

Turkey: 2004 Article IV Consultation and Eighth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criterion—Staff Reports; Staff Supplement; Public Information Notice and Press Release of the Executive Board Discussion; and Statement by the Executive Director for Turkey

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with Turkey and eighth review under the Stand-By Arrangement and request for a waiver of nonobservance of a performance criterion, the following documents have been released and are included in this package:

- the staff reports for the 2004 Article IV consultation and the eighth review under the Stand-By Arrangement and request for waiver of nonobservance of performance criterion, prepared by a staff team of the IMF, following discussions that ended on June 19, 2004 and June 22, 2004, respectively, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff reports were completed on July 8, 2004 and July 16, 2004, respectively. 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 July 27, 2004, updating information on recent economic developments;
- a Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its July 30, 2004 discussion of the staff reports that concluded the Article IV consultation and the request and review.
- a statement by the Executive Director for Turkey.

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

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

*May also be included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

TURKEY

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with Turkey

Approved by Michael Deppler and Liam P. Ebrill

July 8, 2004

- **Article IV Discussions.** During June 3–19 the staff team met a wide range of senior officials and private sector representatives. This included: Deputy Prime Ministers Gül, Şener and Şahin, State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Foreign Trade Minister Tüzmen, Industry Minister Coşkun, Labour Minister Başesgioğlu, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Chairman Ertürk, other senior officials, representatives from the banking and business communities, and the labor unions.
- **Staff.** The team comprised Reza Moghadam (head), Mark Griffiths, Donal McGettigan and Christian Keller (EUR), Ernesto Ramirez Rigo (FAD), Maike Luedersen (LEG) and John Austin (LEG consultant), Mats Josefsson (MFD), Chris Lane (PDR), Ashoka Mody (RES), Hugh Bredenkamp, Odd Per Brekk and Christoph Klingen (resident representatives), and Janet Shelley (EUR, administrative assistant). Michael Deppler (EUR) and Willy Kiekens (OED) joined the Article IV discussions during June 7–10. Levent Veziroglu (OED) also attended the meetings.
- **This report covers Article IV issues.** A discussion of policies related to the Stand-By Arrangement is contained in a separate staff report for the Eighth Review.
- **2002 Article IV consultation.** At the conclusion of the last Article IV discussion, Directors urged strict implementation of policies aimed at fiscal consolidation to avoid concerns over the debt position, emphasized the importance of fiscal structural reforms, and stressed the need for monetary policy to promote disinflation.
- **Exchange system.** Turkey has accepted the obligations of Article VIII, Sections 2, 3, and 4, and it maintains a system free of restrictions on payments transfers for current international transactions.
- **Data.** Turkey's statistical base is adequate for effective surveillance. However, the coverage and timeliness of fiscal data in particular should be improved.
- **Publication.** The authorities have not yet decided on the publication of this staff report. The authorities have decided not to publish the staff report for the Sixth Review, and are still considering publication of the Seventh Review staff report. The mission's Article IV concluding statement was not released to the public.

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EXECUTIVE SUMMARY

Economic performance over the last three years has been impressive. High primary surpluses have lessened concerns over debt sustainability, lowering risk premia and real interest rates. As a result, the economy has recovered strongly from the 2000-01 crisis, growing by almost 8 percent in 2002 and 6 percent in 2003. Inflation has fallen sharply from 70 percent at end-2000 to less than 20 percent at end-2003 and is now in single digits.

Although on track to meet or exceed this year's targets of 5 percent growth and 12 percent inflation, the economy faces problems of excess demand and a current account deficit rising towards 4 percent of GNP. The recent increase in secondary market interest rates and the depreciation of the exchange rate, associated with tensions in emerging markets generally, should help to contain domestic demand growth. But if these prove insufficient, the authorities need to be ready to take fiscal measures to arrest the deterioration of the current account. Further exchange rate adjustment may also be needed, even though this will raise the burden of external debt and add to inflation.

For the medium term, the main challenge is to implement policies that achieve the goals of sustained growth and low inflation. With its commanding majority in Parliament and with new elections not needed for another three years, the government has an unprecedented opportunity to implement the difficult structural reforms needed to achieve this.

- **Fiscal policy.** The government needs to complement its strong record of fiscal consolidation by implementing structural fiscal reforms to sustain this adjustment. This includes reform of the social security system (which is running deficits of close to 5 percent of GNP), tax administration reform to combat the informal economy, and tax policy reform to simplify the tax system and broaden the base. These reforms will make it easier to maintain the 6½ percent of GNP primary surplus target.
- **Monetary policy.** Inflation reduction has been a major success, but the framework of base money targets and implicit inflation targeting is coming under strain. While adopting formal inflation targeting (the CBT's ultimate objective) may still be premature, the CBT could make its operating framework more transparent.
- **Banking reform.** Confidence in the banking system has improved considerably since the crisis. Priorities now include monitoring the removal of the blanket guarantee, ensuring the state banks do not distort the banking system, removing tax impediments to financial intermediation, and recovering assets seized from failed banks.
- **Improving the investment climate.** The authorities need to take steps to encourage foreign direct investment (which is much lower than in other emerging market countries), to make good on their plans for privatization, and to reform the judicial system to facilitate the functioning of Turkey's market economy.
- **Financing needs.** Turkey faces considerable external debt repayments in the next three years. This challenging financing outlook, together with the need to contain domestic demand and to preserve debt sustainability, highlights the importance of continued tight fiscal policy.

I. INTRODUCTION

1. **The 2004 Article IV consultation takes place at an opportune time.** First, the current program is drawing to an end, and the authorities will soon decide whether they wish to request a successor arrangement. Second, later this year the European Union will formally assess Turkey's compliance with the Copenhagen criteria and its eligibility to begin accession negotiations. Finally, recent tensions in financial markets have brought out a number of difficult short-term policy challenges that the authorities need to address—a reminder that, despite recent progress, Turkey is still highly vulnerable to shifts in sentiment towards emerging markets. The Article IV consultation therefore offers a well-timed opportunity to take stock of what has been achieved under the program, to set out reform priorities ahead (which could provide useful input for any new program), and to gauge Turkey's challenges in commencing EU accession negotiations.

II. FROM ECONOMIC CRISIS TO ECONOMIC RECOVERY

A. The Economic Crisis

2. **For Turkey, the 1990s was a decade of economic mismanagement.** Although economic growth averaged 4 percent, it was extremely volatile. Inflation was variable and high, averaging close to 80 percent and peaking in 1994 at more than 100 percent. High inflation raised nominal interest rates, and with it the public sector borrowing requirement, which increased from 10 percent of GNP in 1991 to more than 20 percent in 1999. High deficits and inflation uncertainty pushed up real interest rates and slowed growth, and doubled the public debt ratio to 60 percent of GNP.

3. **The collapse of the 2000 exchange rate based disinflation program magnified these weaknesses.** Although the crawling peg had reduced inflation and interest rates significantly, competitiveness deteriorated. With domestic demand booming and fiscal policy failing to tighten, the current account deficit worsened. Vulnerabilities in the financial sector increased, as poorly supervised banks bet on the success of the program by borrowing overnight and in foreign currency, and investing in longer-term TL paper, anticipating further reductions in interest rates. When the exchange rate came under pressure in late 2000 and again in early 2001, interest rates increased, highlighting these weaknesses in the financial system. When the exchange rate was finally allowed to float in February 2001, it lost more than half of its value. This pushed inflation back up to 70 percent by the end of the year, and increased the government's net debt ratio to more than 90 percent of GNP (75 percent using centered GNP). Parts of the banking system faced huge losses both because of the collapse of the exchange rate, and the high interest rates and borrowing costs that preceded it.

B. The Economic Recovery Strategy

4. **With the devaluation of the exchange rate and the sharp rise in interest rates, the outlook for disinflation, debt sustainability, and renewed growth appeared bleak.** Although the possibility of debt restructuring loomed, it was quickly ruled out.

5. **The reforms launched in May 2001, and extended into the current program in early 2002, were a strong attempt to address Turkey's underlying vulnerabilities.** With debt restructuring ruled out, the first priority was to ensure debt rollover and debt sustainability. Notwithstanding the severe recession, this meant committing to high and sustained primary surpluses. For 2001, the target was 5½ percent of GNP; this was increased to 6½ percent of GNP in 2002 and beyond. The exchange rate was allowed to float, its role as nominal anchor abandoned. Instead, to reduce inflation the central bank was freed from any obligation to finance the deficit, and given operational independence to reach its new primary objective of achieving and maintaining price stability. To do this, the staff advocated the early introduction of formal inflation targeting, though this was perhaps premature given the high inflation rate and fiscal dominance problems. However, given Turkey's severe balance of payments and government financing problems, these efforts at macroeconomic stabilization would not have had the chance to succeed without substantial outside financial assistance. This was supplied by the Fund.

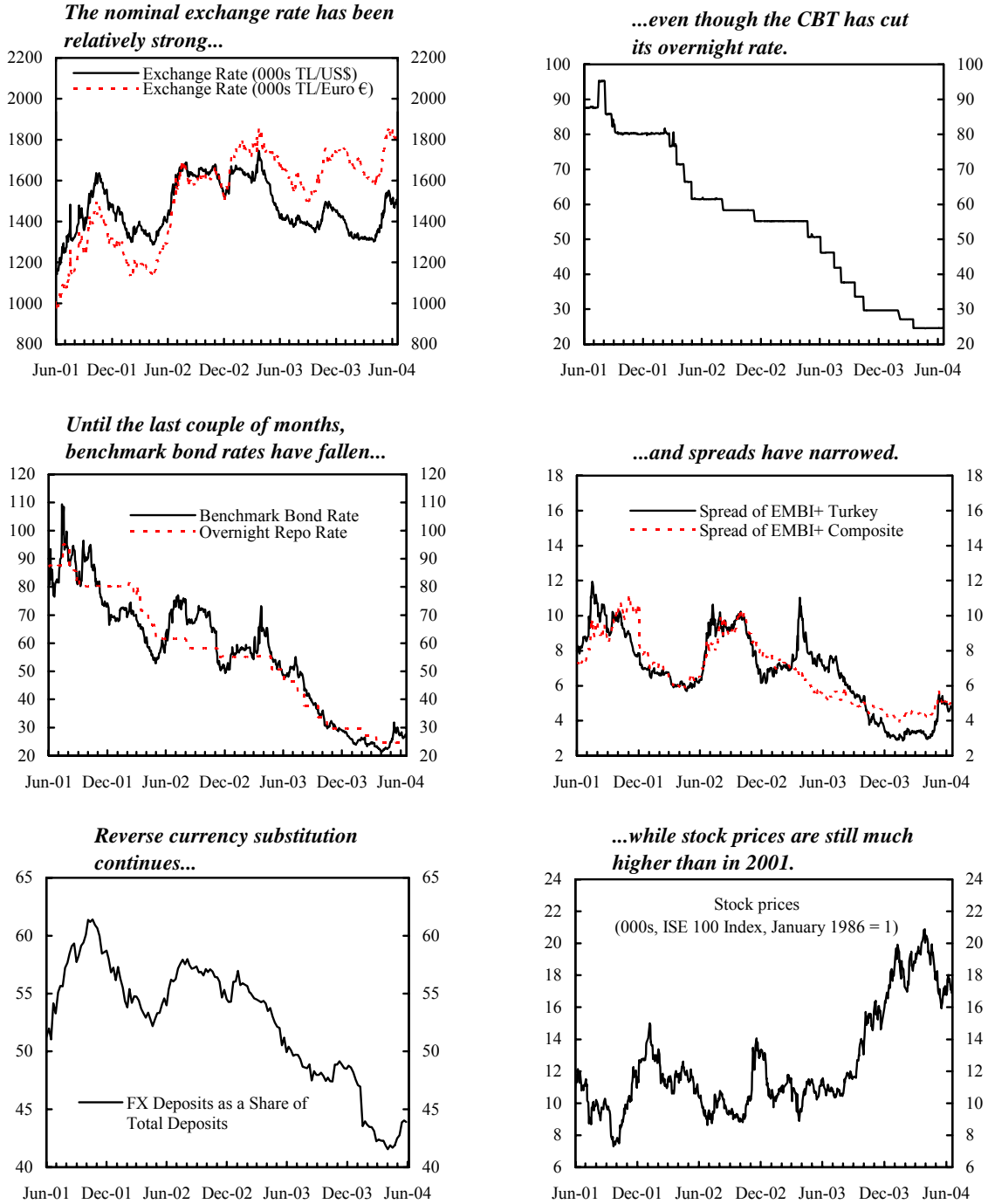
6. **The program also strongly emphasized structural reform, largely to signal a break from the failed economic policies of the past.** To reduce a key source of vulnerability and quasi-fiscal activity, the banking system was restructured and recapitalized (first the state banks, then the private banks), at a cost of US\$47 billion (more than 30 percent of GNP). A wide range of other structural reforms was also introduced, from privatization to governance reform, in an attempt to change the way the economy functioned and to demonstrate this to markets.

C. Macroeconomic Performance under the Program

7. **The program strategy has delivered a dramatic improvement in financial market confidence (Figure 1).** Though markets were volatile through much of 2001, the February 2002 augmentation and relaunching of the program helped assuage the financing concerns that had resurfaced after September 11, 2001. Despite interruptions from domestic political tensions (early elections in 2002) and outside shocks (the Iraq War), interest rates have declined substantially and debt maturities have lengthened, helping the government's debt rollover. The program's focus on generating large primary surpluses and on reducing inflation have been integral to this improvement. But outside factors—the availability of substantial financial assistance: first from the Fund, later (potentially) from the United States, and the extended period of low world interest rates—have also been important.

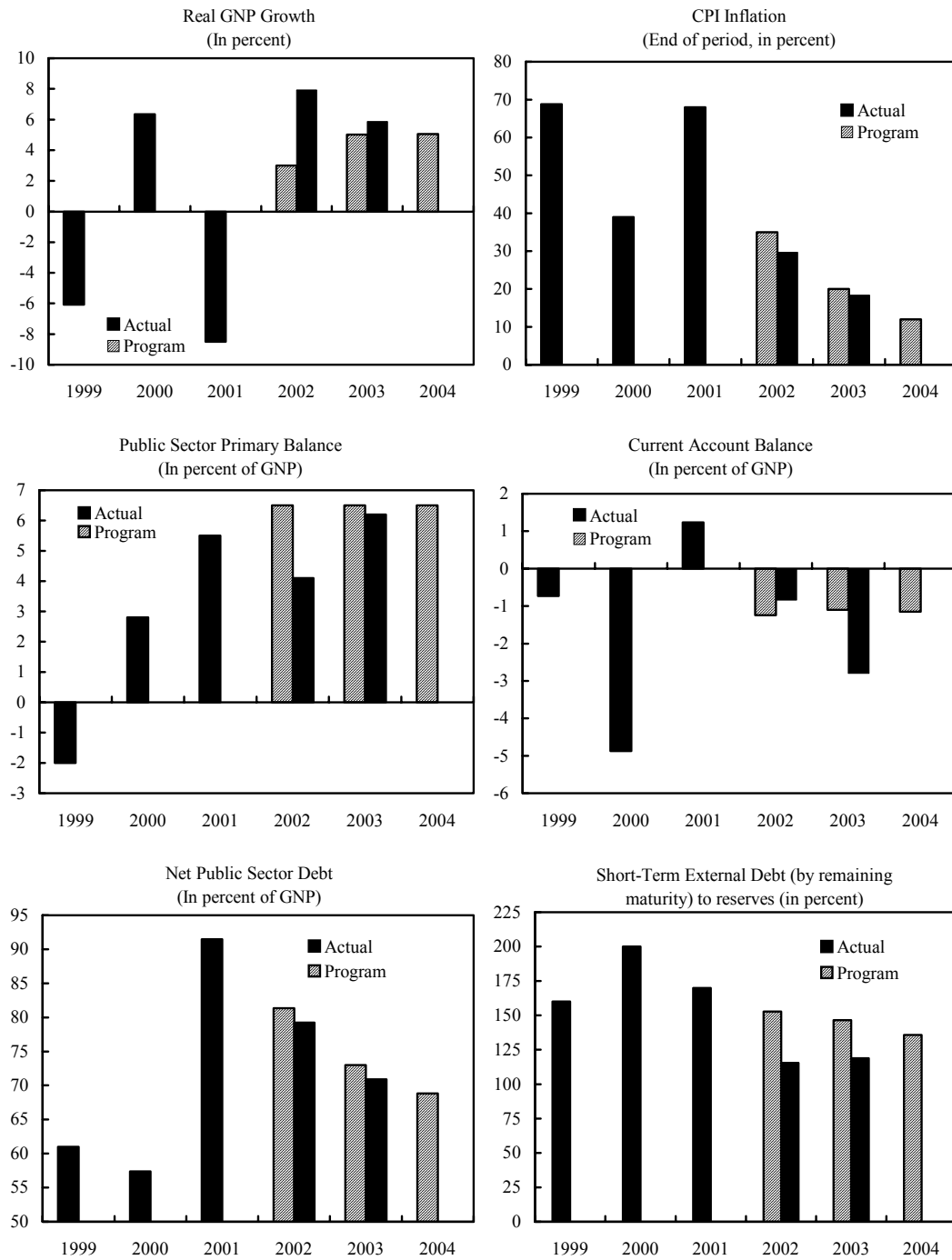
8. **Recovery has been rapid and powerful (Table 1).** After contracting by nearly 10 percent in 2001, GDP grew by close to 8 percent in 2002 and 6 percent in 2003, well above program projections (Figures 2 and 3). Once political stability emerged and the

Figure 1. Turkey: Financial indicators, 2001-04
(in percent, unless otherwise indicated)



Source: Data provided from the Turkish authorities.

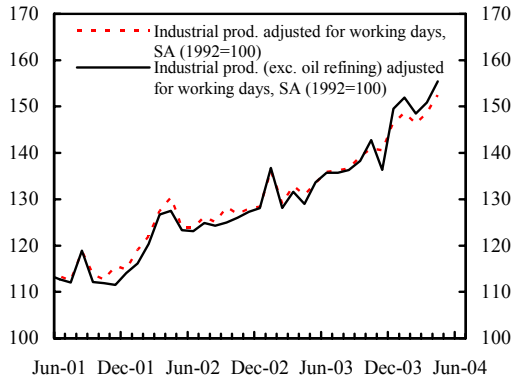
Figure 2. Turkey: Macroeconomic Indicators, 1999-2004



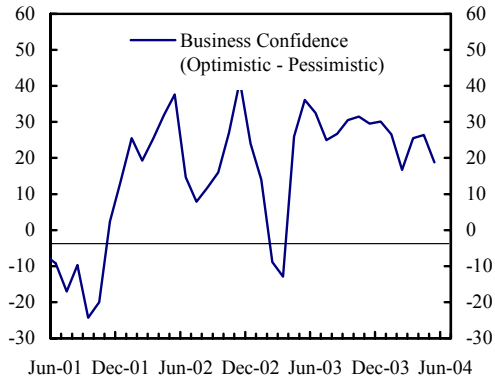
Source: Fund staff estimates and projections.

Figure 3. Turkey: Output and inflation, 2001-04
(in percent, unless otherwise indicated)

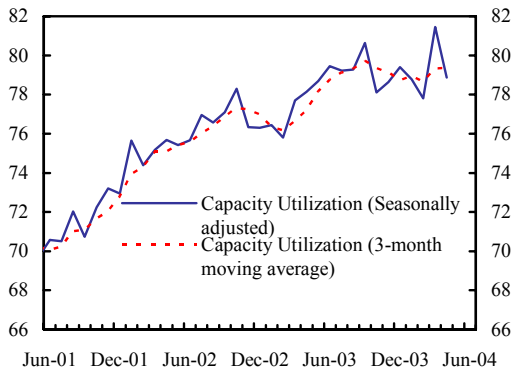
The recovery continues...



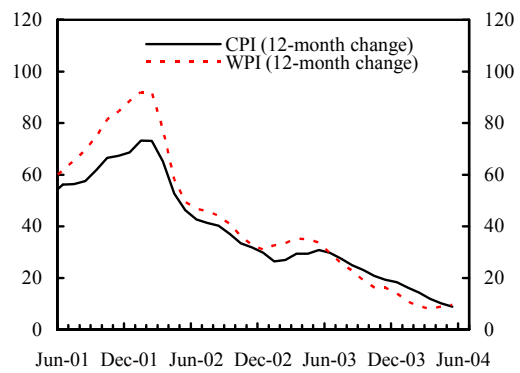
...as confidence recovers...



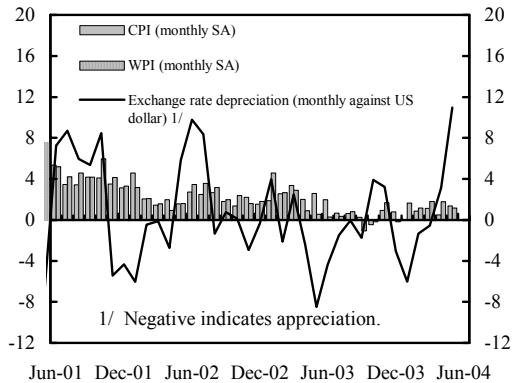
...and activity strengthens.



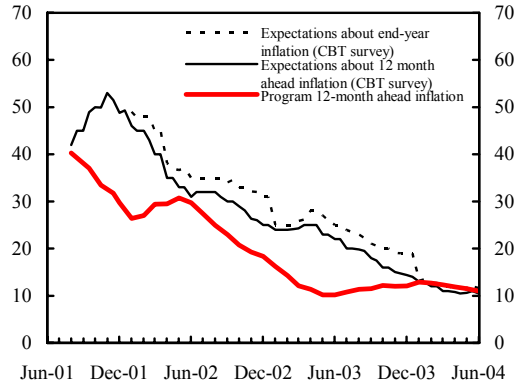
Inflation continues to decline...



...helped by a stable currency...

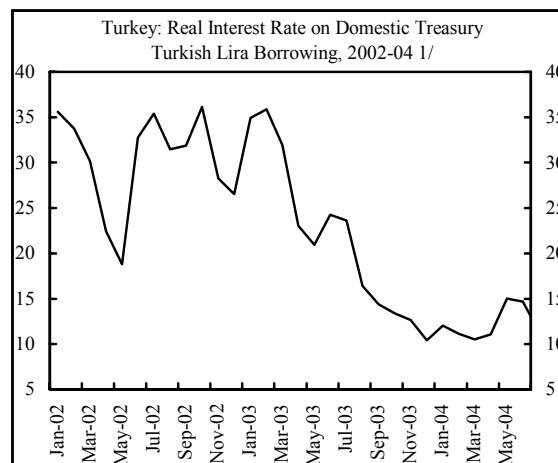


...and improving expectations.



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

authorities demonstrated their commitment to keep fiscal policy on track, real interest rates declined sharply in 2003, below program projections, setting the stage for a rapid increase in consumer credit. With consumer and investor confidence picking up too, the recovery has become increasingly led by domestic demand. The strength of the exchange rate has fuelled private consumption and consumer goods imports, and this year's pension and minimum wage increases have added to this. Despite banks' reluctance to lend to indebted corporates, improved profitability and higher capacity utilization have stimulated private investment.

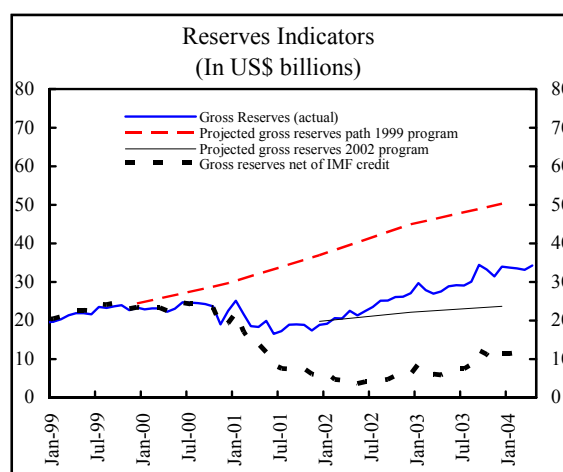


1/ 12-month ahead CPI used in real interest rate calculations.

9. **Inflation too has outperformed expectations.** The contribution of primary surpluses towards achieving debt sustainability, the CBT's adherence to the base money program in 2002 and 2003, and the resulting improvement in financial market confidence and stabilization of the exchange rate, have led to a dramatic decline in inflation to levels not seen since the 1970s. Were it not for the recent exchange rate depreciation and the likely pass-through from higher world oil prices, inflation would have been on track to fall to single digits by end-year, below the CBT's 12 percent target.

10. **The strength of the recovery and the appreciation of the real exchange rate has pushed the current account deficit above the original program path (Table 2).**

Instead of stabilizing at around 1 percent of GNP, by 2003 the current account deficit had widened to close to 3 percent of GNP. Higher capital inflows—mainly the drawdown of residents' foreign currency holdings—have more than compensated, allowing the CBT to accumulate reserves well above the projections made in 2002, but financing has been skewed toward short-term portfolio inflows. The CBT has responded to these developments by intervening to build up reserves.



Source: Data provided by the Turkish authorities.

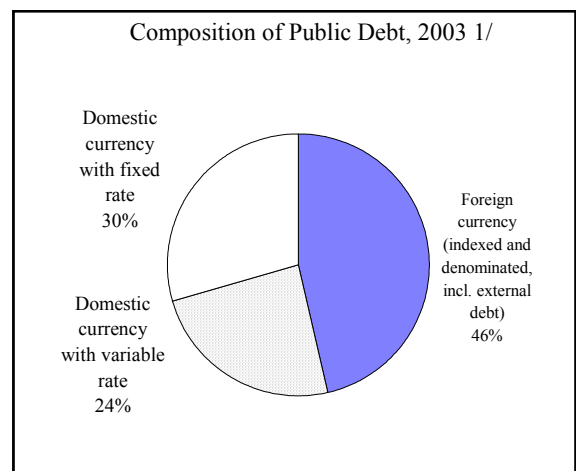
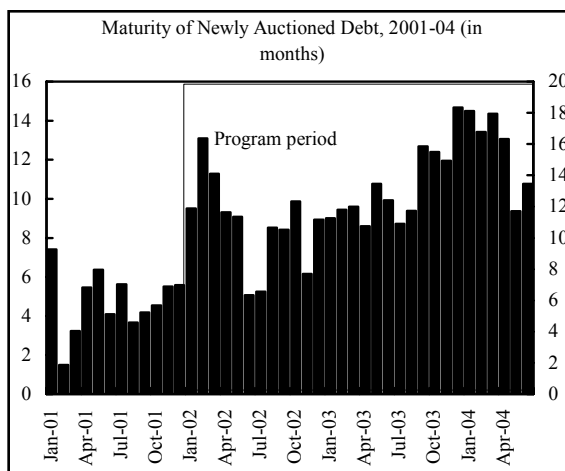
11. **Although extreme poverty remains low, income inequality and unemployment are serious problems.** In 2001, at the peak of the crisis, less than 2 percent of the population had per capita consumption under US\$1 per day, little changed since 1994. However,

inequality remains high, mainly reflecting extreme differences between regions, with the Southeast in particular much poorer than the rest of the country. The strong economic recovery has done little to reverse the increase in unemployment during the crisis (Chapter X of the Selected Issues paper). The official unemployment rate has risen from 6½ percent in 2000 to 10½ percent in 2003, and is especially high for educated youth, at almost 30 percent. Although the overall rate seems to be leveling off, this reflects declines in labor force participation—employment has actually fallen. With population growth in the 20–54 age group of around 2 percent per annum, generating a sustained recovery that lowers the unemployment rate will be a major challenge.

D. Remaining Vulnerabilities

12. Turkey's economy is still vulnerable, and at the heart of this problem lies the magnitude of public debt, its short maturity, and currency composition (Table 3).

Although the corporate sector has used the recovery to improve its financial health, its high leverage and unfavorable debt structure still leaves it vulnerable (Box 1). Banking sector balance sheets have improved, although much of this has come at the government's expense. It has socialized many of the private sector's risks, by taking on higher foreign currency and floating rate debt (Chapter III of the Selected Issues paper). Although the government has gradually lengthened maturities of new debt, average maturity remains low, so that rollover risk and vulnerability to increases in short-term interest rates are still concerns. And despite the shift to floating exchange rates, foreign currency risk is also a problem. Dollarization is extensive—around half the government debt and bank deposits are foreign currency denominated—and short-term external debt by remaining maturity exceeds gross international reserves.



1/ Consolidated "budget debt stock" (central government).

Box 1. Corporate Sector Vulnerabilities—During and After the Crisis¹

Turkish corporations were highly exposed to exchange rate and interest rate risk at the eve of the crisis.

Similar to banks, corporations had significantly increased their foreign currency liabilities during 2000.

Given that an increasing share of the domestic banks' lending was going to the government, corporations relied heavily on borrowing from abroad. And a large share of their foreign currency debt, including that owed to domestic banks, had short maturities, even if it was not necessarily trade-related.

In addition, corporations had signed (off-balance sheet) forward contracts with domestic banks, to which they were often closely linked, allowing these banks to meet the regulatory limits regarding their open foreign

currency positions (banks reported a positive net forward position of US\$9 billion by end-2000).

Foreign currency assets and liabilities of companies traded on the ISE

	1999	2000	2001	2002	2003 (Sept.)
In billions of US\$					
Assets	2.1	2.3	3.1	4.1	4.4
Liabilities	8.1	10.1	8.6	10.9	9.7
Net position	-6.1	-7.9	-5.5	-6.8	-5.3
No. of companies	217	217	217	214	208

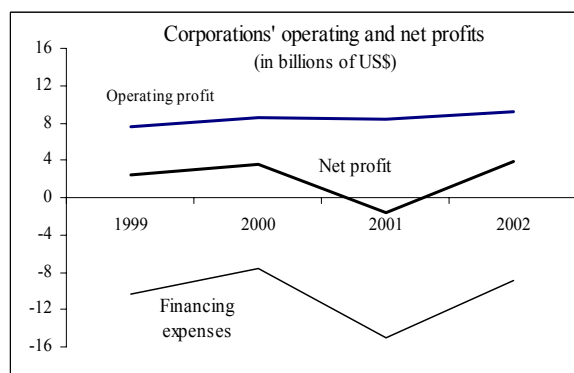
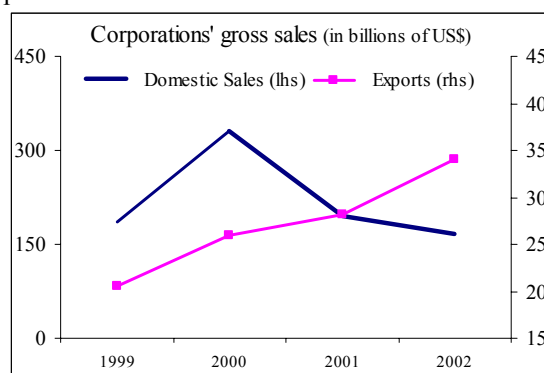
Source: CBT, ISE (Istanbul stock exchange)

External debt of non-financial private sector

	1999	2000	2001	2002	2003
In billions of US\$					
Short-term (original maturity)	9.1	9.7	7.7	8.4	10.4
Medium and long-term	22.6	24.6	24.3	27.2	29.5

Source: CBT, Balance of Payments data (International Investment Position)

The fall of the lira and the surge in interest rates created large financial losses in 2001, which the depreciation-induced export gains could not compensate.² Corporations' natural hedge (improved export competitiveness from a weaker exchange rate) showed some effect in 2001. However, the rise in exports was much less than would have been needed to offset the parallel collapse in the value of domestic sales. A lack of financing—as external credit was cut and domestic banks were in distress—is likely to have limited the full exploitation of export opportunities. Since the weak lira also implied a sharp fall in corporations' domestic input costs, however, corporations managed to maintain positive operating profits during the 2001 crisis. Yet, the massive surge in financing expenses caused by a depreciated lira and rising interest rates turned these operating profits into net losses.



The financial health of corporations has much improved in tandem with the economic recovery. Profits swiftly recovered during 2002, and profitability ratios relative to capital, sales and financial obligations all improved, often showing stronger values than in 1999, before the crisis. Even with annual 2003 results not yet available for the larger sample, the further reduction in interest rates, the regained access to external credit,

¹ For an overview of Turkey's sectoral balance sheets see Chapter III of the Selected Issues paper.

² The following analysis is based on annual aggregate corporate balance sheet data of over 8000 Turkish companies provided by the CBT (<http://www.tcmb.gov.tr>). End-2003 data will only be available later in 2004.

Box 1. Corporate Sector Vulnerabilities—During and After the Crisis (concluded)

and the resolution of the banking crisis, should in principle have helped corporations to further strengthen their balance sheets. Yet, some 2003-data from larger companies traded on the ISE also indicates that the appreciation of the lira has lowered the margins of export-oriented companies.

Selected profitability ratios of Turkey's corporate sector

	1999	2000	2001	2002
Relative to capital				
Net Profit / Own Funds	7.5	8.0	0.0	8.9
Net Profit / Total Assets 1/	2.3	2.7	0.0	3.0
Relative to sales				
Operating Profit / Net Sales	3.8	2.5	3.9	4.8
Net Profit / Net Sales 1/	1.2	1.0	0.0	2.0
Cost of Goods Sold / Net Sales	90.5	93.0	91.0	87.5
Interest Expenses / Net Sales	5.1	2.2	7.0	4.6
Relative to financial obligations				
Profit Before Interest and Tax / Interest Expenses (Interest Coverage Ratio)	146.8	182.3	103.0	170.4
Net Profit and Interest Expenses / Interest Expenses	123.8	146.0	89.3	143.1

1/ Profits in 2001 were negative, but the profitability ratios are reported as zero.

Source: CBT

Relatively high leverage ratios and the unfavorable structure of the debt continue to pose risks. Leverage ratios of Turkish corporations remain relatively high on average, leaving them with only a limited equity buffer against balance sheet shocks. Although it is estimated that between 10 to 20 percent of the funds recorded as debt on corporate balance sheet are funds provided by the owners and shareholders of the relevant company, it remains questionable to what extent such loans can provide an equity-like function in times of financial stress. Importantly, the short maturity of the debt financing and its extensive denomination in, or indexation to, foreign currencies implies that corporations still have considerable exposure to interest rate and foreign currency liquidity risk. Given that this composition of corporations' debt is to a large extent simply the reflection of the banks' need to create assets that balance their own foreign currency and interest rate exposures, the further strengthening of the domestic financial system will be key to moving such risks off the corporations' balance sheets. This includes also a deepening of local capital markets and better access to equity financing.

Selected financial ratios of Turkey's corporate sector

	1999	2000	2001	2002
	(in percent)			
Liquidity				
Current assets / Short-term liabilities (Current Ratio)	117.8	121.1	113.4	118.5
Liquid assets (incl. marketable securities)/ short term liabilities (Cash Ratio)	25.7	25.6	23.5	25.4
Financial position				
Total Loans / Total Assets (Leverage Ratio)	69.4	66.5	71.3	66.5
Total Loans / Own Funds (Debt-to-Equity Ratio)	226.4	198.5	248.2	198.9
Short-Term Liabilities / Total Liabilities	49.1	47.5	48.5	44.6
Short-Term Liabilities / Total Loans	70.7	71.4	68.1	67.1

Source: CBT

13. **Recent financial market turbulence highlights these vulnerabilities.** For much of 2003, the exchange rate appreciated and domestic interest rates and spreads on external borrowing declined sharply. But in May this year, the benchmark bond rate rose sharply, Eurobond spreads increased considerably, and the exchange rate depreciated by around 15 percent against the dollar. In part these shifts reflected changing expectations over the future path of US interest rates, and have been shared with other emerging markets. But in Turkey's case the reaction has been more severe, reflecting the greater vulnerabilities in its economy, and also concerns over the widening current account deficit. Any exchange rate adjustment needed to boost net exports would also tend to exacerbate the debt burden.

III. SHORT-TERM MACROECONOMIC POLICY CHALLENGES

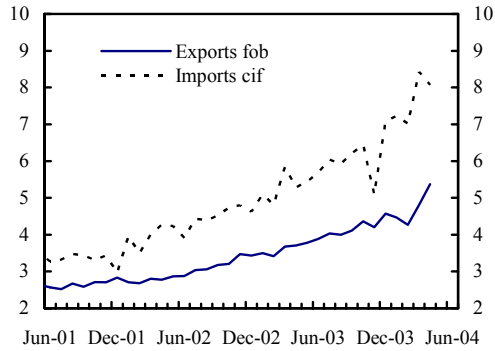
14. **The economy is on track to meet or exceed this year's targets of 5 percent growth and 12 percent inflation,** but faces problems of excess demand and a growing current account deficit (Figure 4). In the first few months of the year, growth of consumer credit, retail sales and imports have all been very strong (Figure 5). Indeed, it appears that domestic demand and growth have been running above the program targets, widening the current account deficit. In the staff's view, current indicators pointed to growth well in excess of the target, the authorities thought any revision of the growth outlook for 2004 should await the first quarter outturn. (The first quarter national accounts released since the mission indicate that year-on-year growth in the first quarter was about 10 percent. An analysis of these data will be presented in the supplement to the staff report).

15. **Though closely monitoring the risks to the current account, the authorities felt that subsequent developments had mitigated these somewhat.** Recent real exchange rate depreciation would depress incomes and make imports more expensive. Higher secondary market interest rates had been passed on by banks to their borrowers, and there were signs that the growth in consumer credit was slowing. The government had also cautioned state banks to curtail consumer credit growth, and had reduced tax incentives for new car purchases. And although it had worsened the current account, the oil price increase would, if fully passed on, reduce domestic demand by lowering real incomes.

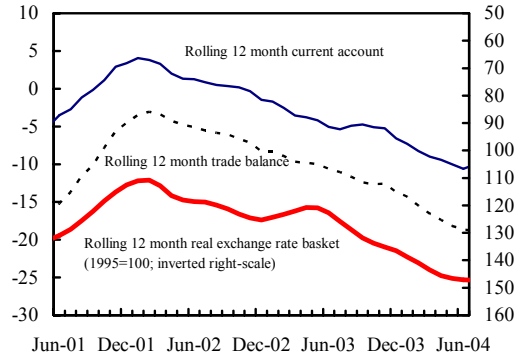
16. **Even so, it was not clear whether these factors would suffice to contain domestic demand and stabilize the current account.** While a slowdown was likely, it would take time to gauge whether it would be sufficient. Financial market conditions had already started to improve again, so the effects of the earlier correction might dissipate. The staff therefore urged the authorities to let the automatic fiscal stabilizers work and to save the recent demand-driven over performance of tax revenues, at least until the risks to the current account had clarified. It was also important to accept any exchange rate adjustment, even if this might have the short-run effect of raising prices. Historically, the current account had been a bell-weather of the need for policy correction and needed to be watched closely. The authorities accepted much of this, agreeing to let the stabilizers operate, but wishing to review the situation later in the year to see if some of the budget over performance could be spent on social priorities.

Figure 4. Turkey: External indicators, 2000-04
(in billions of U.S. dollars; unless otherwise indicated)

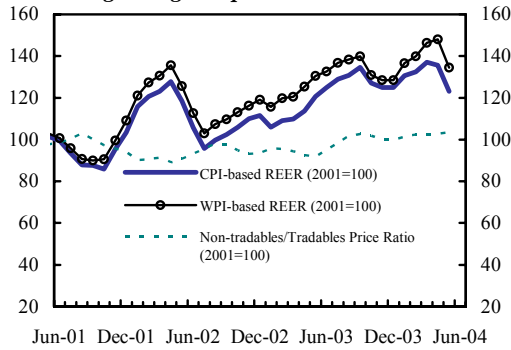
Despite the strong growth in exports, a surge in imports...



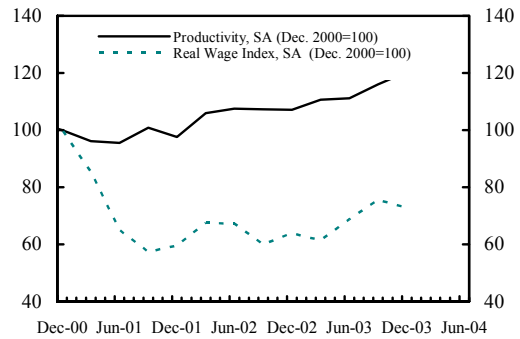
...and real appreciation has weakened the current account.



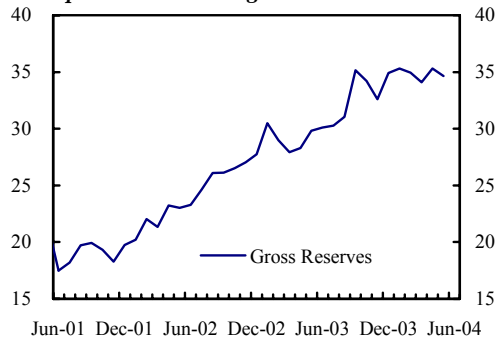
Until recently, the currency appreciation had raised questions regarding competitiveness...



...but productivity and wage measures had allayed these concerns somewhat.



Reflecting a stronger capital account and valuation gains, the reserves position has strengthened...

