July 2004
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Turkey: Seventh Review Under the Stand-By Arrangement, and Requests for Waiver of Applicability and Nonobservance of Performance Criteria, Rephasing of Purchases, and Extension of Arrangement—Staff Report; and Press Release on the Executive Board Discussion

In the context of the seventh review under the Stand-By Arrangement, and requests for waiver of applicability and nonobservance of performance criteria, rephasing of purchases, and extension of arrangement with Turkey, the following documents have been released and are included in this package:

- the staff report for the seventh review under the Stand-By Arrangement and requests for waiver of performance criteria, rephrasing of purchases, and extension of arrangement, was prepared by a staff team of the IMF, following discussions that ended on March 13, 2004, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 2, 2004. 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 April 12, 2004 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during the April 16, 2004 Executive Board discussion of the staff report that concluded the review and requests.

The document listed below have 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

Seventh Review Under the Stand-By Arrangement, Requests for Waiver of Applicability and Nonobservance of Performance Criteria, Rephasing of Purchases, and Extension of the Arrangement

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Liam P. Ebrill

April 2, 2004

- **Stand-By Arrangement.** The Fund supports Turkey's economic program for 2002-04 under an SBA approved in February 2002. Total access under the arrangement is SDR 12.8 billion, or 1,330 percent of quota, of which about SDR 11.1 billion has been purchased so far (Appendix I). A further SDR 340 million becomes available on the completion of this review.

- **Discussions.** During January 12–21 and February 27–March 13 the staff team met with Deputy Prime Ministers Şener and Şahin, State Minister for Economic Affairs Babacan, Minister of Finance Unakitan, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Chairman Ertürk, other senior officials, and representatives of the private banking and business communities.

- **Staff.** Team members included Reza Moghadam (head), Mark Griffiths and Donal McGettigan (EUR), Ernesto Ramirez Rigo (FAD), Ross Leckow and Maike Luedersen (LEG), John Austin (LEG consultant), Mats Josefsson (MFD), Chris Lane (PDR), and Odd Per Brekk and Christoph Klingen (resident representatives). Levent Veziroglu (OED) attended most meetings.

- **Publication**. The Turkish authorities have not yet decided on the publication of this staff report. The staff report for the Sixth Review is expected to be published shortly.

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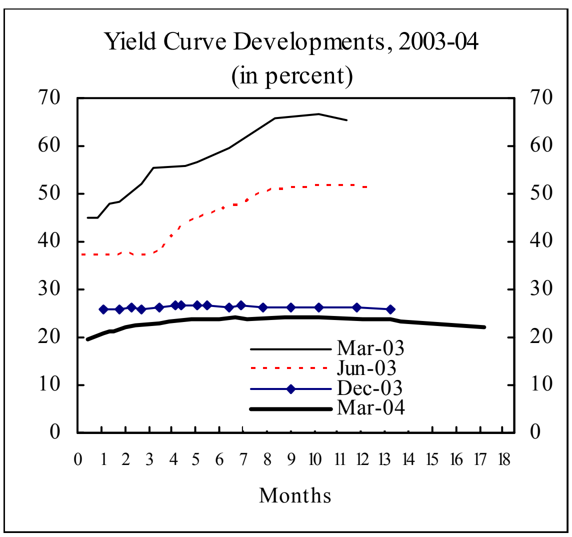
I. Introduction

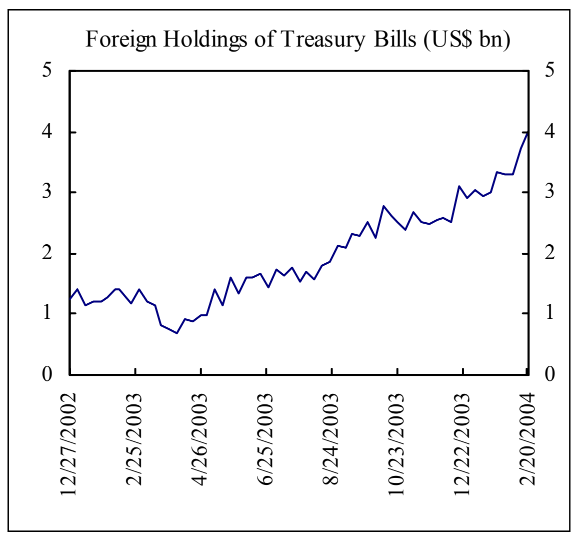
Successful macroeconomic management delivered an impressive economic performance in 2003. However, budget slippages early this year interrupted this success, delaying the completion of the Seventh Review. Fortunately, the policy credibility that was established last year, as well as favorable political developments and positive global financial market conditions, shielded Turkey from adverse market reaction, and gave time for fiscal policy to be adjusted. The challenge in this final year of the program is to maintain macroeconomic policies firmly on track and to move decisively on a comprehensive program of structural reforms to safeguard and advance the recent achievements.

