.

29. Reflecting the success of the program, Turkey has expanded significantly its trade and investment links with the rest of the world, converged further to the economies of the European Union, strengthened its international reserve position, and reduced it reliance on Fund financial support. We intend to build on this economic success by persevering in the period ahead with disciplined macroeconomic policies and structural reforms to secure even greater economic prosperity.

Very truly yours

Mehmet Şimşekc /s/	Durmuş Yılmaz /s/
Minister of State for Economic Affairs	Governor of the Central Bank of Turkey

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

(Millions of new Turkish lira, unless otherwise indicated)

	Mar. 31, 2006		Jun. 30, 2006		Sep. 30, 2006		Dec. 31, 2006		Apr. 30, 2007		Aug. 31, 2007				Dec. 31, 2007	
	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome			Ceiling/ Floor	Outcome
I. Quantitative Performance Criteria 1/																
1. Floor on the cumulative primary balance of the consolidated government sector 2/	7,771	10,603	17,366	25,042	29,684	33,272	34,490	36,159	12,338	9,358	32,338	23,066			40,738	29,183
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/	7,471	8,403	16,414	22,095	28,052	31,417	31,796	34,646	11,738	7,327	31,138	19,845			38,238	26,665
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/	n.a.	n.a.	n.a.	n.a.	124,046	124,859	173,084	174,972	56,485	59,690	118,593	125,003			190,795	195,988
4. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$)	8,500	4,196	14,000	4,806	18,000	6,829	21,500	10,853	9,000	4,247	15,000	8,175			22,000	10,263
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0			1,000	0
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	19.7	32.4	24.3	31.0	25.7	31.0	28.7	32.6	28.7	40.6	35.0	44.0			36.0	43.7
7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/	-6,100	-6,634	-12,000	-10,554	-18,400	-16,481	-24,300	-22,001	-5,000	-8,976	-16,300	-17,549			-24,200	-25,041
II. Indicative Targets																
1. Floor on the cumulative overall balance of the consolidated government sector 2/	-3,429	1,202	-3,934	7,133	-5,466	2,080	-6,460	-1,168	-6,612	-6,580	-3,612	-6,512			-5,512	-9,972
2. Privatization Proceeds (in millions of US$)	1,900	4,579	2,800	7,970	3,200	8,008	4,200	8,010	n.a.	n.a.	n.a.	n.a.			n.a.	n.a.
III. Inflation Consultation Bands (12-month change, in percent) 4/																
									Mar. 31, 2007		Jun. 30, 2007		Sep. 30, 2007		Dec. 31, 2007	
									Target	Outcome	Target	Outcome	Target	Outcome	Target	Outcome
Outer Band (upper limit)	9.4		8.5		7.8		7.0		11.2		8.7		7.3		6.0	
Inner Band (upper limit)	8.4		7.5		6.8		6.0		10.2		7.7		6.3		5.0	
Central Point	7.4	8.2	6.5	10.1	5.8	10.5	5.0	9.7	9.2	10.9	6.7	8.6	5.3	7.1	4.0	8.4
Inner Band (lower limit)	6.4		5.5		4.8		4.0		8.2		5.7		4.3		3.0	
Outer Band (lower limit)	5.4		4.5		3.8		3.0		7.2		4.7		3.3		2.0	

1/ Cumulative targets are set from January 1, 2006 for targets within 2006 and from January 1, 2007 for targets within 2007.
2/ After being adjusted for program adjusters. Coverage from June 2006 onwards expanded, to account for new institutions now covered under the Central Government Budget.
3/ Indicative target for March 2006, performance criteria from June 2006 through December 31, 2007.
4/ Test dates for inflation consultation bands are kept at a quarterly frequency throughout 2007 and thus reported separately in Annex D of the TMU (Country Report 07/363)

Attachment II. CBT Letter on Inflation Consultation

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

HEAD OFFICE

Please refer to :
Communication and Foreign Relations Department
2008-OKM-D/ 13

ANKARA, ...3.1 JAN 2008

07055

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. Strauss-Kahn,

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

Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Durmuş YILMAZ
Governor

Dr. Erdem BAŞÇI
Vice Governor

-Enclosed 13 pages

İSTİKLAL CAD. 10 06100 ULUS - ANKARA
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Central Bank of Turkey

Ankara, January 31, 2008

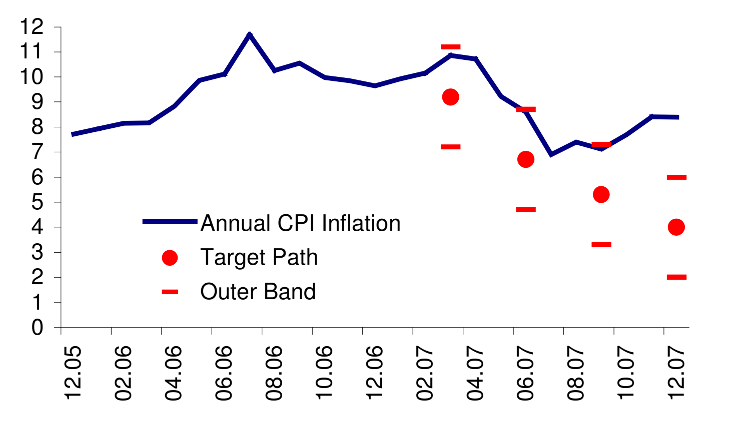
No: 2008-03

Mehmet ŞİMŞEK
Minister of State
ANKARA

Central Bank of Turkey (CBT) is implementing a formal inflation-targeting regime since the beginning of 2006. Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. To facilitate the accountability principle, the CBT has been disclosing a quarterly path for inflation with an uncertainty band. In this context, any breach of upper or lower limits of the band requires the CBT to write an open letter to the Government, explaining the reasons for the breach and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

Accordingly, end-year inflation target for 2007 was set as 4 percent, with an uncertainty band of 2 percentage points on either side. The annual Consumer Price Index (CPI) inflation outturn by the end of December 2007 was 8.39, breaching the upper limit of the uncertainty band (Figure 1). This open letter explains the reasons why inflation in 2007 exceeded the end-year target by a large margin, evaluates the measures taken by the Central Bank of Turkey to bring inflation back to the target, and presents the medium term outlook. As mentioned in our policy statement titled "General Framework of Inflation Targeting and Monetary and Exchange Rate Policy" published in December 2005, this Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual CPI Inflation and Target Path



Source: TURKSTAT, CBT

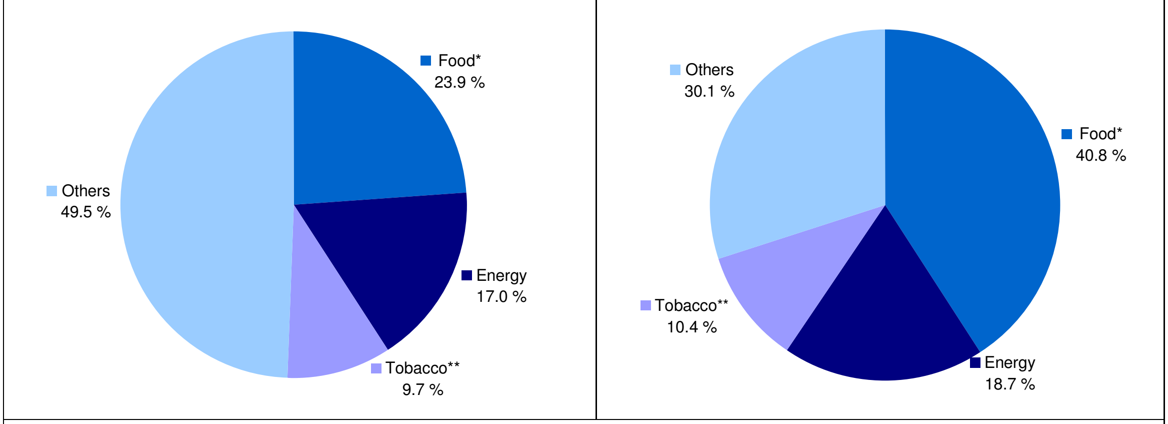
Reasons For Exceeding the Target

The monetary tightening exercised since mid-2006 has been successful in leading to a significant reduction in the underlying inflation. The fall in headline inflation, however, was more limited, owing mainly to factors beyond the control of monetary policy, such as developments in food, energy, and administered prices.

Both domestic and international developments have played a part on the course of food prices. A prolonged shortage of rainfall in Turkey since Autumn 2006 has resulted in low crop yields in 2007, which in turn translated to an adverse supply shock. Global developments, such as increasing bio-fuel production, strong global demand for food and consequent rises in agricultural commodity prices, further added to the domestic food inflation through the external trade channel. These factors had an impact not only on the prices of *unprocessed* food (such as fresh vegetables and fruit) but also on the prices of *processed* food (such as grain and dairy products). Accordingly, annual food inflation maintained its high levels, with an end-year figure of 12 percent. Hence, food prices became the main factor impeding the disinflation process in 2007, with a marked contribution of about 3.4 percent on headline inflation. Consequently, the contribution of food prices to the headline inflation in 2007 was significantly higher than it had been in the past three years (Figure 2).

Figure 2: Contribution to End-year CPI Inflation (Percentage Share)

2004- 2006 Average | **2007**



* Food: Food and non-alcoholic beverages
** Tobacco: Tobacco products and alcoholic beverages

Source: TURKSTAT, CBT

Another major factor slowing the disinflation process was adverse developments in energy and administered prices. The crude oil price in December 2007 was nearly 50 percent above the levels registered at the end of 2006. This development, together with the changes in special consumption tax on fuel-oil products, led to a significant rise in the prices of fuel-oil products in 2007. Another energy item, housing water prices, which is administered by municipalities, edged up in the last quarter of 2007, partly owing to the drought conditions. Overall, 1.6 points of the headline inflation resulted from the energy price hikes, where the contribution of administered component outweighs that of the oil price. Moreover, the prices of tobacco products increased by about 18 percent in 2007, due to adjustments in special consumption tax. In sum, the contribution of energy and tobacco products to the headline annual inflation reached 2.4 percentage points at the end of 2007.

A closer look at the last couple of years' annual inflation in certain subgroups of the CPI reveals the main factors behind the rise in inflation in 2007. Figure 3 depicts the marked contribution of the hikes in food, energy and tobacco prices. The fast pace of disinflation in services and core goods (goods excluding food, energy and tobacco) in 2007,confirms that supply side shocks were mainly responsible for the breach of the uncertainty band.

Figure 3: Subcomponents of CPI (Annual Percentage Change)

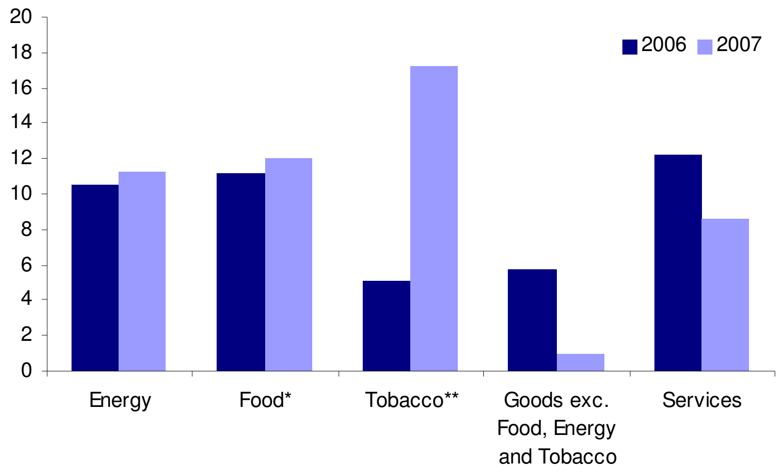


Table 1: Contribution to Annual CPI Inflation (percentage points)

	Energy	Food*	Tobacco**	Goods exc. Food, Energy and Tobacco	Services
2007	1.57	3.42	0.87	0.24	2.28
2006	1.51	3.09	0.28	1.43	3.33