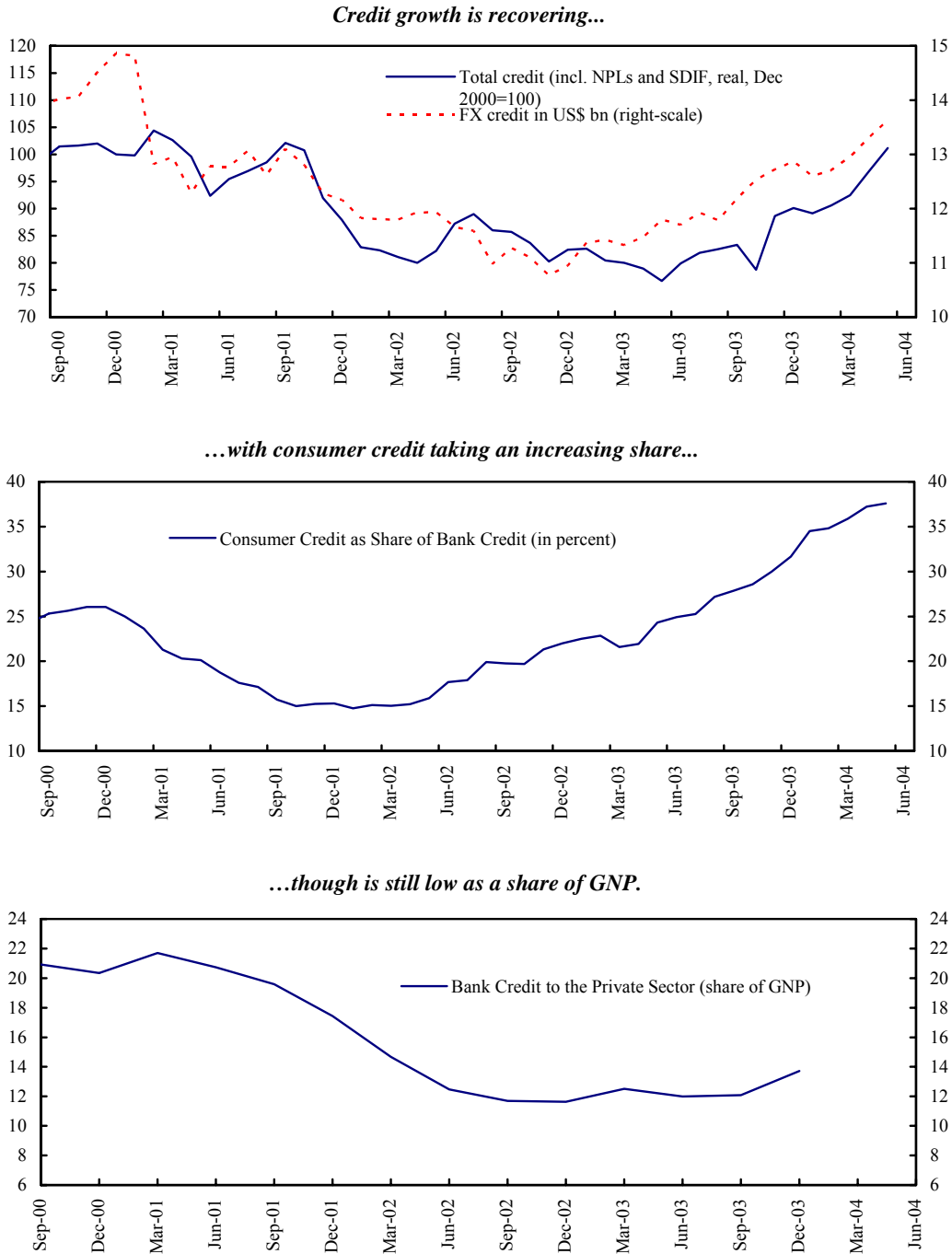


...and net reserves have turned positive.



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

Figure 5. Turkey: Recent Credit Developments, 2000-04



Source: Central Bank of Turkey.

IV. SUSTAINING AND ADVANCING RECENT GAINS: MEDIUM-TERM POLICY CHALLENGES

Discussions took place against a backdrop of consensus on the key medium-term challenge: generating sustained and rapid growth with low inflation. Rapid growth would provide the most promising avenue for achieving lasting remedies to Turkey's social challenges, especially unemployment. The government had been extremely successful in achieving macroeconomic stabilization, with fiscal consolidation supporting low inflation and growth, and this augured well for the future. The record was more mixed as regards the composition of the adjustment and the pace of structural reforms. While rooted in social concerns, spending initiatives inconsistent with the aims of the program and delays in the implementation of reforms raised questions about the sustainability of fiscal consolidation and growth. Looking ahead, the government needed to build on its record of fiscal consolidation by demonstrating greater ownership of structural reforms. The political conditions for doing this had rarely been better. Unlike the coalition governments of the past, the single party government had the opportunity to introduce fundamental reforms (such as in social security or public expenditure) where short-term (political) costs may be high, but where long-term benefits to the country would be substantial.

A. Reassessing the Medium-Term Macroeconomic Framework

17. **Historically, Turkey has gained much from economic liberalization but paid dearly for policy indiscipline.** Since 1980, greater openness to trade and financial market liberalization have helped boost economic growth. However, this growth has been extremely uneven, and prone to interruption by economic and political crisis. The problem is that liberalization has gone hand in hand with increased fiscal, monetary and financial indiscipline that has effectively negated its beneficial effects. This has depressed economic growth and made it more volatile.

18. **With continued liberalization and a refocusing on microeconomic reforms, Turkey has the potential for sustained rapid growth.** Although the current program's 5 percent medium-term growth path has seemed ambitious, it is not that far above the 4 percent historical average. Indeed, in the medium term Turkey has the potential for even higher growth. If the emergence of greater political stability can be used to contain demands for greater spending and translated instead into less discretionary fiscal policy, and if the recent reduction in inflation can be sustained, growth should pick up considerably (Box 2). The analysis in Chapter I of the Selected Issues paper indicates that growth could then be as much as 2 percentage points above its historical average of 4 percent. This stable environment would also be conducive to TFP-led growth, contrasting with the investment-led growth of the past, which has often run into current account constraints.

19. **Despite this potential upside, the baseline scenario assumes a more conservative growth path (Table 4).** For the medium term, growth is still assumed to be 5 percent, with inflation staying in single digits. Domestic demand is assumed to slow, lowering the current account deficit to more sustainable levels. Despite the reform program and passage in 2003 of the Foreign Direct Investment Law, FDI has averaged less than US\$1 billion (½ percent of

Box 2. Turkey's Growth Record and its Determinants, 1960–2000^{1/}

Turkey's relative economic growth performance has improved since the 1980s. Although during the last four decades real per-capita GDP expanded on average only slightly faster than in the rest of the world, this masks pronounced differences in growth performance during the two subperiods 1960–80 and 1981–2000. In the first two decades Turkey trailed the rest of the world but then surged ahead in the last two decades, when growth decelerated around the globe but not in Turkey. During 1981–2000, Turkey posted per-capita growth rates about one percentage point higher than in the rest of the world. And while Turkey did not escape the worldwide productivity slowdown, it was much less drastic than in the rest of the world. Notably, it managed to step up rates of capital accumulation when investment faltered elsewhere.

Growth Accounting, 1961-2000

(Annual percent changes)

	Per-capita GDP 1/	TFP	Physical Capital 2/	Human Capital 2/
1961-2000				
Turkey	2.33	0.92	1.77	0.40
Middle East	2.75	1.27	1.71	0.41
Uppermiddle income countries	2.45	0.97	1.76	0.40
All countries	1.98	0.73	1.56	0.34
1961-1980				
Turkey	2.32	1.10	1.69	0.37
Middle East	3.71	1.94	2.09	0.39
Uppermiddle income countries	3.07	1.41	2.01	0.43
All countries	2.62	1.07	1.92	0.33
1981-2000				
Turkey	2.35	0.73	1.86	0.43
Middle East	1.79	0.61	1.34	0.43
Uppermiddle income countries	1.83	0.53	1.51	0.36
All countries	1.33	0.37	1.20	0.34

Note: The table covers 73 countries in our sample for which Bosworth & Collins (2003) provide physical and human capital stock data. GDP data are from the Penn World Tables (6.1), TFP is calculated as the residual, as described in the text.

Turkey's changing growth record reflects the influence of conflicting forces. Econometric analysis of a cross-country dataset covering 92 economies helps identify the factors chiefly responsible for the difference in growth experience in 1981–2000 and 1960–80. The main determinants turn out to be (i) trade openness, (ii) fiscal volatility, (iii) inflation, and (iv) financial development. This specification is robust to the inclusion of other potential explanatory variables, such as external volatility, government size, or measures of political constraints.

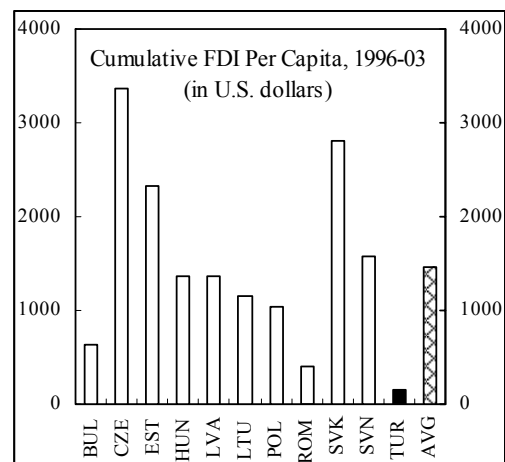
Increased trade openness was the main engine of the post-1980 growth performance. Between the two subperiods trade as a share of GDP rose from 13 to 38 percent—a much larger change than elsewhere. According to the regression results, this added some 2.3 percentage points to growth during 1981–2000, mainly through stimulating investment. Indeed, had trade and financial liberalization been the only policy changes, Turkey would have posted growth rates similar to those in east-Asia.

Growing fiscal volatility and inflation, however, acted increasingly as a drag on growth. After 1980 fiscal policy became more discretionary, as measured by unexpected, cyclically-adjusted deviations from the past fiscal policy stance. Even though this development was not associated with larger government, it still knocked 0.5 percentage points off Turkey's annual growth rate, mainly by discouraging investment. Rising inflation reduced growth by another 0.7 points, mainly by lowering productivity.

Turkey's recent advances in combating inflation augur well for the growth outlook especially if fiscal discretion can also be scaled back. With inflation rates firmly heading toward single digits one key ingredient for better future growth is already falling into place. While there is some evidence that fiscal discretion might be positively correlated with deregulation, and indeed trade liberalization, a strengthening of institutions, more reliance on rules, and adherence to pre-set targets appear to offer the best way forward.

^{1/} This box summarizes the main findings of Chapter I of the Selected Issues Paper.

GNP) each year, very low compared with new member states and countries acceding to the EU. Without such long-term flows, a current account deficit above 3½-4 percent of GNP in Turkey is unlikely to be sustainable, and would likely result in an exchange rate correction (Box 3). However, the staff stressed that achieving the desired current account adjustment and sustained low inflation would depend on tight fiscal policy and wage restraint, and success in containing the growth in domestic demand. If the authorities were unable to implement policies that delivered such a slowdown, a more abrupt exchange rate adjustment might result instead, with adverse implications for inflation and debt.



Source: IMF, *World Economic Outlook*.

B. Fiscal Policy: Safeguarding Debt Sustainability

Fiscal adjustment to date

20. **There was strong agreement that the strategy of targeting a high primary surplus had been critical in reducing debt and stabilizing the economy.** This had helped improve policy credibility, supported the CBT's disinflation efforts, and delivered lower interest rates. By alleviating worries over debt sustainability, fiscal discipline had also helped re-establish consumer and investor confidence.

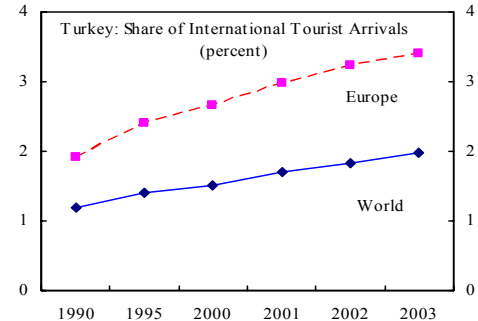
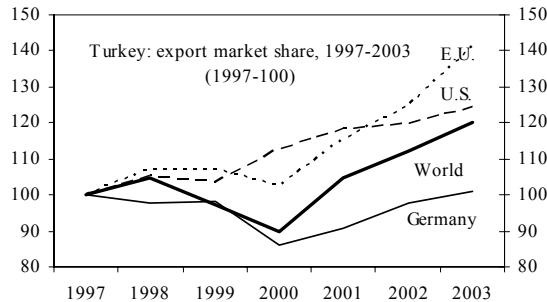
Turkey: Summary of Primary Surplus, 1999-2003
(In percent of GNP)

	1999	2000	2001	Current SBA				Changes	
				2002		2003		2001-03	1999-2003
				Prog.	Act.	Prog.	Act.		
Consolidated public sector primary surplus	-1.4	3.0	5.5	6.5	4.1	6.5	6.2	0.7	7.6
Central government	1.4	4.6	4.8	5.4	2.4	5.1	5.1	0.3	3.7
Rest of public sector	-2.7	-1.6	0.8	1.1	1.7	1.4	1.1	0.3	3.8
Social Security	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	0.0
Unemployment insurance fund	...	0.3	0.6	0.3	0.4	0.3	0.3	-0.3	0.0
Extra-budgetary funds	-0.5	-0.2	0.1	-0.2	-0.1	-0.2	0.1	0.0	0.6
SEEs	-2.1	-1.5	0.1	1.1	1.1	1.2	0.7	0.6	2.8
Local Governments	-0.2	-0.2	0.1	0.0	0.1	0.0	0.0	-0.1	0.2
Revolving funds	0.0	0.1	0.1	0.0	0.1	0.0	0.1	0.0	0.1
Memorandum item:									
Social security transfers	3.5	2.6	2.9	3.0	4.1	3.3	4.5	1.6	1.0

Source: Fund staff estimates.

Box 3: Competitiveness and the Current Account Balance

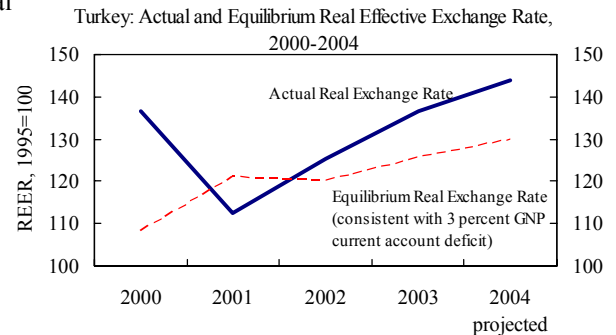
Turkish exports have performed well since the 2000 crisis, underpinned by a more competitive exchange rate, market diversification, productivity gains, and a reduction in real wages. However, the exchange rate appreciated as the economy recovered, imports accelerated and the current account deficit widened from a position of surplus to a projected deficit of nearly 4 percent GNP in 2004. This has ignited concerns that Turkey’s recovery is generating excessive external financing needs. In particular, the focus is on short-term debt financing and portfolio flows that may be curtailed by tighter international liquidity conditions, as well as longer-term considerations of debt sustainability.



Short-term external financing has increased significantly, though not to levels seen before earlier crises. Short-term external debt rose 40 percent in 2003, though remains some 20 percent below its peak of \$28 billion in 2000. While this undoubtedly poses a higher risk of a credit reversal and currency mismatch, the stock of trade credit is below 20 percent of annual import value, compared to more than 40 percent before the 1994 and 2000 crises. Similarly, banks’ foreign exchange credits are well below historical peaks and, more importantly, their on balance sheet open foreign currency positions have been maintained in the range of zero to US\$2 billion and within prudential limits. Nonetheless, short-term external debt remains high by international standards in relation to gross official reserves, underlining the importance of continued reserve accumulation in coming years.

Over the longer term, the path of the current account deficit will need to be consistent with a level that will stabilize a prudent level of external debt to output. Starting from a debt stock of 60 percent of GNP, and 5 percent GNP growth, Turkey’s debt ratio will continue to fall gradually as long as the current account deficit stays below 4 percent of GNP. But to stabilize at more prudent debt/GNP levels of 40 percent or lower, the current account will need to fall below 3 percent of GNP. An increase in non-debt creating inflows would allow higher deficits. Rapid productivity growth consistent with EU convergence will also help lower the ratio of debt/GNP through the channel of real exchange rate appreciation.

What exchange rate adjustment would be needed to move Turkey to the long-run debt stabilizing current account deficit? Using estimates of trade responsiveness to exchange rate changes, we can calculate the “equilibrium” exchange rate that will deliver a debt stabilizing current account deficit when the Turkish economy and trade partners operate at full output potential. While this assessment is sensitive to the target current account balance, estimates of potential output gaps and assumed trade price and output elasticity’s it provides some indication of exchange rate divergence relative to the desired long-run equilibrium. Staff estimates show that the equilibrium real exchange rate has appreciated significantly since 2000, indicating that the Turkish economy has become more competitive, i.e. any given current account deficit can be sustained at a more appreciated real exchange rate than before. In addition, market forces have appreciated the actual exchange rate some 10 percent above the long run equilibrium rate. This divergence can be explained by factors such as a positive market assessment of future productivity gains associated with EU accession negotiations, higher real interest rates and the risk preferences of investors.



21. **While fiscal consolidation had been impressive, the quality of adjustment raised concerns.** Staff analysis presented to the authorities showed that the fiscal effort since 2001 had been high and more enduring than previous episodes of adjustment in Turkey (Chapters VI and VII of the Selected Issues paper). However, the quality of the fiscal adjustment under the program had been mixed. Adjustment at the state enterprise level had been supported by increasing prices, lowering costs, and explicit targets for reducing employment. However, current spending at the central government level had risen, financed by tax increases and cuts in capital expenditure. This raised questions about the sustainability of the fiscal adjustment, especially as the international experience suggested that adjustments based on lasting reductions in expenditure were more likely to be sustainable (Chapter VII of the Selected Issues paper).

22. **Short-term policy choices had at times also aggravated the quality of the adjustment.** Unplanned spending initiatives outside the budget cycle, such as the pensions and minimum wage increases earlier this year, had undermined the budget process and required compensatory or corrective measures. And while corrective steps helped put the primary surplus targets back on track, they had often come at the expense of the quality of the fiscal adjustment. Investment, for example, had borne the brunt of budget cuts. Frequent ad hoc policy changes (proposals for selective tax reductions, incentives and tax amnesties) had also undermined the credibility of the budget process.

23. **The authorities thought that the achievement in 2003 of the highest primary surplus on record had substantially enhanced policy credibility.** They stressed that the markets no longer doubted the government's determination to deliver on fiscal consolidation. Strong fiscal policy had also gained increasing acceptability in the population at large as it was credited with helping to restore growth and reduce inflation. However, the authorities emphasized that sustaining the fiscal adjustment necessitated paying sufficient attention to social concerns. The increases in pensions and the minimum wage had been necessary to restore them to their pre-crisis levels and maintain social consensus for reform. However, they agreed that such decisions should and would be considered and acted upon within the budgetary framework.

24. **There has also been progress on structural fiscal reforms.** A major improvement in fiscal management had been the approval after much delay of the Public Financial Management and Control Law which established a clear delineation of responsibilities in the preparation and formulation of the budget, introduced a medium-term budget framework, and established new systems for control and auditing of government operations. Tax administration reform had recently gained momentum; this should help with efficiency of collection and begin to tackle the unregistered economy. Indirect taxes had also been reformed: simplifying and reducing the number of taxes, and consolidating excises and VAT. However, the reform of direct taxes had fallen short of the original objectives.

Structural challenges to sustained fiscal consolidation in the medium term

25. **Looking ahead, the authorities saw an overhaul of the taxation system to reduce distortions and fight tax evasion as a top priority.** Although Turkey's tax rates did not stand out as too high compared with the EU and the OECD, they were very high compared to other emerging markets. The personal income tax system was too complicated, with multiple rates and deductions. High social security taxes imposed a large cost on employment. The headline corporate income tax rate in Turkey was high, particularly compared to EU accession countries, and yet the effective yield was much lower because of generous investment tax credits and exemptions. The authorities were also concerned that VAT avoidance was high. Staff estimates indicated that the VAT yield was not out of line with international experience but collections accounted for about 70 percent of the calculated potential VAT.

Cross Country Tax Rate Comparison

	VAT	CIT	PIT	Social Security 1/
Turkey	18, 8&1	30 2/	20-45 3/	38.5
OECD (average standard rates)	17.8	...	...	...
OECD Europe	19.9	...	...	...
OECD Pacific	9.4	...	...	...
Poland	22, 7&3	19	19-40	37.8-45.5
Hungary	25&12	18	20-40	57.2
Bulgaria	20	23.5	18-29	54.7
Romania	19	25	18-40	45-62
Greece	18,4&8	35		
Croatia	22	20		
Czech Republic	22&5	31		
Korea	10	27	10-40	9
Thailand	7	30	5-37	8.2-10
Chile	19	17	5-40	10--12

Source: OECD, FAD databases and TA reports; VAT rates as of 2001; Turkey's are as of 2004.

1/ Including, employers, employees and unemployment insurance contribution.

2/ Excluding the 10 percent temporary surcharge.

3/ PIT on wage earners is 15-40 percent.

26. **However, the authorities acknowledged that any tax reform needed to take account of an expected structural decline in revenues.** As interest rates come down, the yield of intermediation taxes and the withholding tax on interest income (more than 1 percent of GNP) will fall. Indeed, because of their distortionary nature, the government has rightly declared its intention to phase them out. Also dividends, turnover taxes, and profits from SEEs, which currently contribute some 1 percent of GNP to the primary surplus, will diminish as these firms are privatized. Of course, in the long run this should be at least in part offset by higher private sector tax receipts, but in the interim it would lower revenues. Finally, the government's plans for greater fiscal decentralization posed a significant

challenge to maintaining fiscal discipline. If not handled carefully, this could seriously worsen public finances in the medium term.

27. **Public expenditure reform is also needed.** Non-discretionary spending accounts for some three-quarters of central government budget spending, with social security transfers and wages making up two-thirds of primary spending. Despite an attempt at reform in 1999, central government social security transfers had continued to grow and were now close to 5 percent of GNP, in part because the principles of the 1999 reform, such as no ad hoc increases in benefits, had not been observed. Arguably, the program could have focused on social security reform earlier and more forcefully, but the authorities saw this as a sensitive area of reform which needed strong political will and consensus, which was only now being formed. The authorities also agreed that wage outlays were high by international comparison; however, they thought this could only be addressed gradually. In contrast, they thought that the real decline in public investment over the last three years needed to be reversed in the medium term.

Turkey: Indicators of Government Employment and Wages

	General Government Employment (in % of population)	Average Central Government Wage to Per Capita GDP 1/	Ratio of Public to Private Sector Wages	General Govt. Wages and Salaries (in % of GDP) 1/	Central Govt. Wages and Salaries (in % of revenues)
Turkey	3.2	2.4	1.0	10.2	32.3
EU	10.5	....	....	5.4	13.3
Central and Eastern Europe	...	1.3	0.7	5.1	14.4
Latin America & Caribbean	...	2.5	0.9	...	...
OECD 2/	....	1.6	0.9	10.1	....
Low-income countries	2.3	...	...	5.7	22.6
Middle-income countries	4.3	...	...	6.0	22.1
High-income countries	10.5	...	...	5.9	15.6

Source: FAD guidance note on civil service reform; most data are for the second half of the 1990s, whereas in Turkey it refers to 2003.

1/ In the case of Turkey the ratio is to GNP

2/ Includes 15 OECD and 12 EU countries.

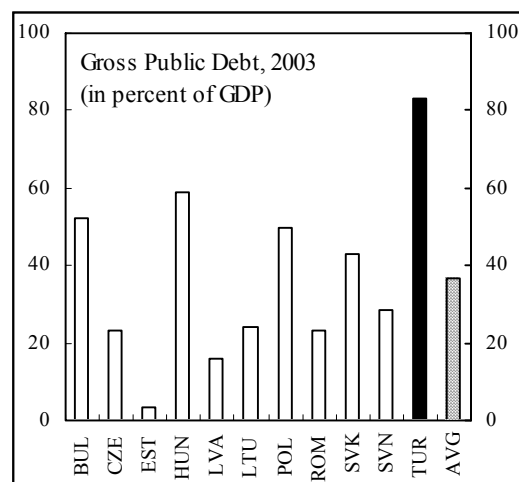
Avenues to sustained debt reduction

28. **There was agreement on the need to elaborate a medium-term debt reduction strategy and an agenda of reforms intended to make consolidation sustainable.** Structural reforms were needed to improve the underlying expenditure composition of the budget, improve tax collection, bring the unregistered economy within the tax base and eventually reduce the tax burden. These were essential to ensure that the adjustment of the last few years could be maintained in the medium-term. A medium-term debt reduction objective and strategy was needed to guide fiscal policy.

29. **On the structural front, a large agenda needed to be tackled.** Health and pension reform were clearly urgently needed given the widening social security deficit. There was also agreement on the importance of pressing ahead with tax administration reform to improve compliance and the efficiency of tax collection, with staff urging civil service reforms as an

avenue to lower the tax burden. To reduce tax distortions, and pre-empt pressures to create new ones, the staff and the authorities agreed that work should begin on a major reform of tax policy, but careful attention had to be paid to maintaining the revenue base of the budget (technical assistance in this area has already been initiated). There was agreement that this agenda needed to be prioritized. The staff saw social security and tax administration reforms as priorities. Expenditure reform also needed to begin in the context of the 2005 budget, and the legal framework for decentralization carefully developed at an early stage. While broadly agreeing with this prioritization, the authorities also thought that tax policy reform needed to be tackled upfront but perhaps in a staged manner.

30. **With public indebtedness at the core of Turkey's vulnerability, debt reduction was seen as the necessary focal point of medium term fiscal strategy, but it needed to be articulated with care.** Given the sensitivity of debt and fiscal variables to financial market conditions, legislative adoption of conventional rules such as a balanced budget rule, a borrowing rule, or a debt rule did not seem feasible at this stage. Instead, to guide fiscal policy over the next few years and ensure debt sustainability, the staff and the authorities saw merit in adopting a multi-year debt reduction plan to build government consensus, manage expectations, and guide policy. One option discussed was targeting a specific reduction in the debt (say 12–15 percentage points in the debt to GNP ratio over a four-year period) with an explicit commitment to adjust policies every year to achieve the targeted debt reduction. With a view to strengthening growth and limiting vulnerabilities to financing shocks, the medium-term aim should be to lower gross debt substantially, for example, to the average level of the recent EU accession countries (40 percent of GNP). If debt diverged from the target path, the primary surplus would be adjusted to achieve the targeted reduction in debt.



Source: IMF, *World Economic Outlook*.

31. **Staff noted that, for an unchanged pace of debt reduction, there did not seem to be room within such a framework for easing the primary surplus target.** Recent market tensions and uncertainties over the current account deficit suggested that real interest rates and the exchange rate are subject to a great deal of uncertainty. Therefore, any debt reduction strategy, the staff thought, needed to build in substantial safety margins on the one instrument that the government does control: the primary surplus. Indeed, recent hints by some government members that the 6½ percent of GNP primary surplus target may be relaxed next year had already troubled the markets. A lower primary surplus should only be considered once greater credibility of fiscal policy has been established and real interest rates have been lowered on a sustained basis.

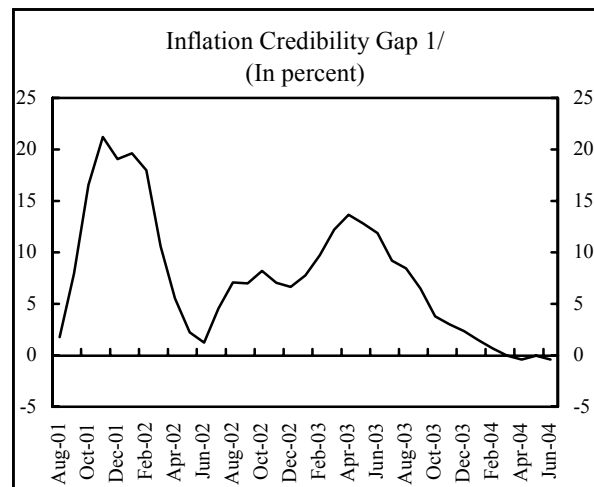
32. **While not ruling out the 6½ percent target beyond 2004, the authorities thought there may be a trade-off between the quality and the size of fiscal adjustment.** To meet the primary surplus target, government investment had declined in real terms and needed to be restored to ensure adequate infrastructure spending, particularly in health and education. Undertaking a major tax reform and ensuring continued decline in financial intermediation taxes would also be difficult, unless some decline in revenues was accommodated. After several years of fiscal consolidation there was also strong pressure from spending ministries for higher resources in priority areas.

33. **The staff argued that a looser fiscal stance would slow debt reduction and could have a severe cost in the form of higher real interest rates.** Indeed, surprising the markets by maintaining a stronger than expected fiscal stance was likely to be the most effective way of lowering real interest rates. Provided that the authorities were prepared to initiate expenditure policy reforms (FAD has provided TA to facilitate this), the staff presented a three year fiscal adjustment scenario that indicated it was possible to cope with the expected revenue decline, reverse the real fall in investment, and make room for a major tax policy reform within the constraints of the existing primary surplus targets (Table 5).

C. Monetary Policy—Strengthening the Operating Framework

Sustaining the reduction in inflation

34. **Reducing inflation has been central to the economic program.** This was one of the key objectives of the original 1999 program. Lower inflation has become a gauge of the success of monetary policy and also the fiscal and structural reforms that support it. After the abandonment of the crawling peg, under the revised program the nominal anchor for reducing inflation has been base money. In both 2002 and 2003 the CBT met every one of its base money targets (Tables 6 and 7). As inflation has fallen and debt rollover concerns lessened, real interest rates have fallen dramatically. Disinflation has been associated with recovery rather than recession, and has been a major boost to the CBT's credibility. Success in disinflation has also reduced exchange rate pass-through, and increased the significance of forward-looking rather than backward-looking inflation in price-setting behavior (Chapter II of the Selected Issues paper).



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

35. **Despite this success, monetary policy faces a number of challenges, both short- and medium-run.** In the short run, recent exchange rate depreciation is likely to add to

inflation. So far, the pass through into prices from this adjustment has been modest and, with seasonally adjusted inflation having fallen to single digits over the last six months, the 12 percent inflation target should still be met. Higher oil prices could also threaten the target, though cuts in excises have so far limited the impact on domestic prices. However, the staff warned against using administered prices to meet the inflation target, especially given Turkey's fiscal constraints and the need for relative prices to change as part of the adjustment mechanism. Instead, some one-off impact on the price level might need to be accepted, but any second-round effects onto higher wages and prices would need to be resisted.

36. **The main challenge for the medium term is to put in place a more transparent monetary framework.** With monetary targets starting to be missed, the program's formal nominal anchor—base money—is showing signs of strain. The overshoots are in part benign, as they mirror the program's success in reducing inflation and restoring confidence in the currency. But more recently they also seem to reflect rapid growth in credit and domestic demand. The CBT agreed that base money targeting was becoming problematic, but argued that this was of little consequence since in practice it had adopted an implicit inflation targeting framework instead. The CBT nonetheless still considered the adoption of formal inflation targeting as inadvisable because of continuing concerns over fiscal dominance, weaknesses in the financial system, uncertainties over the transmission mechanism, upcoming changes in the CPI basket, and uncertainties associated with EU accession.

37. **The staff suggested that a strengthening of the monetary framework would help guard against the risks that concerned the CBT.** For example, a strong monetary framework was needed regardless of EU accession process, even more so if this stalled. Fiscal dominance was a concern, but the track record of primary surpluses and debt reduction had arguably made this less so. The CBT's credibility would only be boosted by being tested, not by waiting for the perfect moment to launch inflation targeting. The staff therefore encouraged the CBT to adopt more of the features of its ultimate objective—formal inflation targeting—through steps to enhance the transparency of monetary policy. These could include a greater role for the monetary policy council, and more predictable timing of interest rate decisions.

38. **Foreign exchange intervention policy could be strengthened, with the goal being the steady accumulation of reserves.** Frequent changes to the foreign exchange purchase auctions had confused the markets and undermined the CBT's intervention framework. With reserve accumulation essential both to reduce vulnerability and to prepare for external debt repayments, the staff argued for a steadier and less reactive approach. However, the staff conceded that the occasional discretionary foreign exchange purchases of the last year had been extremely helpful in building reserves. The CBT explained that it had carefully gauged market developments prior to any change in its foreign exchange purchase auctions; however, market movements had recently become too volatile. They agreed, however, with the need for a more steady intervention approach in the future.

D. Foundations of an Effective Banking Sector

The strategy to deal with a severe banking crisis: how has it fared?

39. **The key objective of banking reforms has been to address the long-standing weaknesses that were brought into the open by the financial crisis of 2000–01 (Table 8).** Years of poor governance and excessive risk taking by banks, abuse by their owners, a weak regulatory and supervisory framework, lack of market discipline, and extreme macroeconomic volatility had left the banking system vulnerable. The financial crisis of late 2000 and early 2001, and the economic slowdown that followed, magnified these weaknesses. Banking sector profits and capital adequacy ratios fell sharply even before the full effect of credit losses was recognized. State banks, which had financed large “duty losses” (associated with politically directed lending) through short-term borrowing, experienced massive losses when short-term rates soared. Many private banks also had unviable balance sheets and a negative net worth.

40. **To address these weaknesses, a comprehensive reform program was introduced.** The staff reviewed with the authorities the reform strategy that essentially had two key components:

- **Enhancing the operating environment.** To contain the immediate crisis and protect against panic driven deposit withdrawals, the authorities introduced a blanket guarantee of all bank depositors and creditors (blanket guarantee has been removed and replaced by a limited deposit guarantee scheme as of July 5, 2004). The independent Banking Regulation and Supervision Agency (BRSA), established too late to prevent the crisis, would bring the supervisory and regulatory framework closer in line with international standards. Prior to this, banking supervision had been fragmented between the Treasury and the Central Bank, and dominated by a semi-autonomous group of on-site bank examiners.
- **Strengthening the balance sheet of banks.** State banks were recapitalized at a cost of close to US\$30 billion, and a far reaching operational restructuring program was initiated. Their “duty losses” and overnight borrowing positions were eliminated; new management was installed; the housing bank Emlak was shut; 800 branches of Ziraat and Halk were closed and some 30,000 employees laid off; and a time table was developed for privatizing the state banks. Further, the core private banking system was strengthened: unviable banks were intervened; banks’ foreign exchange risk was reduced by the CBT’s sales of foreign exchange and by swapping Turkish lira for foreign currency denominated government paper; and the BRSA’s three stage audits forced banks to disclose NPLs and for their capital needs to be assessed uniformly. Recapitalization took place mainly by injecting private funds. Finally, to facilitate corporate debt restructuring, the bankruptcy law was overhauled and a voluntary framework for debt restructuring—the Istanbul Approach—was introduced.

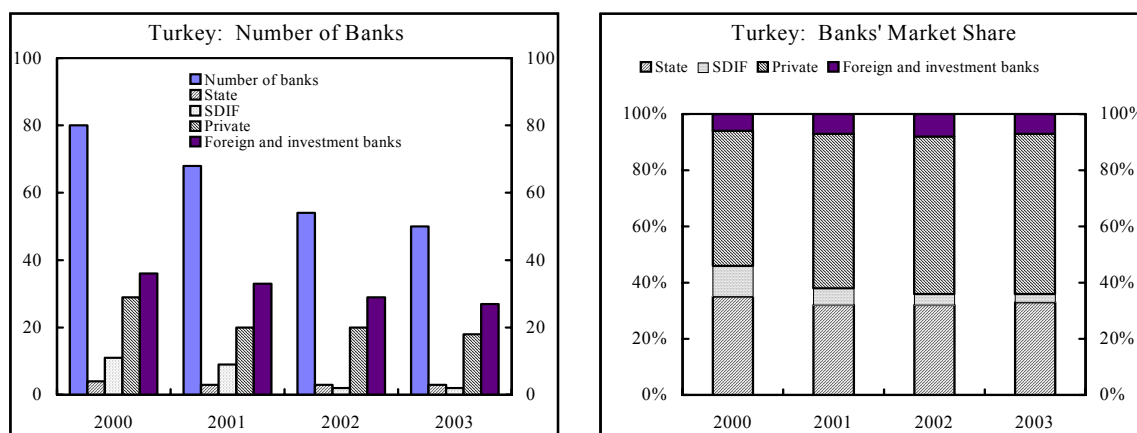
Banking system profitability (in percent)

	1998	1999	2000	2001	2002	2003
Return on assets (ROA)	1.9	-0.4	-0.8	-5.5	1.1	2.3
Private banks	2.8	3.8	2.3	-7.5	2.0	2.1
State banks 1/	0.5	1.0	-0.4	-1.2	1.6	2.2
SDIF banks	-19.0	-46.5	-17.9	-21.2	-18.0	3.8
Return on equity (ROE)	23.1	-7.2	-10.5	-69.4	9.3	16.0
Private banks	27.4	33.7	16.2	-97.9	15.9	13.9
State banks 1/	14.3	27.6	-16.1	-15.5	15.7	18.7
SDIF banks	...	...	...	...	-153.0	-32.1

1/ State banks include Ziraat, Halk and Vakif

41. The current and previous authorities, and the banking industry acknowledged that the above strategy was successful in substantially strengthening the system.

Banking practices and the regulatory environment had gone through a sea change over the last few years. The banking system was properly capitalized, bank profitability had been restored and NPLs were falling. There had also been a consolidation in the banking system with the number of banks reduced from 80 to 49. Despite intervention in some 22 private banks, other private banks had increased their market share such that the role of state and SDIF banks in the banking system had gradually declined since 2000.



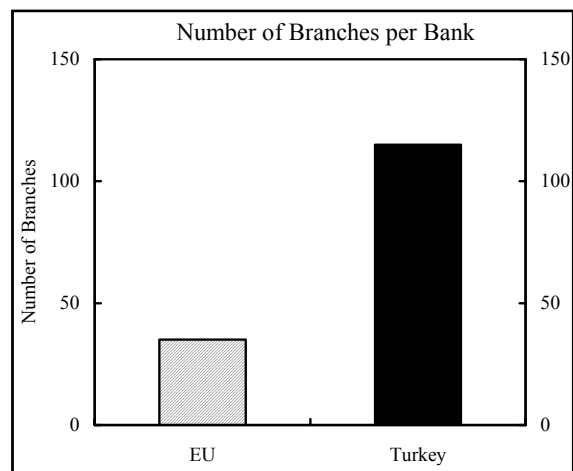
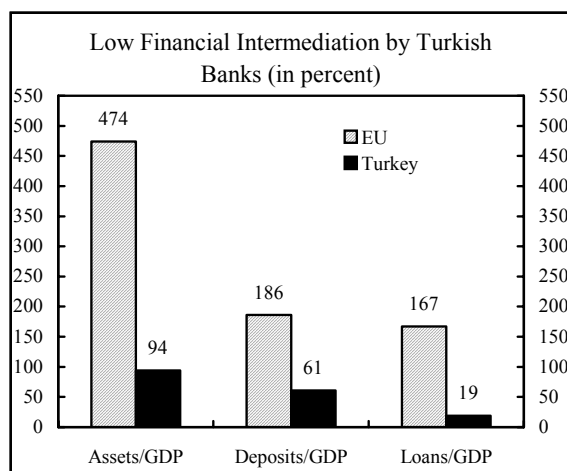
Source: Data from the Turkish authorities.

42. However, there was also broad agreement that while the initial pace of reform was dramatic, sustaining it and preserving its achievements had been challenging.

Although the regulatory framework had improved markedly, program conditionality had failed to recognize sufficiently early on deficiencies in the Banking Act and weaknesses in the judicial system. Former bank owners had been able to challenge BRSA decisions, long after their banks have been intervened and resolved, even in cases where the banks appear to have been clearly insolvent. Staff and board members of the SDIF and BRSA had

insufficient protection against law suits for actions performed while carrying out their duty. As a result, supervisors were unwilling or reluctant to make decisions, and asset disposition had been slow (since staff are potentially liable if assets are sold at too low a price). Resolution of bad assets, had been very disappointing and slow and, the staff thought, not sufficiently transparent. Failure to split the Boards of the BRSA and SDIF upfront, and lack of experienced staff with banking experience were also seen by the banking community as contributing to the above problems.

43. **Many in the banking industry also pointed to a number of remaining future challenges.** Financial intermediation in Turkey was very low compared to other countries. This was in part because of distortionary intermediation taxes, which the government was committed to reducing but only gradually given its fiscal impact. Macroeconomic volatility and Turkey's high debt also crowded out private lending in favor of government bonds. State bank assets consisted almost entirely of government securities, while the private banks also invested heavily in government paper. It was widely believed that Turkey was still over-banked and that further consolidation was inevitable, indeed desirable (see Chapter VIII of the Selected Issues paper). Increased foreign bank participation, which had already risen in the last three years, might facilitate this process. Further restructuring and eventual privatization of the state banks was another focus of discussions, with many arguing that the initial momentum of reform had been lost.



Tackling medium-term challenges

44. **The authorities agreed that the unfinished agenda of financial sector reform needed to be tackled forcefully over the next few years.** Although the 2000–01 financial crisis now seemed to have been successfully resolved, this came at the cost of a huge increase in the government debt, which had put a severe constraint on the conduct of economic policy and continues to raise concerns regarding debt sustainability. It thus needed to move more forcefully with a medium-term banking reform agenda. The staff and the authorities identified four key areas where further reform or an acceleration of reform was

needed: state bank restructuring and privatization, the supervisory regime, asset resolution, and reducing financial disintermediation.