II. Recent Developments

1. **Financial market indicators have continued to improve, aided by positive economic and political developments (Tables 1 and 2):**

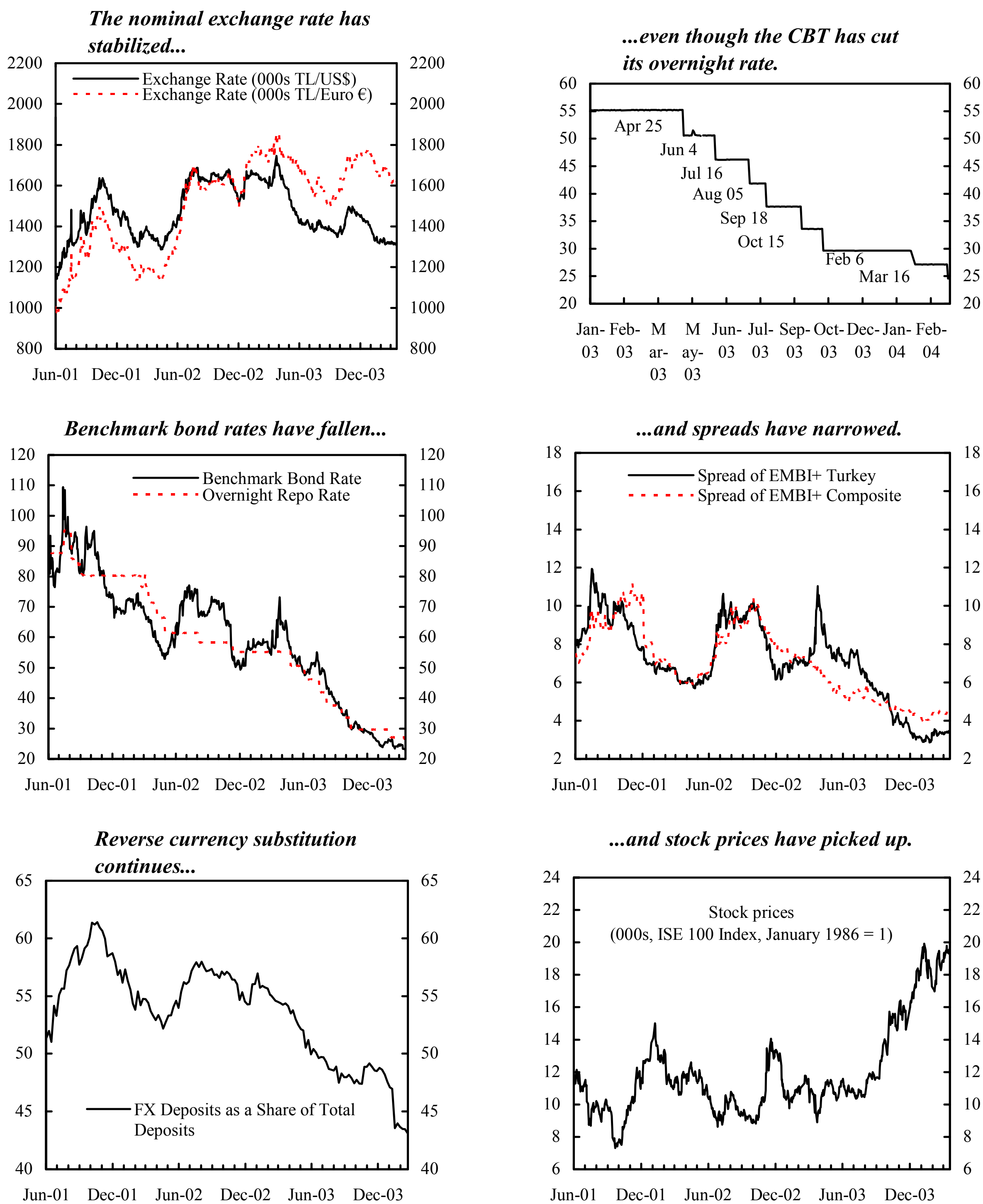
- **Financial markets have remained strong through mid-March** (Figure 1). With good prospects for further disinflation, the yield curve has continued to shift down—with benchmark bond yields now in the low-20s—and the stock market has posted large gains. The lira has strengthened further against the U.S. dollar, and has been broadly stable against the euro, despite the resumption of the CBT's daily foreign exchange purchase auctions and occasional large discretionary interventions.