* Food: Food and non-alcoholic beverages

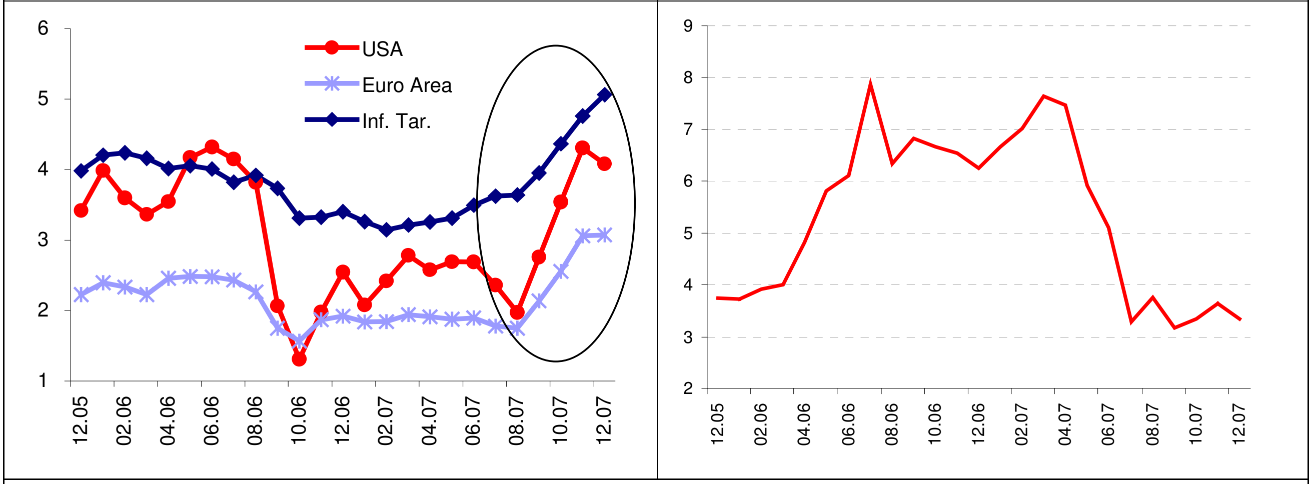
** Tobacco: Tobacco products and alcoholic beverages

Source: TURKSTAT, CBT

Adding some international perspective may help to better evaluate the recent inflation dynamics. Lately, inflation has been rising almost all over the world (Figure 4). Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures. Although second round effects have been so far limited–thanks to well-established credibility of monetary authorities all over the world, sustained increases in commodity prices have started to take their toll on headline inflation, if not on core inflation. Inflation in US and Euro area edged up in the last quarter of 2007 while emerging economies under inflation targeting have been facing an upward trend since June 2007. Figure 4 illustrates that in 2007 inflation in Turkey followed a more favorable trend compared to other emerging economies with inflation targeting, notwithstanding the administrative price hikes in November, which added by about 1-percentage points to the Turkish CPI inflation.[1] During the past year, inflation in Turkey declined from 9.7 percent to 8.4 percent, while average of inflation in emerging market economies under inflation targeting rose from 3.4 percent to 5.1 percent.

Figure 4: International Perspective:
Inflation in US, Euro Area and Inflation Targeting Emerging Economies

a. Inflation in Other Regions* | **b.** Diff. Between Turkey and Other Emerg. IT'ers*



*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.
Source: Web sites of central banks

Measures Taken to Ensure the Convergence of Inflation to the Targets

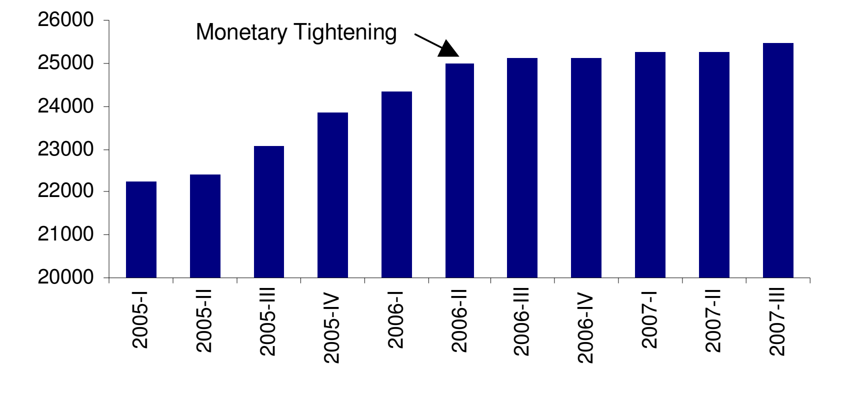
Monetary policy affects inflation with a considerable lag. Therefore, in order to understand the recent inflation dynamics, it would be useful to go back to the monetary policy implementation in 2006. The volatility in the financial markets in May-June 2006 period and the consequent deterioration in inflation expectations had compelled the CBT to react decisively by hiking policy rates by a total of 425 basis points in a relatively short period of time. This policy reaction was successful in containing inflation expectations. However, since inflation followed a relatively elevated course due to the lagged impact of exchange rate pass-through, the gap between targets and inflation expectations remained at considerable levels. These factors, together with prevailing uncertainties over the impact of monetary policy and the risks pertaining to potential second round effects of a series of supply side shocks, necessitated a tight monetary policy for an extended period. Accordingly, policy rates were kept on hold for the following 13 months.

Strong monetary tightening was effective in moderating the private consumption demand (Figure 5). Although government spending accelerated and

[1] 2007 primary budget surplus was lower than the initial projections, owing mainly to rising government expenditures. The government implemented a fiscal package, through raising indirect taxes on tobacco and some fuel-oil products in November 2007, and increasing the tariff rates on electricity and natural gas in January 2008, to ensure the attainability of revenue targets for 2008.

external demand remained strong in the following quarters, monetary tightening was successful in curbing the aggregate demand, especially through the slowdown in durable goods, housing and other services activities. Starting from the year 2007, the Monetary Policy Committee (MPC) signaled through the policy statements that measured rate cuts were envisaged sometime around the last quarter of 2007.

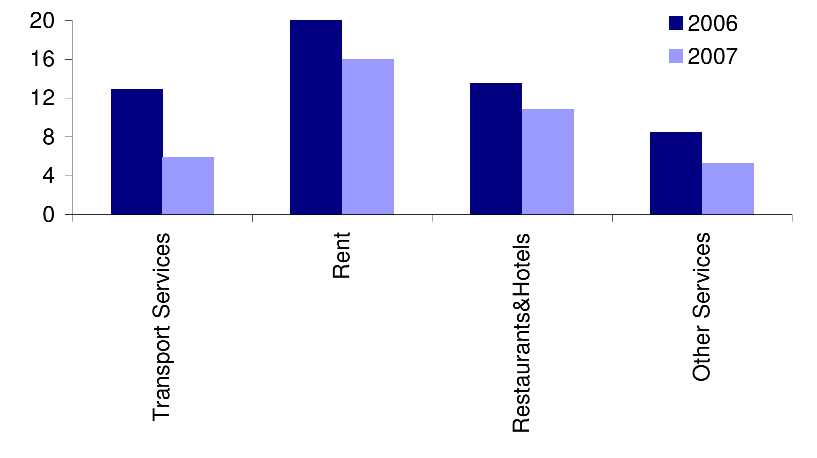
Figure 5: Real Private Consumption (Quarterly, seasonally adjusted)



Source: TURKSTAT, CBT

A year after the monetary tightening, core inflation indicators displayed a significant deceleration. The effects of the tightening were clearly visible on the prices of durable goods and services, consistent with the slowdown in the economic activity of related sectors. The weaker demand, coupled with a strong domestic currency, helped durables inflation to come down significantly. Services inflation also eased remarkably, declining by 3.6 percentage points throughout 2007. The improvement in services inflation spread across all sub-items. Especially, the fall in rent inflation, the stickiest component of services inflation, was significant (Figure 6).

Figure 6: Subcomponents of Services Inflation (Annual % Change)



Source: TURKSTAT, CBT

These developments set the ground for a relatively less restrictive monetary policy. Moreover, the turbulence in mature financial markets in August increased the likelihood of sooner-than-envisaged slowdown in global economic activity, and thus paved the way for initiating the policy rate cuts that was hinted earlier in the year. Accordingly, the MPC decided to start the measured rate cut cycle in September 2007. Policy rates were lowered by 200 basis points since then (Table 2). The MPC underscored that monetary policy remained restrictive even after these rate cuts, pointing to further room for easing. However, the MPC also underlined the need to remain cautious against the risks related to potential second round effects of food and energy prices, as manifested in the sticky inflation expectations.

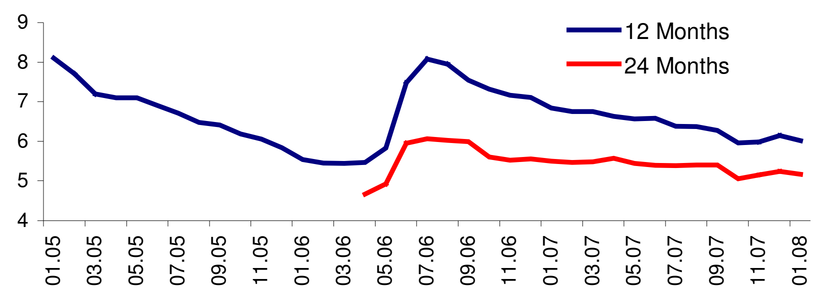
Table 2: Monetary Policy Committee (MPC) Decisions in 2007 and 2008

Dates for MPC Meeting	Decision on Interest Rate	Interest Rate
January 16th, 2007	No Change	17.50
February 15th, 2007	No Change	17.50
March 15th, 2007	No Change	17.50
April 18th, 2007	No Change	17.50
May 14th, 2007	No Change	17.50
June 14th, 2007	No Change	17.50
July 12th, 2007	No Change	17.50
August 14th, 2007	No Change	17.50
September 13th, 2007	-.25	17.25
October 16th, 2007	-.50	16.75
November 14th, 2007	-.50	16.25
December 13th, 2007	-.50	15.75
January 17th, 2008	-.25	15.50

Source: CBT

Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern throughout 2007 (Figure 7). However, the improvement in expectations, especially in the last quarter, was rather limited, owing to a backward looking behavior, and possibly, due to pre-announced hikes in administered energy prices. Nevertheless, it is worthwhile to mention that the administrative price hikes in November had little effect on medium term expectations, despite the upward revision in the year-end inflation expectations. This observation shows that inflation target, to a significant extent, continue to serve as an anchor and that economic agents expect the disinflation process to continue in the medium term. Nevertheless, the fact that currently medium term inflation expectations are significantly above our medium term target of 4 percent necessitates a cautious policy stance.[2]

Figure 7: Medium Term Inflation Expectations *



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

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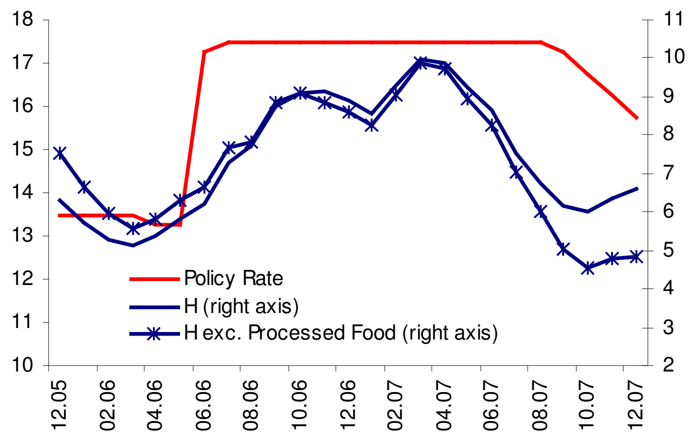
[2] As of January, one-year and two-year ahead inflation expectations are at 6.01 and 5.17 percent, respectively.

Outlook For Inflation and Monetary Policy

There are several reasons why inflation should decelerate further in the forthcoming period:

Annual percentage change in CPI excluding food, energy and tobacco items imply an inflation trend of 4.8 percent (Figure 8).[3] In other words, underlying inflation in the past year was not far away from the medium term targets. Therefore, under the assumption that oil and food inflation will follow a more benign path in 2008 than in 2007, it is fair to expect some contribution to disinflation from the base effects.