45. **The mission stressed the importance of an ambitious but realistic strategy for moving the state banks to the private sector.** The staff indicated that the excess capitalization of state banks, together with their subsidized funding base and their lack of a clear profit motive distorted the competitive environment with private banks. The authorities explained that while the state banks have been restructured and were now profitable, a realistic assessment of whether and how they can be privatized is only now being made in the context of the World Bank's PFPSAL III loan and with the assistance of international consulting firms. They remained committed to privatization of Halk and thought that its integration with Pamuk, with its private sector culture, should facilitate this process. However, they thought that Ziraat's privatization was a more long-term objective given its size, its reliance on government securities, and the social role it played by having branches in rural areas. The staff emphasized that an arms length relationship between these banks and the government was the best way of ensuring their effective restructuring in the long run.

46. **While the supervisory environment had improved, the staff noted many shortcomings that needed to be addressed in the coming years.** The ambiguous relationship between the BRSA and the Sworn Bank auditors (which have the sole right to conduct on-site supervision) was also a problem, preventing off-site supervisors or outside technical expertise being brought in to examine banks. This artificial split in responsibilities was one of the factors that in the staff's view had contributed to the failure to detect the Imar bank scandal. The existing split in the supervision of banks (BRSA) and nonbank financial institutions (Treasury) remained a source of vulnerability, especially given the extensive interlinkages between corporates and financial intermediaries in Turkey. Supervision also needed to better enforce existing prudential requirements to ensure that banks have the appropriate risk management systems and capital cushions to withstand recent sharp movements in interest rates and exchange rates.

47. **The authorities were confident that many of these supervisory shortcomings would be addressed in the new banking law currently under preparation (Chapter IX of the Selected Issues).** They also saw the new law as an opportunity to clarify the responsibilities of the BRSA and the SDIF and provide adequate legal protection for their staffs in order to accelerate asset recovery. In this regard, the staff also noted that setting realistic price expectations and explaining these to the public, and transparent negotiations with former bank owners, were equally important. The authorities also noted that judging by recent court decisions, new legislation by itself might not be sufficient to ensure a predictable environment for banking. The new Banking Act will try to address some of the legal shortcomings that had led to recent court decisions against the BRSA but, ultimately, more far-reaching judicial reform may also be needed. However, this was an extremely sensitive and divisive issue that might best be undertaken with reforms needed to facilitate EU accession.

48. **There was broad agreement that distortions in the taxation of the financial system needed to be reduced further.** Intermediation taxes fundamentally undermined banking sector profitability, and encouraged banks to concentrate assets in government paper instead of extending loans. The taxes may also have reinforced dollarization and encouraged transactions to move off-shore where they can also escape regulation. The authorities emphasized that although the cost of these distortions was now more clearly recognized, fiscal constraints slowed their removal; nonetheless they remained committed to a phased reduction. There was also agreement that money and foreign exchange markets needed to be developed further in Turkey to facilitate improved risk management by banks. These markets were extremely thin in Turkey, with the CBT the primary counterpart to most transactions.

E. Sustaining Economic Growth by Strengthening the Investment Climate

49. **The authorities have made some progress in improving Turkey's investment climate.** Achieving macroeconomic and political stability has been foremost among these. Together with structural reforms, the creation of independent regulatory institutions and increased transparency had also helped. In addition, the 2003 Foreign Direct Investment Law established the principle of equal treatment for foreign and domestic investors, allowed foreign investors to purchase real estate, and streamlined investment procedures. Other actions include: a new government procurement law which limits supplies of Turkish origin to a 15 percent price preference, governance reform (for both civil servants and SEEs), and the inaugural Investment Advisory Council (IAC) meeting in March 2004.

Factors Determining Investment in Turkey 1/
(Percentage weight assigned to general categories)

Category	Weight (in %)
Political environment	25
Macroeconomic environment	19
Labor	17
Taxes/incentives	17
Infrastructure	12
Energy	8
Research and development	2
Total	100

1/ YASED (foreign investor association) survey results.

Turkey's Place in International Competitiveness Rankings

	Ranking	Percentile
UNCTAD FDI potential	86 (out of 140)	61
Hertie Foundation Index of Economic Freedom	106 (out of 152)	70
PRS International Country Risk Guide	101 (out of 140)	72
World Economic Forum Global Competitiveness Report	65 (out of 102)	64
IMD World Competitiveness Yearbook	55 (out of 60)	92
Transparency International Corruption Perceptions Index	77 (out of 133)	58
Turkey (median percentile ranking)		67
Bulgaria		49
Czech Republic		35
Hungary		30
Poland		40
Romania		67
Slovakia		40

50. **Despite this, further reforms were needed to improve the business environment.** Foreign direct investment is low, consistent with Turkey's poor ranking in several widely-used measures of international competitiveness. To address these concerns, the Investor Advisory Council advocated several reforms to improve the investment climate, including accelerated privatization, a clearer judicial framework, less red tape, more efficient customs, and bringing standards and regulations in line with the EU. The staff noted that a key test will be to ensure these recommendations are prioritized and acted upon. It would also be important to stick to rule-based decision making and to deal with these defects directly, rather than trying to compensate for them through distortionary and costly tax incentives.

51. **Progress in privatization has been disappointing.** From the outset, the program has stressed the importance of privatization as a test of the authorities' commitment to changing the way of doing business in Turkey. The focus of the program has been on bringing state enterprises to the point of sale (by improving management and developing privatization plans, often in conjunction with the World Bank) and on agreeing on realistic overall targets for privatization receipts, rather than requiring specific enterprises to be sold by a specific date. While the coalition government arguably failed this test, the new government's greater enthusiasm for privatization has not shown much success. All of the large-scale privatizations of the last year—PETKIM (sale to the Uzan group fell through), TEKEL tobacco unit (price rejected as too low), and TÜPRAŞ (overturned by the local Administrative Court)—have failed.

52. **Greater emphasis needs to be placed on judicial reform.** In particular, problems have arisen with the scope of judicial review of actions of the BRSA and SDIF concerning the banking sector and, more broadly, in the area of bankruptcy and commercial proceedings. On several occasions, administrative courts have overturned BRSA decisions with respect to insolvent banks relying on broad judicial review powers. These court actions make it difficult for BRSA to fulfill its supervisory mandate. The lack of judicial predictability is now extended to the government's ability to sell assets, bringing its privatization program into question. While the authorities have taken steps to address some of these problems in the recently adopted Bankruptcy Law and in the new draft Law on Credit Institutions, the authorities recognize the need for more fundamental judicial reform to support the functioning of Turkey's market economy, and they are of the view that such reform would best be undertaken as part of EU accession.

53. **Turkey will need to continue with tariff liberalization, particularly in the area of agriculture where barriers remain high.** Key challenges will be to resist pressures to raise tariffs closer to their binding limits, but also to avoid overuse of trade remedies such as anti-dumping, where the number of cases has risen rapidly (Box 4). Addressing these challenges will help maintain trade flows and improve the investment climate. The scheduled removal of quotas on clothing and textiles imports in 2005 (in Turkey as well as the U.S. and EU) will represent a significant liberalization of Turkey's import regime, and will be a challenge for low value added clothing exports to the EU and U.S. markets (Box 5).

54. **The authorities are also taking steps to improve the quality and transparency of their operations.** A new fiscal ROSC is likely to take place in 2005, once the Public Financial Management and Control Law is in effect. The authorities are also likely to request an FSAP in 2005, to take stock of the banking reforms made under the current program. Procedures against anti-money laundering had been reviewed twice (1994 and 1998) by FATF without any criticism and a third review is expected in 2006. A new law is expected to be passed before the end of the year to bring procedures in full compliance with new FATF regulations introduced last year. Macroeconomic statistics have some shortcomings, notably as regards coverage of the public sector, but are usually published in a timely fashion. Turkey subscribes to the Fund's Special Data Dissemination Standard (SDDS).

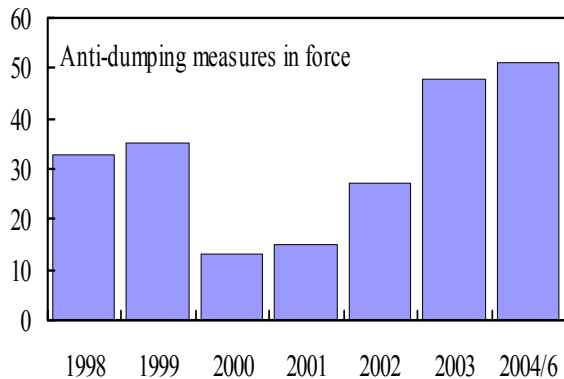
Box 4. Trade Policy—Recent Developments

Turkey’s trade policies are framed by commitments under World Trade Organization agreements and, since joining the EU customs union in 1996, the *acquis communautaire*. This box highlights selected trade policy issues discussed with the Turkish authorities.¹

Tariffs have remained stable since 1998. The tariff regime is generally liberal, with EU customs union and free trade arrangements with ECSC and EFTA covering about half of imports excluding basic agricultural products. However, agricultural goods, especially processed food, are highly protected owing to low agricultural productivity while tariffs on industrial products remain low. Average tariff protection increased slightly in 2004 reversing decreases in previous years. This likely reflected increased competitive pressures from a more appreciated exchange rate. Increases were focused on some agricultural products. The number of tariff spikes (lines with tariffs greater than 15 percent) continues to decrease. EU enlargement in May 2004 had no discernible on tariff preferences, as Turkey had FTAs with 8 of the 10 new members (all except Cyprus and Malta). The authorities have no plans for major changes of tariffs (or NTBs) in 2005.

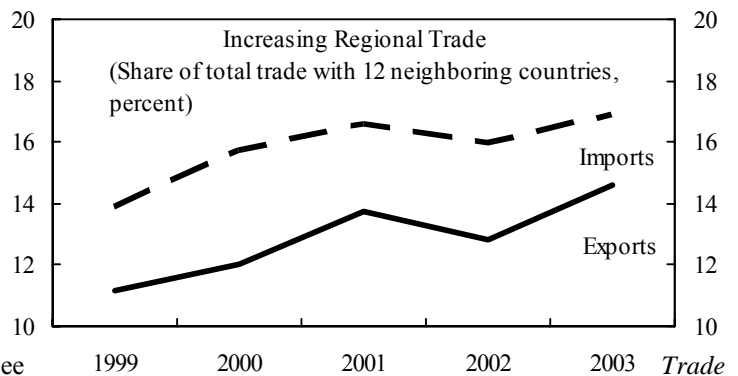
Structure of MFN Tariffs in Turkey (percent)

	1998	2003	2004
Simple average tariff rate	12.4	11.8	12.6
Industrial products tariff rate	5.3	4.4	4.2
Agricultural products tariff rate	53.1	55.4	55.6
Tariff peaks (>15 percent, share of all tariff lines)	16.7	15.5	14.7
Standard deviation of applied rates	23.4	25.8	27.2



The use of **anti-dumping measures is on the rise**, with 51 measures in force in mid-2004, one third against China. Turkey is ranked seventh in the WTO in terms of anti-dumping cases initiated in 2003. The authorities explained that these measures represent cases of material injury to domestic industry, and goods affected include yarns and fibers and manufactures (lighters, tires and tubes, etc.). The expanded use of anti-dumping may also be indicative of competitive pressures from exchange rate appreciation since 2002. Safeguard legislation was amended in May 2004 to bring it fully in line with the WTO agreement on safeguards. Turkey also faces 19 measures against exports, mostly for iron and steel products. These measures were later removed.

The authorities have made considerable efforts to **promote regional trade** focused on buyers missions and trade fairs. With the passage of UN Security Council resolution 1483 in May 2004, trade sanctions against **Iraq** were lifted. Trade has expanded quickly, reflecting close trade linkages before sanctions were imposed and exports are expected to reach US\$1.7 billion in 2004. With the border with **Armenia** closed trade flows are redirected through neighboring third countries.

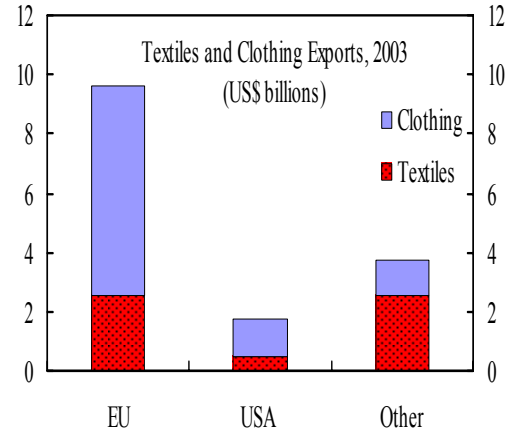
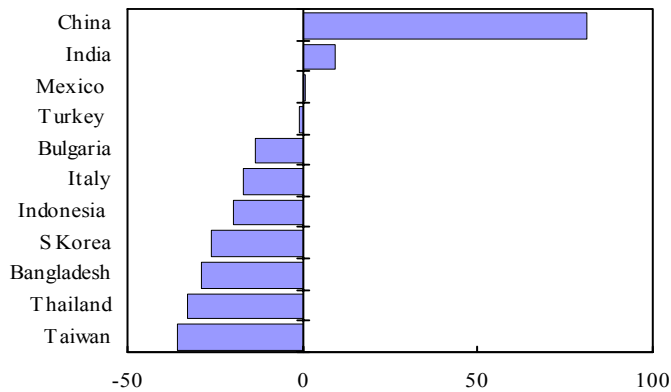


¹ For an in-depth description of trade-related legislation see *Policy Review Turkey, 2003*, World Trade Organization, WT/TPR/S/125.

Box 5. Textiles and Clothing—Implications of Quota Removal

The elimination of remaining U.S. and EU textiles and clothing quotas in January 2005 envisaged under the Agreement on Textiles and Clothing poses a significant challenge to Turkish exporters. 2003 Turkish textiles and clothing exports to EU and U.S. markets total US\$11.4 billion (4.7 percent GNP) in 2003. Significant price or volume reductions would have macroeconomic effects as well as dis-proportionately affecting employment owing to the labor-intensive nature of clothing production. In the U.S. market, Turkey will gain on product lines where its exports are presently quota constrained. But in the EU, Turkey already benefits from quota protection and will inevitably face price declines and volume reductions in mass market segments.

Change in U.S. Import Value 2002, for Clothing and Textiles Categories Where Quotas Eliminated (in percent)



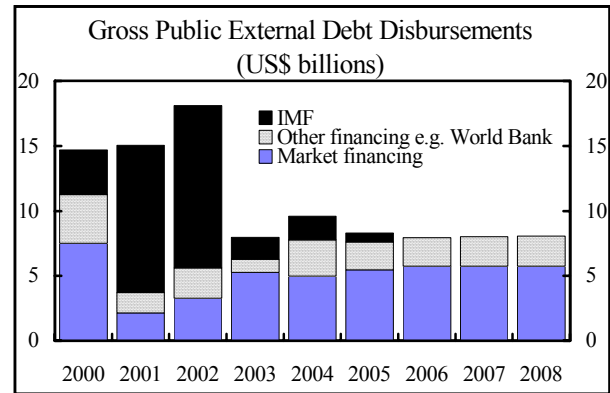
Lessons from the Phase III quota elimination in 2002 in the United States, which eliminated 15 percent of remaining quotas, suggest that gains (from elimination of constraining quotas) almost compensated losses (from unit price declines) for Turkey. U.S. imports from Turkey on products where quotas were removed fell 1 percent in value in 2002 against a total import value change of 2 percent, and rose 4 percent in volume. With 43 percent of 2003 U.S. imports from Turkey quota constrained (80 percent+ quota fulfillment), Turkey may well again hold its ground against low cost producers.

The challenge will be greater in the EU where Turkish exports are protected by quotas. Exporters will face price declines where they compete with hitherto quota constrained competitors, e.g. China, India, and Pakistan. Just over half Turkish exports of textiles and clothing are in quota constrained categories. Average price declines may amount to 5 percent, as experienced in the US in 2002. While price declines are likely to be much higher in the basic mass market segment, the effect is moderated by higher value lines less affected by quota removal (some 30 percent of Turkish clothing exports are in mass market segments). The extent of volume reductions will depend in large part on the cushion existing profit margins provide. As margins have been squeezed with TL appreciation, volume declines could amount to between 10 and 20 percent, or most of the mass market sector. Assuming textiles and clothing exports are similarly affected, the potential Turkish export loss with average prices down 5 percent and 10 percent volume declines amounts to US\$810 million, and with a 20 percent volume decline some US\$1,340 million. The higher end of these estimates corresponds to estimates of export losses of US\$1,316 million calculated by the American Textiles Manufacturers Association. While this will be a significant setback in 2005 and may cut GNP growth by 0.3–0.4 percent, the Turkish authorities believe that quota removal will accelerate the shift of production towards higher quality fashion items, higher margin own brand items, and that Turkey will retain the geographical advantage necessary for fast moving clothing items.

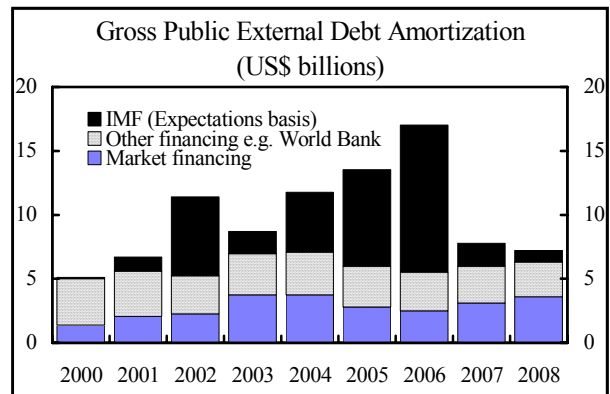
Turkey will also remove its own quotas on textile and clothing imports, which will lower prices in the domestic market. Quota constrained imports apply to 19 countries and amount to 13 percent of total textile and clothing imports. The authorities believe that quota removal will not have a destructive impact on the domestic market, while producer losses will likely be offset by consumer gains from lower prices.

V. FINANCING OUTLOOK: EXTERNAL AND GOVERNMENT DEBT

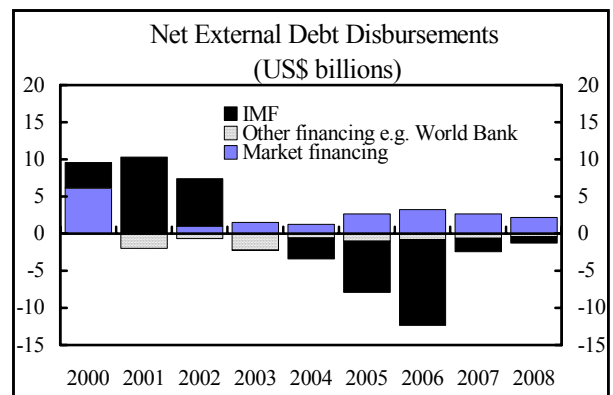
55. **The authorities were examining the financing outlook in an environment that was becoming more challenging.** They were well aware that markets were increasingly focusing on the financing outlook beyond the expiration of the program. Turkey’s medium-term external financing requirements were challenging because of the high current account deficit and increasing external debt payments (Tables 9 and 10). A coherent medium-term financing and macroeconomic framework was desirable not only to respond to this outlook but also to prepare for uncertainties ahead. Rising world interest rates and the possible reduction of flows to emerging markets made the financing picture uncertain, especially given Turkey’s significant reliance on short-term external financing. While the authorities were hopeful of a positive EU accession decision, and in fact the markets had already priced in a favorable outcome, this could not be taken for granted and added to financing uncertainties.



56. **The authorities financing scenarios pointed to a tight outlook.** These scenarios were of course highly sensitive to underlying assumptions such as private market access, FDI, privatization receipts, real interest rates, the primary surplus target, and external reserves build up.



57. **The authorities noted the role of increased net public sector external repayments—principally to the Fund—as a cause of the high rollover rates in 2005–06.** These public sector debt repayments required both higher domestic rollover rates and a drawdown of official foreign reserves from present levels. The authorities argued that relying on external market borrowing to address these financing constraints would be difficult given Turkey’s sub-investment grade rating and tightening liquidity in global financial markets. They also noted the possibility of requesting an extension of payments falling due to the Fund on an expectations basis in 2006; this would postpone almost US\$4 billion beyond the peak repayment period.



58. **While the staff acknowledged that the financing outlook was challenging, it also noted that the Fund's exposure to Turkey was extremely high** (accounting for some one-quarter of total outstanding credit). There was a need, therefore, to plan on significant net repayments to the Fund in the coming years now that the financial crisis was behind us.

59. **Against this background, the staff and authorities explored different avenues that could strengthen the financing situation.** The staff emphasized that the amount of market financing that Turkey could expect would depend on the perceived quality of policies. Strong policies could act as a catalyst for potential capital inflows and also enable Turkey to tap international capital markets more aggressively than currently projected. Correspondingly, a higher primary surplus would reduce the public sector borrowing requirement; and a more aggressive privatization program might help alleviate financing constraints, though progress here remained slow. If market conditions improved, the authorities could also over borrow domestically, reinstate their pre-announced foreign exchange purchase auctions, and move aggressively to extend maturities. A positive EU decision on accession negotiations could also boost financing prospects, although this could not be counted on.

60. **Given these complexities, it was agreed that discussions on relations with the Fund after the current program expires would need to continue.** The authorities, however, stressed that no decision had yet been taken on whether to approach the Fund for a successor program, but expected a decision to be taken by September, in tandem with work on the 2005 budget.

61. **While Turkey's debt sustainability outlook has improved in recent years, risks remain** (Appendix II—Debt Sustainability).

- The **standard debt sustainability analysis** continues to show that sustainability is reached in the baseline, and is robust to individual shocks, but that it could be jeopardized by a combination of large shocks. However, external financing needs are rising on account of the larger current account deficits and increasing external public repayments.

- Staff also presented **nonstandard debt sustainability analysis** to the authorities. Under a “sudden stop” scenario—which involves both the external and domestic sides—external capital flows decline, and the exchange rate depreciates to bring about the required adjustment in domestic savings. Real growth declines sharply, automatic stabilizers are allowed to operate, while real interest rates are driven higher as Treasury reliance on the domestic market increases. If the float is allowed to operate freely, and strict macroeconomic policies are preserved, the reserve position is safeguarded and external debt and reserve indicators improve modestly. The main impact would be expected to take place on the domestic financing side. Here, the debt burden increases, and would require strong policies to ensure that the situation remains manageable.

62. **Against this background, the authorities emphasized that the Treasury continues to improve the structure of its debt.** It has used favorable market conditions to lower the share of riskier foreign exchange debt from almost two-thirds at end-2003 to less than half, and has also lowered the proportion of floating rate instruments in its debt (see Chapter V of the Selected

Issues paper). Consistent with its internal risk analysis, Treasury intends to further reduce its reliance on domestic foreign exchange borrowing and floating rate notes.

63. **Nevertheless, Turkey's debt situation poses risks.** For a start, Turkey's debt burden remains high, in a situation where there are concerns that emerging markets may have over-borrowed given their vulnerabilities (see Chapter IV of the Selected Issues paper). The debt structure also remains risky: average maturities are low, and the share of foreign exchange and floating rate notes remains too high.

VI. STAFF APPRAISAL

64. **Economic performance since the last Article IV consultation has been impressive.** Growth has been sustained and rapid, while inflation has been lowered dramatically, reaching single digits. Large primary surpluses have reduced government debt ratios and improved market confidence. The result has been a significant reduction in real interest rates and an end to decades of continuous exchange rate depreciation. The economy has also become much more robust to shocks, with the Iraq conflict and the recent market turbulence having had only a limited adverse impact on economic performance.

65. **Despite these considerable achievements, Turkey's economy is still very vulnerable.** At the heart of this vulnerability lies the high public debt. Its short maturity and large foreign currency component make Turkey vulnerable to interest rate and exchange rate shocks. Recent market turbulence and concerns regarding a widening current account deficit are a reminder of these vulnerabilities. Related to this, the quality of the fiscal adjustment and the pace of structural reforms raises questions about the sustainability of the fiscal consolidation and growth prospects.

66. **The most pressing concern for the short run is that domestic demand may now be growing too rapidly.** Although this year's targets of 5 percent growth and 12 percent inflation should be met or exceeded, the authorities need to ensure that the rising current account deficit does not jeopardize macroeconomic stability. While these will help, it is not clear that the recent exchange rate and interest rate adjustment, the slowdown in consumer lending, and the reduction in tax incentives for new car purchases will slow domestic demand sufficiently.

67. **The authorities need to be ready to take additional policy measures to contain domestic demand.** With the inflation target on track and with fiscal dominance constraints, tighter monetary policy is unlikely to be appropriate. Instead, the authorities need to rely on fiscal and exchange rate policy. At a minimum, the authorities need to let the automatic fiscal stabilizers work and to over perform on the primary surplus targets, at least until the risks to the current account are clarified. Further tightening of the fiscal stance should not be ruled out if domestic demand continues to be strong. Incomes policy can also help, and while the authorities' efforts to restrain government sector wages have been helpful here, repeated increases in the minimum wage have not. Finally, the authorities need to continue to allow the exchange rate to adjust to contain the current account imbalance.

68. **To sustain growth over the medium-term, the authorities need to maintain their record of fiscal consolidation.** Fiscal consolidation—the move towards sustained high primary surpluses and greater prospects of ensuring debt sustainability—has been key to the improved economic performance of recent years, and will also be key to its continuation. The reduction in real interest rates that resulted has boosted growth. And the lessening in concerns over fiscal dominance has given the Central Bank greater freedom to follow a monetary policy that supports disinflation. The authorities should resist pressures to relax the primary surplus targets as any benefits are likely to be far outweighed by higher real interest rates, which will slow growth. Indeed, with considerable public sector debt repayments coming due in the next few years, continued high primary surpluses are needed to help forestall potential financing problems.

69. **Improving the quality and composition of the adjustment will be critical to sustaining this fiscal consolidation.** Though the authorities deserve credit for their fiscal consolidation, too often they have had to introduce temporary revenue measures and cuts in investment spending to pay for large increases in current spending—pensions and the minimum wage. This has exacerbated short-run demand pressures and constrained the budget's flexibility. Looking ahead, the authorities face an even steeper hill in sustaining this consolidation. As interest rates fall, revenues from intermediation taxes are set to decline; revenues from SEEs will fall as these firms are privatized; and plans for decentralization pose a risk to fiscal discipline. Although contribution rates are high, the social security system is in large deficit, and again faces the need for reform, while reform of tax administration is also needed to combat widespread tax evasion. To make room for increased capital and social spending in the coming years, the authorities will face the challenge of having to reduce current non-discretionary spending and to reform the tax system.

70. **A less discretionary environment for fiscal policy would also be helpful.** Too much attention has been given to *ad hoc* initiatives such as VAT cuts for selective sectors, tax holidays for preferred investments, amnesties for tax and social security arrears, adjusting excises to insulate the economy from changes in world oil prices, or increasing social spending beyond what had been agreed. This tendency towards discretion and short-run remedies rewards those that lobby for tax relief or directed spending, and undermines the long-term effectiveness and credibility of fiscal policy. Instead, the authorities need to consider a more fundamental reform of the tax system that reduces tax rates and simplifies the system for those that do comply.

71. **To guide fiscal policy over the next few years and ensure debt sustainability, the authorities need to adopt a multi-year debt reduction plan.** With financing conditions for emerging market countries such as Turkey susceptible to shocks, the medium-term aim should be to lower gross debt to pre-crisis levels, say, to the 40 percent average for EU accession countries. If debt dynamics diverge from the target, the primary surplus path would be adjusted to achieve the targeted reduction in debt. However, to maintain the pace of debt reduction under such a framework, there does not seem to be room to ease the 6½ percent primary surplus target. This should only happen once greater credibility of fiscal policy has been established and real interest rates have fallen on a sustained basis.

72. **Both the CBT and the government deserve credit for reducing inflation to single digits.** The CBT's skilful use of monetary policy has been central to this success, but so has fiscal discipline and public sector wage restraint. To continue the disinflation process, commitment to medium-term debt reduction through sustained primary surpluses and wage moderation remain critical, including for minimum wages. The CBT's independence also needs to be preserved and its monetary framework enhanced, by adopting more of the features of its ultimate objective—formal inflation targeting. As first steps, this could include giving the monetary policy council more of a role in advising the Governor on interest rate decisions, and timing these decisions to coincide with monetary policy council meetings.

73. **Foreign exchange intervention policy could also be improved.** Given the need to reduce vulnerability and to prepare for external debt repayments, the Treasury should have made greater use of last year's more favorable market conditions to build up reserves. On the CBT's side, a steadier and less reactive approach to the foreign exchange purchase auctions would have been less confusing to markets, and might also have limited the risks of a sharp exchange rate appreciation. Clearer mechanisms for sharing the costs of sterilizing foreign exchange purchases, including by the Treasury building up deposits at the CBT, could make intervention policy more effective.

74. **Confidence in the banking system is largely restored but formidable challenges remain.** Creation of an independent Banking Regulation and Supervision Agency, tightening of supervisory practices, introduction of the blanket guarantee, recapitalization and restructuring of the state banks, and the triple audit of the private banks have all strengthened the banking sector. However, weaknesses in the Banking Act and fundamental deficiencies in the court system have allowed former owners of insolvent banks to contest the loss of their banks and undermine the effectiveness of the supervisory regime.

75. **Financial sector reform needs to be tackled forcefully.** The first priority should be to monitor removal of the blanket guarantee, in particular developments in individual banks, and to have contingency plans ready in case weaknesses emerge. A realistic strategy for privatizing the state banks needs to be developed and, in the interim, distortions to competition with the private sector reduced. For the medium-term, the reform agenda needs to improve the environment for private banking. To improve banking supervision, the Sworn Bank auditors' exclusive right to conduct on-site supervision should be removed, leaving the BRSA free to send off-site supervisors or outside technical experts to examine banks. To boost profitability and to encourage diversification of assets, a clear timetable for removing tax distortions in the financial system needs to be established.

76. **Asset recovery and legal reforms also need to be pursued.** The SDIF should announce a clear timetable for future loan auctions, otherwise bidders will not be interested, and more realistic asset valuations prepared and presented to the public. The recent takeover of assets owned by former bank owners will prove difficult to resolve and the SDIF will need outside assistance if it is not to be overwhelmed. Consideration also needs to be given to legal reforms. This should include passage of a new Banks Act, more closely in line with EU standards, with appropriate "fit and proper" criteria for bank owners, legal protection of BRSA and SDIF staffs

and clear delineation of responsibilities between BRSA and SDIF. But more far-reaching judicial reform that ensures that judges who consider financial sector cases have sufficient expertise in the area and are aware of the systemic impact of the decisions they make, may also be needed.

77. **To allow the private sector—foreign and domestic—to spearhead economic growth, Turkey needs to further improve the investment environment.** While maintaining stable macroeconomic and financial conditions is critical here, other impediments also need to be tackled. Implementing rules fairly, strengthening the independence of regulatory institutions, and reforming the judicial system are all key to improving the business climate. The government should move ahead expeditiously to put in place the steps recommended by the inaugural Investment Advisory Council meeting in mid-March 2004. These reforms should also facilitate privatization of state assets, where the government's commitment is encouraging, but which has been undermined by the legal system. To turn this commitment into reality, the government will need to persevere in its efforts, ensure impeccable preparation to avoid legal challenges, and be ready to accept realistic market prices.

78. **Turkey faces an historic opportunity.** Macroeconomic conditions are the best they have been in decades. The government needs to show that, unlike in the past, this period of stability and hope is not followed by complacency and reversal. Instead, it needs to seize this unique opportunity to reduce vulnerabilities; press ahead with fiscal, financial, and structural reforms; and thereby put Turkey firmly on an irreversible path towards convergence with European economies.

79. **Finally, although the Fund-supported program has contained the key elements of success, there are also lessons for future program design.** Adoption of the floating exchange rate regime, comprehensive banking system restructuring, and maintenance of a high primary surplus through relentless, and often difficult, fiscal adjustment have all been essential for success. However, with the benefit of hindsight several aspects of the program might have been better formulated or sequenced. Inflation targeting may have been promoted too early, given concerns over fiscal dominance. Arguably, social security reform could have been included in the program at the outset; even if it was thought at the time that the 1999 reform would be sufficient to bring the deficit under control. Deficiencies in the judicial process and the Banking Act were also not recognized early enough. Many of these issues will need to be addressed as the authorities move ahead with economic reform.

80. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle.** However, this could be switched to a 24-month cycle if there is a successor arrangement.

Table 1. Turkey: Selected Indicators, 2000-05

	2000	2001	Projections			
			2002	2003	2004	2005
			(In percent)			
Real sector						
Real GNP growth rate	6.3	-9.5	7.9	5.9	5.0	5.0
GNP deflator	50.9	55.3	44.4	22.5	11.5	10.1
Nominal GNP growth rate	60.4	40.5	55.8	29.7	17.1	15.6
WPI (12-month, end-of-period)	32.7	88.6	30.8	13.9	14.2	8.0
CPI (12-month, end-of period)	39.0	68.5	29.7	18.4	12.0	8.0
Average nominal treasury bill interest rate	38.0	99.1	63.5	44.1	24.8	19.0
Average ex-ante real interest rate 1/	-9.5	35.5	30.3	28.6	12.8	12.1
			(In percent of GNP)			
Central government budget						
Primary balance 2/ 3/	4.6	4.8	2.4	5.0	5.0	5.0
Net interest payments 4/	15.8	24.7	17.5	16.1	13.6	10.4
Overall balance	-11.2	-20.0	-15.1	-11.1	-8.6	-5.3
Consolidated public sector						
Primary balance 3/	3.0	5.5	4.1	6.3	6.5	6.5
Net interest payments 5/	21.9	26.6	16.1	16.1	13.5	10.3
PSBR (including CBT profits)	18.9	21.1	12.0	9.8	7.0	3.7
Operational balance	-6.9	-4.7	-4.4	-4.8	-2.9	-1.0
Net debt of public sector	57.4	93.9	78.8	70.5	70.3	64.7
Net external	19.0	37.7	32.1	22.2	22.7	20.1
Net domestic	39.3	56.2	46.7	48.3	47.7	44.6
Net debt of public sector (in percent of centered GNP) 6	52.4	75.6	68.7	65.9	65.7	58.9
External sector						
Current account balance	-4.9	2.4	-0.8	-2.8	-3.6	-3.0
Gross external debt	59.0	79.0	72.1	61.8	53.2	51.2
Net external debt	38.8	53.8	54.6	45.1	40.7	39.7
Short-term external debt (by remaining maturity)	21.7	22.7	17.9	17.5	16.2	16.1
Monetary aggregates						
Seignorage 7/	1.8	1.1	1.0	1.2	1.4	0.5
Nominal growth of M2Y broad money (in percent)	40.2	87.5	25.4	13.0	20.8	13.5
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	3.3	2.8	0.5	0.3	3.0	3.0
Net external financing of central government	4.1	-2.3	-1.4	-1.4	-0.1	-0.3
Amortization	6.2	7.8	6.8	8.9	8.6	8.6
Gross borrowing	10.3	5.5	5.3	7.5	8.5	8.3
<i>Of which</i> : Eurobond issues	7.5	2.2	3.3	5.3	5.0	5.0
GNP	201.3	144.0	182.7	238.5	...	...
GNP (in quadrillions of Turkish lira)	125.6	176.5	275.0	356.7	417.6	482.8

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

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation. With average maturity of newly issued debt less than one year, and with FRNs paying quarterly coupons, this measure overstates the effective real interest rate when inflation is declining.

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

3/ For 2003 and 2004, program projections.

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

5/ Interest payments minus interest receipts plus CBT profits before transfers to the government..

6/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.

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

Table 2. Turkey: Balance of Payments, 2001–08 1/
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
Current account balance	3.4	-1.5	-6.6	-10.1	-8.8	-7.2	-7.7	-9.1
Trade balance	-4.5	-8.3	-13.7	-19.1	-18.8	-17.9	-18.9	-20.8
Exports (f.o.b.)	34.4	39.8	51.0	62.9	68.6	75.1	82.4	90.5
<i>Of which:</i>								
Exports (f.o.b.) in trade returns	31.3	35.8	47.1	58.6	64.4	70.9	78.1	86.2
Shuttle trade	3.0	4.1	4.0	4.3	4.3	4.3	4.3	4.3
Imports (f.o.b.)	-38.9	-48.1	-64.7	-82.1	-87.5	-93.0	-101.3	-111.4
<i>Of which:</i>								
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.2	-68.8	-87.2	-93.0	-98.8	-107.6	-118.4
Energy imports (c.i.f.)	-8.3	-9.2	-11.4	-14.5	-14.7	-14.5	-15.0	-15.7
Services and Income (net)	4.1	3.3	5.1	6.8	7.6	8.1	8.4	8.9
Services and Income (credit)	18.8	17.3	21.3	25.4	27.4	28.9	30.1	31.9
<i>Of which:</i>								
Tourism receipts	8.1	8.5	13.2	16.1	16.8	17.6	18.5	19.5
Services and Income (debit)	-14.7	-13.9	-16.2	-18.6	-19.8	-20.9	-21.7	-23.0
<i>Of which:</i>								
Interest	-7.1	-6.4	-6.9	-7.6	-8.4	-8.8	-8.9	-9.2
Private transfers (net)	3.6	3.0	1.7	1.9	1.9	2.0	2.1	2.2
Official transfers (net)	0.2	0.5	0.3	0.3	0.4	0.6	0.6	0.6
Capital account balance	-14.6	1.4	5.9	11.5	9.4	11.3	11.4	11.7
(including errors and omissions)	-16.3	1.3	10.7	11.7	9.4	11.3	11.4	11.7
Direct investment 1/	2.8	0.9	0.1	1.6	1.8	2.1	2.5	3.1
Portfolio investment in securities	-4.6	-1.2	1.2	2.3	1.6	1.3	1.5	1.7
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.7	1.6	2.4	2.0	1.7
Bonds (net)	0.1	1.0	1.5	1.2	2.7	3.2	2.6	2.1
Eurobond drawings	2.1	3.3	5.3	5.0	5.5	5.7	5.7	5.7
Eurobond repayments	-2.0	-2.3	-3.8	-3.7	-2.8	-2.5	-3.1	-3.6
Loans (net)	-2.0	-0.7	-2.2	-0.6	-1.0	-0.8	-0.6	-0.4
Loan disbursements	1.6	2.3	1.0	2.8	2.1	2.2	2.3	2.3
Loan repayments	-3.6	-3.0	-3.2	-3.3	-3.2	-3.0	-2.9	-2.7
Central Bank of Turkey, (Excl. reserve assets, liabilities)	0.8	1.4	0.6	0.1	0.0	0.0	0.0	0.0
Domestic money banks (net)	-9.4	-1.8	3.0	5.0	1.3	1.6	1.5	1.5
Domestic money banks (FX deposits abroad, -: accumulation)	0.9	0.6	0.7	2.1	-0.2	-0.3	-0.3	-0.3
Domestic money banks (other, net)	-10.3	-2.4	2.3	2.9	1.5	1.9	1.8	1.8
Other private sector (net)	-2.3	1.8	1.7	1.8	3.1	3.8	3.8	3.7
Other private sector (medium and long term, net)	0.3	2.7	1.5	2.4	2.3	2.8	2.8	2.9
Other private sector (short term, net)	-2.6	-0.9	0.2	-0.6	0.7	1.1	1.0	0.9
Errors and omissions 2/	-1.7	-0.1	4.8	0.2	0.0	0.0	0.0	0.0
Overall balance	-12.9	-0.2	4.1	1.5	0.5	4.2	3.7	2.6
Overall financing (NIR change excl. ST liabilities, + denotes decline)	12.9	0.2	-4.1	-1.5	-0.5	-4.2	-3.7	-2.6
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-1.5	-0.5	-4.2	-3.7	-2.6
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	1.3	6.3	7.3	-1.9	-1.8
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-2.8	-6.9	-11.5	-1.8	-0.9
Purchases	11.3	12.5	1.7	1.8	0.7	0.0	0.0	0.0
Repurchases	-1.1	-6.1	-1.7	-4.7	-7.6	-11.5	-1.8	-0.9

Table 2. Turkey: Balance of Payments, 2001–08 1/
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, incl. shuttle trade	2.4	-0.8	-2.8	-3.6	-3.0	-2.3	-2.3	-2.5
Trade account balance, incl. shuttle trade	-3.2	-4.6	-5.8	-6.8	-6.5	-5.8	-5.6	-5.8
Exports of goods and non-factor services	36.1	31.0	30.0	31.1	32.8	33.0	33.2	33.6
Imports of goods and non-factor services	32.2	30.6	31.0	33.1	34.1	33.8	34.1	34.7
Percent change								
Value growth in exports of goods (incl. shuttle trade)	11.9	15.8	28.1	23.3	9.1	9.4	9.7	9.9
Value growth in exports of goods (excl. shuttle trade)	12.8	14.1	31.6	24.6	9.8	10.1	10.2	10.4
Value growth in imports of goods	-26.8	23.7	34.5	26.7	6.6	6.3	8.9	10.0
Volume growth in exports of goods	16.6	11.7	16.3	14.8	10.1	10.7	9.9	9.5
Volume growth in imports of goods	-22.9	21.1	17.8	15.4	7.4	7.6	8.9	9.4
Terms of trade	1.7	0.0	-0.8	-1.2	0.5	0.7	0.4	0.3
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey)								
In billions of U.S. dollars	19.8	28.1	35.2	33.9	27.6	20.3	22.2	24.0
Months of goods & NFS imports	4.4	5.4	5.2	4.0	3.1	2.1	2.2	2.1
External debt (end-of-period)								
In billions of U.S. dollars	113.8	130.9	147.3	149.6	148.3	144.0	148.9	154.4
Percent of GNP	79.0	72.1	61.8	53.2	51.2	46.3	44.5	42.9
Percent of exports of goods & NFS	218.8	232.5	205.5	170.9	156.3	140.2	133.9	127.6
Net external debt (end-of-period) 3/								
In billions of U.S. dollars	77.5	99.1	107.5	114.3	115.1	106.2	107.1	109.7
Percent of GNP	53.8	54.6	45.1	40.7	39.7	34.1	32.0	30.4
Short-term debt (end-of-period)								
In billions of U.S. dollars	16.4	16.4	22.9	26.2	29.0	32.1	35.2	38.4
Ratio to end-period foreign reserves	82.6	58.4	65.1	77.2	104.9	158.3	158.7	160.1
Short-term debt plus MLT repayments								
In billions of U.S. dollars	32.7	32.5	41.8	45.4	46.6	49.4	53.7	57.9
Ratio to foreign reserves	164.7	115.4	118.8	133.9	168.8	243.5	241.9	241.6
Debt service ratio 4/	41.3	37.3	34.9	29.8	26.5	24.6	23.8	23.1

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

1/ Including privatization receipts.