- **Treasury's financing prospects have further improved.** On the external side, favorable investor sentiment towards emerging markets has helped narrow spreads on Turkey's international bonds, allowing the Treasury to meet more than half of its US$5 billion issuance target for the year. On the domestic side, despite a challenging redemption schedule, Treasury has met its borrowing needs at declining interest rates.

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



Source: Data from the Turkish authorities.

- **Demand for Turkish lira assets continues to strengthen (Figure 2, Tables 3–4)**. Last year's increase in Turkish lira deposits has continued, as has demand for government paper from mutual funds and the public, while foreign currency deposit growth has slowed. Although still small, foreign holdings of treasury bills have risen sharply, from little more than US$1 billion at the end of 2002 to around US$4 billion.

- **With real interest rates falling, credit growth has accelerated (Figure 2)**. Adjusting for loans transferred to the SDIF or classified as non-performing, credit has increased by more than 10 percent in real terms over the last six months. Still wary of lending to indebted corporates, banks have instead focused on consumer credit. From a low base this has increased threefold over the last year, driven by new car loans. State banks have also dropped interest rates on consumer loans to gain market share.

- **Political developments remain supportive**. The Turkish government's determination to resolve the Cyprus issue—where the European Commission had noted that absence of a settlement could become a serious obstacle to Turkey's EU aspirations—and the decision by a committee of the European Council Parliamentary Assembly to recommend that Turkey be taken off the monitoring list (meaning that its human rights record has improved appreciably) have enhanced prospects that the European Union will by end-year set a date for accession negotiations. The AKP government remains popular and, with more than 40 percent of the vote, dominated the end-March local elections.

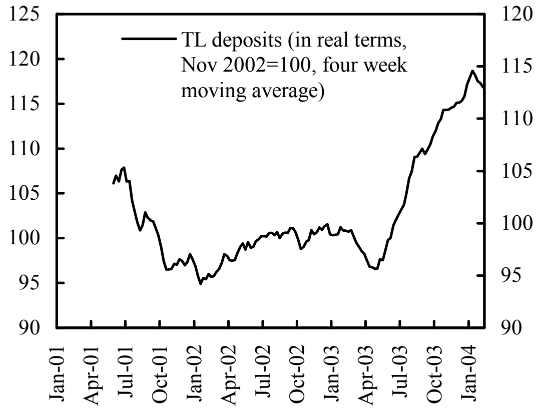
2. **Macroeconomic developments have also been positive (Figure 3)**:

- **Last year's growth target of 5 percent should have been met comfortably (Box 1).** In the first three quarters of 2003, both GDP and GNP grew by more than 5 percent. Private consumption grew 5 percent and private investment 13 percent. Measured on a national accounts basis, exports of goods and nonfactor services grew rapidly too, by more than 16 percent in volume terms, though with imports growing 24 percent, the contribution from the external sector was negative. Although stock-building again registered a significant contribution, this is simply a residual and likely represents under-recorded domestic demand or exports. Fourth quarter national accounts outturns were released on March 31, after the report was finalized, indicating GNP growth of 7.2 percent year-on-year in the fourth quarter, and 5.9 percent for 2003 as a whole. Details will be provided in the staff supplement.