Figure 8: Response of Inflation to the Monetary Tightening

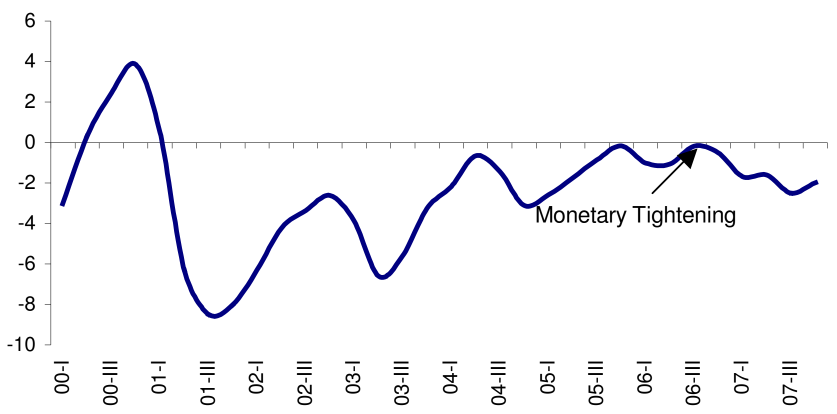


H: CPI excluding unprocessed food, energy, alcoholic beverages, tobacco, and gold.
Source: TURKSTAT, CBT

Another factor likely to contribute to the disinflation is a continuing output gap. Economic activity responded significantly to the strong monetary tightening in mid-2006. The sharp slowdown in the second half of 2006 created an ample slack in the economy. Domestic demand showed some signs of recovery in the second half of 2007. Latest readings suggest that economic activity was more vigorous at the turn of the year than implied by the third quarter figures; yet, the pace of the domestic demand was not enough to completely eliminate the output gap. Accordingly, we estimate that current demand and capacity conditions continue to contribute to the disinflation process (Figure 9). The recent loosening in the labor market also supports this view. Unemployment in September-November period has risen from 9.3 percent in 2006 to 9.7 percent in 2007. Annual rate of growth in non-farm employment in this period was only 1 percent, lowest value registered in the past two years.

[3] Official core inflation measures, published under the name " Special CPI Aggregates", do not exclude processed food prices. We believe that excluding this item, in line with the international practice, could give a better proxy for recent inflation trends.

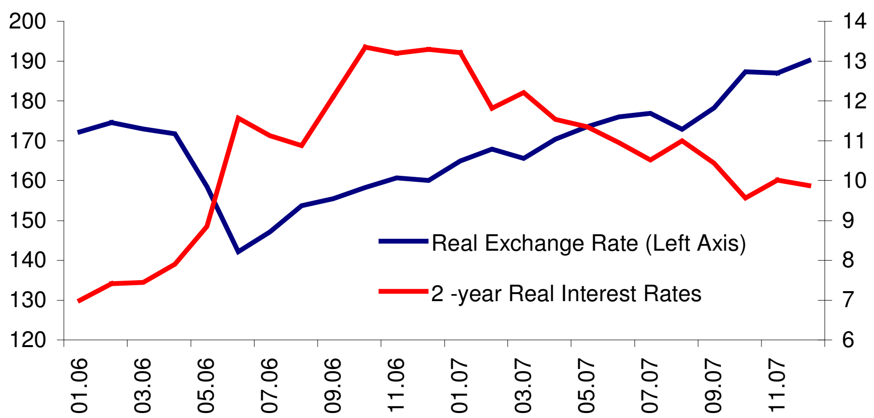
Figure 9: Output Gap



Source: CBT.

Tight monetary conditions continue to support the disinflation process. Despite the recent rate cuts, monetary policy can still be considered to be in the restrictive territory. Underlying rate of monetary expansion remains modest, consistent with a relatively restrictive monetary stance. Although medium term interest rates followed a downward trend in the past quarter, 2-year real rates at this point fluctuate between 9 and 10 percent, implying a non-accommodative monetary stance. Moreover, the currency remains strong, curbing inflationary pressures and easing the impact of rising commodity prices on domestic production costs (Figure 10).

Figure 10: Real Interest Rate and Real Exchange Rate*



*Real interest rates are computed by using the Expectations Survey and 2-year nominal rate estimated with Extended Nelson-Siegel method. Real exchange rate is CPI based (an increase means an appreciation).
Source:CBT

Credit data also suggest that monetary conditions are still non-accommodative. Annual growth rates in the automobile and housing loans are at much lower levels compared to the periods of vigorous domestic demand (Figure11). Following the significant slowdown in the second half of 2006, consumer credits showed signs of recovery after the first quarter of 2007 (Table 3). However, cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.

Figure 11: Selected Subitems of Consumer Loans (Annual Percentage Change)

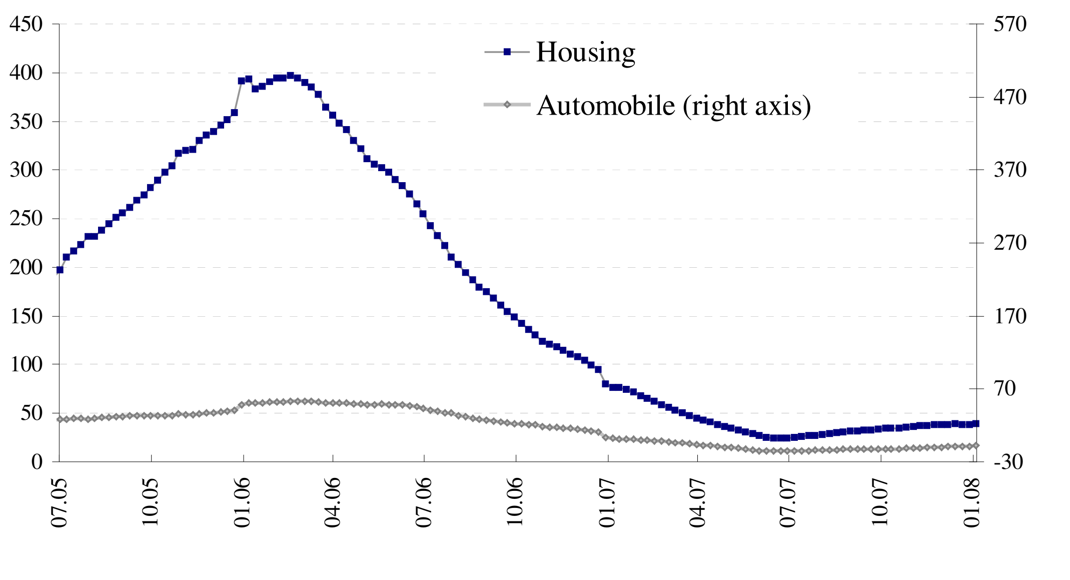


Table 3: Consumer Loans and Claims From Credit Cards

(Quarterly Real Percentage Change)

	2006Q2	2006Q3	2006Q4	2007Q1	2007Q2	2007Q3	2007Q4
Consumer Loans	20.0	1.5	3.6	2.6	9.0	10.0	6.6
Housing	22.8	0.9	2.2	2.7	7.5	10.2	5.4
Automobile	5.1	-6.4	-5.0	-8.9	-3.4	-2.0	-1.4
Other	24.3	6.0	8.9	6.6	14.5	12.8	9.9
Claims From Credit Cards	6.8	2.1	2.1	-1.6	7.7	2.4	3.2

Source: CBRT.

External demand conditions are also expected to contribute to disinflation in 2008. Recent data on global activity suggest that world economic growth is likely to moderate in the forthcoming period. Difficulties related to credit markets and subsequent concerns on financial stability have increased the downside risks on global demand and hence on the pace of export growth. Although the reaction by central banks, in the form of liquidity injection and easier monetary policy stance, has somewhat alleviated these concerns, they are not expected to be sufficient to engineer a rebound in economic activity anytime soon.

The fiscal policy should also support disinflation in 2008. Although, rising fiscal expenditures in 2007 partly offset the effects of monetary tightening, fiscal targets for 2008 imply a relatively more restrictive policy. Taking the government's targets/projections as given, the contribution of fiscal expenditures on aggregate demand is expected to decline in 2008.

Overall, we expect aggregate demand conditions to support the downward trend in the underlying inflation, i.e., inflation excluding items beyond the control of monetary policy such as energy, food and tobacco prices. Hence, barring new supply shocks, headline inflation should continue to move towards the target. The speed of the convergence to the target, however, will depend mainly on the course of food and energy prices.

Our forecast in the 2007 October Inflation Report incorporated two main assumptions: The assumption for oil price was set as 70 USD per barrel. Observing the high base created by the unusually elevated food prices in 2006, we assumed food inflation to correct towards the values consistent with medium term inflation in 2007. However, food and energy inflation turned out to be more persistent than we had envisaged, as the prices of oil and agricultural commodities continued to rise throughout 2007. These developments not only led to an undershooting of our inflation projections for end-year 2007, but also necessitated an upward revision in our medium term forecasts.

Accordingly, we revised our assumption for oil prices to 85 USD per barrel in 2008. We have also revised up our projections for the food inflation. We now envisage that the lagged impacts of last year's drought and elevated prices of agricultural commodities in global markets are likely to keep *processed* food inflation at relatively high levels throughout 2008.

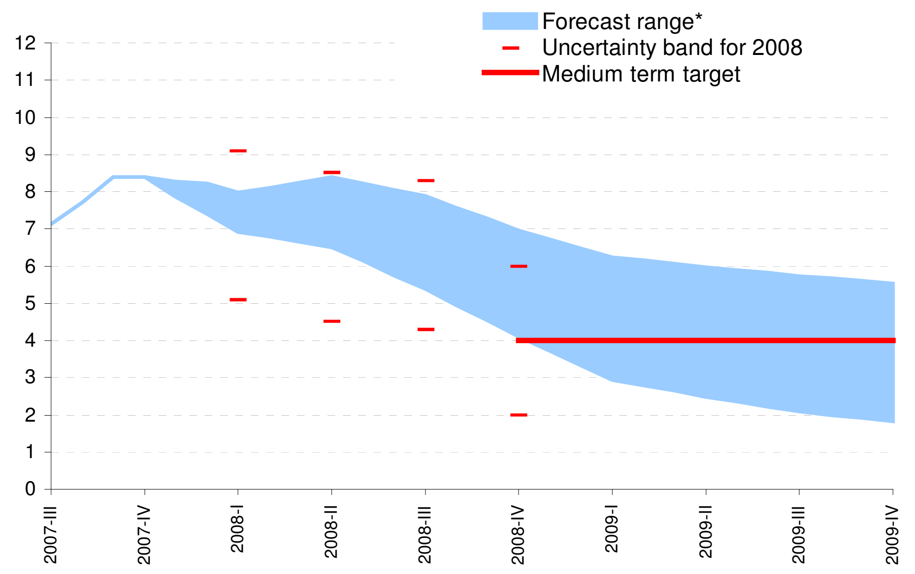
Higher oil price assumption added about 0.5 percentage points to the end-2008 inflation forecasts. Moreover, the first round impact of the recent hikes in end-user electricity and natural gas prices is computed to be around 0.6 percentage points, which is higher than we assumed in the previous Inflation Report. These factors, together with the assumption of higher food inflation, largely explain the upward revision of the end-2008 inflation forecast, implying that it will take longer to bring headline inflation to 4 percent, than envisaged in our latest Inflation Report. Therefore, in the absence of a significant correction in food inflation, headline inflation will most probably exceed the target level of 4 percent at the end of 2008.

Accordingly, we forecast inflation, with 70 percent probability, to be between 4.1 percent and 6.9 percent (midpoint 5.5) at the end of 2008, and between 1.8 percent and 5.5 percent (midpoint 3.7) at the end of 2009 (Figure 12). The forecast is based on a scenario in which policy rates display a limited decline in 2008. Main message of the forecast is that continuation of the gradual easing cycle that started in September 2007 will remain conditional on favorable data and developments. In that sense, the current policy stance envisages a more moderate decline in policy interest rates than indicated in the previous Inflation Report.[4]

It should be emphasized that any new data or information on the inflation outlook may lead to a revision in the policy stance. Therefore, the policy path indicated above should not be perceived as a commitment on behalf of the CBT.

[4] More information on our assessment of the current state of the economy and on the assumptions underlying the forecast are provided in the January 2008 Inflation Report.

Figure 12: Inflation Projections*



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

There are both upside and downside risks to the inflation and monetary policy outlook:

The main upside risk factor for the medium term inflation outlook can be listed as potential second round effects of the accumulated supply shocks, which may also create a higher than expected inflation inertia, as currently manifested in the medium term inflation expectations. So far, second round impacts of food prices have been limited and confined to selected sub-components of the overall index (such as restaurants and catering services). The potential second round impact of elevated food and energy prices, however, should not be overlooked. Therefore, the CBT will keep a close eye on the price setting behavior along with various core inflation measures. Our policy strategy will be to tolerate the first-round impact on inflation resulting from food, energy and one-off adjustments in administered prices, while remaining responsive to the second round effects.