2/ For 2004 includes reported data for January-March.

3/ Nonbank external debt less the NFA of the banking system.

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

Table 3. Turkey: Indicators of External Vulnerability, 2000–05 1/
(In percent, unless otherwise noted)

	2000	2001	2002	2003	Projections	
					2004	2005
CPI inflation (end year)	39.0	68.5	29.7	18.4	12.0	8.0
Public sector borrowing requirement (percent of GNP)	18.9	21.1	12.0	9.8	7.0	3.7
Net debt of the public sector (percent of GNP)	58.3	93.9	78.8	70.5	70.3	64.7
Export volume (percent change)	6.6	16.6	11.7	16.3	14.8	10.1
Import volume (percent change)	29.5	-22.9	21.1	17.8	15.4	7.4
Current account balance, in percent of GNP	-4.9	2.4	-0.8	-2.8	-3.6	-3.0
Capital account balance (in billions of US\$)	6.8	-16.3	1.3	10.7	11.7	9.4
Of which: Foreign direct investment	0.1	2.8	0.9	0.1	1.6	1.8
Foreign portfolio investment	-5.2	-4.6	-1.2	1.2	2.3	1.6
Gross official reserves, in billions of US\$ 2/	23.2	19.8	28.1	35.2	33.9	27.6
In months of imports of goods and NFS	4.0	4.4	5.4	5.2	4.0	3.1
In percent of broad money	27.4	26.8	34.4	32.6	30.1	22.8
Gross total external debt, in billions US\$	118.7	113.8	130.9	147.3	149.6	148.3
In percent of GNP	59.0	79.0	72.1	61.8	53.2	51.2
In percent of exports of goods and NFS	225.0	218.8	232.5	205.5	170.9	156.3
Gross short-term external debt, in billions US\$ 3/	43.7	32.7	32.5	41.8	45.4	46.6
In percent of gross total external debt	36.8	28.7	24.8	28.4	30.4	31.4
In percent of gross official reserves	188.4	164.7	115.4	118.8	133.9	168.8
Debt service 4/	36.9	41.3	37.3	34.9	29.8	26.5
REER appreciation (CPI based, period average)	11.1	-18.2	9.5	8.9	...	...
REER appreciation (CPI based, end of period) 5/	15.5	-21.2	5.0	13.4	1.4	...
Capital adequacy ratio 6/	17.3	15.3	25.3	29.6	...	...
State banks	7.9	34.0	50.2	59.8	...	...
SDIF banks	..	-17.8	-7.6	-9.6	...	...
Private banks	18.3	9.0	19.6	22.3	...	...
Foreign banks	29.4	41.0	48.4	54.9	...	...
Nonperforming loans (in percent of total) 6/	9.2	29.3	17.6	15.3	...	...
Real broad money, percentage change 7/	0.8	11.2	-3.3	-6.6	7.4	5.1
Real credit to the private sector, percentage change 7/	24.5	-27.5	-16.5	16.9	6.9	5.1
Banks' net foreign asset position, in billions of US\$	-5.8	2.4	3.1	2.0	...	...
Banks' net open exchange position, in billions of US\$ 8/	-5.4	-0.1	-0.4	-0.3	-0.5	...
Spread on Turkish dollar Eurobonds (in basis points) 9/	800	707	693	309	463	...

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

1/ For 2004-05, program projections.

2/ As of June 18, 2004, reserves stood at US\$34.0 billion (at actual exchange rates).

3/ By residual maturity.

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

5/ For 2004, as of May 2004.

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

7/ Deflated by the CPI.

8/ For 2004, as of June 18, 2004

9/ For 2004, as of June 21, 2004.

Table 4. Turkey: Medium-Term Scenario, 2000-09
(percentage change, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Real GNP	6.3	-9.5	7.9	5.9	5.0	5.0	5.0	5.0	5.0	5.0
Real GDP	7.4	-7.5	7.9	5.8	5.0	5.0	5.0	5.0	5.0	5.0
Real domestic demand	9.8	-18.5	9.3	9.3	6.7	4.3	4.3	5.1	5.4	5.4
Consumption	6.3	-9.1	2.5	5.6	6.4	3.8	3.9	4.6	4.6	4.6
Private	6.2	-9.2	2.1	6.6	7.5	4.4	4.3	5.0	5.0	5.0
Public	7.1	-8.5	5.4	-2.4	-3.0	-2.0	0.0	0.0	0.0	0.0
Fixed investment	16.9	-31.5	-1.1	10.0	12.2	8.8	8.0	8.0	9.2	9.2
Private	16.0	-34.9	-5.3	20.3	17.5	9.0	8.0	8.0	9.5	9.5
Public	19.6	-22.0	8.8	-11.5	-2.6	8.0	8.0	8.0	8.0	8.0
Change in stocks 1/	1.1	-4.0	7.1	3.0	-0.3	-0.3	-0.3	0.0	0.0	0.0
Exports	19.2	7.4	11.1	16.0	12.6	8.4	8.9	8.3	8.0	8.0
Imports	25.4	-24.8	15.8	27.1	14.6	7.1	7.5	8.7	9.0	9.0
Contributions to growth	7.4	-7.5	7.9	5.8	5.0	5.0	5.0	5.0	5.0	5.0
Real domestic demand	10.3	-19.8	8.8	8.9	6.6	4.3	4.3	5.0	5.3	5.4
Net exports	-3.0	12.4	-0.9	-3.1	-0.7	0.7	0.8	0.0	-0.4	-0.4
Statistical discrepancy	0.1	0.0	0.1	0.0	-1.0	0.0	0.0	0.0	0.0	0.0
Savings and investment (percent of GDP)										
Domestic saving	19.4	19.3	20.7	20.2	19.4	20.3	20.9	20.9	21.0	21.3
Foreign saving 2/	4.9	-2.4	0.8	2.8	3.6	3.0	2.3	2.3	2.5	2.5
Gross investment	24.3	17.0	21.5	23.0	23.0	23.3	23.2	23.2	23.5	23.8
Consumer prices										
Period average	54.9	54.4	45.0	25.3	11.8	10.3	6.4	4.5	3.5	3.0
End-period	39.0	68.5	29.7	18.4	12.0	8.0	5.0	4.0	3.0	3.0
Nominal GNP (in TL quadrillion)	125.6	176.5	275.0	356.7	417.6	482.8	539.2	591.4	642.4	694.8
Nominal GNP (in US\$ billion)	201.3	144.0	182.7	238.5	...	...	...	...	...	...

Sources: SIS; SPO; CBT; and IMF staff projections.

1/ Contribution to the growth of GDP.

2/ Balance of payments basis.

Table 5. Turkey: Public Sector Primary Balances, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
		Est.	Est.	Est.	Prog.	Projections with Reforms		
	(In trillions of TL)							
Public Sector	3,760	9,741	11,156	22,420	27,266	31,442	34,533	37,588
Central government 1/	5,831	8,420	6,644	17,954	20,985	24,274	26,648	29,497
Total revenue	30,346	44,766	63,369	90,445	104,425	116,306	126,227	136,738
Tax revenue	26,514	39,768	59,634	84,335	97,927	114,201	124,320	135,203
Direct taxes	10,849	16,080	20,077	27,800	29,920	33,473	34,782	37,257
Indirect taxes	15,665	23,687	39,557	56,535	68,007	80,728	89,538	97,946
Nontax revenue 1/	5,463	7,916	9,402	14,446	16,628	13,803	15,311	16,375
Tax rebates	-1,632	-2,918	-5,666	-8,335	-10,130	-11,697	-13,403	-14,841
Non-interest expenditure	24,515	36,346	56,726	72,492	83,440	92,032	99,579	107,240
Personnel	9,982	15,204	23,160	30,200	35,101	38,300	40,417	42,432
Other current	1,193	1,431	2,510	2,548	3,432	5,279	5,519	5,968
Defense and security	2,327	3,591	4,485	5,668	5,895	6,491	6,828	7,132
Transfers	8,763	12,218	19,289	26,911	32,113	32,824	36,208	39,617
Social security institutions	3,320	5,910	9,946	16,228	19,468	19,874	21,567	23,108
State enterprises and banks 2/	1,280	1,777	2,245	1,971	1,500	1,500	1,500	1,500
Agricultural subsidies	359	1,033	1,868	2,805	3,215	3,801	4,813	5,822
Other transfers	3,804	3,499	5,230	5,907	7,930	7,649	8,328	9,187
Investment	2,251	3,902	7,282	7,165	6,899	9,138	10,607	12,092
Rest of the public sector	-2,071	1,321	4,513	4,466	6,281	7,168	7,885	8,090
EBFs	-225	149	-249	390	49	0	0	0
Unemployment insurance fund	334	1,098	962	1,228	1,783	2,010	2,207	2,389
Local governments	-284	94	338	-153	0	0	0	0
SEEs	-1,920	149	3,139	2,487	4,099	4,697	5,217	5,241
Social insurance institutions	24	-170	-85	53	0	0	0	0
Revolving funds 3/	99	95	407	461	350	461	461	461
	(In percent of GNP)							
Public Sector	3.0	5.5	4.1	6.3	6.5	6.5	6.5	6.5
Central government 1/	4.6	4.8	2.4	5.0	5.0	5.0	5.0	5.1
Total revenue	24.2	25.4	23.2	25.3	25.0	24.2	23.6	23.5
Tax revenue	21.1	22.5	21.8	23.6	23.5	23.7	23.3	23.2
Direct taxes	8.6	9.1	7.3	7.8	7.2	7.0	6.5	6.4
Indirect taxes	12.5	13.4	14.5	15.8	16.3	16.8	16.8	16.8
Nontax revenue 1/	4.4	4.5	3.4	4.0	4.0	2.9	2.9	2.8
Tax rebates	1.3	1.7	2.1	2.3	2.4	2.4	2.5	2.5
Non-interest expenditure	19.5	20.6	20.7	20.3	20.0	19.1	18.6	18.4
Personnel	7.9	8.6	8.5	8.5	8.4	8.0	7.6	7.3
Other current	2.8	2.8	2.6	2.3	2.2	2.4	2.3	2.2
Transfers 2/	7.0	6.9	7.1	7.5	7.7	6.8	6.8	6.8
Investment	1.8	2.2	2.7	2.0	1.7	1.9	2.0	2.1
Rest of the public sector	-1.6	0.7	1.7	1.3	1.5	1.5	1.5	1.4
EBFs	-0.2	0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.6	0.4	0.3	0.4	0.4	0.4	0.4
Local governments	-0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
SEEs	-1.5	0.1	1.1	0.7	1.0	1.0	1.0	0.9
Social insurance institutions	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 3/	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Memorandum item:								
Social Security deficit (percent of GNP)	2.6	3.3	3.6 #	4.5	4.7	4.1	4.0	4.0

Source: Turkish authorities; and staff estimates.

Note: from end-2003 the figures include special revenues and expenditures. From 2004 the authorities have moved to the GFS 2001 classification.

1/ Excluding privatization proceeds, transfers from the CBT, and interest receipts.

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

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

Table 7. Turkey: Central Bank Balance Sheet, 2000-04 1/

	2000		2001		2002		2003		2004		
	Dec	Actual	Dec	Actual	Dec	Actual	Dec	Actual	Apr	Dec	
	Actual		Actual		Actual		Actual		Actual	Projected	
I. Central Bank Balance Sheet											
Net foreign assets	3.3	-12.7	3.9	8.8	8.0	10.7	8.0	8.0	9.2	12.8	10.7
Gross foreign assets	15.6	28.6	37.7	42.5	40.5	38.4	40.5	40.5	41.2	42.5	38.4
Gross foreign liabilities	12.3	41.2	33.8	33.6	32.5	27.7	32.5	32.5	32.0	29.7	27.7
International reserve liabilities	3.1	20.7	11.5	9.8	8.3	3.5	8.3	8.0	8.0	5.8	3.5
Other reserve liabilities 2/	4.9	10.1	13.2	14.5	14.9	14.9	14.9	14.9	14.9	14.9	14.9
Banks' FX deposits with CBT	4.3	10.4	9.1	9.3	9.3	9.3	9.3	9.3	9.0	9.0	9.3
Net domestic assets	2.5	20.6	6.5	6.0	9.0	10.2	9.0	9.0	8.5	7.7	10.2
Base money	5.8	7.8	10.4	14.9	16.9	20.9	16.9	16.9	17.8	20.5	20.9
Currency issued	3.8	5.3	7.6	10.7	11.6	14.7	11.6	11.6	13.0	14.8	14.7
Banks' lira deposits at the CBT	2.0	2.5	2.8	4.2	5.3	6.1	5.3	5.3	4.8	5.7	6.1
				(in billions of U.S. dollars)							
CBT gross international reserves	23.2	19.8	26.2	29.5	28.1	26.7	28.1	28.1	28.6	29.6	26.7
at current cross rates:	...	19.8	28.1	35.2	...	...	...	...	...	...	...
CBT gross international liabilities	18.3	28.6	23.5	23.4	22.6	19.2	22.6	22.6	22.2	20.7	19.2
CBT net foreign assets	4.9	-8.8	2.7	6.1	5.5	7.4	5.5	5.5	6.4	8.9	7.4
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	7.3	7.1	9.2	10.1	10.4	10.4	10.4	10.4	10.4	10.4	10.4
minus Dresdner one year deposits	0.6	0.7	1.4	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2
minus defence fund	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
CBT net international reserves	11.1	-2.9	10.0	13.6	13.3	15.2	13.3	13.3	14.2	16.7	15.2
Treasury net international reserves 3/	...	-1.3	-14.7	-14.2	-14.1	-15.8	-14.1	-14.1	-14.6	-15.2	-15.8
Net international reserves (Treasury plus CBT)	...	-4.2	-4.6	-0.5	-0.8	-0.5	-0.8	-0.8	-0.4	1.5	-0.5
				(in quadrillions of Turkish Lira, program exchange rate)							
Net foreign assets (Treasury)	...	-1.8	-21.1	-20.4	-20.3	-22.7	-20.3	-20.3	-21.0	-21.8	-22.7
Net foreign assets (Treasury plus CBT)	...	-14.5	-17.2	-11.6	-12.4	-12.0	-12.4	-12.4	-11.7	-9.0	-12.0
Net domestic assets (Treasury) 4/	...	1.8	21.1	20.4	20.3	22.7	20.3	20.3	21.0	21.8	22.7
Net domestic assets (Treasury plus CBT)	...	22.4	27.6	26.4	29.3	32.9	29.3	29.3	29.5	29.5	32.9
Base money (Treasury plus CBT)	...	7.9	10.4	14.9	16.9	20.9	16.9	16.9	17.8	20.5	20.9
Exchange rate (TL per US dollar, in millions)	0.67	1.44	1.63	1.40	1.31	1.44	1.31	1.31	1.44	...	...

Sources: Central Bank of Turkey; Fund staff projections. Although program targets for base money and NDA are five day averages, all

observations in this table are end of period.

1/ Except for 2000, all foreign currency aggregates are valued at end-December 2001 exchange rates (program exchange rates).

2/ Mainly Dresdner deposit liabilities.

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

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

Table 8. Turkey: Banking System—Selected Indicators, 1999-2004 1/
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
Banking System							
Total assets	79,763	117,649	179,675	212,681	225,097	249,693	255,974
Cash and claims on CBT	5,097	6,235	12,558	13,872	13,866	14,962	14,941
Claims on other banks	7,766	13,599	19,871	15,401	11,076	15,141	12,159
Securities portfolio	22,040	31,251	70,026	86,105	96,129	106,844	113,159
Loans, net	22,601	35,789	41,058	52,932	58,764	67,210	72,407
Other assets	22,258	30,775	36,162	44,371	45,261	45,536	43,308
Total liabilities	79,763	117,649	179,675	212,680	225,097	249,693	255,974
Deposits	48,272	68,143	110,298	137,973	141,872	155,312	158,756
Borrowing from banks	10,070	15,996	23,798	21,967	22,329	25,918	25,508
Repos	7,645	12,843	10,776	6,161	7,284	11,241	10,698
Other liabilities	9,539	12,207	20,527	21,351	21,077	21,683	22,134
Shareholders' equity (incl. profits)	4,234	8,461	14,276	25,228	32,534	35,539	38,878
Memorandum items:							
Capital adequacy ratio (%)	...	17.3	15.3	25.3	31.4	30.9	32.1
NPLs (%) total loans	9.7	9.2	29.3	17.6	13.8	11.5	10.2
Provisions (%) NPLs	61.9	59.8	47.1	64.2	77.5	88.5	89.8
Net profit (loss) after tax	-305	-888	-9,910	2,336	4,410	5,678	921
ROA (%)	-0.4	-0.8	-5.5	1.1	2.0	2.3	0.4
ROE (%)	-7.2	-10.5	-69.4	9.3	13.6	16.0	2.4
Share in assets (%)	100	100	100	100	100	100	100
Share in deposits and repos (%)	100	100	100	100	100	100	100
Private Banks							
Total assets	42,165	56,179	97,930	119,471	125,925	142,270	142,621
Cash and claims on CBT	2,707	3,362	8,434	9,356	9,140	9,868	9,488
Claims on other banks	5,386	9,769	10,494	7,623	5,255	6,369	5,420
Securities portfolio	14,335	13,491	27,146	39,819	44,471	51,485	50,174
Loans, net	12,445	19,587	26,506	35,752	40,729	46,402	49,759
Other assets	7,292	9,971	25,350	26,921	26,331	28,146	27,781
Total liabilities	42,165	56,179	97,930	119,471	125,925	142,270	142,621
Deposits	23,160	30,827	67,223	80,629	79,758	88,180	85,518
Borrowing from banks	6,508	10,045	15,585	13,703	16,080	18,158	18,141
Repos	4,654	3,918	1,803	4,074	4,396	8,103	7,870
Other liabilities	3,036	3,503	5,779	5,871	6,990	6,872	7,902
Shareholders' equity (incl. profits)	4,806	7,886	7,540	15,194	18,701	20,958	23,191
Memorandum items:							
Capital adequacy ratio (%)	...	18.3	9.0	19.64	23.5	23.5	24.7
NPLs (%) total loans	3.5	3.5	27.6	8.9	7.7	6.5	6.2
Provisions (%) NPLs	62.2	63.0	31.0	53.0	67.5	80.0	81.1
Net profit (loss) after tax	1,618	1,276	-7,383	2,410	2,024	2,917	772
ROA (%)	3.8	2.3	-7.5	2.0	1.6	2.1	0.5
ROE (%)	33.7	16.2	-97.9	15.9	10.8	13.9	3.3
Share in assets (%)	52.9	47.8	54.5	56.2	55.9	57.0	55.7
Share in deposits and repos (%)	49.7	42.9	57.0	58.8	56.4	57.8	55.1

Table 8. Turkey: Banking System—Selected Indicators, 1999-2004 1/
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
State Banks							
Total assets	27,104	40,655	57,583	67,831	76,140	83,134	89,335
Cash and claims on CBT	1,999	2,588	3,544	4,000	4,283	4,589	4,912
Claims on other banks	1,088	1,639	5,096	3,996	2,809	5,365	3,894
Securities portfolio	4,671	8,139	32,756	39,245	44,302	47,716	55,104
Loans, net	6,521	10,025	9,177	8,804	10,158	12,202	14,325
Other assets	12,825	18,265	7,011	11,786	14,589	13,263	11,099
Total liabilities	27,104	40,655	57,583	67,831	76,140	83,134	89,335
Deposits	19,204	27,606	37,258	48,489	55,115	59,862	66,098
Borrowing from banks	630	1,339	2,381	2,230	1,472	2,338	2,103
Repos	1,922	4,949	3,844	1,022	935	1,018	897
Other liabilities	4,317	5,659	9,707	9,343	9,633	10,342	9,825
Shareholders' equity (incl. profits)	1,031	1,101	4,393	6,747	8,986	9,574	10,411
Memorandum items:							
Capital adequacy ratio (%)	...	7.9	34.0	50.2	62.0	56.3	56.2
NPLs (%) total loans	9.1	11.1	37.3	37.4	31.9	26.2	23.5
Provisions (%) NPLs	35.1	30.3	63	74	86	98	97.8
Net profit (loss) after tax	284	-177	-681	1,056	1,471	1,790	182
ROA (%)	1.0	-0.4	-1.2	1.6	1.9	2.2	0.2
ROE (%)	27.6	-16.1	-15.5	15.7	16.4	18.7	1.7
Share in assets (%)	34.0	34.6	32.0	31.9	33.8	33.3	34.9
Share in deposits and repos (%)	37.8	40.2	33.9	34.4	37.6	36.6	39.5
SDIF Banks							
Total assets	5,480	12,912	11,035	9,310	6,919	7,075	6,825
Cash and claims on CBT	248	103	45	62	43	52	35
Claims on other banks	211	535	874	619	307	456	545
Securities portfolio	2,511	8,572	8,451	4,655	4,909	4,964	4,942
Loans, net	1,052	2,533	602	1,889	1,042	910	655
Other assets	1,458	1,169	1,064	2,085	618	693	647
Total liabilities	5,480	12,912	11,035	9,310	6,919	7,075	6,825
Deposits	5,363	8,827	3,566	5,770	4,190	4,133	3,994
Borrowing from banks	263	819	2,020	1,274	479	837	837
Repos	1,426	3,993	5,023	1,024	1,853	2,025	1,896
Other liabilities	968	1,329	814	2,338	1,164	927	995
Shareholders' equity (incl. profits)	-2,540	-2,056	-388	-1,096	-767	-847	-897
Memorandum items:							
Capital adequacy ratio (%)	...	...	-17.8	-7.6	-16.6	-21.6	-25.6
NPLs (%) total loans	61.9	41.4	67.3	69.4	58.1	53.8	28.6
Provisions (%) NPLs	75.3	80.3	89.1	60.5	70.8	75.4	67.9
Net profit (loss) after tax	-2547	-2314	-2,344	-1,677	321	272	6
ROA (%)	-46.5	-17.9	-21.2	-18.0	4.6	3.8	0.1
ROE (%)	...	...	...	-153.0	-41.8	-32.1	-0.7
Share in assets (%)	6.9	11.0	6.1	4.4	3.1	2.8	2.7
Share in deposits and repos (%)	12.1	15.8	7.1	4.7	4.1	3.7	3.5

Table 8. Turkey: Banking System—Selected Indicators, 1999-2004 1/
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
Foreign and Investment Banks							
Total assets	5,014	7,903	13,126	16,068	16,112	17,213	17,194
Cash and claims on CBT	143	182	535	454	400	454	506
Claims on other banks	1,082	1,657	3,408	3,164	2,706	2,951	2,300
Securities portfolio	523	1,049	1,673	2,386	2,448	2,680	2,939
Loans, net	2,583	3,645	4,773	6,487	6,835	7,695	7,668
Other assets	683	1,370	2,738	3,577	3,723	3,434	3,781
Total liabilities	5,014	7,903	13,126	16,068	16,112	17,213	17,194
Deposits	546	882	2,252	3,086	2,810	3,137	3,145
Borrowing from banks	2,670	3,792	3,812	4,761	4,298	4,585	4,427
Repos	-357	-17	105	40	100	95	36
Other liabilities	1,218	1,716	4,227	3,798	3,290	3,542	3,412
Shareholders' equity (incl. profits)	937	1,529	2,730	4,383	5,614	5,854	6,173
Memorandum items:							
Provisions (%) NPLs	31.3	51.8	81.2	69.3	84.8	85.5	86.0
Net profit (loss) after tax	340	328	498	548	594	698	-39.2
ROA (%)	6.8	4.1	3.8	3.4	3.7	4.1	-0.2
ROE (%)	36.3	21.4	18.2	12.5	10.6	11.9	-0.6
Share in assets (%)	6.3	6.7	7.3	7.6	7.2	6.9	6.7
Share in deposits and repos (%)	0.3	1.1	1.9	2.2	2.0	1.9	1.9

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

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

Table 9. Turkey: External Financing Requirements and Sources, 2000 -08
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Gross financing requirements	39.9	39.0	37.4	45.9	49.9	49.8	49.3	52.8	56.9
Current account deficit (excluding official transfers)	10.0	-3.2	2.0	6.9	10.5	9.3	7.8	8.3	9.7
Amortization on debt securities (bonds)	1.7	2.1	2.7	3.9	3.7	3.2	2.6	3.2	3.7
<i>Of which:</i>									
Public sector	1.4	2.0	2.3	3.8	3.7	2.8	2.5	3.1	3.6
Medium and long-term debt amortization (loans)	13.8	14.3	13.4	15.0	15.5	14.5	14.7	15.3	15.8
<i>Of which:</i>									
Public sector 1/	3.6	3.6	3.0	3.2	3.3	3.2	3.0	2.9	2.7
Short-term debt amortization	14.3	25.8	19.3	20.0	20.2	22.9	24.2	26.0	27.7
Public sector (net)1/	-1.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade credits 2/	20.2	17.9	17.9	22.3	23.5	24.2	25.5	27.3	29.0
Banks and other private (net)	-4.9	6.9	1.5	-2.3	-3.2	-1.3	-1.3	-1.3	-1.3
Available financing	39.9	39.0	37.4	45.9	49.9	49.8	49.3	52.8	56.9
Foreign direct investment (net)	0.1	2.8	0.9	0.1	1.6	1.8	2.1	2.5	3.1
Debt securities (bonds)	3.4	-1.7	4.2	7.9	7.6	8.1	8.3	8.3	8.3
Public sector	7.5	2.1	3.3	5.3	5.0	5.5	5.7	5.7	5.7
Medium and long-term debt (loans)	18.1	13.2	15.7	14.1	16.1	14.8	15.4	16.1	16.9
<i>Of which:</i>									
Public sector 1/	3.4	3.2	2.9	0.7	2.7	2.1	2.1	2.2	2.3
Short-term trade credits, currency and deposits	17.9	13.2	16.0	22.9	25.7	25.2	27.0	28.9	30.7
Official transfers	0.2	0.2	0.5	0.3	0.3	0.4	0.6	0.6	0.6
Other 3/	-2.8	-1.7	-0.1	4.8	0.2	0.0	0.0	0.0	0.0
Net reserves (+/- = decrease/increase)	3.0	12.9	0.2	-4.1	-1.5	-0.5	-4.2	-3.7	-2.6
Accumulation of gross reserves	-0.4	2.7	-6.2	-4.0	1.3	6.3	7.3	-1.9	-1.8
IMF (net)	3.4	10.2	6.4	-0.1	-2.8	-6.9	-11.5	-1.8	-0.9
Purchases	3.4	11.3	12.5	1.7	1.8	0.7	0.0	0.0	0.0
Repurchases	-0.1	-1.1	-6.1	-1.7	-4.7	-7.6	-11.5	-1.8	-0.9
Memorandum item:									
Net public sector financing (incl. IMF, excl. reserves)	9.4	10.2	7.8	-0.7	-1.9	-4.9	-8.5	0.8	1.4

1/ General government and Central Bank of Turkey.

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

3/ Errors and omissions.

Table 10. Turkey: Indicators of Fund Credit, 2000-08 1/

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Outstanding Fund credit (end of period)									
In billions of SDRs	3.2	11.2	16.2	16.2	14.3	9.6	1.9	0.7	0.1
In percent of quota	333	1,165	1,685	1,682	1,483	1,000	195	68	7
In percent of exports of G&NFS	8	27	37	32	24	15	3	1	0
In percent of GNP	2	10	12	10	7	5	1	0	0
In percent of public sector external debt	7	20	24	24	23	16	4	1	0
In percent of overall external debt	4	13	16	15	14	10	2	1	0
In percent of end-period foreign reserves	18	72	75	64	62	52	14	4	0
Repurchases of Fund Credit									
In billions of SDRs	0.1	0.9	4.9	1.2	3.2	5.1	7.8	1.2	0.6
In percent of quota	7	90	510	127	328	531	806	126	62
In percent of exports of G&NFS	0	2	11	2	5	8	11	2	1
In percent of GNP	0	1	4	1	2	3	4	1	0
In percent of public sector external debt service	1	9	36	11	27	39	51	14	7
In percent of overall MLT external debt service	0	5	22	6	15	23	32	7	3
In percent of start period foreign reserves	0	5	32	6	13	22	42	9	4
In percent gross public sector ext. financing 2/	0	22	21	7	19	39	43	7	4
Net Fund Resource Flows 3/									
In billions of SDRs	2.5	7.7	4.4	-0.7	-2.5	-5.4	-8.1	-1.3	-0.6
In percent of quota	259	798	455	-73	-258	-556	-844	-133	-64
In percent of exports of G&NFS	6	19	10	-1	-4	-8	-12	-2	-1
In percent of GNP	2	7	3	0	-1	-3	-4	-1	0
In percent of public sector external debt service	33	80	33	-6	-21	-41	-53	-14	-7
In percent of overall MLT external debt service	16	42	20	-4	-12	-24	-33	-7	-3
In percent start period foreign reserves	14	42	29	-3	-10	-23	-44	-9	-4
In percent gross public sector ext. financing 2/	18	193	19	-4	-15	-41	-45	-7	-4
						(In percent of total)			
Public debt to preferred creditors/public debt	13	27	32	31	...	...	...	...	...
Collateralized & securitized public debt/public debt	35	30	28	29	31	36	44	47	49
Debt service: public debt to preferred creditors/public debt	8	18	44	21	...	...	...	...	...
Debt service: collateralized & securitized public debt/public debt	28	30	24	40	38	29	25	50	57

1/ Projected on an expectations basis, except repurchase expectations on purchases made between February 2002 and July 2003 falling due in 2004-05 which are projected on an obligations basis.

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

3/ Net purchases less repurchases and charges.

Table 11. Turkey: Social and Demographic Indicators, 1998-2002

	Unit of Measurement	1998	2000	2002
Natural resources				
Area	Thousand sq. Km			769.63
Agricultural land	Percent of land area			31.4
Access to improved water sources	Percent of population			82.0
Human resources				
Total population	In millions	65.16	67.42	69.63
Urban population	Percent of population	64.9	65.8	66.6
Population growth	Percent per annum	1.77	1.69	1.59
Life expectancy at birth	Years	...	69.6	69.9
Infant mortality rate	Per thousand live births	...	38.0	35.0
Labor force (ages 15-64)	Millions	30.7	32.3	33.7
Health and education				
Physicians	Per 100,000 population	120	130	130
Child malnutrition	Percent of population under 5 years	8	...	8
Immunization rate	Percent of population under 12 months	81.0	85.0	78.0
Primary school enrollment	Percent of school age group	...	91.9	...
Secondary school enrollment	Percent of school age group	...	73.3	...
Illiteracy rate (age 15 and above)	Percent of population	16.2	13.5	14.0
Income and poverty				
GDP per capita (PPP basis)	US dollars annually	6,000	6,250	6,390
Share of top 20 percent	Percent of income	...	46.7	...
Share of bottom 20 percent	Percent of income	...	6.1	...
Population below poverty line	Percent of population	...	2.0	...

Sources: State Planning Organization; and World Bank, *World Development Indicators*.

TURKEY: FUND RELATIONS
(As of April 30, 2004)

I.	Membership Status: Turkey became a member of the Fund on March 11, 1947. It has accepted the obligations of Article VIII, Sections 2, 3, and 4 as of March 22, 1990.					
II.	General Resources Account:	Millions of SDRs	Percent of Quota			
	Quota	964.00	100.00			
	Fund holdings of currency	16,436.15	1,704.99			
	Reserve position in Fund	112.78	11.70			
III.	SDR Department:	Millions of SDRs	Percent of Allocation			
	Net cumulative allocation	112.31	100.00			
	Holdings	148.03	131.81			
IV.	Outstanding Purchases and Loans:	Millions of SDRs	Percent of Quota			
	Stand-by Arrangements	15,494.55	1,607.32			
	First credit tranche	90.38	9.38			
V.	Latest Financial Arrangements:					
	Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn	
				<u>In millions of SDRs</u>		
	Stand-By	02/04/02	02/03/05	12,821.20	11,460.40	
	Stand-By	12/22/99	02/04/02	15,038.40	11,738.96	
	<i>Of which:</i> SRF	12/21/00	12/20/01	5,784.00	5,784.00	
	Stand-By	07/08/94	03/07/96	610.50	460.50	
VI.	Projected Payments to Fund (Expectations Basis)¹					
	(In millions of SDRs; based on existing use of resources and present holdings of SDRs)					
		<u>Forthcoming</u>				
		2004	2005	2006	2007	2008
	Principal	2,190.17	5,158.07	7,556.20	595.42	85.05
	Charges/Interest	432.87	452.17	164.30	9.83	0.78
	Total	2,623.04	5,610.24	7,720.50	605.26	85.83

¹This 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				
	2004	2005	2006	2007	2008
Principal	284.38	5,225.57	6,930.55	2,463.95	595.42
Charges/Interest	449.34	547.50	267.22	44.46	9.53
Total	733.72	5,773.07	7,197.77	2,508.41	604.95

VII. Safeguard Assessments:

Under the Fund's safeguards assessment policy, the Central Bank of the Republic of Turkey (CBT) is subject to a full safeguards assessment with respect to the SBA arrangement, which was approved on February 04, 2002 and is scheduled to expire on December 31, 2004. A safeguards assessment was completed on April 4, 2002 and staff's findings and recommendations are reported in Section IV of IMF Country Report No. 02/137. The CBT authorities have implemented all of the measures recommended by staff.

VIII. Exchange Rate Arrangement:

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

Turkey has taken measures to implement **United Nations sanctions** that affect international payments and transfers and can give rise to exchange restrictions subject to Fund jurisdiction. In particular, Turkey has implemented financial sanctions against persons and entities associated with the Al-Qaida network, Usama bin Laden, and the Taliban. A list of the persons affected is published as Council of Ministers

²This 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.

Decrees by the Ministry of Foreign Affairs. Turkey will notify these measures shortly in accordance with Decision 144.

IX. Article IV Consultations:

The 2002 Article IV staff report (IMF Country Report No. 02/137) was issued on April 4, 2002, and the accompanying Statistical Appendix (IMF Country Report No. 02/138) was issued on April 8, 2002. Board discussion took place on April 15, 2002.

X. ROSCs

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 26, 2000	SM/00/139
Corporate Governance (prepared by the World Bank)	December 11, 2000	
Data ROSC	March 14, 2002	Country Report No. 02/55

XI. Technical Assistance: (1993–present)

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

Department	Timing	Purpose
MAE	October 1999	Banking sector reform
MAE	March 2000	Banking sector reform
FAD	April 2000	Fiscal transparency
FAD	April 2000	Tax policy
MAE	April 2000	Banking sector reform
MAE	May 2000	Banking sector reform
MAE	July 2000	Inflation targeting
STA	September 2000	Balance of payments statistics
MAE	Sept. 2000–April 2001	Banking sector reform
MAE	April 2001	Debt management
FAD/STA	May 2001	Fiscal accounting and reporting
MAE/RES	September 2001	Inflation targeting
STA	October 2001	Data ROSC
STA	April 2002	National accounts statistics
MAE/RES	April/May 2002	Inflation targeting
STA	July 2002	Public finance statistics
FAD	July 2003	Social security
FAD/MFD	September 2003	Taxation of Financial Intermediation Direct Tax Reform
MFD	December 2003	Banking legislation

Department	Timing	Purpose
FAD	December 2003	Informal sector and tax administration reform
MFD	March 2004	Currency reform
STA	April 2004	Consumer and wholesale price indices
STA	May 2004	National account statistics
FAD	May 2004	Public expenditure analysis

TURKEY: ASSESSING DEBT SUSTAINABILITY

This Appendix analyzes public sector debt and external sustainability and considers the impact of several shocks proposed as part of the debt sustainability framework. Although domestic and external debt sustainability can be achieved even under a range of plausible shocks, a combination of large shocks could jeopardize this. A nonstandard test involving a sudden stop of external capital flows would likely be manageable, as long as good policies remain in place. Any prolonged deviation from sound policies could, however, undermine Turkey's public debt sustainability.

Public sector debt sustainability

1. **Under the program's baseline projections, Turkey's public sector debt ratio declines substantially over the medium term** (Table 12). Turkey's public debt burden has fallen sharply in 2002–03 from its end-2001 peak of 94 percent of GNP. Helped by strong fiscal performance, declining real interest rates, the recovery of economic growth, and above all, by the appreciation of the real exchange rate, Turkey's net public sector debt stock is estimated to have fallen to about 71 percent of GNP at end-2003. Although still high, public debt is set to decline even further under baseline projections—to 58 percent of GNP by 2009 (modestly higher than Seventh Review projections given the recent real exchange rate weakening).
2. **For the purposes of the debt sustainability exercise, assumptions remain broadly unchanged from recent reviews.** Specifically, it is assumed that annual economic growth will be 5 percent over the medium term, the primary surplus will reach 6.5 percent of GNP each year, and average real interest rates on domestic debt will remain at above 17 percent. (Real interest rates are currently about 15 percent.) The real exchange rate path is, however, slightly weaker, reflecting recent currency movements.
3. **The standard alternative scenario tests continue to show that Turkey's public debt burden is manageable under a variety of scenarios, but setting key parameters to their historical averages gives rise to an unsustainable debt burden over the medium term** (Table 12, panel A).
 - **Turkey's public debt ratios continue to remain manageable under the standardized fiscal and growth shocks.**
 - **Using macroeconomic assumptions from consensus economic forecasts results in a decline in debt ratios.** As a rough metric against which to test the staff's projections, the Eastern Europe Consensus Forecasts and selected market analysis was used to simulate Turkey's public debt path over the medium term. Although, when the conservative DSA interest rate assumptions are imposed, these are somewhat more pessimistic than staff's baseline projections—with assumed primary balances of 5½ percent over the medium term—our simulated consensus projections still show Turkey's debt burden declining over the medium term.

- **A repeat of Turkey’s historical economic performance would, however, leave the debt path unsustainable.** With real GNP growth set at the average for the past ten years (2½ percent), a primary surplus of 3½ percent of GNP (about half of current targets), and the real benchmark bond rate set at 24 percent (about 10 percentage points higher than current levels), Turkey’s debt ratio increases to more than 100 percent in 2009. This scenario continues to show that a combination of poor fiscal performance, low growth and high interest rates would produce an unsustainable path for public debt.

4. **The standardized bound tests show that, while Turkey would be in a position to cope with individual shocks, a combination of large shocks would undermine sustainability** (Table 12, panel B). Individual shocks relating to fiscal balances, depreciation and contingent liabilities show manageable debt ratios over the medium term. However, the debt burden increases to more than 95 percent under both the interest rate and growth shock scenarios. As might be expected, the combined shock shows a clearly unsustainable debt position, with the debt burden rising to more than 125 percent of GNP over the medium term.

External debt sustainability³

5. **The broad picture of external debt sustainability has slightly weakened since the Seventh review under the program principally reflecting a reversal of confidence (Figure 6).** A 10 percent real depreciation relative to the program path during April–May 2004 as well as a modest increase of the projected current account deficit path has pushed up the debt-to-GNP ratio by some 5 percentage points of GNP to 53 percent, and modestly raised gross financing requirements.