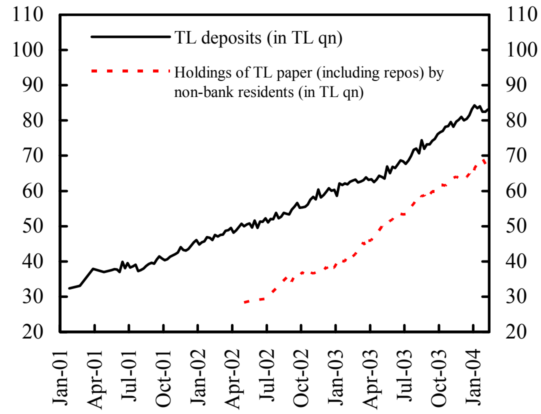
- **Real sector indicators strengthened at the end of last year.** Growth in industrial output averaged 10 percent year-on-year in the last three months, though it moderated somewhat in January. Domestic demand was also strong at the end of last year, with retail sales increasing rapidly (Box 1). While this strong rebound does not yet seem to be excessive, the next Article IV report will analyze this issue, and the macroeconomic framework in 2004 and beyond, more fully.

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

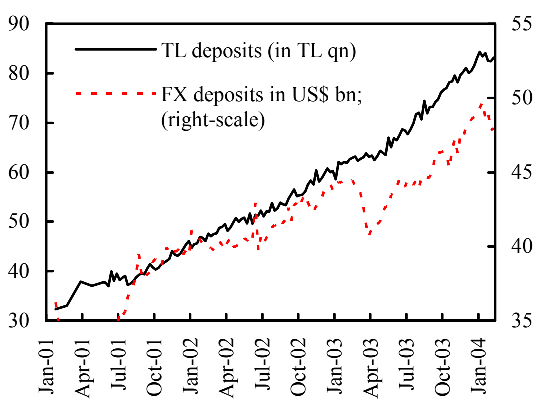
TL deposits increased sharply in real terms in 2003...



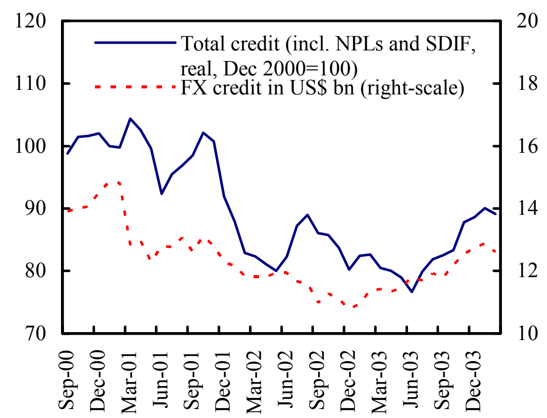
..as has public demand for treasury bills...



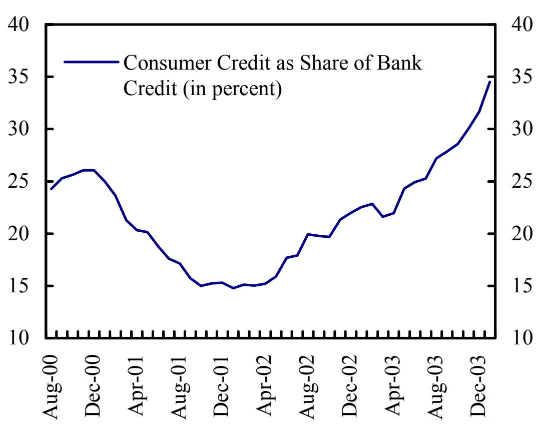
...while the growth in foreign currency deposits has slowed in recent weeks.



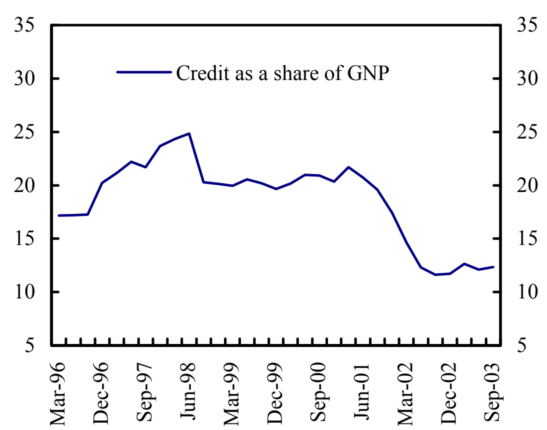
Credit growth is recovering strongly...