Monetary policy remains attentive to developments in global markets. The ongoing reappraisal of risk in financial markets continues to create uncertainty about the course of the global economy. Emerging markets have been resilient up to this point. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, a sharper than expected slowdown could further dampen the global risk appetite, possibly having an adverse impact on inflation through a weakening in YTL. While the possibility of a sharper-than envisaged slowdown in global economic activity, through its potential impact on the exchange rates, may constitute an upside risk for the *short term* inflation outlook, it creates a downside risk for external demand, and hence, for inflation in the *medium term*.

It should be underlined that fiscal discipline of the past several years, by reducing the long-term risk premium, has been the key force allowing the achievement of robust output growth during a remarkable disinflation period. In that sense, we believe maintaining the prudent fiscal policy during an episode of worsening risk appetite is critical for preserving the resilience of the economy.

Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented primarily through expenditure cuts rather than hikes in indirect taxes. Therefore we envisage no major shocks arising from administered price adjustments, except the hikes in electricity and natural gas in January 2008. Any deviation from this framework may have an effect on the outlook for inflation and monetary policy.

The recent increase in end-user energy prices may continue to exert some temporary upward pressure on headline inflation in the coming months. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy production. Hence the central bank's policy is not to react to these price adjustments, except to contain second-round effects.

Developments in food prices are still considered as an important risk to the short-term inflation outlook, as food items constitute more than one fourth of the CPI basket. The course of food inflation is highly dependent on domestic weather conditions as well as global developments. Although our baseline scenario envisages a higher food inflation compared to the projections in the previous Inflation Report, there is a significant chance of a downward correction in *unprocessed* food inflation, especially given the base effect created by the last two years' elevated food prices. On the other hand, it is also possible that global developments and increasing demand for certain food items may further push up the food prices. Therefore, potential volatility in food prices continues to pose risks to the inflation outlook on both sides.

Conclusion

Despite the persistently high food and energy inflation, monetary policy managed to control underlying inflation and inflation expectations in 2007. We expect inflation excluding energy, food and tobacco items to stay close to medium term inflation target of 4 percent in the forthcoming period. Barring new supply shocks, the restrictive monetary conditions over the coming months are expected to drive headline inflation towards the target. The speed of the convergence, however, will largely depend on the course of food and energy prices. Although our highest priority is price stability, the CBT, in line with its medium term approach, will not react aggressively to the shocks beyond the control of monetary policy, as doing so could create undesirable fluctuations in economic activity and distortions in relative prices. Therefore, in the case of persisting supply shocks, we will tolerate inflation to exceed the target temporarily, while closely monitoring the core indicators. This strategy will ensure hitting the target once the shocks fade away.

With the official inflation target being missed by a noticeable margin in the past two years, managing expectations have become an issue of utmost importance. The CBT remains prepared to act preemptively so that risks to second-round effects of the rising energy and food prices do not materialize. Ongoing uncertainties in the global economy, hikes in electricity prices, and the risks to price setting behavior compel the CBT to be attentive to the incoming information. In this context, further monetary accommodation will depend on the factors affecting medium term inflation outlook.

So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. The support of fiscal policy and structural reforms are critical in shielding the economy against possible further deterioration in global sentiment. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be important. Particularly, advances in structural reforms enhancing quality of fiscal discipline and raising productivity are monitored closely with regard to their implications on macroeconomic and price stability.

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Durmuş Yılmaz	Erdem Başçı
Governor	Deputy Governor

INTERNATIONAL MONETARY FUND

TURKEY

Seventh Review and Inflation Consultation Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criteria—Informational Annex

Prepared by the European Department

April 28, 2008

TURKEY: FUND RELATIONS

Missions: Istanbul and Ankara, October 3-17, 2007; Ankara, December 17-20, 2007; Istanbul, Ankara, and Washington, April 3-14, 2008.

Staff Team: Messrs. Giorgianni (Head), Benelli, Fletcher, Kannan, Meier (EUR), McGrew (PDR), Barnett (FAD), and Josefsson and Ms. Mitchell Casselle (both MCM). The mission was assisted by Messrs. Samiei (senior resident representative) and Lombardo (resident representative). Mr. Demirkol (OED) joined the discussions.

Country Interlocutors: Deputy Prime Minister Ekren, Economy Minister Şimşek, Energy Minister Güler, Finance Minister Unakıtan, Health Minister Akdağ, Labor and Social Security Minister Çelik, Central Bank of Turkey Governor Yilmaz, Treasury Undersecretary Çanakcı, Finance Undersecretary Aktan, Energy Undersecretary Cimen, State Planning Organization Undersecretary Tiktik, Bank Regulation and Supervision Agency Chairman Bilgin, Revenue Administration former head Arioğlu and current head Ulusoy, Privatization Administration President Kilci, other senior officials, and representatives from the banking and business community. The staff liaised closely with the World Bank.

Fund Relations: A three-year SDR 6.7 billion (559 percent of quota) Stand-By Arrangement was approved in May 2005. Cumulative purchases amount to SDR 4.4 billion. A further SDR 2,248 million will become available upon completion of the seventh review. Outstanding Fund credit amounted to SDR 4.2 billion at end-March 2008.

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

(Data as of March 31, 2008)

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	1,191.30	100.00
Fund holdings of currency	5,301.07	444.98
Reserve position in Fund	112.78	9.47

III. **SDR Department:**	**Millions of SDRs**	**Percent of Allocation**
Net cumulative allocation	112.31	100.00
Holdings	46.68	41.57

IV. **Outstanding Purchases and Loans**:	**Millions of SDRs**	**Percent of Quota**
Stand-By Arrangements	4,222.55	354.45

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved** (In millions of SDRs)	**Amount Drawn** (In millions of SDRs)
Stand-By	05/11/05	05/10/08	6,662.04	4,413.60
Stand-By	02/04/02	02/03/05	12,821.20	11,914.00
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

VI. **Projected Payments to Fund (Expectations Basis):**[1]

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

	2008	2009	2010	2011	2012
Principal	936.63	1,880.64	1,217.90	187.37	
Charges/Interest	137.32	113.39	40.40	5.65	1.78
Total	1,073.95	1,994.03	1,258.30	193.02	1.78

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

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

	Forthcoming				
	2008	2009	2010	2011	2012
Principal		936.63	1,880.64	1,217.90	187.37
Charges/Interest	148.46	183.96	113.66	40.53	5.67
Total	148.46	1120.60	1,994.29	1,258.44	193.04

VII. **Safeguard Assessments**:

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

VIII. **Exchange Rate Arrangement**:

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

IX. **Article IV Consultations**:

The 2007 Article IV staff report (Country Report 07/362) was issued on May 4, 2007, and the accompanying Selected Issues paper (Country Report 07/364) was issued on May 7, 2007. Board discussion took place on May 18, 2007.

X. **ROSCs**

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

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

XI. **Recent Technical Assistance**:

Dept.	Timing	Purpose
FAD/MFD	Feb. 05	Treasury cash management and state bank reform
MFD	2005-06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May 05	Investor relations office
FAD	July 05	Income tax reform
FAD	2005-08 (numerous missions)	Revenue administration reforms
FAD	Feb. 07	Health spending
STA	June 07 and Nov. 07	Revision of national accounts statistics and communication strategy

INTERNATIONAL MONETARY FUND

TURKEY

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

Supplementary Information

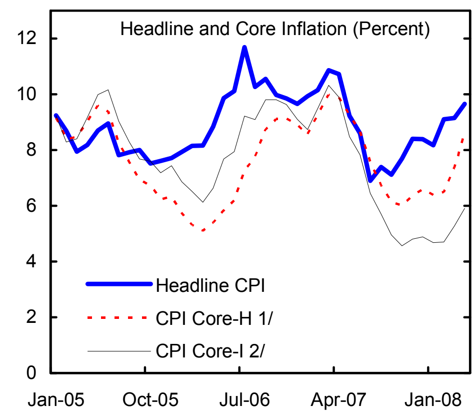
Prepared by the European Department
(in consultation with other departments)

Approved by Alessandro Leipold and Matthew Fisher

May 6, 2008

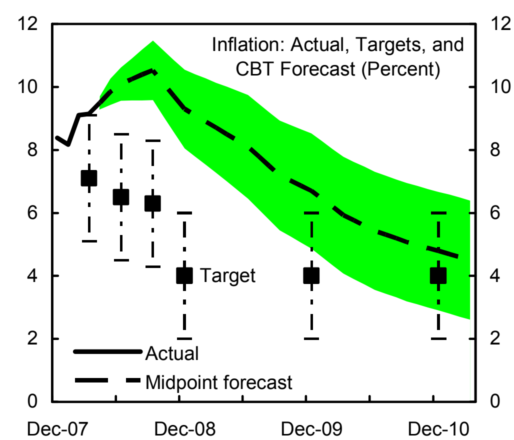
This supplement provides an update on economic developments and policy implementation since the circulation of the staff report. The thrust of the staff appraisal is unchanged.

1. **April data confirmed a broadening of inflationary pressures**. Monthly inflation was 1.7 percent (above market expectations), raising the annual rate to 9.7 percent from 9.2 percent a month earlier. While food and energy prices accounted for the bulk of the increase in headline inflation, the pick-up of core inflation points to a broadening of price pressures.



Sources: Turkstat; Eurostat; and IMF staff calculations.
1/ Excludes energy, unprocessed food, alcohol, tobacco, and gold.
2/ Excludes energy, food, tobacco, and alcohol.

2. **The central bank revised its inflation forecasts upward and signaled a tightening of monetary policy**. In its April open letter (Attachment I), the central bank reaffirmed its commitment to reduce inflation to the 4 percent target, but indicated that this would take longer than previously envisaged due to the persistence of supply shocks. To contain the second-round effects of these shocks, the central bank signaled a measured and gradual tightening of interest rates in the period ahead and emphasized that the new forecast path should serve as the anchor for inflation expectations during the transition to the medium-term target. Staff supports this approach.

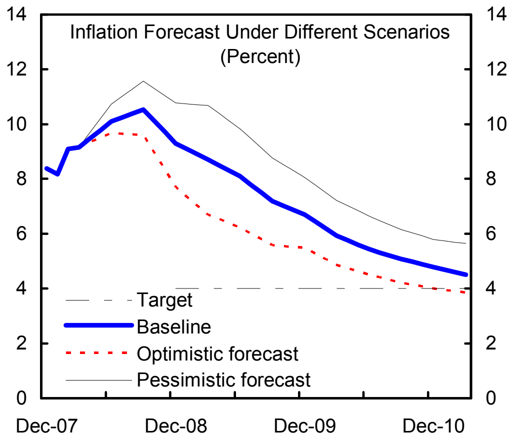


Source: Central Bank of Turkey.

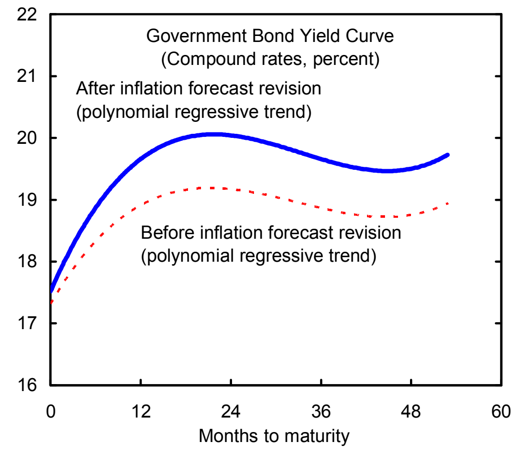
- The new midpoint inflation forecasts for end-2008 and 2009 are, respectively, 9.3 and 6.7 percent (compared to 5.5 and 3.7 percent in the January *Inflation Report*). Inflation is projected to fall further to 4.9 percent at end-2010 and reach the 4 percent target in 2011.

- This upward revision is based on the conservative assumption that supply shocks (especially to food prices) will continue to exert significant upward pressure on inflation during the next two years.

- Central bank analysis indicates that, even under benign supply-shock developments, near-term interest rate hikes will be necessary to contain inflationary pressure.



Source: Central Bank of Turkey.



Sources: Bloomberg; and IMF staff calculations.

- In response to the announcement, the yield curve on government bonds shifted upward, reflecting expected near-term rate hikes and possibly also upward revisions to market expectations for inflation.

3. **The two pending prior actions have been implemented** (Table 1):

- On May 3, the authorities announced a revised medium-term fiscal plan targeting a gross debt ratio of 30 percent of GDP by 2012 and underpinned by a primary surplus path declining gradually from 3½ percent of GDP in 2008 to 2½ percent of GDP in 2012.