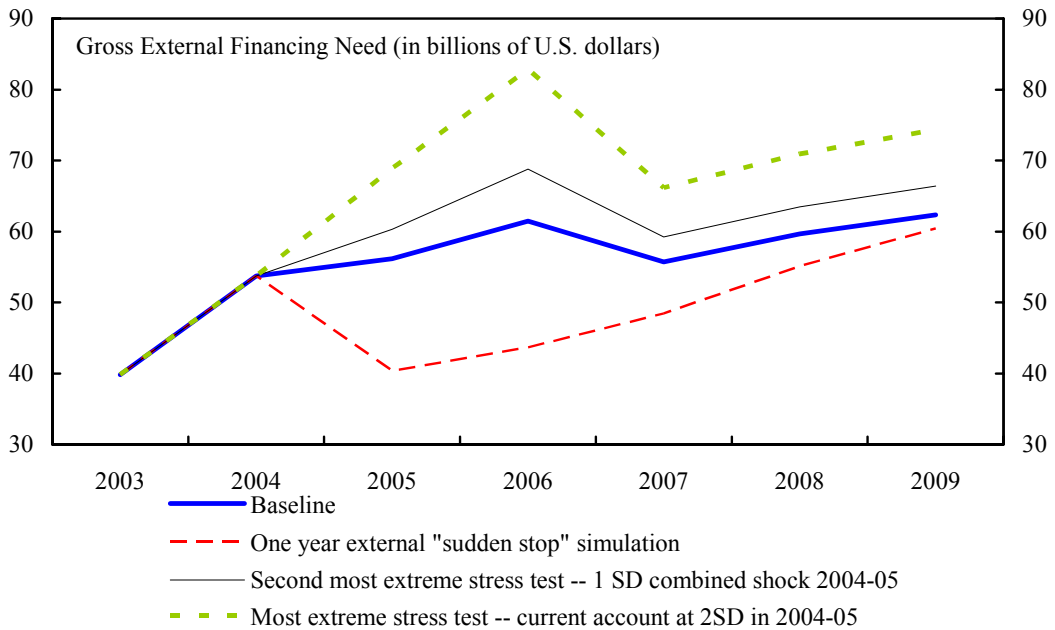
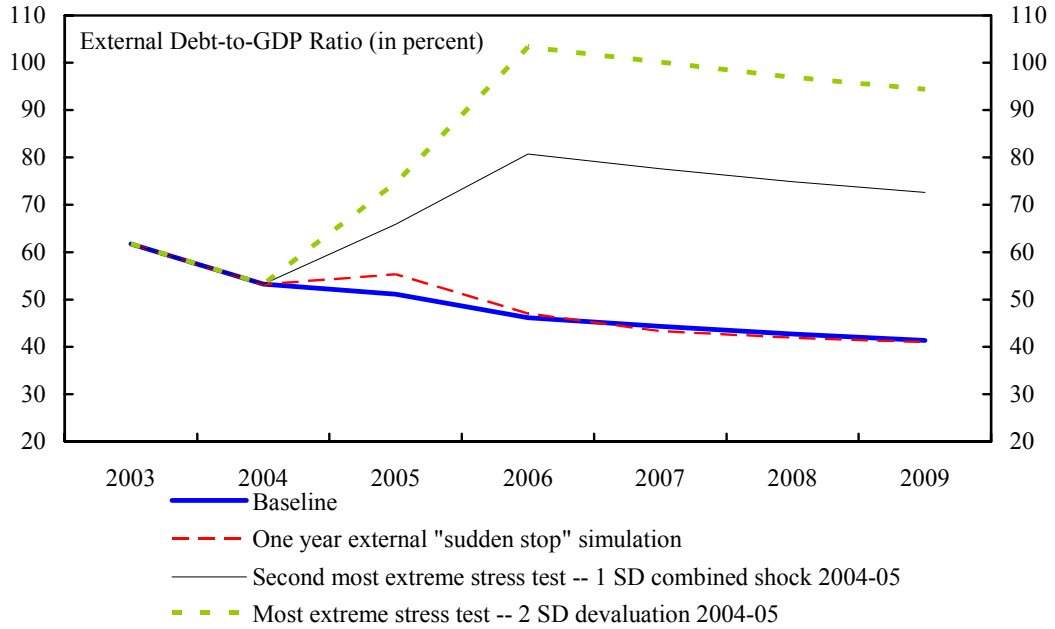
6. **External debt remains vulnerable to extreme standardized shocks.** The historic volatility of macroeconomic indicators mean that the “standardized” bound debt sustainability tests are particularly demanding in comparison to most countries. Notwithstanding high historical vulnerability, the debt ratio is fairly robust over the medium term to two-year two standard deviation shocks to the current account balance, interest rates, and GNP growth, and to a once-off permanent shock of 30 percent nominal depreciation. More extreme combined shocks and two standard deviation shocks to the exchange rate would significantly test debt sustainability.

Tailored test for both external and domestic debt sustainability

7. **A “sudden stop” tailored test illustrates the effect that temporary closure of international capital markets to Turkey might have on both external and domestic debt**

³ External debt in general refers to current, noncontingent claims by non-residents on residents usually in the form of loans, bonds, leases etc. For the purpose of this analysis it is assumed that: (i) securities issued abroad, e.g., Eurobonds, are held by non-residents; (ii) domestically issued securities denominated in foreign currencies are held by residents.

Figure 6. Turkey: External Debt Ratio and Gross External Financing Need, 2003-08



Source: Fund staff estimates and projections.

(Tables 12 and 13, lower panels, see footnotes for further details).⁴ In this scenario it is assumed that adverse global liquidity developments result in the temporary closure of public international bond borrowing in 2005 and a net outflow of short-term bank and private sector financing. On the assumption that much of the high frequency trade financing would be unimpaired, this would reduce total external financing sources by about a quarter.

8. **Such a shock would likely affect the economy through multiple channels:** the exchange rate would weaken to strengthen domestic saving and pass-through effects would raise domestic inflation. Domestic interest rates (both nominal and real) would increase and growth would slow significantly. On the assumption that growth falls to zero, a 15 percent real depreciation (and higher nominal depreciation to offset higher inflation) would be required to bring about the required current account adjustment to offset the reduction in external financing sources. In subsequent years (2006 and 2007) growth recovers quickly, narrowing the output gap, financing flows return to the baseline scenario and the exchange rate depreciation is reversed.

9. **The impact of the sudden stop on external debt dynamics is modest.** This reflects both the forced reduction of external financing through the sudden stop itself, an assumed domestic adjustment and a quick reversal of the initial real exchange rate depreciation. Such an outcome depends crucially on both the parameters of the scenario and the authorities' policy reaction. Notably, if short-term financing were to weaken even further, in a re-run of the 2001 crisis when net bank financing was cut by some US\$10 billion, the required exchange rate correction would be even larger and the impact on debt sustainability correspondingly greater. However, providing the exchange rate adjusts promptly (in contrast to the earlier crisis) and does not overshoot, it seems reasonable to assume a much weaker reaction from private creditors, as the external financing situation would be relatively quickly be brought into balance.

10. **The impact on domestic debt dynamics would be stronger, but likely remain manageable.** With lower external public financing increasing Treasury's reliance on shallow domestic financial markets, real interest rates would be expected to come under pressure, especially in the first year of the shock. Assuming automatic stabilizers are allowed to work, lower growth and the resulting temporarily lower primary surpluses also add to the domestic debt burden. The end result is that while public debt jumps to almost 80 percent of GNP by end-2006, it stabilizes at this level. Again, the impact of the sudden stop under this scenario depends critically on the policy response, especially on the maintenance of fiscal discipline.

⁴ Previous tailored tests illustrate that Turkey's public debt burden leaves it vulnerable to shocks, especially if policies are allowed to slip (see IMF Country Report No. 04/227, Appendix II, April 2, 2004).

Table 12. Turkey: Public Sector Sustainability Framework, 1999-2008

	Projections											
	t-5	t-4	t-3	t-2	t-1	t	t+1	t+2	t+3	t+4	2008	
I. Baseline Medium-term Projections												
2 Public debt/GNP (staff baseline)	61.0	57.5	91.0	78.7	70.5	70.3	66.5	63.0	60.9	59.5		
3 Change in public debt/GNP	17.3	-3.6	36.5	-15.1	-8.3	-0.2	-3.8	-3.5	-2.1	-1.4		
4 Net debt-creating flows/GNP (lines 5+8+11)		-1.6	1.0	-11.0	-9.0	-2.8	-2.8	-3.4	-3.1	-2.7		
5 Primary deficit/GNP	2.0	-2.4	-5.6	-4.1	-6.0	-6.5	-6.5	-6.5	-6.5	-6.5		
8 Minus net non-debt creating inflows/GNP		-0.8	-3.4	-1.8	-1.1	-1.0	-1.1	-1.0	-1.0	-0.9		
9 Change in reserve money/GNP		0.8	1.4	1.5	1.1	0.7	0.6	0.5	0.5	0.4		
10 Privatization receipts/GNP		0.0	1.9	0.3	0.1	0.4	0.5	0.5	0.5	0.5		
11 $(r-g-(\pi+gpi))/(1+g+\pi+gpi)$ debt/GNP (lines 13/12)		1.6	10.0	-5.1	-1.8	4.7	4.8	4.1	4.4	4.8		
12 Adjustment factor: $1+g+\pi+gpi$		1.6	1.4	1.6	1.3	1.2	1.2	1.1	1.1	1.1		
13 $(r-g-(\pi+gpi)$ debt/GNP (lines 14+15+16)		2.6	14.0	-8.0	-2.3	5.5	5.6	4.7	4.9	5.2		
14 r (interest rate) times debt/GNP		39.6	37.4	44.5	21.1	17.6	16.6	13.6	12.0	11.5		
15 minus g (real GNP growth rate) times debt/GNP		-3.8	5.4	-7.5	-4.6	-3.5	-3.5	-3.3	-3.2	-3.0		
16 minus $(\pi+gpi)$ (π = GNP deflator, growth rate) times debt/GNP		-33.2	-28.8	-45.0	-18.8	-8.5	-7.5	-5.6	-4.0	-3.2		
17 Residual, incl. change in assets/GNP (lines 3-4)		-2.0	35.5	-4.2	0.7	2.6	-1.0	-0.1	1.0	1.2		
Key Macroeconomic and Fiscal Assumptions												
Real GNP growth		-6.1	6.3	-9.4	7.9	5.9	5.0	5.0	5.0	5.0		
Nominal GNP deflator (in local currency, change in percent per year)		55.8	51.2	55.3	44.4	22.5	11.5	10.1	8.0	6.0		
Effective nominal interest rate on government debt		106.2	38.0	99.1	63.5	29.3	24.2	25.6	21.5	19.4		
Benchmark bond rate		36.4	-11.2	37.9	33.5	29.2	17.2	18.2	17.6	17.0		
memo: Ex-ante real rate (using GNP deflator) 1/			112.1	32.7	7.3	6.2	21.4	13.9	12.4	12.4		
Nominal TL rate on dollar debt			8.0	8.0	8.0	7.0	7.0	7.0	7.0	7.0		
memo: Nominal dollar rate on dollar debt			36.3	50.7	60.9	52.5	44.9	42.7	39.0	37.0		
Share of FX-linked debt (average)			6.1	14.5	5.5	11.4	12.5	12.6	13.1	13.3		
Effective real interest rate on government debt (using GNP deflator)												
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2004-08 2/						76.4	80.5	85.5	93.4	103.7		
A2. Primary balance under no policy change in 2004-08						70.8	67.5	64.5	63.0	62.2		
A3. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation						84.2	81.3	78.7	77.8	77.6		
A4. Selected variables are consistent with market forecast in 2004-09 3/						71.3	68.6	66.2	65.4	65.3		
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005						76.9	87.8	93.7	93.8	94.9		
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						84.2	97.9	96.3	96.6	97.9		
B3. Primary balance is at zero in 2004 and 2005						76.8	80.0	77.3	76.2	76.0		
B4. Combination of B1, B2, B3 using one standard deviation shocks						88.5	112.3	117.6	119.4	122.5		
B5. One time 30 percent real depreciation in 2004						80.6	75.3	75.0	73.5	73.0		
B6. 10 percent of GDP increase in other debt-creating flows in 2004						80.3	77.2	74.4	73.1	72.6		
C. Tailored Tests												
C1. Sudden stop: real depreciation, higher real interest rates, lower growth and smaller primary surplus. 4/						70.3	79.5	75.8	76.9	79.4		

Sources: Data provided by the Turkish authorities; Fund staff estimates; Consensus Economics Inc.

1/ Real interest rate assumptions used for 2005-2008 include safety margin.

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

3/ Assumes growth of 5.0 % and primary balances of 5.5% of GNP over medium term. Real interest rates are assumed to be those in the program as consensus forecasts of interest rates are now close to those of program.

4/ Assumes zero growth in 2005, 3% in 2006 and 7% in 2005; a primary surplus of 4.5% of GNP in 2005 and 5.5% of GNP in 2006, returning to 6.5% of GNP in 2007; a 15 percentage point real interest rate increase in 2005 and a 10 percentage point increase in 2006; and a 15% real depreciation in 2005 followed by a recovery in 2006-07.

Table 13. Turkey: External Debt Sustainability Framework, 2001-09
(In percent of GNP, unless otherwise indicated)

	Actual			Projections						Debt-stabilizing non-interest current account 7/
	2001	2002	2003	2004	2005	2006	2007	2008	2009	
External debt										
Change in external debt	79.0	72.1	61.8	53.2	51.1	46.2	44.3	42.7	41.4	-0.8
Identified external debt-creating flows (4+8+9)	20.1	-7.0	-10.3	-8.5	-2.1	-5.0	-1.8	-1.6	-1.3	
Current account deficit, excluding interest payments	19.2	-15.8	-14.8	0.3	-0.8	-1.4	-1.3	-1.1	-1.2	
Deficit in balance of goods and services	-7.3	-2.7	-0.1	1.1	-0.2	-0.8	-0.7	-0.4	-0.4	
Exports	0.3	2.7	3.6	4.6	3.6	2.9	2.8	2.9	2.9	
Imports	36.9	31.4	30.3	31.4	33.1	33.4	33.6	34.0	34.3	
Net non-debt creating capital inflows (negative)	37.2	34.2	33.9	36.0	36.7	36.3	36.4	37.0	37.2	
Automatic debt dynamics 1/	-1.9	-0.2	-0.4	-0.9	-0.9	-1.0	-1.1	-1.2	-1.3	
Contribution from nominal interest rate	5.0	3.5	2.9	0.1	0.3	0.4	0.5	0.5	0.5	
Contribution from real GNP growth	7.9	-4.9	-3.2	2.7	2.9	2.8	2.6	2.6	2.5	
Contribution from price and exchange rate changes 2/	15.6	-11.5	-13.9	-2.6	-2.6	-2.4	-2.1	-2.1	-2.0	
Residual, incl. change in gross foreign assets (2-3) 3/	0.8	8.8	4.5	-8.8	-1.3	-3.6	-0.5	-0.5	-0.2	
External debt-to-exports ratio (in percent)	214.1	229.3	203.7	169.3	154.3	138.1	131.9	125.5	120.6	
Gross external financing need (in billions of US dollars) 4/	40.3	37.4	39.8	53.7	56.2	61.5	55.7	59.7	62.3	
in percent of GNP	28.0	20.6	16.7	19.1	19.4	19.7	16.6	16.6	16.1	
										Projected Average
Key Macroeconomic Assumptions										
Real GNP growth (in percent)	-9.5	7.8	5.9	5.0	5.0	5.0	5.0	5.0	5.0	5.0
GNP deflator in US dollars (change in percent)	-20.9	17.0	24.0	17.5	12.3	-1.9	2.3	2.4	2.5	3.4
Nominal external interest rate (in percent)	6.0	5.6	5.3	6.0	5.2	5.6	5.9	6.2	6.3	5.9
Growth of exports (US dollar terms, in percent)	-1.4	7.4	26.6	11.2	11.8	22.3	8.7	8.3	8.2	10.8
Growth of imports (US dollar terms, in percent)	-22.3	15.9	30.4	12.6	22.7	25.1	5.1	6.3	7.9	10.3
Current account balance, excluding interest payments	7.3	2.7	0.1	2.0	-1.1	0.2	0.8	0.7	0.4	0.2
Net non-debt creating capital inflows	1.9	0.2	0.4	0.7	0.9	0.9	1.0	1.1	1.2	1.1
A. Alternative Scenarios										
A1. Key variables are at their historical averages in 2004-08 5/										
A2. Country-specific shock in 2005, one year "sudden stop" scenario										
A3. Selected variables are consistent with market forecast in 2004-08										
B. Bound Tests										
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005										
B2. Real GNP growth is at historical average minus two standard deviations in 2004 and 2005										
B3. Change in US dollar GNP deflator is at historical average minus two standard deviations in 2004 and 2005										
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005										
B5. Combination of 2-5 using one standard deviation shocks										
B6. One time 30 percent nominal depreciation in 2004										

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

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

3/ For projection, line includes price and exchange rate changes

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

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

6/ The implied change in other key variables under this scenario is discussed in the text.

7/ Long-run, constant balance that stabilizes debt ratio assuming that key variables (real GDP growth, nominal interest rate, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year. Dollar deflator is assumed to be zero.

II. Stress Tests for External Debt Ratio

	2004	2005	2006	2007	2008	2009
Debt-stabilizing non-interest current account 6/	53.2	48.4	43.5	41.5	39.5	37.8
	53.2	55.3	47.0	43.3	41.9	41.0
	53.2	51.4	47.0	45.7	44.5	43.3

	2004	2005	2006	2007	2008	2009
Debt-stabilizing non-interest current account 6/	53.2	51.8	47.3	45.4	43.8	42.4
	53.2	59.8	63.3	61.1	59.0	57.3
	53.2	74.6	103.3	100.1	96.9	94.4
	53.2	55.0	54.4	52.5	50.7	49.3
	53.2	65.9	80.7	77.6	74.9	72.6
	53.2	65.2	59.0	56.9	54.9	53.3

STATISTICAL INFORMATION

1. Macroeconomic statistics have some important shortcomings, but are usually published in a timely fashion. Turkey is a subscriber to the Fund's Special Data Dissemination Standard (SDDS).

Real sector data

2. Data on wholesale and consumer prices are published monthly, with a very short lag. Monthly data on various production indices are published with lags of some five to six weeks, while quarterly national accounts are published with a three-month lag (although the second and third quarters are more timely—a 70-day lag). The State Institute for Statistics (SIS) publishes national accounts from the income side. Following technical assistance, an improved consumer price index and a new producer price index—replacing the old wholesale price index—are expected to be published in January 2005. Ongoing assistance is also helping to improve the quality of the national accounts.

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

Fiscal data

4. Budgetary data are published monthly, with a lag of some two to three weeks. However, the coverage of the budget is incomplete, with sizable fiscal operations conducted through extra budgetary funds, for which data are available only with long lags. Fiscal analysis is further complicated by the omission of certain transactions from the fiscal accounts; failure to account for sizable quasi-fiscal operations carried out by state banks and SEEs; and technical problems associated with consolidating the cash-based accounts of governmental entities with the accrual-based accounting of SEEs. The failure to assign a single agency responsible for fiscal statistics also creates reporting weaknesses. It is difficult to reconcile fiscal data with monetary and BOP data, especially in the accounting of external debt flows and central government deposits. Under the IBRD-financed Public Financial Management Project (PFMP), the authorities are to adopt an improved budget coding system, a chart of accounts, and a new debt management database.

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

Monetary data

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

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

External sector

8. In line with SDDS prescriptions Turkey disseminates

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

9. The central bank reports quarterly BOP data to STA with about four months lag.

10. The BOP is compiled in broad conformity with the conceptual framework of the *BPM5*. The CBT periodically reviews the bank's foreign exchange records to redress, to the extent possible, problems of coverage and misclassification. However, the banks' foreign exchange records need to be supplemented with estimation techniques and other sources.

Turkey: Core Statistical Indicators
(June 30, 2004)

	Exchange Rates 1/	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates 2/	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 3/	GDP/GNP
Date of latest observation	June 30	June 30	June 30	June 30	June 1	June 30	May 2004	Mar. 2004	Mar. 2004	Apr. 2004	Q1 2004
Date received	June 30	June 30	June 30	June 30	June 15	June 30	June 3	May 31	May 31	June 15	June 30
Frequency of data	Daily	Daily	Daily	Daily	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Daily	Daily	Daily	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of data	CBT Reuters	CBT	CBT	CBT	CBT	CBT Reuters	SIS Press release	SIS	CBT	TRE Press release	SIS Press release
Mode of reporting	Email	Email	Email	Email	Email	Email	Website	Website	Email	Fax	Website
Confidentiality		4/	4/								
Frequency of publication	Daily	Weekly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

1/ TRE=Undersecretariat of the Treasury; SIS=State Institute for Statistics; CBT=Central Bank of Turkey.

2/ Interest rates for overnight interbank transactions and treasury bill auctions are available on a daily basis; data on deposit interest rates are provided on an end-week basis, with the most recent data available being for November 26, 1999.

3/ Consolidated budget only; data on general government position is available only on an annual basis.

4/ Daily data on international reserves and reserve money are provided to the Fund on a confidential basis.

INTERNATIONAL MONETARY FUND

TURKEY

Eighth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criterion

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Liam P. Ebrill

July 16, 2004

- **Stand-By Arrangement.** The Fund supports Turkey's economic program for 2002-05 under an SBA approved in February 2002 and extended in April 2004. Total access under the arrangement is SDR 12.8 billion, or 1,330 percent of quota, of which about SDR 11.5 billion has been purchased so far (Appendix I). A further SDR 454 million becomes available on the completion of this review.
- **Discussions.** During June 3–22 the staff team met with Deputy Prime Ministers Gül, Şener and Şahin, State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Foreign Trade Minister Tüzmen, Industry Minister Coşkun, Labor Minister Başesgioğlu, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Chairman Ertürk, other senior officials, and representatives from the banking and business communities, and labor unions.
- **Staff.** Team members comprised Reza Moghadam (head), Mark Griffiths, Christian Keller and Donal McGettigan (EUR), Ernesto Ramirez Rigo (FAD), Maike Luedersen (LEG), John Austin (LEG consultant), Mats Josefsson (MFD), Chris Lane (PDR), Hugh Bredenkamp, Odd Per Brekk and Christoph Klingen (resident representatives), and Janet Shelley (administrative assistant, EUR). Levent Veziroglu (OED) attended most meetings.
- **Publication.** The Turkish authorities have not yet decided on the publication of this staff report. The Seventh Review staff report is expected to be published shortly but the authorities have decided not to publish the staff report for the Sixth Review.

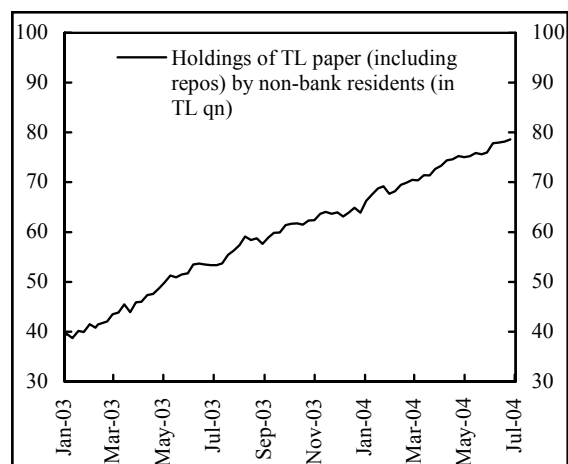
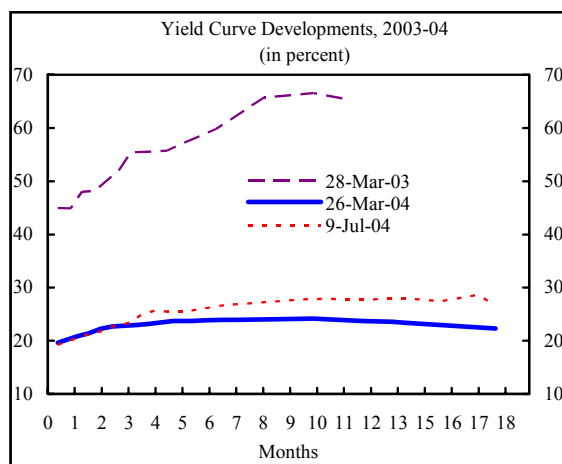
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I. RECENT DEVELOPMENTS

1. **Turkish financial markets have steadied following a brief episode of market turbulence** (Figure 1). Global market sentiment towards emerging markets worsened in early April, with high debt countries such as Turkey most affected. Domestic developments in Turkey added to investor concerns. These included a widening current account deficit and mixed signals from the government over the future course of fiscal policy. Following the market correction—the lira declined by 15 percent in a month and benchmark bond yields rose by 7 percentage points—conditions have stabilized.

2. **Despite this turbulence, demand for Turkish assets has held up well** (Figure 2, Tables 1–4). The increase in Turkish lira deposits has continued apace, as has demand for government paper from mutual funds and the public. Dedollarization has also persisted, with foreign currency deposits declining in U.S. dollar terms. Foreign holdings of treasury bills—now about US\$4½ billion—have also held up.

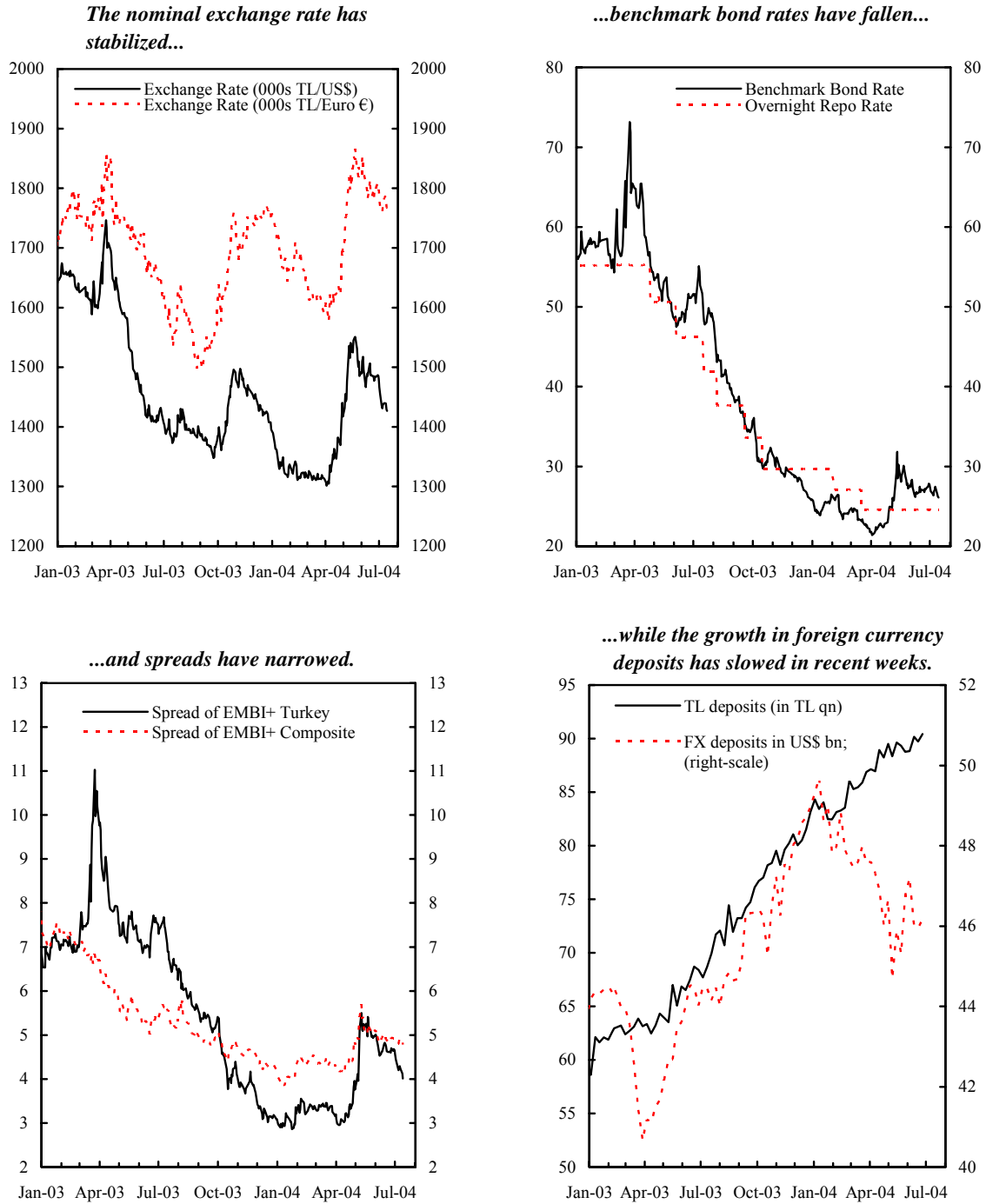


3. **Credit growth also remained strong, although the pace of increase has moderated in recent weeks** (Figure 2). Consumer credit has grown especially rapidly, with consumer loans having increased threefold over the last year, albeit from a low base. However, in recent weeks higher real interest rates have helped moderate credit growth.

4. **Macroeconomic developments have remained generally positive:**

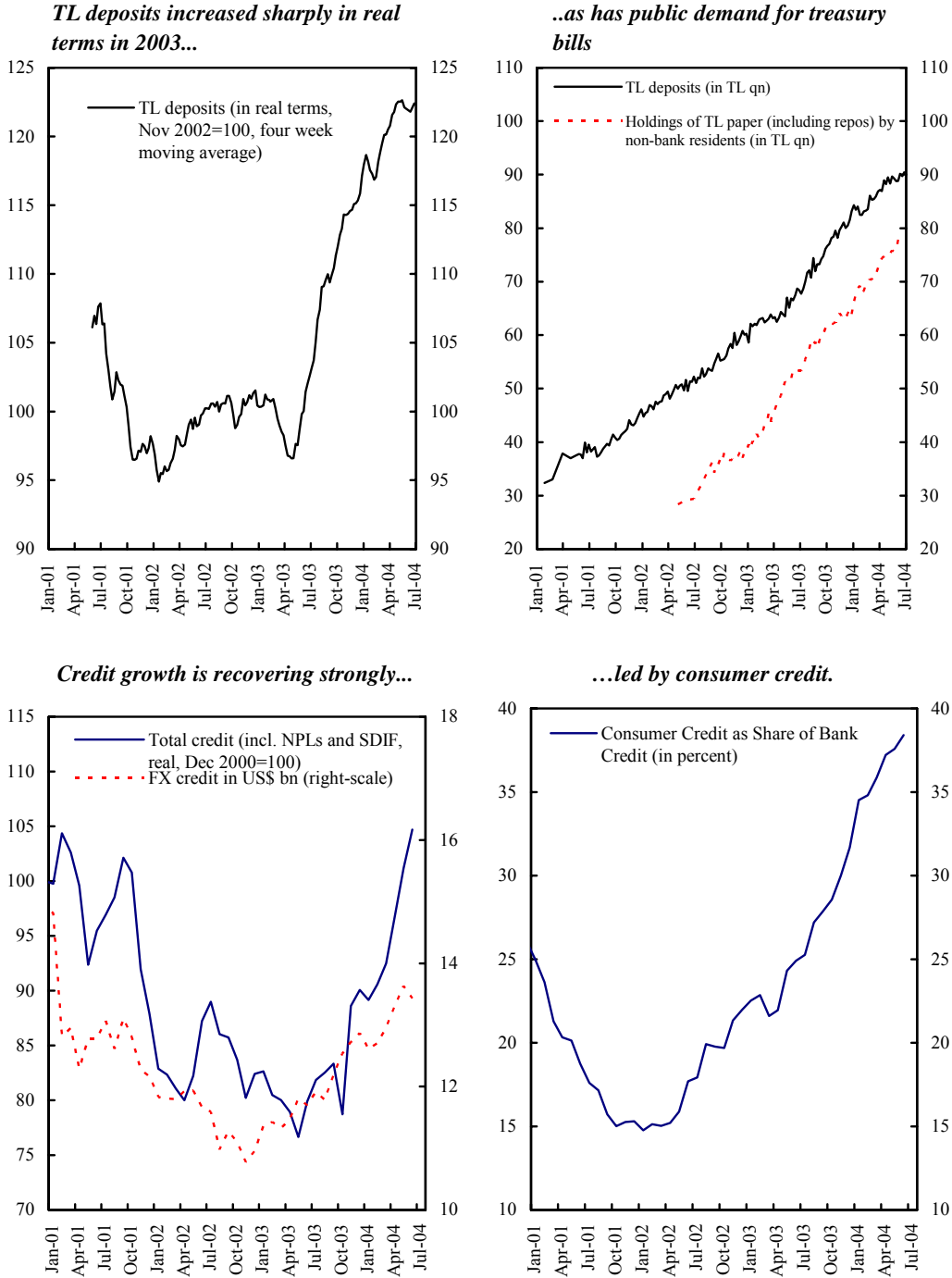
- **Economic growth appears strong.** National accounts data for the first quarter released after the mission indicate year-on-year growth of more than 10 percent, driven by domestic demand. Recent adverse market developments have, however, begun to dampen market sentiment, as reflected in the latest business surveys.
- **Inflation has continued to decline despite the weaker lira.** Exchange rate pass-through effects have so far been muted. Monthly wholesale prices declined by

Figure 1. Turkey: Financial indicators, 2003-04
(in percent, unless otherwise indicated)



Source: Data provided from the Turkish authorities.

Figure 2. Turkey: Money and Credit, 2001-04



Source: Central Bank of Turkey.

1.1 percent in June. And, with a monthly CPI decline of 0.1 percent, annual inflation remained in single digits, its lowest level for more than 30 years.

5. **The one black spot—the large current account deficit—has thus far been comfortably financed by capital inflows, although these are mainly short term** (Figure 3):

- **Reflecting strong domestic demand growth, the current account deficit continued to widen.** The deficit reached US\$5 billion in the first quarter. While exports remain strong, and tourism receipts have rebounded, this has been overshadowed by a broad-based import surge, reflecting high fuel prices and rapid domestic demand growth.
- **In contrast, the capital account has remained strong, albeit tilted towards short-term flows.** Portfolio inflows remained strong through April, banks drew down their foreign asset holdings abroad (reflecting dedollarization), and domestic banks' short-term borrowing increased significantly.
- **Taken together, the overall external position ended up approximately in balance in the first half of the year.** Central Bank of Turkey (CBT) foreign exchange purchases of US\$5 billion helped to support the reserve position and ensured the program NIR floor was comfortably met.

6. **Meanwhile, political developments have remained supportive.** The government's resolve on Cyprus and other developments—including a revised penal code, and broadcasting in different languages and dialects—are viewed by markets as having enhanced Turkey's EU prospects. Events in neighboring Iraq, however, have added to uncertainties in recent months.

II. POLICY DISCUSSIONS

A. Macroeconomic Framework

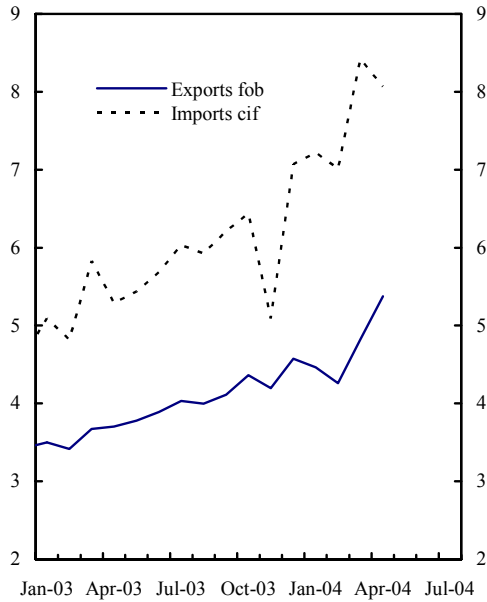
7. **Both sides agreed to leave the existing framework broadly unchanged (§5):¹**

- **The risks for the growth target of 5 percent are clearly on the upside** (Box 1). With a strong first quarter GDP outturn, positive production and demand side indicators, and a large positive growth carryover from 2003, economic growth would likely exceed the 5 percent growth projection. While currency weakness and higher

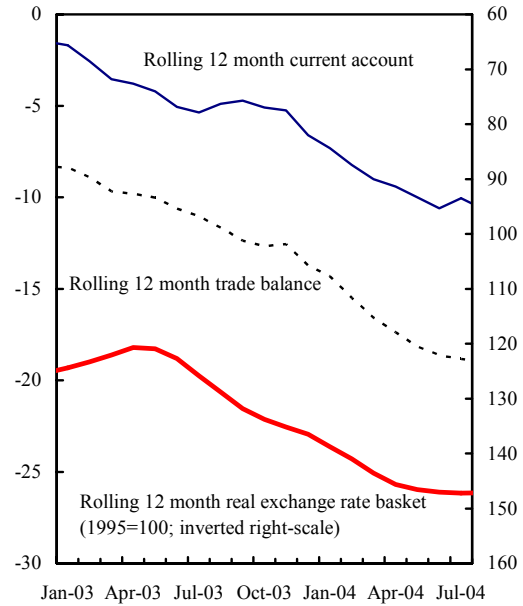
¹ ¶ refers to the relevant paragraph in the attached Letter of Intent.

Figure 3. Turkey: External indicators, 2000-04
(in billions of U.S. dollars; unless otherwise indicated)

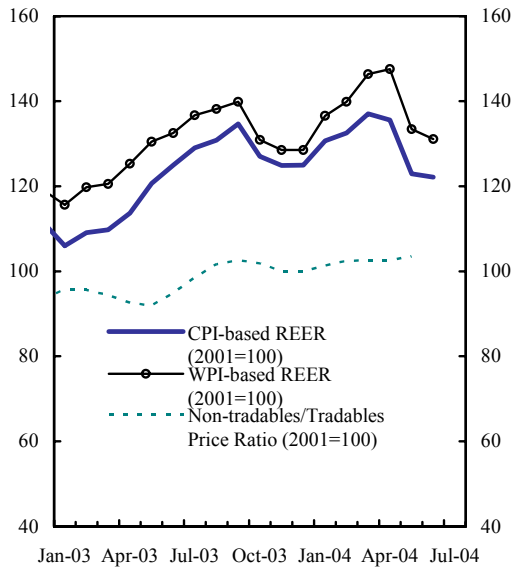
Despite the strong growth in exports, a surge in imports...



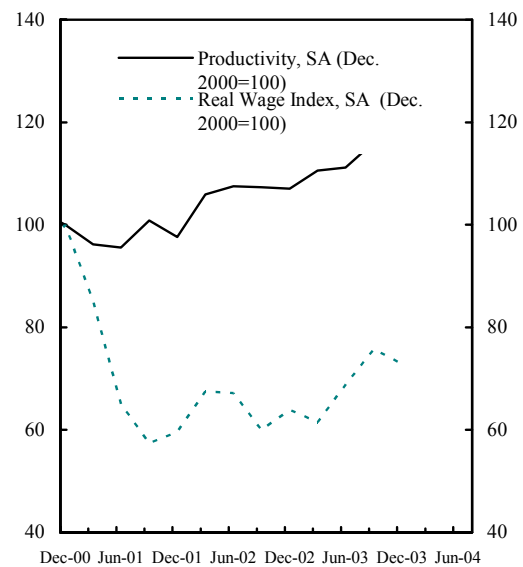
...and real appreciation has weakened the current account.



Until recently, the currency appreciation had raised questions regarding competitiveness...



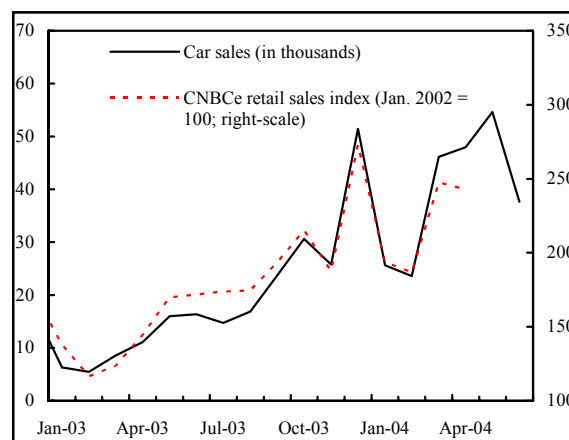
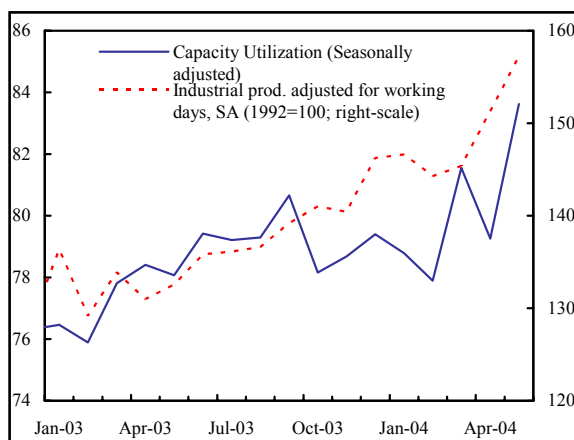
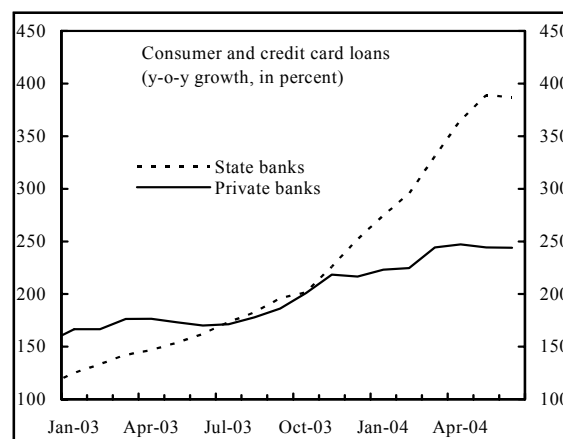
...but productivity and wage measures had allayed these concerns somewhat.



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

Box 1. Turkey's Economic Growth Performance in 2004: Developments and Prospects

Production and demand side indicators both point to strong growth performance so far this year. The industrial production index—the most reliable domestic output indicator in Turkey—increased by more than 14 percent in the first four months over the same period last year. Capacity utilization reached a record high in March, falling in April only because of public sector maintenance in the petroleum sector. On the demand side, surging car and retail sales—following large minimum wage and pension increases, a car tax rebate and booming consumer credit—signal continued strong domestic consumption growth. Imports continue to grow strongly, led by consumer goods but also reflecting strong capital goods imports. Tax revenues, which have so far outpaced program targets, particularly on VAT and motor vehicles taxes, lend further support to the growth story.



Looking ahead, recent financial market turbulence may temper domestic demand. Reflecting the increase in benchmark bond yields, consumer lending interest rates have risen, and credit growth has begun to decelerate. The impact of higher interest rates and a weaker lira was also seen in the most recent business survey data, which show signs of declining growth expectations.

Three-months forward looking business indicators (CBT business survey)

	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04
Business confidence 1/	26.6	16.7	25.5	26.4	18.8	21.5
New orders from domestic market 2/	17.2	23.0	26.6	23.2	13.2	17.1
Output volume 3/	17.6	25.1	29.3	27.9	18.8	20.0

1/ "General course of business in your industry" (optimistic - pessimistic)

2/ "New orders received from domestic market, excl. seasonal variations" (optimistic - pessimistic)

3/ "Volume of output, excl. seasonal variations" (optimistic - pessimistic)

Annual growth is, however, well on track to meet the 5 percent target this year, even if growth slows in the second half. The robust growth thus far combined with the positive carry-over effect from 2003 make the annual growth target of 5 percent attainable even with a slowdown in the second half of 2004. By the same token, a quick recovery in confidence and a return to the trend of declining real interest rates would likely see annual growth rising well above the 5 percent program target.

interest rates would likely curb growth in the coming months, they are unlikely to alter the economy's general direction. And, although consumer confidence had fallen in recent surveys, positive responses still predominated.

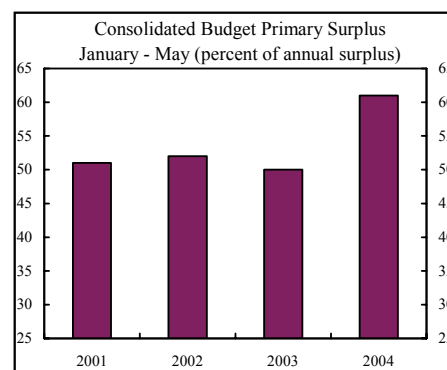
- **The end-year inflation target remains achievable despite the weaker lira.** Both sides agreed that price pressures would likely increase in coming months. The output gap has narrowed, reflecting rapid demand and credit growth, and exchange rate pass-through effects of the weaker lira remain incomplete. Bringing petroleum excise adjustments in line with the budget would also add to price pressures. However, given the existing cushion—the continuation of the inflation path through May would have seen inflation end up about 3 percentage points below the end-year target—the 12 percent CPI inflation target remains achievable.
- **The current account deficit is expected to widen to some 3½–4 percent of GNP in 2004.** This mainly reflects rapid demand-fuelled import growth, twinned with high oil prices. Both sides agreed that the recent lira depreciation should, after a lag, bolster the current account balance. Buoyant tourism receipts would also help. It was agreed, however, that with growth likely to exceed its target and oil prices remaining high, there was a risk that the external accounts could show a further deterioration relative to baseline program projections over the rest of the year.

B. Fiscal Policy and Reforms

Fiscal outturns have so far exceeded program targets. But part of this overperformance is expected to be unwound in coming months. Against the backdrop of strong domestic demand growth, discussions focused on compensating for past policy slippages and thereby on allowing automatic stabilizers to work fully. Progress continues to be made on structural reforms, including on social security and tax administration.

8. **Fiscal performance has been strong.** Fiscal outturns through May have exceeded program targets (Table 6). The performance criteria for the broader consolidated general government were exceeded by ½ percent of GNP in both March and April, with the overperformance about evenly divided between tax revenues and expenditures. Performance in May continued to be strong, with the primary surplus of the consolidated budget overperforming by ¾ percent of GNP.

9. **With the overperformance likely to narrow, both sides agreed that caution was warranted.** For a start, savings achieved through postponing spending were likely to be unwound as the fiscal year drew to a close. And, on the revenue side, any growth slowdown in the second half of the year would have a negative impact. For these reasons, both the authorities and staff agreed that there was no room to increase budget spending ceilings.



Primary Surplus (program definition)
(In quadrillions of Turkish lira)

	January-May		
	Proj.	Act.	Diff.
Consolidation budget primary surplus	9.9	12.9	3.0
Revenues	39.2	40.6	1.4
Primary	29.3	27.7	-1.6
Rest of public sector primary surplus (CGS) 1/	2.6	1.8	...
EBRs	-0.1	0.2	...
Social security	0.3	0.1	...
Unemployment insurance fund	0.7	0.5	...
SEEs	1.7	1.0	...

1/ April figures. SEE figures are provisional.

10. **Staff noted that the fiscal record to date had been helped by strong growth, masking fiscal slippages.** The write-over of “special revenues” were well behind target. (“Special revenues” are fees collected by off-budget institutions; these fees are used for off-budget spending by these institutions unless they are transferred to the central government.) This reflected spending pressures arising from the across-the-board spending cuts implemented in March to compensate for the earlier pension and wage increases. In addition, petroleum excises had also been cut to cushion the impact of rising international oil prices.

11. **Against a backdrop of strong domestic demand growth, staff urged that past slippages be corrected and automatic stabilizers be allowed to operate freely (¶9).** While the authorities argued for some flexibility on budget implementation, staff called for the unimpeded functioning of automatic stabilizers given the strength of demand. This would entail saving any revenue overperformance due to higher growth and keeping spending within budget limits. The authorities noted that the tax incentive scheme for new car purchases had been scaled back. And, to make up for past slippages, they decided to write over to the budget TL 1.2 quadrillion of special revenues and to adjust petroleum pump prices to bring excises in line with budget assumptions (structural benchmark, ¶9). Staff noted the risk that, without flexible pump prices, there was a danger that higher oil prices would hurt excise revenues. Looking ahead, the authorities agreed to adjust all excises to bring them in line with budget assumptions. They also argued that, should oil prices decline, they would not adjust pump prices, de facto achieving an increase in excises and providing a cushion. Finally, the authorities have also implemented an energy market reform, effective January 1, 2005 that completely liberalizes petroleum prices.

12. **Looking further ahead, the 2005 budget call, to be issued by end-June, aims at maintaining fiscal discipline:**

- **Staff argued unsuccessfully for a budget call announcement that would explicitly include the 6.5 percent primary surplus as a goal.** Such a move would have helped reassure markets. The authorities noted that a decision on next year’s primary surplus target had not yet been taken.

- **Both sides agreed, however, on the need for non-interest current spending to decline in real terms.** This would help compensate for the loss of temporary tax measures and reduced financial intermediation taxes, and would make room for an increase in investment.

13. **To lay the basis for sustained medium-term fiscal consolidation, further progress is being made on the structural side (¶10):**

- **With social security reform preparations now at an advanced stage, it is expected that draft legislation will be submitted to parliament by mid-December.** The authorities explained that the planned administrative reform, aimed at combining and unifying the three existing pension systems, would be the most critical element in reducing the social security outlays in the long run. The main effects of this unification would be to reduce the generosity of the civil service pensions. Both sides agreed that parametric changes beyond current administrative reforms are also needed to put the social security deficit on a firmly declining path. The political sensitivity of such reforms called for continued careful preparations. With the technical work over, a White Paper was being prepared to explain the reform proposals; this was expected to be ready this summer. After consulting with interested parties, a final decision would be made by the Council of Ministers on the proposal for reform in September (new structural benchmark). Draft legislation would then be sent to parliament in December (new performance criterion), with the aim of securing parliamentary approval by early 2005.
- **Draft tax administration legislation has been completed in line with international best practice but its parliamentary passage has been delayed due to a heavy legislative agenda.** The draft law, which is now expected to be submitted to parliament in July (delayed May benchmark) and passed by end-October (new performance criterion), will create a semi-autonomous tax administration, to be structured along functional lines, and reporting directly to the Minister of Finance. Local tax offices will be directly under the control of the new entity and tax policy responsibilities will be shifted elsewhere in the Ministry of Finance. The authorities and staff agreed that, while the transition would be difficult, the move would usher in improved tax administration and tax compliance. As a further step, staff suggested to consider unifying all tax auditing functions under the new entity after it had become fully operational.
- **Further expenditure reforms are being considered for next year's budget.** The authorities recently received technical assistance from the Fund on short-term expenditure reforms. While the authorities are considering including some of the recommendations in their 2005 budget, they felt that the budget call did not require such details, and that further time was needed to build consensus in certain critical areas. Staff urged the authorities to undertake the reforms as soon as possible, especially those measures designed to curb the public wage bill and address the special tax treatment of civil servants and pensioners.

- **Progress is being made on improving public sector governance.** The civil servant code of conduct was approved by parliament in May 2004. The commission report on strengthening SEE governance was also completed in May. Following consideration of the report's recommendations, and a consultative process with interested parties, the authorities intend to prepare draft legislation, which is expected to be sent to parliament by end-2004.

14. **Both sides agreed that tax incentives should be avoided.** While the authorities had broached the idea of possible investment tax incentives—to attract foreign investors and level the playing field with other countries in the region—staff argued against this, since it would represent a move away from the direct tax reforms of April 2003 and from the general strategy of simplifying the direct tax system, widening the tax base, and lowering overall tax rates. Further, ad hoc policy changes would also undermine policy credibility. In the end, the authorities decided to pursue the avenue of comprehensive, rather than piecemeal, tax policy reform. They initiated a study covering comprehensive direct tax reform; in this context, the authorities requested early technical assistance from the Fund.

15. **To keep wider public sector balances under control, the authorities have taken steps to limit local government and SEE borrowing.** The authorities intend to issue a circular requiring SEEs to provide prior notification to Treasury of their borrowing plans. In preparation for decentralization, the authorities are embarking on an important legislative agenda to define local authority responsibilities and financing arrangements.

- The authorities indicated that they would set strict **borrowing limits for local governments**, a major improvement on current practice where there are no limits. The debt stock of municipalities and provinces will be limited to no more than their annual revenue, while for larger metropolitan municipalities the limit will be 1.5 times annual revenue. New domestic borrowing of all local governments will be limited to 10 percent of annual revenue. Staff agreed that the new limits and new data reporting requirements were indeed an improvement. However, the staff would have preferred a uniform debt limit equivalent to annual revenue. The authorities pointed out that the debt stock of most of the larger metropolitan municipalities already exceeded 1.5 times annual revenue and therefore borrowing would be strictly limited.
- Staff recommended close monitoring of the **larger municipalities** with an eye to tightening the debt limits in the future if needed. The forthcoming public administration framework law (PAF) could transfer more expenditures to the local governments and therefore a stronger system could be needed in future to deal with debt and arrears problems. The authorities agreed that after the PAF is approved and in the context of new legislation setting out fiscal intergovernmental relations, the debt limits of the large municipalities could be tightened further.
- The staff warned against any restructuring of **local government arrears** that could give the impression of an amnesty and create a negative incentive structure for local authority fiscal control in the future. The authorities explained that all local authority

external debt arrears have been fiscalized already and are included in the public sector debt statistics. They had decided to create a commission that would restructure arrears on a case-by-case basis. Both sides agreed that arrears restructuring be guided by ability to pay, contain adequate safeguards, and be conducted in a transparent manner.

C. Monetary and Exchange Rate Policy

16. **Both sides agreed on the need for continued caution in setting base money targets** (¶11). Falling inflation and inflation expectations and strengthening real activity had increased demand for currency and TL deposits. The mission therefore agreed to revise the base money targets to accommodate the base money increase through May. But several factors had made the end-year inflation target more challenging (see above). And the recent increase in market interest rates and currency depreciation should help slow money demand (as well as helping to slow bank credit expansion and to contain the current account deficit). Base money targets for the rest of the year were therefore increased only in line with nominal activity. This would require continued caution in reducing overnight rates, which in any event were now below treasury bill rates. The staff also welcomed the central bank's intention to announce steps aimed at increasing the transparency of its monetary policy operations.

17. **The floating rate regime had illustrated its effectiveness during the recent episode of market turbulence.** It was agreed that, while the CBT's modest sales of foreign exchange had helped stabilize markets in May, discretionary intervention would remain strictly limited. Staff took issue with the frequent changes to foreign exchange purchase arrangements in recent months, as this had confused financial market participants, possibly adding to recent market volatility. The authorities argued that they needed to respond to changing market conditions, while acknowledging that fewer changes would be desirable.

18. **The mission also argued that the buildup in international reserve should resume as soon as market conditions permit** (¶12). While the CBT has built up its reserve position by intervening, including through auctions, Turkey's external obligations remained large, and the CBT should restart its purchases of foreign exchange in a predictable and transparent manner once the balance of payments position allows. Staff also noted that Treasury should overborrow and deposit the proceeds at the CBT once market conditions settle. This would lower Treasury exposure to shifts in market sentiment (see below), but would have the indirect benefit of helping the CBT in its sterilization operations.

D. Financial Sector Reform (¶14)

19. **Following a major review of the Banking Act, the authorities have prepared a new draft Credit Institutions law.** The new legislation, which is expected to be passed by parliament by November (a new structural performance criterion), will bring the legal framework more closely in line with EU standards. Areas that received particular attention in the review included the scope of the legislation, "fit and proper" criteria, licensing process, related party lending, on-site supervision, legal protection for Bank Regulation and

Supervision Agency (BRSA) and Savings Deposit Insurance Fund (SDIF) staffs and boards and the delineation of responsibilities between the two institutions. These are all covered in the draft law. The exclusive right of Sworn Bank Auditors to conduct on-site supervision will be reviewed to permit the BRSA to engage off-site personnel and outside experts as needed.

20. **Responding to industry concerns, the original timetable for the new legislation has been extended.** Given the fundamental reforms envisaged, the banking sector community had urged that more time be allowed for consultation. The authorities and staff agreed on the need to proceed carefully. The authorities now plan to submit the draft law to parliament by end-September 2004.

21. **A comprehensive strategy has finally been developed for restructuring and privatizing state banks.**

- **In a move welcomed by staff, a strategy has been formulated for the integration of the intervened Pamuk with state-owned Halk.** The combined bank is expected to become fully operational by end-October. Integration of the two banks should lead to operational and financial synergies, including on IT, the customer base, and branch networks. Given these synergies, staff urged the authorities to aim at privatizing the new bank by end-2005. The authorities would not commit to a fixed timetable to doing this, preferring to wait until market conditions were supportive. Staff regretted that the resolution of Pamuk had taken more than two years to bring to closure.
- **A comprehensive restructuring plan for Ziraat is being developed with the assistance of international consultants.**
- **The due diligence of Vakif has been further delayed.** The authorities noted that the terms of reference has now been drafted, and that a consulting firm would be hired shortly. The assessment was expected to be completed by end-October.

22. **Unfortunately, the SDIF asset sales strategy continues to proceed slowly:**

- **The SDIF has relaunched last December's failed auction, with winning bids to be selected by end-August, but its prospects remain uncertain.** After the auction announcement, SDIF made a general discount offer to all its debtors, ending mid-July. The offer includes loans in the portfolio currently being auctioned. Staff noted that with high-quality borrowers more likely to accept the offer, the quality of the portfolio being auctioned and the price likely to be offered may deteriorate. Staff nevertheless stressed the importance of a successful auction, indicating that another failure would deter potential investors.
- **Staff urged the SDIF to sell its assets through regular auctions with successive loan portfolios being put up for sale until the sales process is complete.** It was agreed that the reassessment of SDIF asset valuations should foster a better understanding of recovery rates and allow more realistic auction reservation prices.

Staff indicated that bilateral deals with individual borrowers should take place only after seeking outside expert opinion, with the general terms of each deal being made public.

23. **Another unwelcome development is recent court rulings on Demirbank and Kentbank.** In April the courts made a ruling that BRSA's intervention in Demir and Kent had been unlawful. This could have implications for future bank intervention strategy. However, the new Credit Institutions legislation will help address existing legal shortcomings.

24. **Looking ahead, staff stressed that the removal of the blanket guarantee on bank liabilities, implemented on July 5, warranted careful monitoring.** The BRSA indicated that the TL 50 billion guarantee would cover almost 99 percent of bank accounts (64 percent by value). They were also confident that the banking sector was ready and had presented a detailed assessment to the government, and issued a press release confirming the banking system's ability to deal with the abolition of the guarantee. More generally, the authorities indicated their preparedness for the move and stressed that individual bank liquidity was being monitored closely. Staff urged the authorities to continue to pay close attention to monitoring individual banks, and to follow up on any disparities between deposit rates offered.

E. Other Structural Reforms

25. **Despite recent setbacks, the authorities remain committed to privatization (¶17).** A recent procurement law amendment had removed an important bottleneck, by facilitating the hiring of consultants. Preparations for the sale of Türk Telekom are advancing, against a backdrop of strong foreign and domestic investor interest. Public offerings are also planned for PETKIM (petrochemicals) and Turkish Airlines by end-year, and financial consultants have already been appointed. Several smaller companies have already been sold, including the alcohol arm of TEKEL, with cash proceeds through June totaling US\$475 million (against an end-June indicative target of US\$500 million). Staff noted the judicial system as a major hurdle. With the privatization of TUPRAŞ in doubt, following a recent court ruling, the US\$3 billion end-year privatization proceeds target might be difficult to achieve.

26. **Responding to business concerns that follow up to the Investment Advisory Council (IAC) was moving slowly, the authorities have taken further steps to improve the business climate (¶15).** These include the preparation of draft legislation on streamlining investor approval procedures, and for a new Investment Promotion Agency. The authorities committed to providing a progress report to the Prime Minister and IAC members by October.

III. FINANCING ISSUES

27. **With comfortable rollover needs for the rest of this year, the staff urged the authorities to build up a cushion for a more challenging environment next year.** Treasury had managed, until recently, to improve its borrowing terms with rollover rates of

about 90 percent. Baseline projections of rollover requirements over the rest of the year are lower. Depending on market conditions, Treasury should use this opportunity to build its deposits at the CBT and prepare for tighter medium-term financing requirements (see the Article IV staff report).

28. **To help address rollover concerns, the authorities have agreed to address remaining impediments to Treasury and CBT coordination** (§13). The authorities agreed to identify remaining practical obstacles to Treasury deposit buildup and to prepare an action plan, by end-September, for their removal (new structural benchmark). Staff noted that borrowing limits, appropriations for interest payments, payment terms on government deposits, and the taxation of CBT money market securities should all be covered in the plan.

29. **Discussions continued on relations with the Fund after the program expires** (Box 2).

- **The authorities have developed comprehensive medium-term macroeconomic scenarios** covering the balance of payments, national accounts, and the budget, along with detailed alternative financing projections. Although financing requirements look tight (see the Article IV staff report), the authorities have not yet decided on what form of relationship they wish to pursue once the current program expires.
- **The authorities also expressed their intention to announce their post-program plans by September.** Staff indicated that, should the authorities decide to opt for a successor arrangement, any request for a future program would have to be considered under exceptional access procedures and would depend not only on Turkey's financing needs, but also on its large outstanding obligations to the Fund. Discussions would continue during the Ninth Review against the backdrop of the budget preparation process. While reasonably satisfied with the announcement timetable, staff nevertheless urged the authorities to announce their policy plans for 2005 promptly, including on the primary surplus. The authorities were not yet in a position to do this, however, and wanted to consider the options carefully before making an announcement.

IV. PROGRAM MODALITIES

A. Program Monitoring

30. **Quantitative performance criteria.** The attached Letter of Intent describes progress in implementing the program supported by the Stand-By Arrangement and requests completion of the Eighth Review.

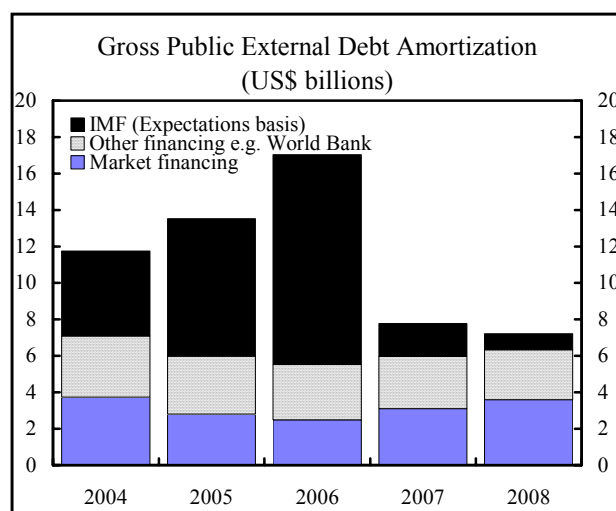
- **The authorities request a waiver of nonobservance of the base money ceiling performance criterion for end-April.** Given the small size of the deviation, staff supports the waiver request.

Box 2. Post-Program Considerations

This box lays out some key considerations should the authorities seek a successor arrangement. ^{1/}

A successor program could be either disbursing or precautionary. By seeking a precautionary arrangement, the authorities could benefit from continued market confidence while signaling that Fund resources were no longer necessary. The external outlook is, however, difficult without additional official financing. With large repayments falling due to the Fund, baseline program projections show a loss of reserves of one-third over 2004–06. While the possibility of extending expected repurchases falling due in 2006 helps, the baseline financing assumptions themselves are subject to downside risk.

Under either a precautionary arrangement or a disbursing stand-by, the aim should be to reduce Fund exposure. With the Fund so heavily exposed to Turkey, prudential considerations call for a reduction in Fund exposure over the program period. Directors have called for reduced exposure, and the authorities themselves have also signaled publicly that they would favor a continuation of net repayments to the Fund. At the same time, Turkey faces large financing needs. For the public sector, external medium- and long-term debt amortization is projected to reach US\$26 billion in 2005–06, with more than half falling due to the Fund even after allowing for an extension of 2006 repurchases (see figure).



An ambitious reform program is needed, however, if Turkey is to build on its recent achievements. Besides continuing with the program's macroeconomic stabilization, including on the primary surplus and inflation, critical structural reforms are required in banking (state banks, intermediation taxes, legal reforms), fiscal (quality of adjustment, social security, streamlining of taxes, tax administration, expenditure policy), and monetary (the move to inflation targeting and coordination between Treasury and the CBT).

^{1/} With Turkey's high outstanding Fund access post-program monitoring (PPM) would be needed even if Turkey chose to graduate. Given its vulnerabilities, and high outstanding access, frequent (possibly quarterly rather than the usual bi-annual) PPM would appear to be appropriate.

- **Annex B of the Letter of Intent outlines the updated program.** The new performance criteria are unchanged from the indicative targets set in the Seventh Review, apart from the base money ceilings (see above).
31. **Structural performance criteria.** The performance criteria on banking and on social security reform legislation have now been specified. A new performance criterion is also proposed on the parliamentary passage of tax administration reform legislation.
32. **The prior action for completion of the Eighth Review is:**
- Write over to the central government budget TL1.2 quadrillion of special revenues.

B. Data Issues

33. **The authorities are continuing their efforts to disclose in-kind foreign financed defense spending** (whose exclusion from reported fiscal data for past test dates may have resulted in misreporting). The plan is to use estimates of this spending from reported debt stock movements to determine, by end-July, whether a noncomplying purchase may have taken place in the period January 2000 to June 2003.

V. STAFF APPRAISAL

34. **Despite recent market turbulence, Turkey's macroeconomic outlook remains positive.** Political conditions have remained supportive, and, on the economic side, both the float and strong fiscal outcomes have aided the adjustment process. With few signs of flagging activity, economic growth looks likely to exceed this year's 5 percent program target. The 12 percent inflation target remains achievable, although recent currency weakness, high oil prices, rapid credit growth, a narrowing output gap, and prospective administered price increases make this task more demanding.
35. **The immediate macroeconomic challenge is the widening current account deficit, which reflects rapid domestic demand growth.** So far the financing of the deficit has not been a problem, although capital flows have been mainly short-term. Recent currency and interest rate movements, together with rebounding tourism revenues, should help narrow the trade and services deficit over time. Other steps have also been taken to address the deficit. State banks have reined in their lending. Lower car tax incentives and the operation of automatic fiscal stabilizers should also help dampen import demand. The situation warrants continued close monitoring, however, and additional corrective measures, including on the fiscal side, may need to be taken promptly.
36. **Against this backdrop, the government needs to maintain strict fiscal discipline.** Rapid growth had masked slippages in budget implementation, but the authorities have since taken remedial actions. Looking forward, the government needs to allow automatic fiscal stabilizers to function unimpeded, and save any revenue overperformance. With the current account widening, for example, the authorities' focus on pump prices, rather than excises, is misplaced. The failure to adjust automatically to world oil prices amounts to a de facto tax

cut when world oil prices are rising. The liberalization of pump prices should, therefore, be allowed to take effect next year as planned. It is also important to avoid new tax incentives and to keep a lid on spending. Finally, it is unfortunate that the budget call did not include an explicit commitment to a 6½ percent primary surplus target for next year. A clear commitment to maintaining this target would ease market concerns about financing needs and the pace of debt reduction.

37. The decentralization process entails many risks and needs to proceed carefully.

The government's intention to introduce explicit debt and borrowing limits for local authorities as well as new reporting systems is welcome. While the local authority debt and borrowing limits appear on the whole prudent, the larger debt ceiling for the major metropolitan municipalities could have been avoided by providing a transition period for those whose debt exceeded the new limits. An amnesty of local government arrears should also be avoided to ensure an appropriate incentive structure for the future. While the authorities' intention to deal with arrears on a case-by-case basis is welcome, the process needs to be dealt with in a transparent manner.

38. On the structural side, the government is to be commended for working to improve the underpinnings of its fiscal policy. Notwithstanding some delays, its efforts to improve tax administration and the social security system are especially welcome in this respect.

39. This year's monetary goals are challenging, but achievable. Although consumer price inflation is now in single digits, possible pass-through from the recent depreciation and high oil prices need to be contained. Accordingly, the central bank, which deserves continued credit for its conduct of monetary policy, should stick closely to its revised base money targets and to a prudent interest rate path. Incomes policy, including limiting the increases in the minimum wage and for government workers, would also need to be kept tight.

40. The floating exchange rate had worked well as a safety valve during the recent bout of market turbulence. While the float remains essential, Turkey's external obligations are large. Foreign exchange reserves buildup should therefore resume as soon as market conditions allow, but in a predictable and transparent manner. Recent turbulence served as a reminder of the need for continued close coordination between the central bank and the Treasury in their operations.

41. The banking reform agenda is challenging but critical to the success of the program. State bank reform has been long-awaited. Another priority is to continue with the close monitoring of individual banks following the transition to the limited deposit guarantee in early July. It is also important to regain momentum on SDIF asset sales, including by setting realistic price expectations. Any bilateral loan restructuring deals should be handled professionally and transparently.

42. The authorities need to gain momentum in privatization and improve the business climate. With the recent setback on TUPRAŞ, the end-year privatization receipt

target will be difficult to achieve. But recent steps, including the procurement law amendments and the preparation of large companies for sale, are welcome. Looking ahead, the authorities need to ensure that sales preparations are as thorough as possible and designed in ways that minimize the scope for court challenges. The follow-up work to the March inaugural Investment Advisory Council needs to be accelerated.

43. **Against this background, the staff recommends the completion of the Eighth Review and approval of the authorities' request for a waiver.** Turkey has a good program implementation record, including for the current review, and deserves the support of the international community. The authorities have also taken some steps to address the risks to the external outlook, the clearest near-term risk. On this basis, the staff recommends the granting of the waiver on base money and the completion of the review.

Table 1. Turkey: Quantitative Targets and Structural Conditionality Relevant for the Eighth Review

Action	Type 1/	Status
I. Quantitative Targets		
Meet (i) performance criteria on primary balance, contracting or guaranteeing of external public debt, issuance of short-term external public debt, net international reserves, and base money, and (ii) indicative targets on primary and overall balances, net domestic assets and privatization proceeds (all end-April).	PC	All end-April targets were met, except for base money.
II. Structural Conditionality		
Prior actions for the Eighth Review		
Write over to the central government budget cumulative TL1.2 quadrillion of special revenues in the period January-June 2004	PA	Met.
April		
Announcement by the SDIF of a new strategy for asset resolution.	BM	Met with delay. Settlement offer to borrowers at end-May. Auction strategy announced in June.
Assessment of the banking system prior to lifting of blanket guarantee.	BM	Met.
May		
Submission to Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance.	BM	Delayed to July.
Prepare report outlining key elements of state enterprise governance strategy.	BM	Met. Inter-agency committee completed study end-May.
June		
Improve the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators (previous target end-December 2003).	BM	Met. Legislation was passed in May 2004.
Make public key elements of the new strategy for state banks and a timetable for the action plan (mid-June).	BM	Partially met. Strategy for Halk-Pamak announced and related legislation is expected to be approved by Parliament shortly. Ziraat strategy prepared and will be announced in July.
All excises will be adjusted to be brought in line with budget assumptions.	BM	Partially met. June 29 increases brought excises close to budget assumptions.
July		
Passage by Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance, as defined in paragraph 10 of the Letter of Intent.	BM	Delayed due to heavy legislative agenda. Reset as new performance criterion for end-October 2004.

1/ PA=prior action, PC=structural performance criterion, and BM=structural benchmark.

Table 2. Turkey: Selected Indicators, 2000-05

	2000	2001	2002	2003	Projections	
					2004	2005
	(In percent)					
Real sector						
Real GNP growth rate	6.3	-9.5	7.9	5.9	5.0	5.0
GNP deflator	50.9	55.3	44.4	22.5	11.5	10.1
Nominal GNP growth rate	60.4	40.5	55.8	29.7	17.1	15.6
WPI (12-month, end-of-period)	32.7	88.6	30.8	13.9	14.2	8.0
CPI (12-month, end-of period)	39.0	68.5	29.7	18.4	12.0	8.0
Average nominal treasury bill interest rate	38.0	99.1	63.5	44.1	24.8	19.0
Average ex-ante real interest rate 1/	-9.5	35.5	30.3	28.6	12.8	12.1
	(In percent of GNP)					
Central government budget						
Primary balance 2/ 3/	4.6	4.8	2.4	5.0	5.0	5.0
Net interest payments 4/	15.8	24.7	17.5	16.1	13.6	10.4
Overall balance	-11.2	-20.0	-15.1	-11.1	-8.6	-5.3
Consolidated public sector						
Primary balance 3/	3.0	5.5	4.1	6.3	6.5	6.5
Net interest payments 5/	21.9	26.6	16.1	16.1	13.5	10.3
PSBR (including CBT profits)	18.9	21.1	12.0	9.8	7.0	3.7
Operational balance	-6.9	-4.7	-4.4	-4.8	-2.9	-1.0
Net debt of public sector	57.4	93.9	78.8	70.5	70.3	64.7
Net external	19.0	37.7	32.1	22.2	22.7	20.1
Net domestic	39.3	56.2	46.7	48.3	47.7	44.6
Net debt of public sector (in percent of centered GNP) 6/	52.4	75.6	68.7	65.9	65.7	58.9
External sector						
Current account balance	-4.9	2.4	-0.8	-2.8	-3.6	-3.0
Gross external debt	59.0	79.0	72.1	61.8	53.2	51.2
Net external debt	38.8	53.8	54.6	45.1	40.7	39.7
Short-term external debt (by remaining maturity)	21.7	22.7	17.9	17.5	16.2	16.1
Monetary aggregates						
Seignorage 7/	1.8	1.1	1.0	1.2	1.4	0.5
Nominal growth of M2Y broad money (in percent)	40.2	87.5	25.4	13.0	20.8	13.5
	(In billions of U.S. dollars, unless otherwise indicated)					
Privatization proceeds	3.3	2.8	0.5	0.3	3.0	3.0
Net external financing of central government	4.1	-2.3	-1.4	-1.4	-0.1	-0.3
Amortization	6.2	7.8	6.8	8.9	8.6	8.6
Gross borrowing	10.3	5.5	5.3	7.5	8.5	8.3
<i>Of which</i> : Eurobond issues	7.5	2.2	3.3	5.3	5.0	5.0
GNP	201.3	144.0	182.7	238.5	...	...
GNP (in quadrillions of Turkish lira)	125.6	176.5	275.0	356.7	417.6	482.8

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

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation. With average maturity of newly issued debt less than one year, and with FRNs paying quarterly coupons, this measure overstates the effective real interest rate when inflation is declining.

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

3/ For 2004 and 2005, program projections.

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

5/ Interest payments minus interest receipts plus CBT profits before transfers to the government.

6/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.

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

Table 3. Turkey: Monetary Aggregates, 2000-04
(In quadrillions of Turkish lira)

	2000	2001	2002	2003	2004			
					Mar.	Jun.	Sep.	Dec.
					Projected			
Broad money (M2Y)	56.8	106.6	133.7	151.0	153.8	165.8	174.5	182.4
Lira broad money (M2)	31.9	47.2	61.9	82.7	92.6	97.1	102.6	106.9
Foreign exchange deposits 1/	24.9	59.3	71.8	68.3	61.3	68.7	71.8	75.5
Repos	6.0	2.8	2.8	3.1	3.1	3.1	3.2	3.4
Broad liquidity	62.8	109.4	136.4	154.1	156.9	168.9	177.7	185.9
Base money	5.8	7.8	10.4	14.9	16.9	18.8	20.9	20.9
Net foreign assets 1/ (in billions of U.S. dollars)	2.8 4.1	-1.9 -1.3	-6.3 -3.9	-4.0 -2.9	-4.6 -3.5	-1.3 -0.9	0.2 0.1	-2.6 -1.6
Net domestic assets	54.1	108.5	140.0	155.0	158.4	167.1	174.2	185.0
Net claims on government	31.6	89.7	122.8	138.9	141.4	149.5	154.8	163.3
Claims on business sector 2/	31.7	38.7	42.0	58.0	59.9	61.5	64.3	67.6
Turkish lira claims	22.3	23.1	24.5	39.7	42.8	44.5	46.6	49.0
Foreign exchange claims (est.) 1/	9.4	15.6	17.5	18.4	17.1	17.0	17.8	18.7
Other items (net)	-9.1	-20.0	-24.8	-41.9	-42.9	-43.9	-44.9	-45.9
Memorandum items:					(annual percent change)			
Broad money (M2Y)	40.2	87.5	25.4	13.0	16.3	27.8	26.7	20.8
Lira broad money (M2)	42.5	48.0	31.0	33.7	45.1	43.2	36.9	29.3
Foreign exchange deposits 1/	37.3	137.9	21.0	-4.9	-10.6	11.0	14.5	10.6
Claims on business sector 2/	73.0	22.3	8.4	38.4	27.3	29.9	26.0	16.5
					(billions of U.S. dollars)			
Broad money (M2Y)	84.6	74.0	81.8	108.2	117.3	108.1	110.9	112.6
Lira broad money (M2)	47.5	32.8	37.9	59.3	70.6	63.3	65.2	66.0
Foreign exchange deposits	37.1	41.2	43.9	48.9	46.7	44.8	45.6	46.6
Net claims on government	47.0	62.3	75.1	99.5	107.8	97.5	98.4	100.8
Credit to the private sector	47.1	26.9	25.7	41.6	45.7	40.1	40.9	41.8
					(in percent share)			
Base money/GNP 3/	4.6	4.4	3.8	4.2	4.6	4.9	5.3	5.0
Broad money (M2Y)/GNP 3/	45.3	60.4	48.6	42.3	42.0	43.5	44.0	43.7
Lira broad money (M2)/GNP 3/	25.4	26.8	22.5	23.2	25.3	25.4	25.9	25.6
Private credit/GNP	25.2	21.9	15.3	16.3	16.4	16.1	16.2	16.2
Foreign currency deposits/M2Y	43.9	55.7	53.7	45.2	39.8	41.4	41.2	41.4
Money multiplier								
Broad money (M2Y)	9.8	13.7	12.8	10.2	9.1	8.8	8.4	8.7
Lira broad money (M2)	5.5	6.1	5.9	5.6	5.5	5.2	4.9	5.1

Sources: Central Bank of Turkey and Fund staff projections.

1/ Monetary authorities and deposit money banks; evaluated at current exchange rates.

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

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

Table 4. Turkey: Central Bank Balance Sheet, 2000-04 1/

	2000		2001		2002		2003		2004			
	Dec Actual	Dec Actual	Dec Actual	Dec Actual	Dec Actual	Dec Actual	Dec Actual	Dec Actual	Mar Actual	Apr Actual	Aug Projected	Dec Projected
I. Central Bank Balance Sheet	(in quadrillions of Turkish lira) 1/											
Net foreign assets	3.3	-12.7	3.9	8.8	8.0	9.2	10.7	10.7	8.0	9.2	12.8	10.7
Gross foreign assets	15.6	28.6	37.7	42.5	40.5	41.2	38.4	38.4	40.5	41.2	42.5	38.4
Gross foreign liabilities	12.3	41.2	33.8	33.6	32.5	32.0	27.7	27.7	32.5	32.0	29.7	27.7
International reserve liabilities	3.1	20.7	11.5	9.8	8.3	8.0	3.5	3.5	8.3	8.0	5.8	3.5
Other reserve liabilities 2/	4.9	10.1	13.2	14.5	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9
Banks' FX deposits with CBT	4.3	10.4	9.1	9.3	9.3	9.0	9.3	9.3	9.3	9.0	9.0	9.3
Net domestic assets	2.5	20.6	6.5	6.0	9.0	8.5	10.2	10.2	9.0	8.5	7.7	10.2
Base money	5.8	7.8	10.4	14.9	16.9	17.8	20.9	20.9	16.9	17.8	20.5	20.9
Currency issued	3.8	5.3	7.6	10.7	11.6	13.0	14.7	14.7	11.6	13.0	14.8	14.7
Banks' lira deposits at the CBT	2.0	2.5	2.8	4.2	5.3	4.8	6.1	6.1	5.3	4.8	5.7	6.1
	(in billions of U.S. dollars)											
CBT gross international reserves	23.2	19.8	26.2	29.5	28.1	28.6	26.7	26.7	28.1	28.6	29.6	26.7
at current cross rates:	...	19.8	28.1	35.2	...	...	...	...	...	...	...	...
CBT gross international liabilities	18.3	28.6	23.5	23.4	22.6	22.2	19.2	19.2	22.6	22.2	20.7	19.2
CBT net foreign assets	4.9	-8.8	2.7	6.1	5.5	6.4	7.4	7.4	5.5	6.4	8.9	7.4
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	0.0
plus other reserve liabilities	7.3	7.1	9.2	10.1	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4
minus Dresdner one year deposits	0.6	0.7	1.4	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
minus defence fund	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
CBT net international reserves	11.1	-2.9	10.0	13.6	13.3	14.2	15.2	15.2	13.3	14.2	16.7	15.2
Treasury net international reserves 3/	...	-1.3	-14.7	-14.2	-14.1	-14.6	-15.8	-15.8	-14.1	-14.6	-15.2	-15.8
Net international reserves (Treasury plus CBT)	...	-4.2	-4.6	-0.5	-0.8	-0.4	-0.5	-0.5	-0.8	-0.4	1.5	-0.5
	(in quadrillions of Turkish Lira, program exchange rate)											
Net foreign assets (Treasury)	...	-1.8	-21.1	-20.4	-20.3	-21.0	-22.7	-22.7	-20.3	-21.0	-21.8	-22.7
Net foreign assets (Treasury plus CBT)	...	-14.5	-17.2	-11.6	-12.4	-11.7	-12.0	-12.0	-12.4	-11.7	-9.0	-12.0
Net domestic assets (Treasury) 4/	...	1.8	21.1	20.4	20.3	21.0	22.7	22.7	20.3	21.0	21.8	22.7
Net domestic assets (Treasury plus CBT)	...	22.4	27.6	26.4	29.3	29.5	32.9	32.9	29.3	29.5	29.5	32.9
Base money (Treasury plus CBT)	...	7.9	10.4	14.9	16.9	17.8	20.9	20.9	16.9	17.8	20.5	20.9
Exchange rate (TL per US dollar, in millions)	0.67	1.44	1.63	1.40	1.31	1.44	...	...	1.31	1.44	...	...

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

1/ Except for 2000, all foreign currency aggregates are valued at end-December 2001 exchange rates (program exchange rates).

2/ Mainly Dresdner deposit liabilities.