- Tender processes for the privatization of four regional electricity distribution companies (Baskent, Sakarya, Meram, and Aras) were announced during April 25–30.

Table 1. Turkey: Updated Program Monitoring

Quantitative conditionality (performance criteria)	August 2007	December 2007 (controlling)
1. Floor on primary balance of consolidated government sector (CGS)	*Not observed*	*Not observed*
2. Floor on primary balance of CGS excluding State Economic Enterprises (SEEs)	*Not observed*	*Not observed*
3. Ceiling on consolidated primary spending of central government and social security institutions (SSIs)	*Not observed*	*Not observed*
4. Ceiling on new external public debt with maturities exceeding one year	Observed	Observed
5. Ceiling on new external public debt with maturities up to one year	Observed	Observed
6. Floor on net international reserves of CBT and Treasury combined	Observed	Observed
7. Floor on overall balance (before transfers) of SSIs	*Not observed*	*Not observed*
Inflation consultation clause	Comment	
1. End-June 2007	Inner band *exceeded;* discussions with staff held	
2. End-September 2007	Inner band *exceeded;* discussions with staff held	
3. End-December 2007	Outer band *exceeded* ; open letter issued	
Structural performance criteria		
1. No new amnesties of arrears on public sector receivables as defined in Annex F of the TMU (continuous, ¶19, MEP April 26, 2005)	Observed	
Structural benchmarks 1/		
1. Replacement of at most 10 percent of those leaving through attrition in each state enterprise, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (continuous, ¶17, MEP April 26, 2005) 2/	Observed	
2. Replacement of no more than 50 percent of civil servants leaving through attrition (quarterly, ¶14, LOI November 27, 2006) 2/	Observed	
3. Maintaining excise taxes and SEE prices in line with 2007 program assumptions (continuous, ¶11) 2/	Observed	
4. Publication of report that quantifies existing tax expenditures (end-June 2007, ¶17, LOI November 27, 2006)	*Observed with delay* (report was published October 10)	
5. Parliamentary approval of the insurance law (end-June 2007, ¶22)	Observed	
6. Adoption of a legal framework requiring large employers to pay salaries through bank accounts (end-June 2007, ¶15)	*Observed with delay* (passage in April 2008)	
7. Extension of family medicine program to 22 regions (end-2007, ¶12)	*Partially observed with delay* (program expanded to 20 regions at end-April 2008)	
8. Putting in place a unified tax declaration form for SSI and Revenue Administration (end-2007, ¶15)	*Not observed* ; legal authority was created in April 2008, implementation expected by end-2008	
9. Introduction of a risk-based audit system for VAT refunds (end-2007, ¶16)	*Observed with delay* (introduction in April 2008)	
New prior actions 3/		
1. Adoption of a revised medium-term fiscal plan targeting a debt ratio of 30 percent of GDP (Maastricht definition) by 2012 (¶12)	Done	
2. Adoption of a legal framework requiring large employers to pay salaries through bank accounts (¶16)	Done	
3. Introduction of a risk-based audit system for VAT refunds (¶17)	Done	
4. Launch of the tender process for the privatization of four regional electricity distribution companies (¶20)	Done	

1/ Unless otherwise noted, ¶ refers to the relevant paragraph numbers in the May 1, 2007 Supplementary Letter of Intent.
2/ This benchmark expired at end-December 2007.
3/ ¶ refers to the relevant paragraph numbers in the attached Supplementary Letter of Intent.

Central Bank of Turkey

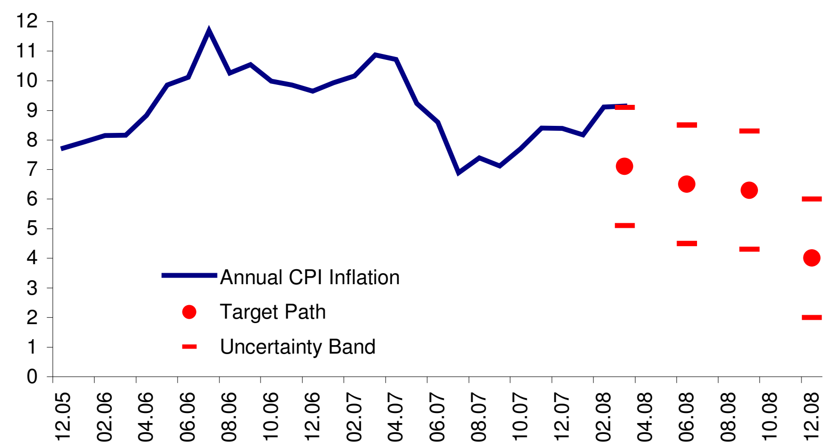
Ankara, April 30, 2008

Mehmet ŞİMŞEK
Minister of State
ANKARA

The Central Bank of Turkey (CBT) has been implementing a formal inflation-targeting regime since the beginning of 2006. Central Bank Law, as stipulated in the Article 42, requires the CBT to be accountable for the non-fulfillment of inflation targets. Inflation target for end-year 2008 was jointly set with the Government as 4 percent. To facilitate the accountability principle, our policy statement titled "Monetary and Exchange Rate Policy in 2008" disclosed a quarterly path consistent with the end-year 2008 targets along with an uncertainty band. In this context, any breach of upper or lower limits of the band requires the CBT to write an open letter to the Government, explaining the reasons for the breach and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits.

Inflation outturn as of March 2008 was 9.15 percent, breaching the upper limit of the uncertainty band, which was set at 9.1 percent for the end of the first quarter (Figure 1). Accordingly, this open letter explains the reasons for this breach, presents the measures we have taken, and puts forth our monetary policy strategy for the forthcoming period. This Open Letter will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual CPI Inflation and Target Path



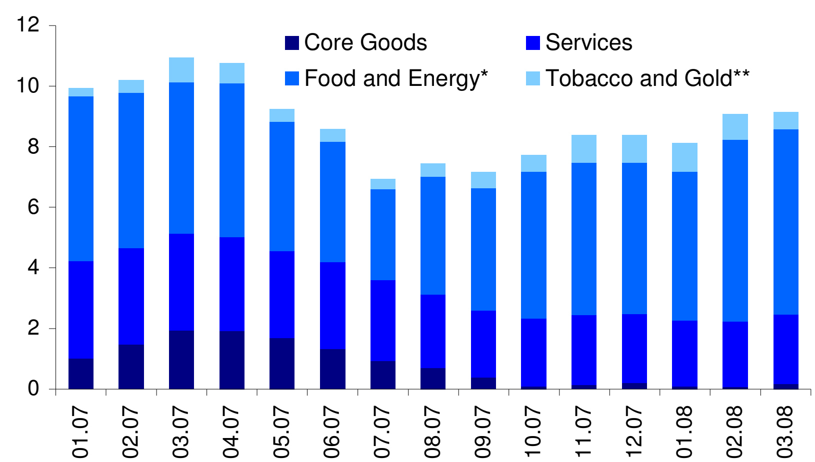
Source: TURKSTAT, CBT.

Reasons For Breaching the Target

The monetary tightening exercised since mid-2006 has been successful in leading to a significant reduction in underlying inflation. The fall in headline inflation, however, was more limited, owing mainly to factors largely beyond the control of monetary policy, such as developments in food, energy, and administered prices.

Prolonged increases in food and energy prices have recently led to upward pressure on headline inflation and in turn to upward revisions in inflation forecasts in many countries across the world. Turkey is not an exception in this regard, as deviations of inflation from our forecasts can be mostly attributed to these factors. For instance, our forecasts in October 2006 Inflation Report suggested that inflation would converge to the 4 percent target at the end of the first quarter of 2008. The forecast was based on a scenario where food inflation moderated to levels comparable with medium term targets and oil prices remained stable at 60 USD per barrel. However, oil prices continued to rise and averaged around 100 USD per barrel in the first quarter of 2008. Moreover, annual food price inflation has continued to remain at elevated levels, reaching 13.4 percent in March. As a consequence 6.13 percentage points of the 9.15 percent annual CPI inflation in March resulted from the food and energy items (Figure 2).

Figure 2: Contribution to Annual CPI Inflation



* Food and Energy: Food, non-alcoholic beverages and energy.

** Tobacco and Gold: Alcoholic beverages, tobacco products and gold.

Source: TURKSTAT, CBT.

Both domestic and international developments have played a part on the course of food prices. A prolonged shortage of rainfall in Turkey resulted in low crop yields in 2007, which in turn translated to an adverse supply shock. Strong global demand for food and continued elevation in agricultural commodity prices further added to the domestic food inflation through the external trade channel. Recently, adverse impacts of these factors have been quite visible especially in processed food prices. Accordingly, annual food inflation maintained its high levels with a marked contribution of about 2.3 points to the 3.1 percent year-to-date headline inflation. Therefore, food prices became the main factor impeding the disinflation process (Figure 3, Table 1).

Adverse developments in energy prices have been another major factor in slowing the disinflation process. Rising oil prices continued to lead to significant hikes in the prices of fuel-oil products. Elevated oil prices also affected the prices of energy items in the housing utilities, including electricity tariff rates, which were adjusted upwards by a significant margin. Consequently, contribution of energy items to year-to-date CPI inflation reached to about 0.9 percentage points.

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Figure 3: Subcomponents of CPI (First Quarter Percentage Change)

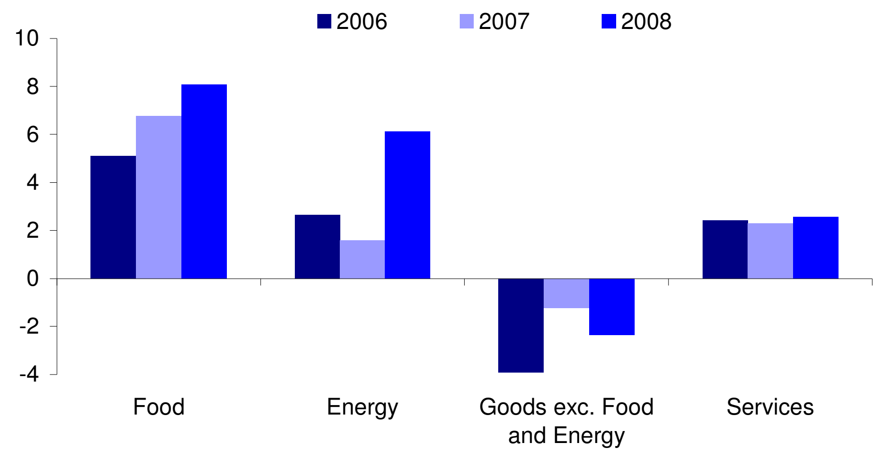


Table 1: Contribution to First Quarter CPI Inflation (Percentage Points)

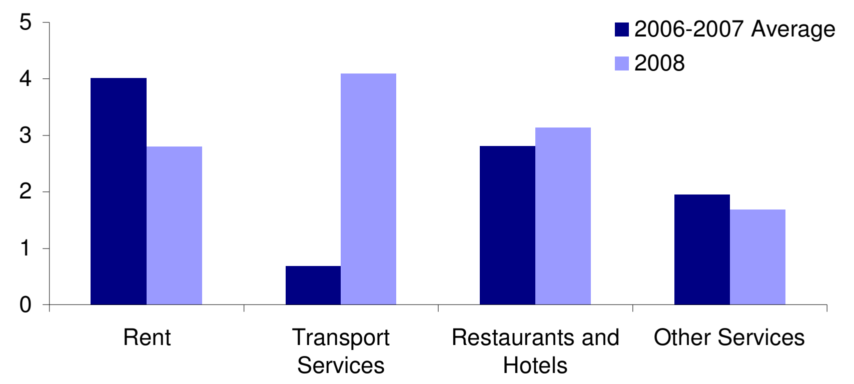
	CPI	Food*	Energy	Goods exc. Food and Energy	Services
2008	3,09	2,31	0,86	-0,74	0,65
2007	2,36	1,93	0,22	-0,39	0,60
2006	1,25	1,41	0,38	-1,20	0,66

*Food: Food and non-alcoholic beverages.

Source: TURKSTAT, CBT.

The decline in services inflation came to a halt in the first quarter of 2008. Elevated food and energy prices have been exerting upward pressures on the prices of catering and transport services. Rents and other services, on the other hand, continued to decelerate.

Figure 4: Subcomponents of Services Index (First Quarter Cumulative Percentage Change)



Source: TURKSTAT, CBT.