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

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

Table 5. Turkey: Balance of Payments, 2001–05
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005
Current account balance	3.4	-1.5	-6.6	-10.1	-8.8
Trade balance	-4.5	-8.3	-13.7	-19.1	-18.8
Exports (f.o.b.)	34.4	39.8	51.0	62.9	68.6
<i>Of which:</i>					
Exports (f.o.b.) in trade returns	31.3	35.8	47.1	58.6	64.4
Shuttle trade	3.0	4.1	4.0	4.3	4.3
Imports (f.o.b.)	-38.9	-48.1	-64.7	-82.1	-87.5
<i>Of which:</i>					
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.2	-68.8	-87.2	-93.0
Energy imports (c.i.f.)	-8.3	-9.2	-11.4	-14.5	-14.7
Services and Income (net)	4.1	3.3	5.1	6.8	7.6
Services and Income (credit)	18.8	17.3	21.3	25.4	27.4
<i>Of which:</i>					
Tourism receipts	8.1	8.5	13.2	16.1	16.8
Services and Income (debit)	-14.7	-13.9	-16.2	-18.6	-19.8
<i>Of which:</i>					
Interest	-7.1	-6.4	-6.9	-7.6	-8.4
Private transfers (net)	3.6	3.0	1.7	1.9	1.9
Official transfers (net)	0.2	0.5	0.3	0.3	0.4
Capital account balance	-14.6	1.4	5.9	11.5	9.4
(including errors and omissions)	-16.3	1.3	10.7	11.7	9.4
Direct investment 1/	2.8	0.9	0.1	1.6	1.8
Portfolio investment in securities	-4.6	-1.2	1.2	2.3	1.6
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.7	1.6
Bonds (net)	0.1	1.0	1.5	1.2	2.7
Eurobond drawings	2.1	3.3	5.3	5.0	5.5
Eurobond repayments	-2.0	-2.3	-3.8	-3.7	-2.8
Loans (net)	-2.0	-0.7	-2.2	-0.6	-1.0
Loan disbursements	1.6	2.3	1.0	2.8	2.1
Loan repayments	-3.6	-3.0	-3.2	-3.3	-3.2
Central Bank of Turkey, (Excl. reserve assets, liabilities)	0.8	1.4	0.6	0.1	0.0
Domestic money banks (net)	-9.4	-1.8	3.0	5.0	1.3
Domestic money banks (FX deposits abroad, -: accumulation)	0.9	0.6	0.7	2.1	-0.2
Domestic money banks (other, net)	-10.3	-2.4	2.3	2.9	1.5
Other private sector (net)	-2.3	1.8	1.7	1.8	3.1
Other private sector (medium and long term, net)	0.3	2.7	1.5	2.4	2.3
Other private sector (short term, net)	-2.6	-0.9	0.2	-0.6	0.7
Errors and omissions 2/	-1.7	-0.1	4.8	0.2	0.0
Overall balance	-12.9	-0.2	4.1	1.5	0.5
Overall financing (NIR change excl. ST liabilities, + denotes decline)	12.9	0.2	-4.1	-1.5	-0.5
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-1.5	-0.5
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	1.3	6.3
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-2.8	-6.9
Purchases	11.3	12.5	1.7	1.8	0.7
Repurchases	-1.1	-6.1	-1.7	-4.7	-7.6

Table 5. Turkey: Balance of Payments, 2001–05
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005
Memorandum items:					
Trade in goods and services					
As percent of GNP					
Current account balance, incl. shuttle trade	2.4	-0.8	-2.8	-3.6	-3.0
Trade account balance, incl. shuttle trade	-3.2	-4.6	-5.8	-6.8	-6.5
Exports of goods and non-factor services	36.1	31.0	30.0	31.1	32.8
Imports of goods and non-factor services	32.2	30.6	31.0	33.1	34.1
Percent change					
Value growth in exports of goods (incl. shuttle trade)	11.9	15.8	28.1	23.3	9.1
Value growth in exports of goods (excl. shuttle trade)	12.8	14.1	31.6	24.6	9.8
Value growth in imports of goods	-26.8	23.7	34.5	26.7	6.6
Volume growth in exports of goods	16.6	11.7	16.3	14.8	10.1
Volume growth in imports of goods	-22.9	21.1	17.8	15.4	7.4
Terms of trade	1.7	0.0	-0.8	-1.2	0.5
Reserve and debt indicators					
Gross foreign reserves (Central Bank of Turkey)					
In billions of U.S. dollars	19.8	28.1	35.2	33.9	27.6
Months of goods & NFS imports	4.4	5.4	5.2	4.0	3.1
External debt (end-of-period)					
In billions of U.S. dollars	113.8	130.9	147.3	149.6	148.3
Percent of GNP	79.0	72.1	61.8	53.2	51.2
Percent of exports of goods & NFS	218.8	232.5	205.5	170.9	156.3
Net external debt (end-of-period) 3/					
In billions of U.S. dollars	77.5	99.1	107.5	114.3	115.1
Percent of GNP	53.8	54.6	45.1	40.7	39.7
Short-term debt (end-of-period)					
In billions of U.S. dollars	16.4	16.4	22.9	26.2	29.0
Ratio to end-period foreign reserves	82.6	58.4	65.1	77.2	104.9
Short-term debt plus MLT repayments					
In billions of U.S. dollars	32.7	32.5	41.8	45.4	46.6
Ratio to foreign reserves	164.7	115.4	118.8	133.9	168.8
Debt service ratio 4/	41.3	37.3	34.9	29.8	26.5

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

1/ Including privatization receipts.

2/ For 2004 includes reported data for January-March.

3/ Nonbank external debt less the NFA of the banking system.

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

Table 6. Turkey: Public Sector Primary Balances, 2000-04

	2000	2001	2002	2003 Prel.	2004 Prog.
(In trillions of TL)					
Public Sector	3,760	9,741	11,156	22,420	27,266
Central government 1/	5,831	8,420	6,644	17,954	20,985
Total revenue	30,346	44,766	63,369	90,445	104,425
Tax revenue	26,514	39,768	59,634	84,335	97,927
Direct taxes	10,849	16,080	20,077	27,800	29,920
Indirect taxes	15,665	23,687	39,557	56,535	68,007
Nontax revenue 1/	5,463	7,916	9,402	14,446	16,628
Tax rebates	-1,632	-2,918	-5,666	-8,335	-10,130
Non-interest expenditure	24,515	36,346	56,726	72,492	83,440
Personnel	9,982	15,204	23,160	30,200	35,101
Other current	1,193	1,431	2,510	2,548	3,432
Defense and security	2,327	3,591	4,485	5,668	5,895
Transfers	8,763	12,218	19,289	26,911	32,113
Social security institutions	3,320	5,910	9,946	16,228	19,468
State enterprises and banks 2/	1,280	1,777	2,245	1,971	1,500
Agricultural subsidies	359	1,033	1,868	2,805	3,215
Other transfers	3,804	3,499	5,230	5,907	7,930
Investment	2,251	3,902	7,282	7,165	6,899
Rest of the public sector	-2,071	1,321	4,513	4,466	6,281
EBFs	-225	149	-249	390	49
Unemployment insurance fund	334	1,098	962	1,228	1,783
Local governments	-284	94	338	-153	0
SEEs	-1,920	149	3,139	2,487	4,099
Social insurance institutions	24	-170	-85	53	0
Revolving funds 3/	99	95	407	461	350
(In percent of GNP)					
Public Sector	3.0	5.5	4.1	6.3	6.5
Central government 1/	4.6	4.8	2.4	5.0	5.0
Total revenue	24.2	25.4	23.2	25.3	25.0
Tax revenue	21.1	22.5	21.8	23.6	23.5
Direct taxes	8.6	9.1	7.3	7.8	7.2
Indirect taxes	12.5	13.4	14.5	15.8	16.3
Nontax revenue 1/	4.4	4.5	3.4	4.0	4.0
Tax rebates	1.3	1.7	2.1	2.3	2.4
Non-interest expenditure	19.5	20.6	20.7	20.3	20.0
Personnel	7.9	8.6	8.5	8.5	8.4
Other current	2.8	2.8	2.6	2.3	2.2
Transfers 2/	7.0	6.9	7.1	7.5	7.7
Investment	1.8	2.2	2.7	2.0	1.7
Rest of the public sector	-1.6	0.7	1.7	1.3	1.5
EBFs	-0.2	0.1	-0.1	0.1	0.0
Unemployment insurance fund	0.3	0.6	0.4	0.3	0.4
Local governments	-0.2	0.1	0.1	0.0	0.0
SEEs	-1.5	0.1	1.1	0.7	1.0
Social insurance institutions	0.0	-0.1	0.0	0.0	0.0
Revolving funds 3/	0.1	0.1	0.1	0.1	0.1
Memorandum item:					
Social Security deficit (percent of GNP)	2.6	3.3	3.6	4.5	4.7

Source: Turkish authorities; and staff estimates.

Note: from end-2003 the figures include special revenues and expenditures. From 2004 the authorities have moved to the GFS 2001 classification.

1/ Excluding privatization proceeds, transfers from the CBT, and interest receipts.

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

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

Table 7. Turkey: Banking System—Selected Indicators, 1999-2004
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
Banking System							
Total assets	79,763	117,649	179,675	212,681	225,097	249,693	255,974
Cash and claims on CBT	5,097	6,235	12,558	13,872	13,866	14,962	14,941
Claims on other banks	7,766	13,599	19,871	15,401	11,076	15,141	12,159
Securities portfolio	22,040	31,251	70,026	86,105	96,129	106,844	113,159
Loans, net	22,601	35,789	41,058	52,932	58,764	67,210	72,407
Other assets	22,258	30,775	36,162	44,371	45,261	45,536	43,308
Total liabilities	79,763	117,649	179,675	212,680	225,097	249,693	255,974
Deposits	48,272	68,143	110,298	137,973	141,872	155,312	158,756
Borrowing from banks	10,070	15,996	23,798	21,967	22,329	25,918	25,508
Repos	7,645	12,843	10,776	6,161	7,284	11,241	10,698
Other liabilities	9,539	12,207	20,527	21,351	21,077	21,683	22,134
Shareholders' equity (incl. profits)	4,234	8,461	14,276	25,228	32,534	35,539	38,878
Memorandum items:							
Capital adequacy ratio (%)	...	17.3	15.3	25.3	31.4	30.9	32.1
NPLs (%) total loans	9.7	9.2	29.3	17.6	13.8	11.5	10.2
Provisions (%) NPLs	61.9	59.8	47.1	64.2	77.5	88.5	89.8
Net profit (loss) after tax	-305	-888	-9,910	2,336	4,410	5,678	921
ROA (%)	-0.4	-0.8	-5.5	1.1	2.0	2.3	0.4
ROE (%)	-7.2	-10.5	-69.4	9.3	13.6	16.0	2.4
Share in assets (%)	100	100	100	100	100	100	100
Share in deposits and repos (%)	100	100	100	100	100	100	100
Private Banks							
Total assets	42,165	56,179	97,930	119,471	125,925	142,270	142,621
Cash and claims on CBT	2,707	3,362	8,434	9,356	9,140	9,868	9,488
Claims on other banks	5,386	9,769	10,494	7,623	5,255	6,369	5,420
Securities portfolio	14,335	13,491	27,146	39,819	44,471	51,485	50,174
Loans, net	12,445	19,587	26,506	35,752	40,729	46,402	49,759
Other assets	7,292	9,971	25,350	26,921	26,331	28,146	27,781
Total liabilities	42,165	56,179	97,930	119,471	125,925	142,270	142,621
Deposits	23,160	30,827	67,223	80,629	79,758	88,180	85,518
Borrowing from banks	6,508	10,045	15,585	13,703	16,080	18,158	18,141
Repos	4,654	3,918	1,803	4,074	4,396	8,103	7,870
Other liabilities	3,036	3,503	5,779	5,871	6,990	6,872	7,902
Shareholders' equity (incl. profits)	4,806	7,886	7,540	15,194	18,701	20,958	23,191
Memorandum items:							
Capital adequacy ratio (%)	...	18.3	9.0	19.64	23.5	23.5	24.7
NPLs (%) total loans	3.5	3.5	27.6	8.9	7.7	6.5	6.2
Provisions (%) NPLs	62.2	63.0	31.0	53.0	67.5	80.0	81.1
Net profit (loss) after tax	1,618	1,276	-7,383	2,410	2,024	2,917	772
ROA (%)	3.8	2.3	-7.5	2.0	1.6	2.1	0.5
ROE (%)	33.7	16.2	-97.9	15.9	10.8	13.9	3.3
Share in assets (%)	52.9	47.8	54.5	56.2	55.9	57.0	55.7
Share in deposits and repos (%)	49.7	42.9	57.0	58.8	56.4	57.8	55.1

Table 7. Turkey: Banking System—Selected Indicators, 1999-2004
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
State Banks							
Total assets	27,104	40,655	57,583	67,831	76,140	83,134	89,335
Cash and claims on CBT	1,999	2,588	3,544	4,000	4,283	4,589	4,912
Claims on other banks	1,088	1,639	5,096	3,996	2,809	5,365	3,894
Securities portfolio	4,671	8,139	32,756	39,245	44,302	47,716	55,104
Loans, net	6,521	10,025	9,177	8,804	10,158	12,202	14,325
Other assets	12,825	18,265	7,011	11,786	14,589	13,263	11,099
Total liabilities	27,104	40,655	57,583	67,831	76,140	83,134	89,335
Deposits	19,204	27,606	37,258	48,489	55,115	59,862	66,098
Borrowing from banks	630	1,339	2,381	2,230	1,472	2,338	2,103
Repos	1,922	4,949	3,844	1,022	935	1,018	897
Other liabilities	4,317	5,659	9,707	9,343	9,633	10,342	9,825
Shareholders' equity (incl. profits)	1,031	1,101	4,393	6,747	8,986	9,574	10,411
Memorandum items:							
Capital adequacy ratio (%)	...	7.9	34.0	50.2	62.0	56.3	56.2
NPLs (%) total loans	9.1	11.1	37.3	37.4	31.9	26.2	23.5
Provisions (%) NPLs	35.1	30.3	63	74	86	98	97.8
Net profit (loss) after tax	284	-177	-681	1,056	1,471	1,790	182
ROA (%)	1.0	-0.4	-1.2	1.6	1.9	2.2	0.2
ROE (%)	27.6	-16.1	-15.5	15.7	16.4	18.7	1.7
Share in assets (%)	34.0	34.6	32.0	31.9	33.8	33.3	34.9
Share in deposits and repos (%)	37.8	40.2	33.9	34.4	37.6	36.6	39.5
SDIF Banks							
Total assets	5,480	12,912	11,035	9,310	6,919	7,075	6,825
Cash and claims on CBT	248	103	45	62	43	52	35
Claims on other banks	211	535	874	619	307	456	545
Securities portfolio	2,511	8,572	8,451	4,655	4,909	4,964	4,942
Loans, net	1,052	2,533	602	1,889	1,042	910	655
Other assets	1,458	1,169	1,064	2,085	618	693	647
Total liabilities	5,480	12,912	11,035	9,310	6,919	7,075	6,825
Deposits	5,363	8,827	3,566	5,770	4,190	4,133	3,994
Borrowing from banks	263	819	2,020	1,274	479	837	837
Repos	1,426	3,993	5,023	1,024	1,853	2,025	1,896
Other liabilities	968	1,329	814	2,338	1,164	927	995
Shareholders' equity (incl. profits)	-2,540	-2,056	-388	-1,096	-767	-847	-897
Memorandum items:							
Capital adequacy ratio (%)	...	...	-17.8	-7.6	-16.6	-21.6	-25.6
NPLs (%) total loans	61.9	41.4	67.3	69.4	58.1	53.8	28.6
Provisions (%) NPLs	75.3	80.3	89.1	60.5	70.8	75.4	67.9
Net profit (loss) after tax	-2547	-2314	-2,344	-1,677	321	272	6
ROA (%)	-46.5	-17.9	-21.2	-18.0	4.6	3.8	0.1
ROE (%)	...	...	...	-153.0	-41.8	-32.1	-0.7
Share in assets (%)	6.9	11.0	6.1	4.4	3.1	2.8	2.7
Share in deposits and repos (%)	12.1	15.8	7.1	4.7	4.1	3.7	3.5

Table 7. Turkey: Banking System—Selected Indicators, 1999-2004
(in trillions of Turkish lira)

	1999	2000	2001	2002	2003	2003	2004
	Dec.	Dec.	Dec. 1/	Dec.	Sep.	Dec.	Mar.
Foreign and Investment Banks							
Total assets	5,014	7,903	13,126	16,068	16,112	17,213	17,194
Cash and claims on CBT	143	182	535	454	400	454	506
Claims on other banks	1,082	1,657	3,408	3,164	2,706	2,951	2,300
Securities portfolio	523	1,049	1,673	2,386	2,448	2,680	2,939
Loans, net	2,583	3,645	4,773	6,487	6,835	7,695	7,668
Other assets	683	1,370	2,738	3,577	3,723	3,434	3,781
Total liabilities	5,014	7,903	13,126	16,068	16,112	17,213	17,194
Deposits	546	882	2,252	3,086	2,810	3,137	3,145
Borrowing from banks	2,670	3,792	3,812	4,761	4,298	4,585	4,427
Repos	-357	-17	105	40	100	95	36
Other liabilities	1,218	1,716	4,227	3,798	3,290	3,542	3,412
Shareholders' equity (incl. profits)	937	1,529	2,730	4,383	5,614	5,854	6,173
Memorandum items:							
Provisions (%) NPLs	31.3	51.8	81.2	69.3	84.8	85.5	86.0
Net profit (loss) after tax	340	328	498	548	594	698	-39.2
ROA (%)	6.8	4.1	3.8	3.4	3.7	4.1	-0.2
ROE (%)	36.3	21.4	18.2	12.5	10.6	11.9	-0.6
Share in assets (%)	6.3	6.7	7.3	7.6	7.2	6.9	6.7
Share in deposits and repos (%)	0.3	1.1	1.9	2.2	2.0	1.9	1.9

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

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

Table 8. Turkey: External Financing Requirements and Sources, 2000-05
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Gross financing requirements	39.9	39.0	37.4	45.9	49.9	49.8
Current account deficit (excluding official transfers)	10.0	-3.2	2.0	6.9	10.5	9.3
Amortization on debt securities (bonds)	1.7	2.1	2.7	3.9	3.7	3.2
<i>Of which:</i>						
Public sector	1.4	2.0	2.3	3.8	3.7	2.8
Medium and long-term debt amortization (loans)	13.8	14.3	13.4	15.0	15.5	14.5
<i>Of which:</i>						
Public sector 1/	3.6	3.6	3.0	3.2	3.3	3.2
Short-term debt amortization	14.3	25.8	19.3	20.0	20.2	22.9
Public sector (net)1/	-1.0	1.0	0.0	0.0	0.0	0.0
Trade credits 2/	20.2	17.9	17.9	22.3	23.5	24.2
Banks and other private (net)	-4.9	6.9	1.5	-2.3	-3.2	-1.3
Available financing	39.9	39.0	37.4	45.9	49.9	49.8
Foreign direct investment (net)	0.1	2.8	0.9	0.1	1.6	1.8
Debt securities (bonds)	3.4	-1.7	4.2	7.9	7.6	8.1
Public sector	7.5	2.1	3.3	5.3	5.0	5.5
Medium and long-term debt (loans)	18.1	13.2	15.7	14.1	16.1	14.8
<i>Of which:</i>						
Public sector 1/	3.4	3.2	2.9	0.7	2.7	2.1
Short-term trade credits, currency and deposits	17.9	13.2	16.0	22.9	25.7	25.2
Official transfers	0.2	0.2	0.5	0.3	0.3	0.4
Other 3/	-2.8	-1.7	-0.1	4.8	0.2	0.0
Net reserves (+/- = decrease/increase)	3.0	12.9	0.2	-4.1	-1.5	-0.5
Accumulation of gross reserves	-0.4	2.7	-6.2	-4.0	1.3	6.3
IMF (net)	3.4	10.2	6.4	-0.1	-2.8	-6.9
Purchases	3.4	11.3	12.5	1.7	1.8	0.7
Repurchases	-0.1	-1.1	-6.1	-1.7	-4.7	-7.6
Memorandum item:						
Net public sector financing (incl. IMF, excl. reserves)	9.4	10.2	7.8	-0.7	-1.9	-4.9

1/ General government and Central Bank of Turkey.

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

3/ Errors and omissions.

Table 9. Turkey: Indicators of Fund Credit, 2000–08 1/

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Outstanding Fund credit (end of period)									
In billions of SDRs	3.2	11.2	16.2	16.2	14.3	9.6	1.9	0.7	0.1
In percent of quota	333	1,165	1,685	1,682	1,483	1,000	195	68	7
In percent of exports of G&NFS	8	27	37	32	24	15	3	1	0
In percent of GNP	2	10	12	10	7	5	1	0	0
In percent of public sector external debt	7	20	24	24	23	16	4	1	0
In percent of overall external debt	4	13	16	15	14	10	2	1	0
In percent of end-period foreign reserves	18	72	75	64	62	52	14	4	0
Repurchases of Fund Credit									
In billions of SDRs	0.1	0.9	4.9	1.2	3.2	5.1	7.8	1.2	0.6
In percent of quota	7	90	510	127	328	531	806	126	62
In percent of exports of G&NFS	0	2	11	2	5	8	11	2	1
In percent of GNP	0	1	4	1	2	3	4	1	0
In percent of public sector external debt service	1	9	36	11	27	39	51	14	7
In percent of overall MLT external debt service	0	5	22	6	15	23	32	7	3
In percent of start period foreign reserves	0	5	32	6	13	22	42	9	4
In percent gross public sector ext. financing 2/	0	22	21	7	19	39	43	7	4
Net Fund Resource Flows 3/									
In billions of SDRs	2.5	7.7	4.4	-0.7	-2.5	-5.4	-8.1	-1.3	-0.6
In percent of quota	259	798	455	-73	-258	-556	-844	-133	-64
In percent of exports of G&NFS	6	19	10	-1	-4	-8	-12	-2	-1
In percent of GNP	2	7	3	0	-1	-3	-4	-1	0
In percent of public sector external debt service	33	80	33	-6	-21	-41	-53	-14	-7
In percent of overall MLT external debt service	16	42	20	-4	-12	-24	-33	-7	-3
In percent start period foreign reserves	14	42	29	-3	-10	-23	-44	-9	-4
In percent gross public sector ext. financing 2/	18	193	19	-4	-15	-41	-45	-7	-4
					(In percent of total)				
Public debt to preferred creditors/public debt	13	27	32	31	...	...	...	...	...
Collateralized & securitized public debt/public debt	35	30	28	29	31	36	44	47	49
Debt service: public debt to preferred creditors/public debt	8	18	44	21	...	...	...	...	...
Debt service: collateralized & securitized public debt/public debt	28	30	24	40	38	29	25	50	57

1/ Projected on an expectations basis, except repurchase expectations on purchases made between February 2002 and July 2003 falling due in 2004-05, which are projected on an obligations basis.

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

3/ Net purchases less repurchases and charges.

Table 10. Turkey: Indicators of External Vulnerability, 2000–05 1/
(In percent, unless otherwise noted)

	2000	2001	2002	2003	Projections	
					2004	2005
CPI inflation (end year)	39.0	68.5	29.7	18.4	12.0	8.0
Public sector borrowing requirement (percent of GNP)	18.9	21.1	12.0	9.8	7.0	3.7
Net debt of the public sector (percent of GNP)	58.3	93.9	78.8	70.5	70.3	64.7
Export volume (percent change)	6.6	16.6	11.7	16.3	14.8	10.1
Import volume (percent change)	29.5	-22.9	21.1	17.8	15.4	7.4
Current account balance, in percent of GNP	-4.9	2.4	-0.8	-2.8	-3.6	-3.0
Capital account balance (in billions of US\$)	6.8	-16.3	1.3	10.7	11.7	9.4
Of which: Foreign direct investment	0.1	2.8	0.9	0.1	1.6	1.8
Foreign portfolio investment	-5.2	-4.6	-1.2	1.2	2.3	1.6
Gross official reserves, in billions of US\$ 2/	23.2	19.8	28.1	35.2	33.9	27.6
In months of imports of goods and NFS	4.0	4.4	5.4	5.2	4.0	3.1
In percent of broad money	27.4	26.8	34.4	32.6	30.1	22.8
Gross total external debt, in billions US\$	118.7	113.8	130.9	147.3	149.6	148.3
In percent of GNP	59.0	79.0	72.1	61.8	53.2	51.2
In percent of exports of goods and NFS	225.0	218.8	232.5	205.5	170.9	156.3
Gross short-term external debt, in billions US\$ 3/	43.7	32.7	32.5	41.8	45.4	46.6
In percent of gross total external debt	36.8	28.7	24.8	28.4	30.4	31.4
In percent of gross official reserves	188.4	164.7	115.4	118.8	133.9	168.8
Debt service 4/	36.9	41.3	37.3	34.9	29.8	26.5
REER appreciation (CPI based, period average)	11.1	-18.2	9.5	8.9	...	...
REER appreciation (CPI based, end of period) 5/	15.5	-21.2	5.0	13.4	1.4	...
Capital adequacy ratio 6/	17.3	15.3	25.3	29.6	...	...
State banks	7.9	34.0	50.2	59.8	...	...
SDIF banks	..	-17.8	-7.6	-9.6	...	...
Private banks	18.3	9.0	19.6	22.3	...	...
Foreign banks	29.4	41.0	48.4	54.9	...	...
Nonperforming loans (in percent of total) 6/	9.2	29.3	17.6	15.3	...	...
Real broad money, percentage change 7/	0.8	11.2	-3.3	-6.6	7.4	5.1
Real credit to the private sector, percentage change 7/	24.5	-27.5	-16.5	16.9	6.9	5.1
Banks' net foreign asset position, in billions of US\$	-5.8	2.4	3.1	2.0	...	...
Banks' net open exchange position, in billions of US\$ 8/	-5.4	-0.1	-0.4	-0.3	-0.5	...
Spread on Turkish dollar Eurobonds (in basis points) 9/	800	707	693	309	463	...

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

1/ For 2004-05, program projections.

2/ As of June 18, 2004, reserves stood at US\$34.0 billion (at actual exchange rates).

3/ By residual maturity.

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

5/ For 2004, as of May 2004.

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

7/ Deflated by the CPI.

8/ For 2004, as of June 18, 2004

9/ For 2004, as of June 21, 2004.

TURKEY: FUND RELATIONS
(As of May 31, 2004)

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

II. **General Resources Account:**

	Millions of SDRs	Percent of Quota
Quota	964.00	100.00
Fund holdings of currency	16,136.30	1,673.89
Reserve position in Fund	112.78	11.70

III. **SDR Department:**

	Millions of SDRs	Percent of Allocation
Net cumulative allocation	112.31	100.00
Holdings	1.68	1.50

IV. **Outstanding Purchases and Loans:**

	Millions of SDRs	Percent of Quota
Stand-by Arrangements	15,194.70	1,576.21
First credit tranche	90.38	9.38

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
In millions of SDRs				
Stand-By	02/04/02	02/03/05	12,821.20	11,460.40
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
<i>Of which:</i> SRF	12/21/00	12/20/01	5,784.00	5,784.00
Stand-By	07/08/94	03/07/96	610.50	460.50

VI. **Projected Payments to Fund (Expectations Basis)²**
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	<u>Forthcoming</u>				
	2004	2005	2006	2007	2008
Principal	1,890.33	5,158.07	7,556.20	595.42	85.05
Charges/Interest	323.03	514.54	191.60	13.98	2.86
Total	2,213.35	5,672.61	7,747.80	609.41	87.91

²This 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)³

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	284.38	4,925.72	6,930.55	2,463.95	595.42
Charges/Interest	334.83	613.81	307.15	55.54	13.61
Total	619.21	5,539.53	7,237.70	2,519.49	609.04

VII. Safeguard Assessments:

Under the Fund's safeguards assessment policy, the Central Bank of the Republic of Turkey (CBT) is subject to a full safeguards assessment with respect to the SBA arrangement, which was approved on February 04, 2002 and is scheduled to expire on December 31, 2004. A safeguards assessment was completed on April 4, 2002 and staff's findings and recommendations are reported in Section IV of IMF Country No. 02/137. The CBT authorities have implemented all of the measures recommended by staff.

VIII. Exchange Rate Arrangement:

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

IX. Article IV Consultations:

The 2002 Article IV staff report (IMF Country Report No. 02/137) was issued on April 4, 2002, and the accompanying Statistical Appendix (IMF Country Report No. 02/138) was issued on April 8, 2002. Board discussion took place on April 15, 2002.

³This schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations—except for SRF repayment expectations—would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country (see repayment schedules and IMF lending for details). SRF repayment expectations are shown on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

X. **ROSCs**

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 26, 2000	SM/00/139
Corporate Governance (prepared by the World Bank)	December 11, 2000	
Data ROSC	March 14, 2002	Country Report No. 02/55

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

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

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

TURKEY: IMF–WORLD BANK RELATIONS

Partnership in support of Turkey's Development Strategy

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

World Bank Country Assistance Strategy (CAS)

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

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

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

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

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

8. As of June 30, 2004, the portfolio of World Bank financed projects in Turkey consists of 16 active projects. These include 13 investment loans, one programmatic adjustment loan (PFPSAL 3), and two grants. Total net commitments amount to about \$4.3 billion. While net IBRD commitments are lower than in the previous two fiscal years, reflecting the recent closure of large loans, about \$1.6 billion was approved in FY04, compared to \$300 million in FY03. New approvals include a \$1.0 billion programmatic adjustment loan, as well as loans in the health, energy and financial sectors.

9. The International Finance Corporation (IFC) has been active in the financial sector, manufacturing, oil and gas, infrastructure and health and education. As of May 31, 2004, IFC's total portfolio in Turkey was US\$881 million of which \$33 million is equity. With a gross exposure of US\$185 million as of April 30 2004, Turkey is an important country for MIGA. The total amount of foreign direct investment facilitated by MIGA is estimated at approximately US\$1 billion.

IMF-World Bank collaboration

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

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

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

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

Ankara, July 15, 2004

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

Dear Mr. de Rato,

1. **Adherence to our macroeconomic program has enabled Turkey to ride recent market turbulence with limited adverse effects.** Our floating exchange rate regime as well as our strong fiscal position have helped us adjust promptly to a combination of tighter international capital markets and pressures on the current account balance resulting from strong import demand and higher oil prices. We have continued to experience broad-based growth from the production side as well as the demand side, and we confidently expect to meet, or exceed, our program projection of 5 percent growth this year. Consumer price inflation has fallen to 9 percent, a new decades-long low.

2. **We are determined to end the “stop-go” economic policies of past years.** The recent pace of consumer demand growth as well as related imports, if continued, could have posed risks for the sustainability of our growth trajectory. However, a rise in market interest rates and slowing of credit growth should contain domestic demand while lira depreciation will impact the current account balance. The over performance of budget revenue should help to dampen demand pressures.

3. **In order to sustain rapid growth over the medium term we are also pressing forward with our ambitious economic policy agenda.**

- **We have met or exceeded most fiscal and monetary targets set under the program.** The primary surplus targets for March and April have been comfortably exceeded, as has the target for net international reserves. The base money target for April was missed by the narrowest of margins.
- In the area of **structural policies**, we have moved forward decisively in most areas although some unavoidable delays have arisen (Annex A). BRSA has assessed the strength of the banking system prior to replacing the blanket guarantee with a more limited deposit protection scheme. SDIF has revalued its assets and announced a new strategy for asset sales, excess capital in state banks has been removed and key elements of a strategy for restructuring and eventual privatization will be announced shortly. The wholesale revision of the Banking Act, however, is delayed to ensure adequate consultation with stake holders and will be passed on to parliament in

September. We have also driven forward our fiscal reforms: draft revenue administration restructuring legislation has now been completed and will be submitted to parliament shortly; the Commission on SEE governance has completed its work; and, the code of conduct for civil servants was approved by parliament on May 25. We have continued to refrain from introducing any new amnesty on public sector receivables, meeting a continuous performance criterion.

4. **In light of this strong performance, we request the completion of the Eighth Review under the Stand-By Arrangement.** Based on our exceptional record in reducing inflation and the resulting increase in currency demand, we request a waiver of nonobservance for end-April 2004 base money performance criterion. Performance criteria for the remainder of the program are set out in Annex B. We will continue to consult the Fund about the progress being made in implementing policies supported by the Stand-By Arrangement, and in advance of any changes to these policies.

Macroeconomic framework

5. **We remain on course to achieve our macroeconomic objectives for 2004.** Consumer price inflation has fallen to single digits, while growth in the first part of the year has been stronger than anticipated. Although higher world oil prices and the depreciation of the exchange rate in April and May could raise the level of consumer prices temporarily, we are well on track to meet our target of 12 percent inflation at end-year. These same factors, together with the recent increase in interest rates, should slow domestic demand growth in the coming months, bringing output growth more closely in line with the 5 percent program projection. On the external side, we expect a current account deficit of some 3½ -4 percent of GNP with strong exports and tourism receipts in large part offsetting higher imports. In light of strong net capital inflows early in the year our net international reserves position will be maintained.
6. **For 2005 and beyond, our emphasis will be on maintaining disinflation and debt reduction through sustaining our high primary surplus.** This environment should permit growth to continue at around 5 percent. We expect inflation to further slow to 8 percent by end-2005. In order to continue reducing real interest rates we will maintain our tight fiscal policy in 2005. Our 2005 budget call will be consistent with our medium term debt reduction strategy.
7. **We are finalizing our medium-term program aimed at accelerating economic convergence with the European Union.** Our economic policy priorities ahead are focused on tax reform – aimed at base broadening and rate reductions, affordable health and social security reform, and completing restructuring of the banking sector. We will continue our close policy dialogue with the Fund in 2005 and beyond.

Fiscal policy

8. **Fiscal policy remains on track to meet, or exceed, our 6.5 percent of GNP public sector primary surplus target in 2004.** Strong revenues as well as expenditure shortfalls

have contributed to this performance through end-May. We intend any revenue over performance to provide a cushion to help ensure that the 2004 budget can be fully implemented.

9. To ensure **full implementation of the approved budget and an appropriate fiscal stance** we have:

- Scaled back tax incentives for automobile purchase. From May, the automobile excise deduction available for new car purchase has been cut from TL4.5 billion to TL2.3 billion.
- Written over to the budget TL1.2 quadrillion of special revenues cutting the scope for extra budgetary spending appropriations as a prior action for this review. While this amount is slightly lower than previously envisaged, our intention remains to transfer TL2.5 quadrillion special revenues for the whole year.
- Increased petroleum excises. In light of the exceptional increase in world oil prices in recent months, excises were lowered temporarily to limit the pass through to domestic prices. As oil price increases now appear not to be temporary, we have increased petroleum excises effective June 29, only narrowly falling short of budget assumptions (structural benchmark for the review). Adjusting excises in line with budget assumptions remains a structural benchmark. The petroleum product market will be liberalized on January 1, 2005 with prices determined by market forces.
- Maintained our incomes policy consistent with our inflation objective. Public sector wages and salaries have been increased in line with the inflation target. The Minimum Wage Commission announced the minimum wage for the remainder of 2004, with an increase in line with those of public workers and civil servants and with no budget compensation for employers.
- Submitted the draft decree to the Council of Ministers to eliminate the RUSF levy on commercial credits later this month as a further step to reduce financial intermediation costs.
- Finally, significant future changes in tax policy will be aligned with the budget cycle.

10. **We are moving forward in implementing our structural reform program to support a sustained improvement in Turkey's fiscal performance.**

- Draft **revenue administration restructuring legislation**, including provisions to make GDR a semi-autonomous agency within the Ministry of Finance, reorganization along functional lines, and to move tax policy functions into the Ministry of Finance has been finalized. The draft legislation will be submitted to Parliament before end-July (structural benchmark). However, parliamentary passage (July structural

benchmark) has been delayed due to a heavy legislative agenda. Passage is now expected by end-October 2004 (new structural performance criterion).

- Our strategy for enhancing **state enterprise governance** (May benchmark) is complete. The strategy entails introducing performance targets, strengthening the accountability and efficiency of management, and allowing performance and financial auditing by external auditors. We will complete the legislative changes in line with the strategy by end-2004.
- We have improved our **public sector personnel system**, through passage of legislation to establish a code of conduct for civil servants and public administrators (June benchmark).
- **The Ministry of Labor has developed a framework for analyzing social security reforms.** Over the Summer we will work on a range of reform options. We will decide our preferred pension system reform strategy by end-September 2004 (new structural benchmark). This strategy will include unification of the existing three pension institutions and an objective to place the pension deficit on a firm downward path by 2007 and to reduce it to 1 percent of GNP over the long term. In the area of health insurance, we plan to have a phased introduction of universal health coverage with any additional expenditures covered by compensatory measures. We will submit this reform package to parliament in mid-December 2004 (performance criterion) with a view to passage by January 2005 and a phased implementation during 2005-07.
- In the context of preparing **legislation for the decentralization of some central government functions to municipalities and special provincial administrations** we will ensure that budgetary discipline is maintained. The legislation will limit municipalities and special provinces debt stock to no more than annual revenue. Metropolitan municipalities debt stock will be limited to 1.5 times annual revenue. Debt limits will be reviewed and tightened, if necessary, in the context of forthcoming legislation concerning intergovernmental relations. New domestic borrowing of all local governments in excess of 10 percent of annual revenues will require central government authorization. The legislation will also require local governments to disseminate timely and accurate fiscal data to enable monitoring and will be complemented by separate legislation that clarifies intergovernmental fiscal relations. A committee is preparing a comprehensive report on the current level of local government debt, including enterprises under local government control.
- **Arrears of local governments**, including penalties and interest, will be dealt with on a case by case basis by a newly created Commission empowered by law to restructure claims, subject to Council of Ministers' approval. Formal settlements will be guided by the ability to pay, contain adequate safeguards for repayment including claw back of central government transfers, and will be made public.

Monetary policy

11. **Monetary policy remains focused on achieving this year's 12 percent inflation target, and reducing inflation over the medium term.** With inflation falling faster than anticipated, demand for base money has again exceeded our projections, causing the end-April performance criterion on base money to be missed by a fractional amount. In light of this increase in money demand we have raised our base money targets for the remainder of the year (Annex B). While our policy of implicit inflation targeting has been successful, we are making progress toward the eventual adoption of formal inflation targeting.

12. **The floating exchange rate regime remains central to our ability to adjust promptly to changing global circumstances.** At end-April we terminated foreign exchange purchase auctions in response to a decline in foreign exchange supply occasioned by banks closing their positions and a reversal of hitherto strong portfolio inflows. Since then we have intervened once in a small amount to dampen excessive exchange rate volatility, and such discretionary intervention will continue to be strictly limited. The recent exchange rate depreciation represents a correction largely in response to tightening global capital markets and a weakening of the current account balance. Its impact on the price level should be contained, and monetary policy will aim to limit second-round effects on inflation.

13. **Coordination between the Treasury and the CBT in their respective policy areas of debt management and monetary policy has been strengthened.** Coordination at the operational level, on a daily basis, is working well. To further enhance the effectiveness of policy coordination we will prepare a joint CBT-Treasury action plan, by end-September 2004, to address remaining legal, regulatory or procedural obstacles (a new structural benchmark).

Financial sector reform

14. **Our efforts to strengthen the financial system continue to move ahead** across several fronts. In particular, through strengthening the legal framework for banking activities, disposing of assets of liquidated and intervened banks, and restructuring state banks for privatization.

- We have completed a comprehensive **review of the Banking Act and prepared a new draft Law on Credit Institutions** to bring the legal framework more closely in line with EU standards. The law will place particular emphasis on strengthening the legal framework in the following areas: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections; (iii) lending to related parties; (iv) legal protection for BRSA and SDIF board members and staff for actions taken in good faith during the course of their duties; and (v) delineating the responsibilities of BRSA and SDIF respectively and providing for their effective coordination. By end-September, 2004, we will conduct seminars for the banking community and other stakeholders to help contribute to the understanding of the new law's principal objectives and features. We will submit the draft law to Parliament by end-September 2004. We expect

Parliament to pass the Law on Credit Institutions with the features above by end-November 2004 (new structural performance criterion). We are committed to maintain the operational and financial independence of the BRSA and the SDIF in the new banking act and other relevant legislation.

- **Regulation and supervision of non-bank financial institutions will be transferred from the Treasury to the BRSA** by January 1, 2005.
- **The İmar bank inquiry** is underway. The commission was appointed in late April and is expected to present its findings to the government in a final report, to be made public by end-August 2004 (performance criterion).
- We have reassessed the **value of SDIF asset holdings** to foster a better understanding of the recovery rates that might be expected from asset sales. To this end, for each intervened bank the SDIF will, in mid-July, announce the value of assets taken over at the time of intervention, accrued interest based on market rates as of end-June 2004, estimated market values (or recovery rates), and the costs borne by SDIF for restructuring or liquidating banks.
- Our **new strategy for SDIF asset resolution** has been announced (structural benchmark for April 2004). The main features are: (i) at end-May 2004, an offer was made to all borrowers except bank owners and individual borrowers to repay all outstanding debt by July 15 with a discount of 50 percent applied to principal and discounted interest, or to pay a 20 percent down payment with a discount of 30 percent on the remaining balances paid in installments over a 24-month period; (ii) in mid-July will re-launch the auction that was cancelled in December with bids to be submitted by August 16 and the winning bid to be selected by end-August (new structural benchmark); (iii) thereafter, new portfolios will be put up for sale by auction periodically until all assets have been disposed; (iv) for assets sold individually SDIF will always obtain a third party opinion about the price; and (v) all asset sales will be conducted transparently ensuring a fair and equal process.
- Our plan for **the resolution of Treasury receivables from the SDIF arising from financing the restructuring of the banking system** by end-2004 is on track.
- The **blanket guarantee** was lifted on July 5, 2004 and replaced with a limited deposit protection scheme protecting savings deposits up to TL 50 billion. Before the replacement, the BRSA undertook a thorough assessment of banking system soundness (April structural benchmark). A brief summary of the assessment has been published. In parallel, the CBT also assessed the effect of the abolition of the blanket guarantee on the Turkish payments system.
- The key elements of our **new strategy for state banks** will be announced shortly (a June structural benchmark). Legislation for the integration of Pamukbank into Halkbank is expected to be approved by Parliament shortly. All legal, managerial and

financial issues regarding the integration, will be completed by end-August 2004 (a new structural benchmark). The integration is expected to be completed by end-October 2004. Treasury will recapitalize Pamukbank and eliminate the negative net worth before integrating Pamukbank and Halkbank. Over time, Treasury will also replace Halkbank's holding of non-marketable securities with securities issued on market terms. The strategy for Ziraat bank has been developed and will be announced by end-July. Our objective remains to privatize these banks as soon as the restructuring is complete and when market conditions permit.

- The **due diligence for Vakifbank** has been delayed. The terms of reference have been finalized, the bank is in the process of hiring a consultant, and the due diligence will be completed by end-September 2004 (new structural benchmark).

Private sector development

15. As a follow up to the **Investment Advisory Council (IAC)** meeting in March, we have prepared draft legislation to streamline permission and approval procedures for investors. Moreover, we revised the draft law on establishing an Investment Promotion Agency and reflected the views of the various stakeholders. Our work also extends to the effective protection of intellectual property rights enforced by new legislation. We will submit a progress report to the Prime Minister and IAC members by October 2004.

16. **Our privatization program is delivering good results and we have made progress on some legal and procedural issues.** In the first quarter, cash receipts from privatization reached U.S.\$311 million, exceeding the indicative benchmark. We have amended public procurement legislation to simplify the hiring of advisors, and are preparing legislative amendments to facilitate sales of minority holdings.

17. Due to a **legal ruling halting the sale of TÜPRAŞ** we may fall short of our annual privatization receipts target of U.S.\$3 billion, though we are determined to maintain forward momentum. To this end, a law enabling the sale of more than 45 percent share of Türk Telekom to foreigners is approved and we expect to launch the tender process before the end of the year. We are also planning public offerings for 10-15 percent shares of PETKIM (petrochemicals) and Turkish Airlines. Privatization of the National Lottery is pending parliamentary approval of the legal framework, and then we will proceed to a request for proposals.

Very truly yours,

/s/

Ali Babacan
Minister of State for Economic Affairs

/s/

Süreyya Serdengeçti
Governor of the Central Bank of Turkey

Turkey: Structural Conditionality, April-December 2004

Action	Type 1/	Status
Prior actions for the eighth review		
Write over to the central government budget cumulative TL1.2 quadrillion of special revenues in the period January-June 2004.	PA	Met.
April		
Announcement by the SDIF of a new strategy for asset resolution.	BM	Met with delay. Settlement offer to borrowers at end-May. Auction strategy announced in June.
Assessment of the banking system prior to lifting of blanket guarantee.	BM	Met.
May		
Submission to Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance.	BM	Delayed to July.
Prepare report outlining key elements of state enterprise governance strategy.	BM	Met. Inter-agency committee completed study end-May.
June		
Improve the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators (previous target end-December 2003).	BM	Met. Legislation was passed in May 2004.
Make public key elements of the new strategy for state banks and a timetable for the action plan (mid-June).	BM	Partially met. Strategy for Halk-Pamuk announced and related legislation is expected to be approved by Parliament shortly. Ziraat strategy prepared and will be announced in July.
All excises will be adjusted to be brought in line with budget assumptions.	BM	Partially met. June 29 increases brought excises close to budget assumptions.
July		
Passage by Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance as defined in paragraph 10 of the Letter of Intent.	BM	Delayed due to heavy legislative agenda. Reset as new performance criterion for end-October 2004.
August		
Publication of final report on the independent inquiry into the Imar bank case in accordance with the terms of reference.	PC	Ongoing
Complete legal, managerial and financial procedures for integration of Halkbank and Pamukbank.	BM	Ongoing.
Select winning bid for relaunched SDIF asset auction.	BM	
September		
Finalize an action plan to address remaining legal, regulatory or procedural obstacles to Central Bank-Treasury coordination on monetary policy and debt management.	BM	
Completion of due diligence for Vakifbank by a consultancy firm.	BM	Ongoing
All excises will be adjusted to be brought in line with budget assumptions.	BM	
Decide on preferred pension system reform strategy.	BM	
October		
Passage by Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance as defined in paragraph 10 of the Letter of Intent.	PC	
November		
Passage by Parliament of Credit Institutions Law that strengthens the legal framework as defined in paragraph 15 of the Letter of Intent.	PC	
December		
Submission to Parliament by December 15 of social security reform legislation, as defined in paragraph 10 of the Letter of Intent.	PC	
Continuous		
No new amnesties of arrears on public sector receivables.	PC	Met

1/ PA=prior action, PC=structural performance criterion, and BM=structural benchmark.

Turkey: Quantitative Performance Criteria and Indicative Targets for 2004

	March 31, 2004		April 30, 2004		June 30, 2004		August 31, 2004		September 30, 2004		December 31, 2004	
	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome
I. Quantitative performance criteria												
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2004 (in trillions of TL)	5,420	7,618	...	...	14,100	...	...	...	22,950	...	26,200	...
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector since January 1, 2004 (in trillions of TL)	...	...	6,300	8,948	...	...	19,000	...	...	...	22,900	...
3. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US\$) 1/	7,000	3,382	...	...	13,000	5,227	...	...	16,000	...	17,500	...
4. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US\$) 2/	1,000	0	...	...	1,000	0	...	...	1,000	...	1,000	...
5. Floor on level of net international reserves of CBT and Treasury combined (in billions of US\$)	-2.00	0.75	-2.00	1.79	...	...	-2.00	...	...	...	-2.00	...
6. Ceiling on base money (in quadrillions of Turkish lira)	16.1	16.9	17.5	17.5	...	...	20.5	...	...	...	20.9	...
II. Indicative targets												
1. Floor on the cumulative overall balance of the consolidated government sector since January 1, 2004 (in trillions of Turkish lira)	-11,420	-6,084	...	...	-20,000	...	...	...	-29,300	...	-35,440	...
2. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in quadrillions of Turkish lira)	29.6	27.3	31.6	26.1	...	...	34.6	...	...	...	35.0	...
3. Privatization proceeds cumulative from January 1, 2004 (in millions of US\$)	100	311	...	...	500	...	...	...	1,000	...	3,000	...
4. Number of employees hired at non-financial state enterprises	...	...	...	...	...	...	...	...	...	...	4,000	...

1/ Applies to nonconcessional external debt with an original maturity of more than one year from end-December 2003. Excludes purchases from the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank and sales of treasury bills and bonds denominated in TL or FX to nonresidents in either the domestic primary or secondary markets.

2/ Stock of debt of maturity of one year or less, owed or guaranteed by the consolidated government sector. Excludes external program financing, sales of treasury bills denominated in TL or foreign exchange to non residents in either the domestic primary market or the secondary market, normal import-related credits, reserve liabilities of the Central Bank, and forwards contracts, swaps and other futures market contracts.

Turkey: Performance Criteria Test Dates and Review Schedule, 2004

Review	Purchase (SDR millions)	Primary balance of the CGS and external debt	PC Test Dates		Earliest Possible Purchase Date
			Primary balance of CGS minus SEEs	NIR, Base Money	
Actual purchases	11,460.4				
8th Review	453.6	...	April 30, 2004	April 30, 2004	June 15, 2004
9th Review 1/	453.6	June 30, 2004	August 31, 2004	August 31, 2004	October 15, 2004
10th Review 1/	453.6	September 30, 2004	December 31, 2004	December 31, 2004	January 15, 2005
Total Purchases	12,821.2				

1/ The June 30, 2004 and September 30, 2004 test date ceilings for the CGS primary balance and external debt performance criteria become applicable for purchases 45 days after the actual test date in view of the time required to report comprehensive monitoring data.

INTERNATIONAL MONETARY FUND

TURKEY

**Eighth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criterion
Supplementary Information**

Prepared by the European Department in consultation with other departments

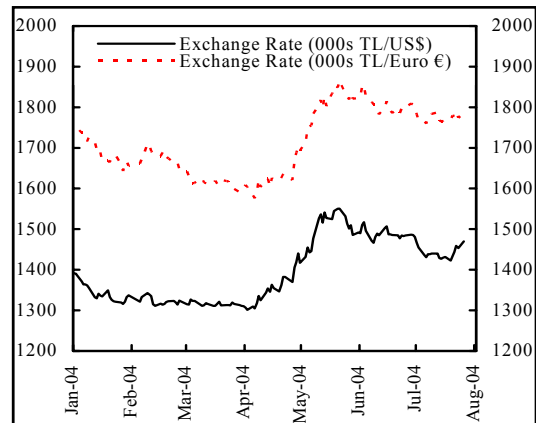
Approved by Michael Depler and Liam P. Ebrill

July 27, 2004

This supplement provides an update on developments and on the implementation of program measures since the circulation of the staff report (July 16, 2004, (www.imf.org)). The authorities have now informed the staff that they intend to publish the Eighth Review staff report. The staff appraisal remains unchanged.

Recent developments

1. **Financial market sentiment has steadily improved.** After depreciating by 15 percent against the U.S. dollar in April and early-May, the Turkish lira has since re-gained some ground. The benchmark bond rate has fallen to 26 percent, after having risen to 30 percent in May, while Eurobond spreads have again fallen to about 400 basis points.



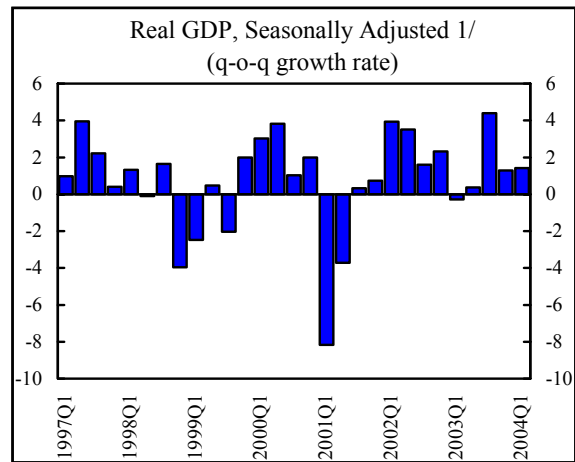
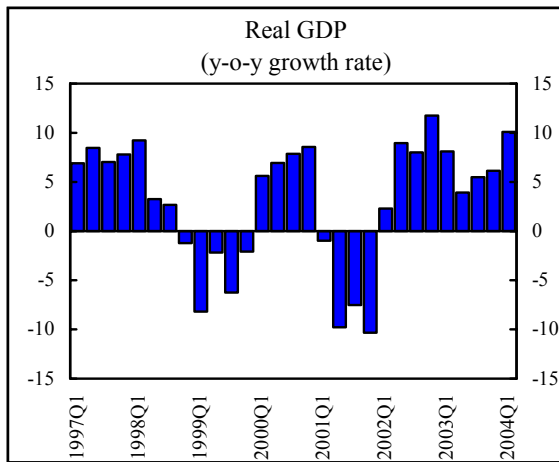
2. **First-quarter national accounts data released in end-June confirm that output has continued to grow strongly:**

- **Real GDP increased by 10.1 percent year on year, and real GNP by 12.4 percent.** Although agricultural output again declined, strong activity in manufacturing, and in domestic wholesale and retail trade contributed to the high overall output growth (Table 1). Construction experienced positive growth for the second quarter in a row, following eleven quarters of decline. In seasonally adjusted terms, GDP grew by 1.4 percent quarter on quarter (close to 6 percent annualized), similar to the last quarter of 2003, though seasonal factors are quite volatile.

Table 1. Turkey - Quarterly Real Output and Expenditure, 2002-2004

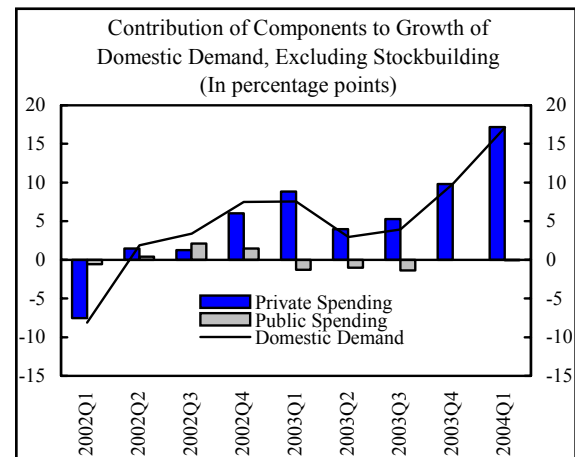
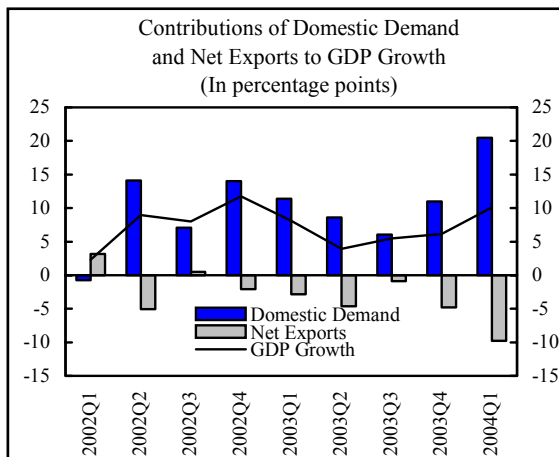
	2002				2002	2003				2003	2004
	March	June	Sept.	Dec.		March	June	Sept.	Dec.		March
	(year on year growth rate, in percent)										
Gross National Product	0.6	10.4	8.0	11.8	7.9	7.4	3.6	5.6	7.2	5.9	12.4
Gross Domestic Product (production side)	2.3	8.9	8.0	11.7	7.9	8.1	3.9	5.5	6.1	5.8	10.1
Agriculture	-1.2	1.9	5.8	16.2	6.9	2.0	-0.8	-0.6	-9.6	-2.5	-7.5
Industry	2.8	12.6	10.5	11.4	9.4	8.8	4.2	9.1	9.2	7.8	10.3
Manufacturing					8.8	10.4	4.9	9.5	10.0	8.1	11.3
Construction					-5.6	-13.8	-12.7	-12.3	1.3	-9.0	2.9
Services	3.5	9.8	9.0	12.2	8.8	9.8	5.9	8.2	8.6	8.1	11.9
Wholesale and retail commerce					1.3	11.7	8.2	10.3	11.0	-0.3	17.3
Gross Domestic Product (demand side)	2.3	8.9	8.0	11.7	7.9	8.1	3.9	5.4	6.1	5.8	10.1
Domestic Demand	-0.7	14.8	8.2	14.9	9.3	10.9	8.5	7.0	11.3	9.3	19.1
Consumption	-1.5	3.1	3.5	4.4	2.5	6.9	2.3	5.2	8.0	5.6	9.9
Private	-1.9	3.2	2.7	4.4	2.1	7.8	2.9	5.8	10.3	6.6	10.6
Public	2.2	2.6	12.0	4.5	5.4	-2.3	-2.0	-0.7	-4.2	-2.4	2.4
Gross Investment	2.1	58.9	27.7	57.9	35.9	25.2	23.9	13.1	20.5	20.4	47.0
Gross Fixed Investment	-28.5	-2.0	5.6	20.5	-1.1	11.7	6.3	3.0	19.2	10.0	52.6
Private	-30.6	-3.8	-3.2	31.0	-5.3	22.6	14.2	16.4	30.1	20.3	60.6
Public	-18.4	3.0	27.9	9.2	8.8	-34.8	-14.6	-22.7	5.0	-11.5	-11.3
Exports of goods & nonfactor services	10.6	5.1	15.9	12.5	11.1	14.5	12.3	19.4	16.9	16.0	10.3
Imports of goods & nonfactor services	2.5	20.4	19.2	22.1	15.8	22.0	24.7	28.3	33.0	27.1	31.2
	(contributions to growth)										
Gross Domestic Product (production side)	2.3	8.9	8.0	11.7	7.9	8.1	3.9	5.5	6.1	5.8	10.1
Agriculture	-0.1	0.2	1.4	1.9	0.9	0.1	-0.1	-0.1	-1.2	-0.3	-0.4
Industry	0.9	3.9	2.5	3.2	2.7	2.9	1.3	2.2	2.6	2.2	3.4
Manufacturing					2.5	2.8	1.3	1.9	2.4	2.1	3.2
Construction					-0.3	-0.6	-0.6	-0.5	0.1	-0.4	0.1
Services	2.0	5.4	4.3	6.6	4.6	5.6	3.2	4.0	4.7	4.3	7.0
Wholesale and retail commerce					0.2	2.2	1.6	1.9	2.1	0.0	3.4
Statistical Discrepancy	-0.1	-0.1	0.4	-0.1	0.1	-0.4	0.0	0.4	-0.1	0.0	-0.5
Gross Domestic Product (demand side)	2.4	9.1	7.5	11.9	7.9	8.5	3.9	5.1	6.2	5.8	10.6
Domestic Demand	-0.8	14.1	7.1	14.0	8.8	11.4	8.6	6.0	11.0	8.9	20.4
Consumption	-1.3	2.3	2.4	3.3	1.9	5.6	1.6	3.4	5.6	4.0	8.0
Private	-1.4	2.1	1.7	2.8	1.4	5.8	1.8	3.5	6.1	4.2	7.8
Public	0.2	0.2	0.8	0.6	0.5	-0.2	-0.2	0.0	-0.5	-0.2	0.2
Gross Investment	0.5	11.8	4.6	10.7	6.9	5.8	7.0	2.6	5.3	4.9	12.5
Gross Fixed Investment	-6.9	-0.5	1.0	4.1	-0.2	2.0	1.3	0.5	4.2	1.9	9.1
Private	-6.1	-0.7	-0.4	3.2	-0.8	3.1	2.2	1.8	3.7	2.6	9.4
Public	-0.7	0.2	1.4	0.9	0.5	-1.1	-0.8	-1.3	0.5	-0.7	-0.2
Change in Stocks	7.3	12.2	3.7	6.5	7.1	3.8	5.6	2.1	1.2	3.0	3.3
External Balance	3.2	-5.1	0.5	-2.1	-0.9	-2.8	-4.7	-0.9	-4.8	-3.1	-9.8
Exports of goods & nonfactor services	4.2	2.2	5.3	5.0	4.3	6.2	5.0	6.9	6.8	6.3	4.7
Imports of goods & nonfactor services	1.0	7.2	4.8	7.1	-5.1	-9.0	-9.7	-7.8	-11.6	-9.4	-14.5

Sources: State Institute of Statistics; SPO; and CBT.



Source: Central Bank of Turkey.
1/ Using Tramo-Seats.

- Private sector demand continues to drive growth.** Private (fixed) investment increased by more than 60 percent year on year, and private consumption by more than 10 percent. After declining steadily in 2003, government consumption increased by 2.4 percent. In the data, inventory accumulation continues to make a significant contribution to growth. However, this likely reflects either an over-estimation of GDP from the production side or an under-estimation of the expenditure components.

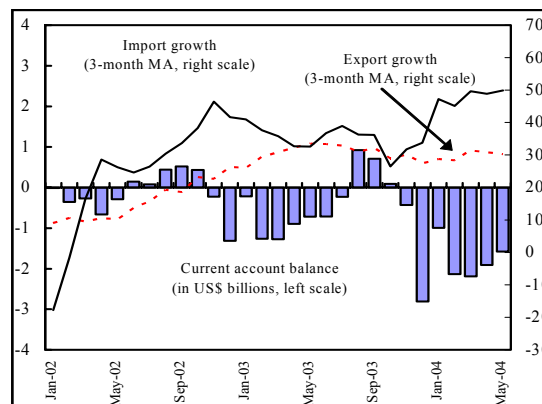


- Real sector indicators in the second quarter also remain strong.** Industrial production grew by 16.5 percent year on year in May, while capacity utilization increased in June to more than 84 percent. Motor vehicle production remains strong, rising more than 80 percent year on year in May, though the detailed June capacity

utilization figures have tentative signs that this may be slowing down. However, output growth in lower value added sectors, such as textiles, has been weak.

3. **The current account deficit continues to weaken, but has been financed by capital inflows.**

- **The current account deficit in April and May remained large.** A surge in import growth (mostly finished consumption and investment goods), not matched by growth in exports, widened the current account deficit to US\$8.8 billion in the first five months of 2004.



- **The deficit has been financed by higher private capital inflows, albeit mostly short-term.** After an outflow of nearly US\$½ billion in non-resident holdings of equities and treasury bills in April (the first significant monthly outflow for over a year), inflows returned in June. At the same time, domestic banks increased their open foreign exchange position (excluding forwards) during June by about US\$1.5 billion.
4. **Although the authorities have not yet revised their official projections, the data suggest that both output growth and the current account deficit are likely to be higher than projected.** Given positive carry-over from the last quarter of 2003, rapid growth in the first quarter of 2004, and demand and output indicators pointing to a strong second quarter, the 5 percent annual target for 2004 is likely to be exceeded by at least 1-2 percentage points. At the same time, current staff estimates suggest that the external current account deficit will also increase to at least US\$11 billion, or around 4 percent of GNP (about ½ percentage point higher than in the staff report).
5. **June inflation data are consistent with achieving the 12 percent annual target.** In June consumer prices fell by 0.1 percent month on month, wholesale prices by 1.0 percent, both well below market expectations. Annual consumer price inflation remained at 8.9 percent, as in May, while wholesale price inflation rose slightly to 10.5 percent. While the latest increase in petroleum prices has yet to feed through, the low June figures together with the recent stability of the exchange rate suggest that the end-year target is likely to be met. This is borne out by the latest CBT survey of market expectations, which projects end-year inflation of 10.9 percent.
6. **Although the primary surplus in June was slightly below program, the consolidated budget for the first half of 2004 continued to overperform.** Although strong domestic demand meant that direct tax and VAT revenues remained strong in June, spending on investment and current transfers was higher than expected. Also, delays in adjusting petroleum excises in the first half of the year have cost 0.2 percent of GNP. Despite some

slight weakening in June, the budget still seems well on track. In the first six months, the cumulative primary surplus of the consolidated budget reached TL 13.3 quadrillion (an overperformance of TL 1.8 quadrillion (0.4 percent of GNP)), more than 60 percent of the annual target.

Turkey: Primary surplus (program definition), Jan-June 2004
(in TL trillions)

	Jan-June		
	Prog.	Act.	Diff
Consolidated budget primary surplus	11,548	13,304	1,756
Revenues	47,243	47,840	597
Primary expenditures	35,695	34,535	-1,160
Rest of Public Sector primary surplus (CGS) 1/	2,711	1,806	...
EBFs	-223	235	...
Soc Sec	413	109	...
UI	861	491	...
SEEs	1,660	971	...

1/Actual data is as of April. SEEs April data is provisional.

7. **The High Planning Council approved the 2005 budget call.** Main macroeconomic parameters for preparation of the 2005 budget include: 5 percent real GNP growth, 8 percent year-end inflation, 10.1 percent GNP deflator, and an average dollar exchange rate of TL 1.67 million. The budget call does not specify any target for the primary surplus, but it does set ceilings on certain expenditure categories, and would imply a decline in primary spending of 0.5 percent of GNP. Key categories such as personnel and purchase of goods and services are assumed to rise with end-year inflation (but below average inflation). Investment spending is projected to increase, but only modestly.

8. **Banking sector developments have been mixed.** The Cukurova Group (the former owners of Yapi Kredi and Pamuk banks) reached agreement in principle with the BRSA and SDIF that would reduce its payments from US\$6.2 billion over 15 years to US\$4 billion over less than 2 years. Yapi Kredi's balance sheet will be further strengthened by the Group's purchase of US\$1 billion in non-core assets. Although the full details (including the safeguards in case of non-compliance) are not yet known, market reaction has been positive. However, negotiations on the sale of a majority stake in Garanti bank to Banca Intesa have failed, a set-back to foreign involvement and restructuring of the banking system. The authorities passed legislation to allow the merger of Halk and Pamuk banks; they are expected to announce further details of their new state bank strategy shortly.

9. **Since completion of the review discussions, the authorities have passed new EU reform legislation.** The 9th EU harmonization package was passed by Parliament on July 14. This removes the death penalty from the penal law and eliminates the seat reserved for the military on the higher education, radio/television, and communications boards.

Program implementation

10. **The prior action on write-over of TL 1.2 quadrillion of special revenues to the budget was met by July 14, not by end-June as indicated in the Letter of Intent.** The authorities informed staff and management that while the official circular instructing the write-over was issued by end-June, the associated transactions were only completed by July 14.

11. **With regard to progress in other areas of structural reform:**

- The law integrating 15 extra budgetary funds into the central government budget was passed by Parliament on July 14. This law abolishes off-budget special revenues and expenditures and fully incorporates them into the budget so that formal write-over would no longer be necessary.
- To reduce further financial intermediation costs, a Cabinet decision abolishing the 3 percent Resource Utilization Support Fund (RUSF) levy on all commercial transaction is expected to be approved this week.
- The Imar Commission has submitted its preliminary report to the authorities and appears on course to complete its work by end-August



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No.04/87
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Turkey

On July 30, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.¹

Background

After the collapse of the 2000 exchange rate-based disinflation program and the floating of the lira in February 2001, the banking system experienced heavy losses, inflation soared and the economy contracted by nearly 10 percent. Public debt climbed to over 90 percent of GNP in 2001, partly owing to the costs of bank restructuring.

Since then, strong fiscal consolidation and disinflation efforts have laid the basis for a rapid and powerful recovery. High primary surpluses, reaching more than 6 percent in 2003, contributed to bringing public debt on a sustainable and declining path. The debt-to-GNP ratio declined to 70 percent in 2003 and the market risk premium on Turkish debt fell significantly.

The adherence to a strict monetary program under the floating exchange rate regime helped establish the Central Bank's credibility and facilitate a dramatic decline in real interest rates as confidence recovered. In this environment, real GDP grew by close to 8 percent in 2002 and 6 percent in 2003, and it is projected to grow by at least 5 percent in 2004. At the same time, inflation has fallen to its lowest levels in decades, and is on track to reach its annual target of 12 percent in 2004.

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

These favorable developments notwithstanding, the Turkish economy faces a number of risks. Domestic demand has started to increase rapidly, and the current account deficit is widening as a result. The high size of the government debt, its short maturity, and its currency composition is also a major source of vulnerability.

For the medium term, the authorities' main challenge is to implement policies that achieve the goals of sustained growth and low inflation. With its commanding majority in Parliament and with new elections not needed for another three years, the government has an unprecedented opportunity to implement the difficult structural reforms needed to achieve this.

Executive Board Assessment

Executive Directors welcomed the opportunity to take stock of what had been achieved over the last few years and to gauge Turkey's challenges and reform priorities ahead. Directors commended the authorities for the impressive economic performance, with macroeconomic conditions at their best in decades. They were particularly pleased to note that the authorities' strategy of disinflation and rapid debt reduction is delivering striking results. Growth has been sustained and rapid, while inflation has been lowered dramatically to single digits. Large primary surpluses have helped reduce government debt ratios and improved market confidence, leading to a significant reduction in real interest rates, an end to decades of continuous exchange rate depreciation, and a markedly improved resilience to shocks.

Despite these considerable achievements, Directors noted that vulnerabilities remain. The size of the public debt, its short maturity and large foreign currency component make Turkey vulnerable to exchange rate and interest rate shocks. In addition, the quality of fiscal adjustment needs to be improved and the pace of structural reform intensified, if the achievements to date were to be sustained and be carried forward in the form of robust medium-term growth.

With regard to short-run challenges, Directors noted that domestic demand growth is exceptionally strong, contributing to the widening of the current account deficit, and they commended the authorities for their efforts to dampen domestic demand. Fiscal policy had been kept tight, with the primary surplus targets exceeded, tax incentives for certain consumer purchases had been reduced, and state banks had reined in their lending. Despite these efforts, Directors saw the need to continue to monitor the rising current account deficit carefully. Against this background, Directors urged the authorities to save this year's fiscal overperformance, at least until the outlook for the current account stabilizes, and to stand ready to tighten fiscal policy further if domestic demand continues to be strong. Directors regretted the repeated increases in minimum wages, but welcomed the authorities' strong efforts in restraining government sector wages, which would help contain domestic demand pressures.

Looking to medium-term prospects and policies, Directors emphasized that continued fiscal consolidation would be central to maintaining Turkey's impressive economic performance and strengthening medium-term growth prospects. They noted that the success in fiscal consolidation had resulted in a reduction in real interest rates and had boosted growth, while

providing the Central Bank of Turkey (CBT) greater freedom to gear its monetary policy to reducing inflation. Against this background, Directors urged the authorities to resist calls to relax next year's primary surplus targets, as any benefits would likely be far outweighed, even in the short run, by higher real interest rates, which will slow growth. Continued high primary surpluses in a predictable medium-term framework would also help the authorities meet the considerable public debt repayments coming due and help strengthen market confidence.

Directors stressed the importance of adopting high quality measures to help sustain this fiscal consolidation. This should include reform of the social security system, which, despite high contribution rates, remains in large deficit, and reform of tax administration to combat widespread tax evasion. Further large increases in current spending should also be resisted; this will also make room for increased public investment. Looking ahead, Directors saw scope for a more fundamental tax reform aimed at simplifying the system and broadening the tax base. To guide fiscal policy over the next few years and to help ensure debt sustainability, Directors encouraged the authorities to cast their plans within a multi-year debt reduction plan.

Directors commended the CBT and the government on their success in reducing inflation to single digits. The end-2004 inflation target of 12 percent is clearly achievable. The CBT's skilful use of monetary policy has been central to this achievement, supported by fiscal discipline and public sector wage restraint. Directors noted the importance of preserving the central bank's independence for keeping inflation low, backed by continued supportive fiscal and incomes policies. They also encouraged the CBT to enhance its monetary framework and increase its transparency. As first steps, this could include giving the monetary policy council more of a role in advising the Governor on interest rate decisions, and timing these decisions to coincide with monetary policy council meetings.

Directors noted the many achievements that had been made in financial sector reform. Creation of an independent Banking Regulation and Supervision Agency (BRSA), tightening of supervisory practices, recapitalization and restructuring of the state banks, and the triple audit and recapitalization of the private banks had each made the banking system much stronger. Directors welcomed the authorities' commitment to implementing the considerable reform agenda that still lies ahead, including accelerating recoveries from bad assets, privatizing the state banks, lowering distortionary taxes on financial intermediation, and legal reform, including passage of a new Banking Act.

Directors welcomed the authorities' commitment to stimulating growth by improving the investment climate, which would lead to more foreign direct investment inflows and boost jobs. Creation of more stable macroeconomic and financial conditions had already brought large benefits here, and would need to be sustained. Looking ahead, Directors urged the authorities to quickly put in place the steps recommended by the inaugural Investment Advisory Council meeting in mid-March 2004. Given that unemployment remains high, despite strong growth, Directors encouraged the authorities to press ahead with labor market reforms. Turkey faces a historic opportunity. Directors encouraged the authorities to seize this unique opportunity to secure sustained growth and reduce vulnerabilities; press ahead with fiscal, financial, and structural reforms; and thereby put Turkey firmly on an irreversible path toward convergence with European economies.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Turkey: Selected Economic Indicators, 2000-04

	2000	2001	2002	Projections	
				2003	2004
Real sector (in percent)					
Real GNP growth rate	6.3	-9.5	7.9	5.9	At least 5
GNP deflator	50.9	55.3	44.4	22.5	11.5
Nominal GNP growth rate	60.4	40.5	55.8	29.7	17.1
WPI (12-month, end-of-period)	32.7	88.6	30.8	13.9	14.2
CPI (12-month, end-of-period)	39.0	68.5	29.7	18.4	12.0
Central government budget (in percent of GNP)					
Primary balance	4.6	4.8	2.4	5.0	5.0
Net interest payments	15.8	24.7	17.5	16.1	13.6
Overall balance	-11.2	-20.0	-15.1	-11.1	-8.6
Consolidated public sector (in percent of GNP)					
Primary balance	3.0	5.5	4.1	6.3	6.5
Net interest payments	21.9	26.6	16.1	16.1	13.5
PSBR (including CBT profits)	18.9	21.1	12.0	9.8	7.0
Operational balance	-6.9	-4.7	-4.4	-4.8	-2.9
Net debt of public sector					
Net external	58.3	93.9	78.8	70.5	70.3
Net domestic	19.0	37.7	32.1	22.2	22.7
	39.3	56.2	46.7	48.3	47.7
External sector					
Current account balance	-4.9	2.4	-0.8	-2.8	-3.5 to -4
Gross external debt	59.0	79.0	72.1	61.8	53.2
Net external debt	38.8	53.8	54.6	45.1	40.7
Short-term external debt (by remaining maturity)	21.7	22.7	17.9	17.5	16.2
GNP (in billions of U.S. dollars)					
GNP (in billions of U.S. dollars)	201.3	144.0	182.7	238.5	...
GNP (in quadrillions of Turkish lira)	125.6	176.5	275.0	356.7	417.6

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



Press Release No. 04/163
FOR IMMEDIATE RELEASE
July 30, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Eighth Review Under Stand-By Arrangement with Turkey and Approves US\$661 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the eighth review of Turkey's economic performance under the Stand-By Arrangement. The decision will enable Turkey to draw an amount equivalent to SDR 454 million (about US\$661 million) from the IMF immediately, bringing total disbursements to an amount equivalent to SDR 11.9 billion (US\$17 billion) under the arrangement.

With this decision, the Executive Board also granted Turkey's request to waive the non-observance of an end-April performance criterion in regard to a small deviation from the target for base money.

Turkey's Stand-By Arrangement was approved on February 4, 2002 ([see Press Release No. 02/7](#)) for a total amount of SDR 12.8 billion (about US\$19 billion).

Following the Executive Board discussion, Rodrigo de Rato, Managing Director and Chair, said:

“Turkey's economic performance continues to be impressive. Growth has been sustained and rapid, and is likely to exceed this year's 5 percent target. Inflation has been lowered dramatically to single digits and the 12 percent end-year target is clearly achievable. The government's record of strict fiscal discipline, including taking remedial actions where necessary, has been instrumental to this success. Together with the Central Bank of Turkey's commendable conduct of monetary policy, fiscal discipline has contributed to the success in reducing inflation and laid the basis for strong and sustained growth.

“The immediate macroeconomic challenge is to avoid a widening current account deficit. So far the financing of the deficit has not been a problem. Indeed, the central bank has been able to build reserves during the first half of the year. The authorities' recent steps to curtail consumer lending and reduce consumer spending, together with rebounding tourism revenues, should help stabilize the current account deficit. However, strict fiscal discipline and saving any budget overperformance, at least until the risks to the current account have been clarified, will remain key to maintaining the success of the authorities' macroeconomic program.

“The authorities’ structural reform agenda is critical for supporting their fiscal effort, sustaining strong economic growth, boosting job creation, and underpinning the success of the program. Notwithstanding some delays, the government’s efforts to improve tax administration and the social security system are especially important in this respect. The planned integration of Pamuk and Halk banks is welcome, as is the authorities’ announcement of their new strategy for the state banks, and the Savings Deposit Insurance Fund’s (SDIF) strengthened commitment to accelerating asset sales. Adoption of new banking legislation more closely in line with EU standards will also be a key landmark. Looking ahead, the authorities need to regain momentum in privatization and should implement policies needed to attract foreign direct investment, building on the March inaugural Investment Advisory Council.

“The Turkish authorities have maintained their strong record of program implementation. They have also demonstrated their commitment to ambitious structural reforms that will help underpin fiscal consolidation and debt sustainability. The result has been strong growth, low inflation, and steady reductions in the government debt ratio. These strong efforts deserve the continued support of the international community,” Mr. de Rato said.

**Statement by Willy Kiekens, Executive Director for Turkey
and Levent Veziroglu, Senior Advisor to Executive Director
July 30, 2004**

Overview

Turkey has achieved encouraging results with its Fund-supported program of stabilization and reform, and with its strategy to qualify for starting accession negotiations with the European Union. Strengthened confidence in Turkey's political stability and continued disciplined economic policies have helped lower the cost of credit and have stimulated investment and growth.

The economy is quite buoyant. Capacity utilization rates, indicators of industrial and agricultural production, and strong export and tourism revenues give reason to project output growth in the range of 6 percent to 7 percent this year. The significant decline in inflation is a great achievement that in no small measure results from strict fiscal policies and skillful monetary management. Annual consumer and wholesale price inflation have now reached 8.9 percent and 10.5 percent, respectively. Turkey's performance under the Stand-By arrangement shows that tight fiscal discipline, disinflation and strong growth can be achieved simultaneously.

The current account deficit is growing significantly. It reached USD 8.8 billion during the first five months of this year, even though during that period there was a record inflow of USD 3.6 billion tourism receipts, a 51 percent increase over the same period last year. Needless to say that the authorities are closely monitoring these developments. The behavior of the exchange rate under the floating exchange rate regime should play a corrective role. But if needed, measures to restrain consumer demand will be taken to avoid a widening of the current account deficit beyond an amount that Turkey can safely finance.

Fiscal Stance and Structural Fiscal Policies

The buoyant economy and strict budget execution have yielded a favorable budget outcome so far this year. During the first 5 months, the primary surplus exceeded the target by 0.75 percent of GDP.

The authorities recognize the need to improve the quality of fiscal adjustment, lest every new budget requires taking significant corrective measures that are politically costly and an administrative burden. Without structural fiscal reforms, sustaining the present fiscal stance might prove difficult. The enactment of the Public Financial Management and Control Law and the indirect tax reform were very important steps in this direction.

The authorities have now intensified their efforts in some major areas: reform of direct taxation, administrative reform, and social security reform. The tax administration reform is expected to be passed by parliament by end-October. The authorities are determined to address the causes of the informal economy. One strategy is to widen the tax base, to increase tax compliance and lower the tax rate. This should improve the business climate and raise revenues. The Fund staff is actively discussing these tax issues with the authorities.

The authorities are also working on a comprehensive social security reform, which has been a major source of the deficit in fiscal accounts. This reform includes institutional arrangements, changes in the pension system to reduce the deficit in the medium term and reform of the health insurance scheme. This reform package will be discussed by Parliament in January 2005.

Monetary policy

The floating exchange rate regime has struck a good balance between reducing inflation and preserving competitiveness. It creates more room for monetary policy to pursue its inflation objective, and makes the economy less exposed to shocks. For low inflation to last, fiscal discipline must be preserved and incomes policy should be consistent with productivity growth.

The revised base money targets under the program will make it possible for the Central Bank to accommodate the increased demand for currency, due to the declining inflation and increasing real activity. The CBT will continue implementing its interest rate policy in such a manner as to achieve and maintain low inflation, while taking into account the external price changes, particularly high oil prices and the pass-through from currency depreciation.

Banking Sector Reform

Bank regulation and supervision will be further improved to ensure that private banks are solid and able to support growth in the economy. The authorities have prepared a draft Credit Institutions Law and are now consulting the banking community. This draft deals with, inter alia, bank licensing procedures, the monitoring of bank ownership, limiting connected lending, and the organization of on site inspections. It also better delineates the responsibilities of the Banking Regulatory and Supervisory Agency (BRSA) and the Savings Deposits Insurance Fund (SDIF). This framework law is expected to be approved by Parliament by November 2004. It will bring the Turkish banking sector more in line with EU standards.

The government has updated the restructuring strategy for the State Banks with the help of international consultants. Pamukbank, which has been intervened, will be integrated in the state-owned Halkbank. These two banks complement each other well, and the newly integrated bank will eventually be privatized. The Parliament has recently approved the legislation to allow this operation. At the same time, a detailed restructuring plan has also been formulated for the other state-owned bank, the Ziraat Bank.

The blanket guarantee of bank liabilities has been recently removed and a new limited guarantee scheme introduced. There have been no panic withdrawals or sudden changes in the composition and distribution of savings. The new guarantee scheme will cover almost 60 percent of the savings deposits by value and 90 percent of accounts under TL 50 billion (approximately USD 33.750). People have learned from experience that savings should not be placed where extraordinarily high interest rates are offered. The BRSA will closely

monitor developments in the sector and take prompt action when needed. The State Banks have addressed the private banking community's concerns by reducing their deposit interest rates below market average.

Recent court rulings declaring invalid earlier BRSA decisions to intervene Kentbank and Demirbank are unfortunate for the banking reform efforts in Turkey. However, the authorities are studying every legal option to contain the possible negative impact of these decisions. The new Credit Institutions Law will address the loopholes in the legal framework and strengthen the position of the independent supervisory agency.

The Savings and Deposits Insurance Fund (SDIF) has continued to implement its strategy for the sale of its asset portfolio. Another auction was launched earlier this week and will be finalized by end-August. Last week, the SDIF has published its updated valuation of its assets.

Debt Management and Sustainability

Prudent public debt management contributes to improved borrowing conditions. As rollover rates are declining during the remainder of the year, the Treasury will increase its cash account at the CBT as market conditions allow. This strategy will help create room for maneuver when market conditions are tight, as witnessed during market turbulence a few months ago. The Treasury will coordinate its debt management with the CBT.

The staff's analysis of Turkey's debt sustainability shows that the public debt to GNP ratio will continue to decline under the program's assumptions for GNP growth, real interest and exchange rates, and primary fiscal surpluses. We know that the set of assumptions in the staff's baseline scenario is conservative. And indeed, almost all key economic indicators are progressing better than expected, notably the growth rate which is a key determinant in this calculation.

Future Relations with the Fund

The government is determined to continue its economic transformation strategy building on the progress made so far. The authorities are in the process of formulating a new medium-term economic program which could secure the necessary public support. The new program is being designed with the aim of further reducing the debt to GNP ratio and borrowing costs, while creating a favorable environment for private sector-led sustainable growth. Social policies will be targeted to protect the most vulnerable segments of the society.

The new economic program will also contribute to Turkey's pre accession program for the European Union. The authorities are eager to continue their close and successful cooperation with the Fund and are considering what format would be the best. The authorities have announced that their decisions will be taken by September.

The authorities are well aware of the need to reduce the Fund's exposure to Turkey. At the same time, continued financial support from the Fund could strengthen the robustness of access to the financial markets and lower the cost of borrowing.

Transparency and Data Issues

The authorities regret that it was not possible to publish the sixth review staff report, which they believe contains highly market sensitive information and assessments, especially regarding the financial sector. However, the Staff Report on the seventh review has been published and the authorities intend to agree with the publication of the Article IV consultation and eighth review staff reports and the background papers in accordance with the Fund's publication rules.