Global uncertainties and their reflections on the domestic financial markets have led to exchange rate movements, which in turn affected March inflation especially through the prices of fuel and high-tech consumer durables. First round effects of exchange rate pass-through are expected to continue in the short term.

Inflation in CPI excluding food, energy and tobacco items remained flat over the previous quarter and remained at 4.8 percent, confirming that the rise in inflation can be mostly attributed to factors beyond the control of the monetary policy.

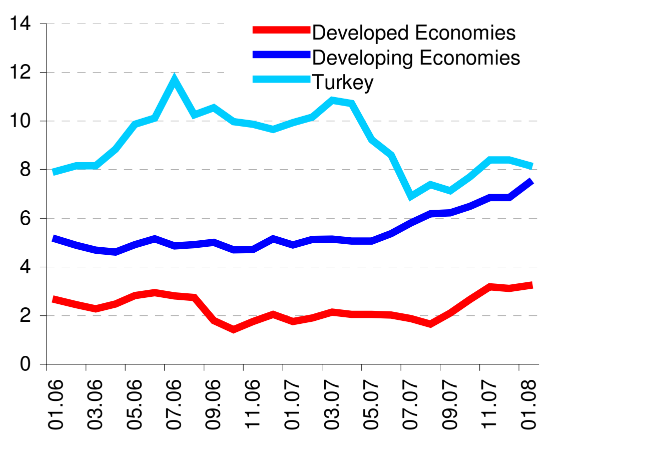
Figure 5: Main Inflation Indicators and Policy Rates

H: CPI excluding unprocessed food, energy, alcoholic beverages, tobacco, and gold.
Source: TURKSTAT, CBT.

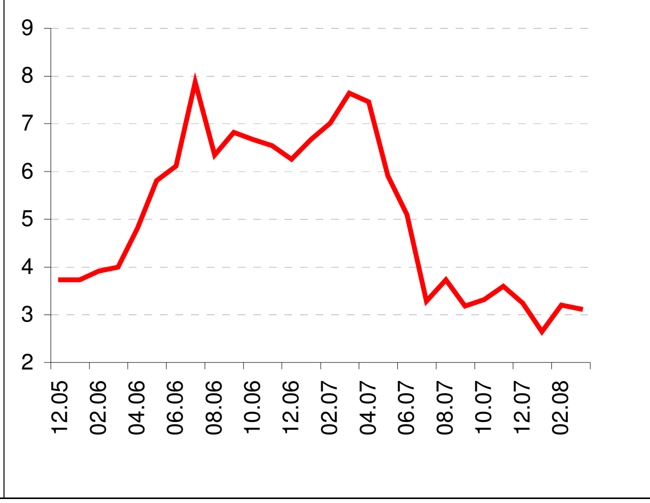
As noted above, inflation has recently been rising all over the world (Figure 6). Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures. Inflation in developed economies edged up in the last quarter of 2007 while emerging economies under inflation targeting have been facing an upward trend since June 2007. Annual inflation in Turkey by the end of the first quarter was 9.2 percent, which is below its end-2006 level of 9.7 percent. During the same period, average inflation in emerging market economies under inflation targeting rose from 3.4 percent to 6 percent.

Figure 6: Inflation in Other Countries

a. Inflation Rates



b. Diff. Between Turkey and Other Emerg. IT'ers*



*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.
Source: Web sites of central banks, IFS, TURKSTAT, CBT

Reaction of Monetary Policy

The CBT has been clear about its approach in responding to inflation resulting from factors beyond its control: Monetary policy will tolerate the first round effects, but will promptly respond to any deterioration in the overall pricing behavior. The policy pursued since September 2007 should be interpreted in this context.

In September 2007, Monetary Policy Committee (MPC) decided to initiate the rate cuts, which had already been signaled earlier in the year. Accordingly, policy rates were lowered by 225 basis points between September 2007 and February 2008 (Table 2).

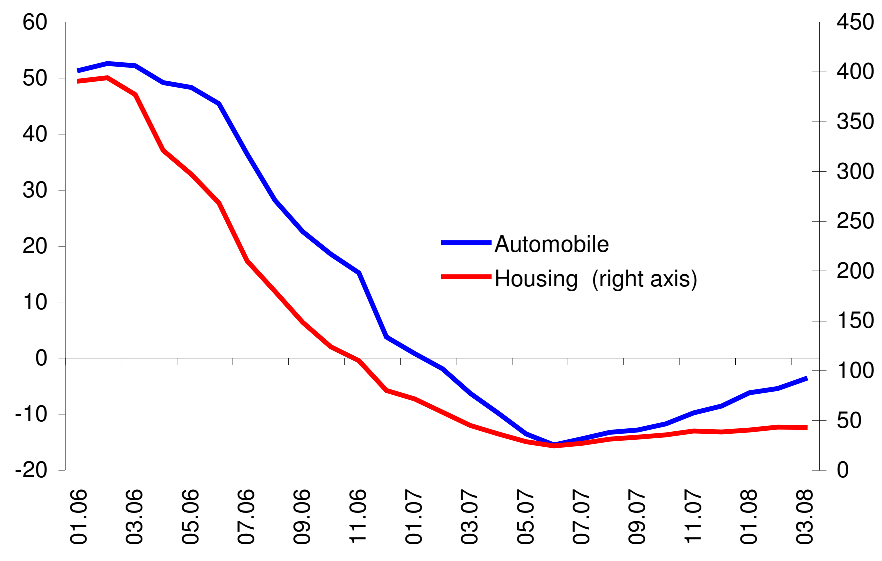
Table 2: Monetary Policy Committee (MPC) Decisions in 2007 and 2008		
Dates for MPC Meetings	**Decision on Interest Rates**	**Interest Rate**
January 16th, 2007	No Change	17.50
February 15th, 2007	No Change	17.50
March 15th, 2007	No Change	17.50
April 18th, 2007	No Change	17.50
May 14th, 2007	No Change	17.50
June 14th, 2007	No Change	17.50
July 12th, 2007	No Change	17.50
August 14th, 2007	No Change	17.50
September 13th, 2007	-0,25	17.25
October 16th, 2007	-0,50	16.75
November 14th, 2007	-0,50	16.25
December 13th, 2007	-0,50	15.75
January 17th, 2008	-0,25	15.50
February 14th, 2008	-0,25	15.25
March 19th, 2008	No Change	15.25
April 17th, 2008	No Change	15.25
Source: CBT.		

In the January 2008 Open Letter, we indicated that uncertainties in the global economy, hikes in electricity prices, and the risks to price setting behavior compelled the CBT to be more responsive to the incoming information. The letter also expressed that further monetary accommodation would depend on the factors affecting medium term inflation outlook. Food and energy prices and global uncertainties have continued to rise since then, feeding into the inflation expectations and core prices and thus increasing the risks regarding the price setting behavior and the degree of inflation persistence. Consequently, the MPC decided to suspend the rate cuts in the March meeting and announced a clear tightening bias going forward in the April meeting.

Inflation Outlook

Current supply and demand conditions support the downward trend in inflation. Data on consumer credits suggest that monetary conditions continue to be non-accommodative. Annual growth rates in the automobile and housing loans are at lower levels compared to the periods of vigorous domestic demand (Figure 7). Although consumer credits displayed signs of recovery in 2007, the cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.

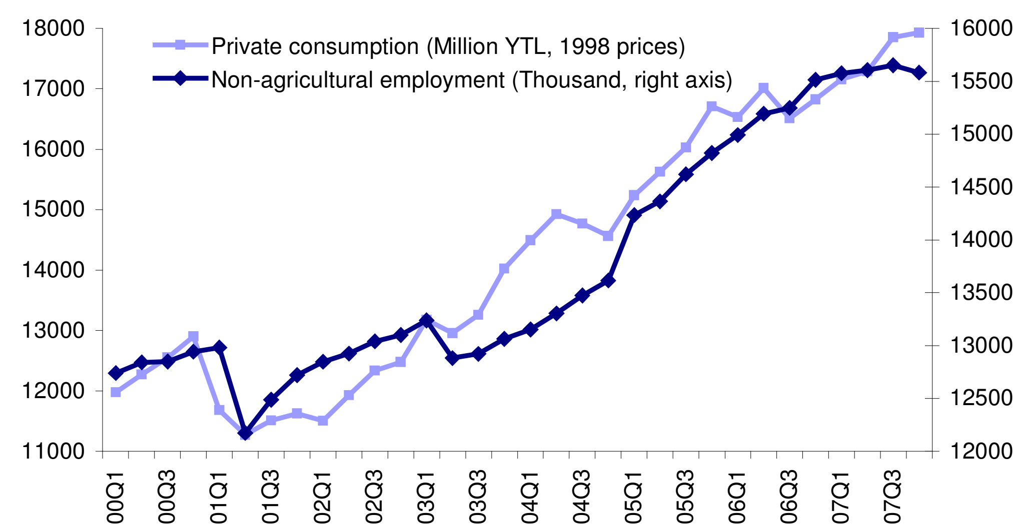
Figure 7: Consumer Loans (Annual Percentage Change)



Source: CBT.

The sharp slowdown in the second half of 2006 created a slack in the economy. The recent methodological change in national accounts led to a limited upward revision in our output gap measure and hence did not change the inflation outlook. Looking ahead, we expect a continued moderation in economic activity and non-farm employment on the back of rising precautionary saving due to global and domestic uncertainties (Figure 8).

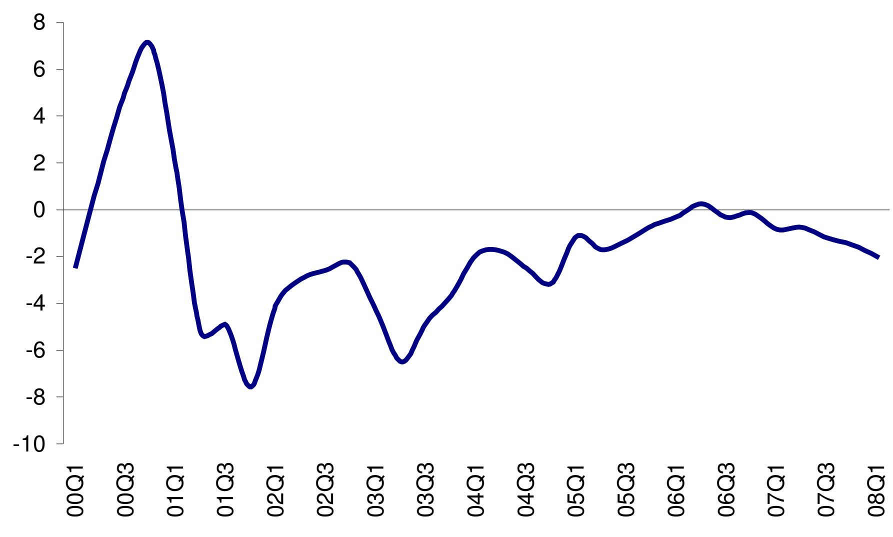
Figure 8: Private Consumption Expenditure and Non-Agricultural Employment*



*Seasonally adjusted
Source: TURKSTAT, CBT.

Accordingly, demand and capacity conditions are expected to continue to support the disinflation (Figure 9). Therefore, assuming that supply shocks gradually fade out over time, headline inflation is expected to decelerate.

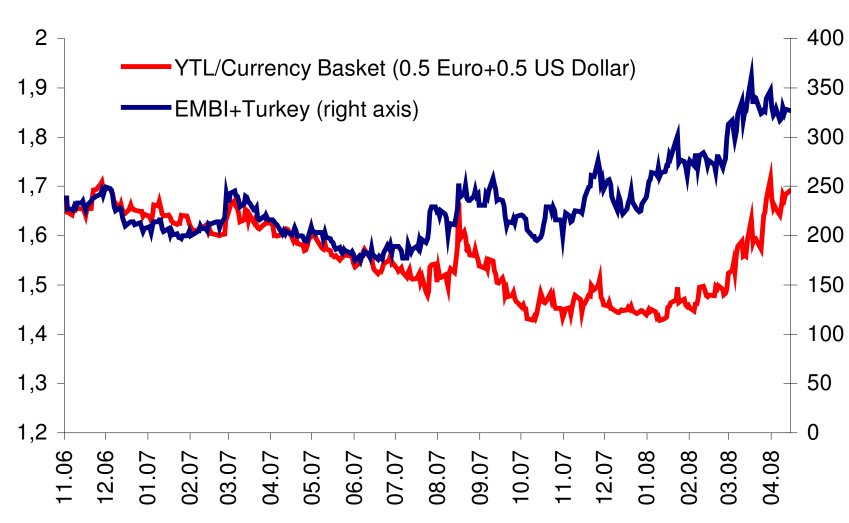
Figure 9: Output Gap



Source: CBT.

The domestic currency has depreciated by more than 15 percent in nominal terms since the beginning of the year (Figure 10). Notwithstanding the expected deceleration in the core inflation indicators in the medium term, the first round impacts of the exchange rate pass-through may be significant in the short term.

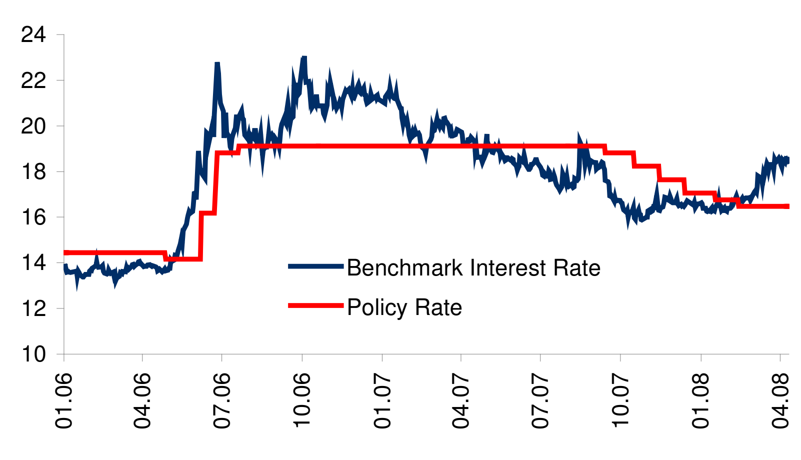
Figure 10: Risk Premium and Nominal Exchange Rates



Source: CBT.

Longer term interest rates have increased lately due to rising risk premium (Figure 11). Although higher interest rates contain the domestic demand and thus support disinflation, the impact of the higher risk premium on the pricing behavior should be closely monitored.

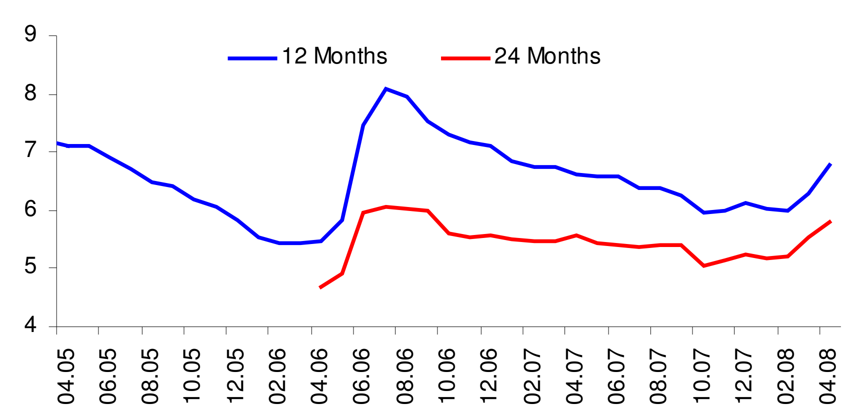
Figure 11: Benchmark Interest Rate and Policy Rate



Source: CBT, ISE.

The CBT survey of expectations suggests that economic agents expect inflation to pursue a downward trend. One year forward expectations are at 7 percent, whereas 2-year ahead inflation expectations stand at around 6 percent. However, the recent upward movement in expectations has increased the risks to the price setting behavior (Figure 12).

Figure 12: Inflation Expectations*



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

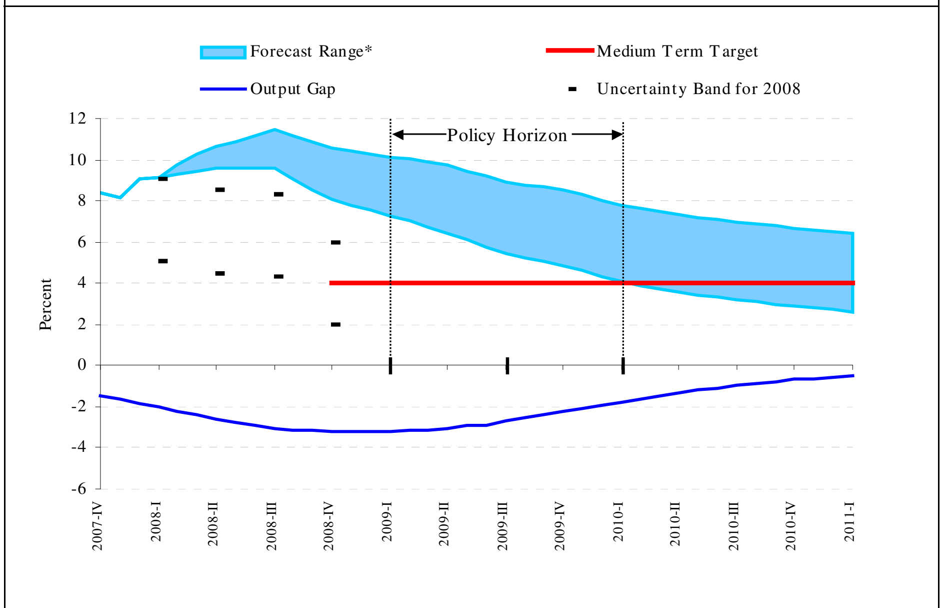
Our revised forecasts for medium term inflation incorporate more conservative assumptions on food prices compared to January Inflation Report, which envisaged a correction in food inflation justified by more favorable weather conditions. However, the long-awaited correction in food prices has not materialized yet. Processed food inflation accelerated even further on the back of rising global demand and elevated agricultural commodity prices. Against this backdrop, we have raised our assumptions for food inflation to 13 percent for the year 2008 and 8 percent for the year 2009. These changes have led to upward revisions in our inflation forecasts, by about 1.2 points for 2008 and 1.1 points for 2009.

The assumption on oil prices in the January Inflation Report stood at 85 USD per barrel. However, oil prices averaged about 100 USD in the first quarter of 2008. Considering the most recent developments, we have revised our assumption for oil prices to 105 USD per barrel. Moreover, we assume that electricity tariffs will be adjusted as needed by the automatic pricing mechanism. These changes imply upward revisions in our forecasts by 0.9 points for end-2008, and 0.4 points for end-2009.

Although weak domestic demand should limit the second round effects of the exchange rate pass-through, the first round impact of the recent depreciation is estimated to be close to 2-percentage points at the end of 2008, which implies further upward revision in our forecasts.

Accordingly, we now forecast inflation to be around 9.3 percent at the end of 2008. Our medium term forecasts suggest, with 70 percent probability that, under the assumption of a measured and gradual tightening towards mid-2008 and constant policy rates thereafter for the rest of 2008, inflation will be between 4.9 and 8.5 percent (mid point 6.7) at the end of 2009 (Figure7). Assuming a gradual moderation in food inflation, headline inflation is expected to decelerate to 4.9 percent at the end of 2010 and to 4 percent by mid-2011. We expect non-food inflation to be lower than these figures.

Figure 13: Inflation Forecasts*



Source : CBT

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

To sum up, supply shocks have turned out to be more persistent than expected, increasing the risks to the second round effects and necessitating a significant upward revision in our inflation forecasts. Accordingly, monetary policy has already assumed a more cautious stance in order to eliminate the materialization of potential second round effects. Ensuring a steady decline in inflation will likely require tight monetary policy to be maintained for an extended period. Even then, the earliest time for reaching the 4 percent medium term targets is likely to extend beyond two years.

It should be emphasized that any new data or information on the inflation outlook may lead to a change in our policy stance. Therefore, the path for the policy rates indicated above should not be perceived as a commitment on behalf of the CBT.

Revised projections suggest that the contribution of energy, food and services will be close to 5 percent at the end of 2009. In other words, assuming no further hikes in administered prices (except the ones implied by automatic pricing mechanisms), meeting the 4 percent target at the end of 2009 would be possible only if the prices of goods excluding food, energy and tobacco deflate by 3 percent. However, factors such as rising import prices, potential second round impacts of the supply shocks, and the structural inertia in inflation could continue to impose downward stickiness in goods prices. Therefore, converging to the medium term target of 4 percent may extend beyond two years, even when tight monetary policy is maintained for an extended period.

Under these circumstances, getting inflation back to the 4 percent by the end of 2009 would require offsetting the first round effects, and thus create undesired fluctuations in the economic activity and relative prices. That is why we envisage a framework in which inflation remains higher than 4 percent at the end of 2009.

The forecasts presented above deserve particular attention, given that inflation is likely to stay above the target in the next two years. The forecasts should serve as anchors for the intermediate term, representing the inflation path that is likely to be followed on the way to 4 percent medium term target.

Risks

Our revised forecasts are based on quite conservative assumptions, especially on food and energy prices, implying that downside risks are as significant as upside risks. April Inflation Report provides projections under alternative scenarios for food and energy prices. The pessimistic scenario assumes food inflation to materialize at 17, 11 and 10 percent in the next three years, and oil prices to soar to 150 USD per barrel at the end of 2009. Under this scenario, assuming that policy rates increase gradually throughout the year 2008 and then stay constant for while, it takes four years for inflation to go back to 4 percent. The other scenario, which is the optimistic one, assumes that food inflation materializes at 9, 5 and 4 percent in the next three years, and oil prices eases to 85 USD per barrel at the end of 2009. Under this scenario, assuming a limited rate hike in the short term and gradual cuts starting from the last quarter, inflation reaches 4 percent at the end of 2010.[1] Therefore, materialization of upside risks would require further tightening of the monetary policy stance, while downward surprises in food and energy prices would be perceived as an opportunity to bring inflation back to target in a shorter period.

[1] More details on these projections are provided in the April Inflation Report.

A protracted period of rising food and energy prices have led to significant breaches in inflation targets since the adoption of the inflation targeting regime and consequently increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long-lasting shocks appeared concurrently has increased the risks to the price setting behavior. Recent pick up in inflation expectations requires the monetary policy to be cautious. In this respect, recent developments in the pricing behavior and the underlying inflation trends are of particular concern. It may be necessary to pursue a tighter monetary policy should the price setting behavior further deteriorate.

Another major risk to the inflation outlook is a sharper than expected slowdown in the global economic activity, which, in turn, could lead to further volatility in financial markets. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. These uncertainties have been dampening the risk appetite and thus slowing the capital flows to emerging economies. The CBT will not react to temporary fluctuations in financial markets. Yet, we will not hesitate to tighten monetary policy in case of a significant worsening in the overall pricing behavior.

Finally, our medium-term projections assume that government expenditures will evolve in line with the official projections and that there will be no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanism. Any deviation from this may have an effect on the outlook for inflation and monetary policy.

Conclusion

Inflation targets have been breached by a significant margin in the past two years as a result of exceptionally persistent supply shocks, and there is a considerable chance that the shocks are likely to stay for a while. Besides, the ongoing uncertainty resulting from the global economy has been increasing the risks related to the second round effects of these supply shocks. Our revised projections incorporating the latest developments suggest that in 2008 and 2009 inflation is likely to materialize at higher levels than 4 percent. Therefore, we envisage a framework in which inflation forecasts serve as an anchor in the short term, while 4 percent targets continue to be the medium term anchor.

Extending the horizon within which inflation converges to the target does not mean that monetary policy will be looser in the forthcoming period. On the contrary, our forecasts presented above are based on a tighter monetary policy stance compared to the previous period. Monetary policy will be more responsive to bad news than good news in the period ahead. This approach reflects our firm commitment to attaining price stability.

Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.

Yours Sincerely,

CENTRAL BANK OF TURKEY
Head Office

Durmuş Yılmaz
Governor

Erdem Başçı
Deputy Governor

Press Release No. 08/106
FOR IMMEDIATE RELEASE
May 9, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Seventh and Final Review Under the Stand-By Arrangement for Turkey and Approves US$3.65 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the seventh and final review under the three-year SDR 6.66 billion (about US$10.8 billion) Stand-By Arrangement for Turkey, which was approved on May 11, 2005 (see Press Release No. 05/104). The completion of this review enables Turkey to draw immediately the remaining balance under the arrangement, equivalent to SDR 2.25 billion (about US$3.65 billion).

The Board also approved Turkey's request for waivers of non-observance of the end-December 2007 quantitative performance criteria in the fiscal area (primary balances of the consolidated government sector including and excluding state economic enterprises, overall balance of the social security institutions, and consolidated primary spending of the central government and social security institutions).

At the conclusion of the Executive Board's discussion on Turkey, Mr. Dominique Strauss-Kahn, Managing Director and Chairman, stated:

"The Turkish economy has continued to perform reasonably well despite a challenging external environment, with economic activity showing resilience and foreign direct investment inflows remaining buoyant. However, supply shocks have raised inflation, and turbulence in global credit markets has heightened Turkey's external financing risks. Recent domestic political developments have also weighed on investor sentiment. In response to these external and domestic developments, Turkish financial markets recently unwound some of last year's large gains.

"The authorities have responded to these challenges by taking important steps to bring their economic program back on track. Adoption of the social security reform is a major achievement that will contribute to the long-run sustainability of public finances. Recent actions to strengthen tax administration, reform the energy sector, and enhance bank prudential requirements are also welcome.

"Short-run macroeconomic policies will need to balance carefully the desire to support growth with the need to contain inflation and the current account deficit. From this perspective, it will be essential that the authorities adhere closely to their updated plans for this year to target an unchanged primary surplus relative to 2007 of at least 3½ percent of GDP. This revised target creates room to decompress infrastructure spending and bring forward a worthy but costly cut in labor taxes. New initiatives that further erode the structural fiscal position should be resisted to preserve the downward path of public debt and avoid further unwarranted pressure on monetary policy to stem inflationary pressures. From this perspective, it is important to make the envisaged reform of subnational governments' finances fiscally neutral.

"The central bank has revised upwards its inflation forecasts in response to a series of shocks to food and energy prices as well as a weakening in the lira, while reaffirming its medium-term target of 4 percent. It has also appropriately adopted a tightening bias. Entrenching the credibility of the inflation targeting regime requires that the central bank respond promptly to broadening price pressures by tightening monetary policy and avoid lifting prematurely its tightening bias once inflation is back on a declining path.

"To anchor fiscal policy expectations, the authorities have announced a new medium-term fiscal framework that aims to cut gross public debt by some 10 percentage points of GDP within five years. This objective is underpinned by a policy commitment on the primary surplus, which is targeted to decline from 3 percent of GDP in 2009 to 2½ percent of GDP in 2012. Achieving these targets will require continued efforts to enhance revenue collection and significant discipline in restraining current spending. The authorities are encouraged to formalize their medium-term fiscal framework by adopting an explicit fiscal rule.

"Turkey has achieved considerable success by adhering to the Fund-supported program that is now drawing to a close. Looking ahead, Turkey's challenge will be to press forward on the reform path to further entrench macroeconomic stability and decisively lift potential growth to facilitate convergence toward EU income levels," Mr. Strauss-Kahn said.

Statement by Willy Kiekens, Executive Director for Turkey and Ozgur Demirkol, Senior Advisor to Executive Director May 9, 2008

The Turkish economy has made significant progress in strengthening its fundamentals over the last six years. Rapid transformation of the economy was accompanied by high growth. In turn, high growth has helped the authorities in implementing many challenging structural reforms necessary for sustaining economic performance. The EU accession negotiations and two consecutive Fund-supported programs have provided a roadmap for the reform agenda. The Turkish authorities greatly value the policy advice and support of the Executive Board, management and staff.

The staff confirms that Turkey over performed on many targets during the program period. Growth has been high, fiscal policy has remained strong, public debt came down rapidly and the foreign reserve position continues to strengthen. Turkey now meets the EU criteria on the budget deficit and public debt. Among other factors, the authorities' ownership and decisive program implementation was critical for this outcome.

Despite the strong economic performance, Turkey faces important challenges. Inflation is above target and the current account deficit continues to be large. Moreover, the current global economic environment is posing additional stress as pointed out in Box 2 of the Staff Report. Indeed, there are signs of a slow down in growth of syndicated and securitized loans. Nonetheless, long-term borrowing by Turkish corporations remained solid in the first quarter of the year.

Furthermore, Turkey needs to increase investment and raise its employment rate and total factor productivity so as to facilitate a rapid convergence with the European Union. These policy targets call for prompt implementation of labor market reforms, upgrading transportation and energy infrastructure, fighting against the informal economy, strengthening the competition in products market, improving the business environment and investing more on human capital. The Turkish authorities believe that in order to meet these challenges, it is important to have a balanced and integrated policy package which keeps the public debt on a declining path while addressing the pressing needs of the economy.

Growth

Turkey has achieved an annual average growth of 6.8 percent over the last six years. Moreover, it is clear that this growth rate is entrenched as it was not only higher but also much less volatile. In 2007, the economy grew by 4.5 percent despite the rather difficult domestic and global conditions. Last year, Turkey held a general election, a presidential election and a referendum. A severe drought harmed agricultural production. Moreover, the monetary tightening undertaken in 2006, global supply shocks and a weaker global economic environment all contributed to a slower growth. In the period ahead, the authorities expect economic activity to remain resilient with growth reaching 4.5 percent thanks to the higher agricultural production and net exports.

Current Account

The current account deficit continues to be high. Although the deficit contracted to 5.7 percent of GDP in 2007, staff expects it to widen again to 6.4 per cent of GDP in 2008. This is because along with the other imports, the surge in energy and commodity prices plays an important role in the current account deficit. A one-dollar rise in oil price, together with the consequential rise in natural gas prices, adds USD 530 million to the total bill of imported energy.

According to the most recent data, the hike in exports continued to hold well in the first quarter of the year. The growth in export volume exceeded that of import volume in the first few months of the year. Some leading indicators signal continued strong export growth in the second quarter. There are no obvious signs of a slowdown of exports to the European Union and exports to non-US and non-EU destinations continue to rise. The volume growth of imports is expected to slow as demand weakens along with the depreciation of the lira.

The financing of the current account deficit has improved. In 2006-07, FDI flows covered more than 60 percent of the current account deficit. According to staff's projection, FDI will cover more than one quarter of the deficit in 2008 and external financing conditions will remain adequate. However, the authorities are cognizant of the risks and closely monitoring the developments in the current account and its financing.

Monetary Policy

The tight monetary policy stance of the central bank (CBT) since mid-2006 resulted in a noticeable reduction in core inflation in 2007. However, like in the rest of the world, higher food, energy and other commodity prices have increased inflationary pressures, resulting in the case of Turkey, in a slowing the decline of headline inflation in 2007.

The CBT's monetary policy strategy has been clearly communicated: monetary policy will tolerate the first round effects of external price shocks but it will promptly respond to any deterioration in the overall pricing behavior. In this context, the CBT suspended the easing cycle in March 2008 because of the medium term outlook for inflation.

The continued rise in food and energy prices and the ongoing uncertainties in the global economy have worsened inflation expectations and increased upside risks along with the recent moves in the exchange rate. As presented in the staff' update, the CBT now forecasts annual inflation to be around 9.3 per cent at the end of 2008. According to the CBT's medium term forecast, assuming a measured and gradual tightening towards mid-2008 and constant policy rates thereafter, inflation will be between 4.9 per cent and 8.5 per cent (mid-point 6.7 per cent) at the end of 2009. Assuming a gradual moderation in food prices, inflation is expected to decelerate to 4.9 per cent at the end of 2010 and come down to 4 percent by mid-2011.

The CBT has emphasized that its updated inflation forecasts will serve as an anchor in the short run while the 4 percent inflation target continues to be the medium-term anchor. The CBT also stressed that extending the horizon of convergence to the inflation target does not imply a loose monetary policy in the period ahead. Monetary policy already assumed a more cautious stance in order to avoid second round effects. Ensuring a steady decline in inflation will likely require tight monetary policy to be maintained for an extended period. The CBT has also announced that monetary policy will be more responsive to bad news than good news in the period ahead.

Fiscal Policy and Medium Term Fiscal Framework

Turkey has sustained large primary surpluses over the past few years. During 2003-06, the average primary surplus was 5 percent of GDP. The policy of targeting large primary surpluses served well and helped in reducing the net debt of the public sector from 61.5 percent of GDP in 2001 to 29.1 percent in 2007. Last year, gross public sector debt was 38.8 percent of GDP, significantly below the EU-27 average. The maturity and composition of the public debt improved considerably, making it less vulnerable to external shocks. The public sector net debt in foreign currency, or linked to foreign currency was 3.2 percent of GDP in 2007, down from its high level of 35.4 percent in 2002.

The improved fiscal position and the declining path of public debt justify a new fiscal framework centered around the target for gross debt (according to the EU definition) of no more than 30 percent of GDP by 2012. This target will be reached by observing primary surpluses of at least 3.5 percent of GDP in 2008, 3 percent in 2009 and gradually declining to 2.4 percent in 2012.

The new primary surplus path will allow the authorities to address some acute investment needs and finance the cost of the long overdue labor market reform. Turkey has the highest taxation on labor income in the OECD, which is a significant deterrent for creating formal employment in the country. Tax rates on labor income will need to be reduced. The new fiscal framework will also allow higher infrastructure investments in the Southeastern Anatolian Project which is expected to increase agricultural production, create employment and address income inequalities in the area. The authorities are also considering to use a limited part of the fiscal space for reforming the local administrations so as to increase the efficiency of public services. The Turkish authorities are committed to continue with prudent fiscal management and will comply in the near term with the announced primary surplus targets, even if the debt ratio falls below the projected level. The authorities are examining various options to institutionalize this framework before the 2009 budget.

As underscored by staff, the 2008 primary surplus target of 3.5 percent of GDP represents a slight tightening of the structural balance. In order to secure the 2008 budget target, the authorities have taken several important measures, including the upfront increase of electricity tariffs, automatic price adjustment mechanism in electricity, adjustment of certain excise taxes, hiring caps in public sector and enhancing the efficiency of healthcare spending.

Structural Fiscal Reforms

A landmark social security reform was adopted in the Parliament last month, after the previous reform of 2006 was struck down by a Constitutional Court. The new law addresses the concerns raised by the Constitutional Court while preserving the overall budget savings targeted in the original 2006 law. The law establishes a universal health insurance, but also creates incentives and authority to manage health expenditures better.

Strengthening of the tax administration is a top reform agenda item. The authorities are determined to increase tax compliance and collection in the country. The authorities have taken many important steps, including the introduction of a risk based audit system for VAT refunds, requiring employers to pay salaries through bank accounts and unified forms for social security and tax declarations.

The authorities are grateful for the generous technical support given by the Fund to enhance the capacity of tax administration. They are giving serious consideration to staff advice with regard to the merger of all audit functions and will soon make a decision on this matter.

Financial Sector

The impact of global developments on the banking sector has so far been limited. The authorities remain vigilant about the developments in this sector and continue to upgrade the regulatory and supervisory practices as advised by the 2006 FSAP study. While Turkish banks enjoy high capital adequacy, strong profitability and sound liquidity, the Banking Regulatory and Supervisory Agency (BRSA) recently tightened provisioning and liquidity requirements as a part of preemptive policy action. The authorities are also vigilant about developments in the banking and corporate sectors and are taking further steps to better monitor the foreign exchange risk. The adoption of a new commercial code will reinforce these efforts in the period ahead.

Privatization and Investment Environment

In the past few years, Turkey has undertaken unprecedented privatization, reaching USD 30 billion in the period 2003-07. The authorities are committed to pushing ahead with the privatization agenda in 2008, including electricity distribution and generation, the national lottery, Turk Telekom (an IPO of 17.5 per cent of the remaining 45 percent state share), the sugar factories, the tobacco company and an additional share offering of Halkbank. The tender process has already begun for the four electricity distribution companies and IPO of Turk Telekom has been launched. Preparations for 24 percent of Halkbank's second offering is also underway. The authorities' efforts to improve the investment climate have elevated Turkey's ranking in the World Bank's Doing Business Report from 93 in 2006 to 57 in 2008.

Stocktaking

This is the last Review under the current Stand-by Arrangement. The increased resilience of the Turkish economy, continuously tested by many external and internal shocks, stands as the best testimony to the success of the program. Rapid convergence with the EU, consolidation of macroeconomic stability, high and uninterrupted growth with relatively low inflation and deep-rooted structural reforms in many areas ranging from social security to privatization are among the main achievements under the program that deserve mention.

The Turkish authorities appreciate the strong support provided by the Fund to Turkey during the program period and would like to thank the Executive Board, Management and staff for their helpful policy advice. The constructive and open dialogue and cooperation between Turkey and the Fund has been and will remain important to overcome many challenges facing the economy.