…led by consumer credit...

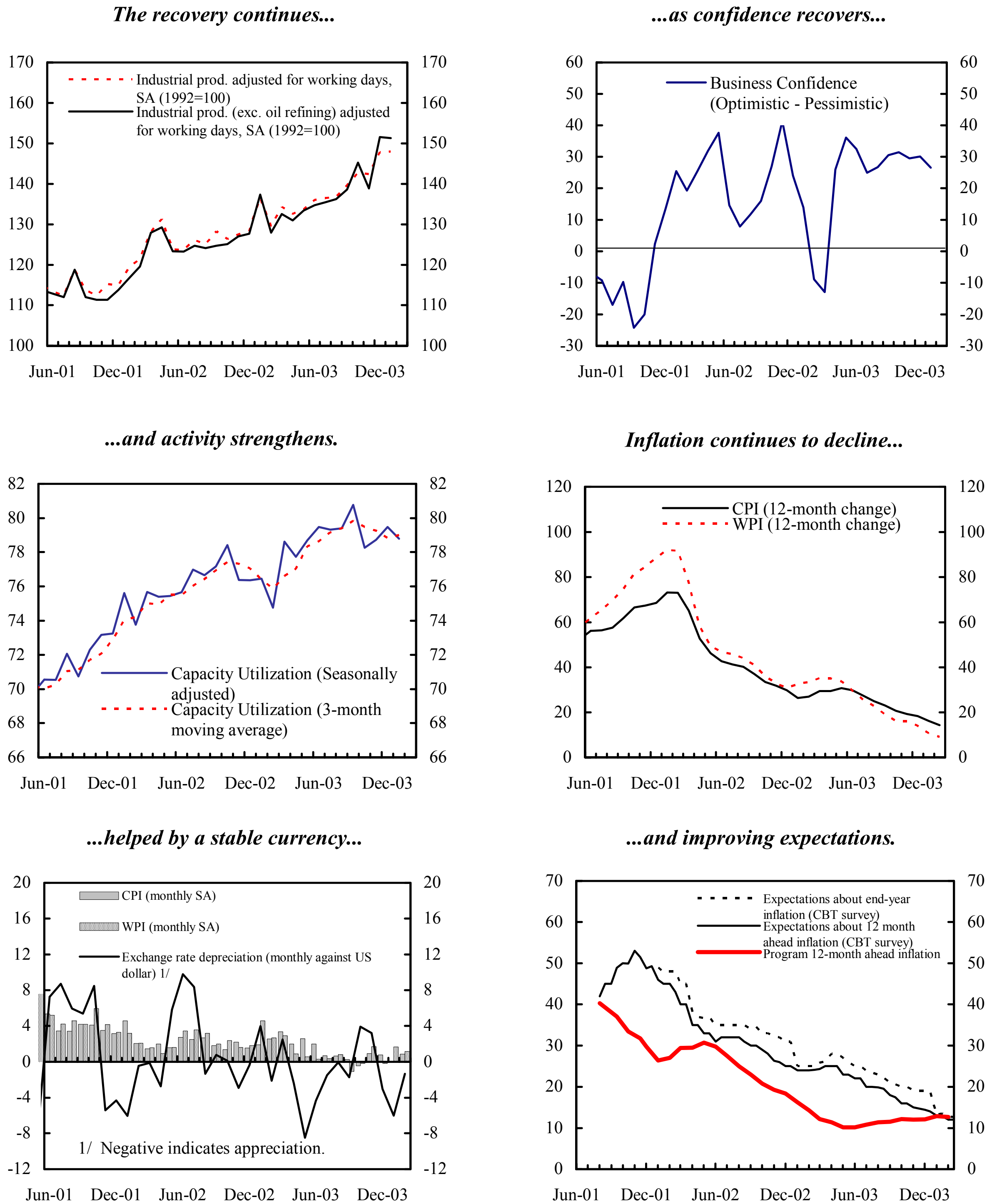


…but is still low as a share of GNP.



Source: Central Bank of Turkey.

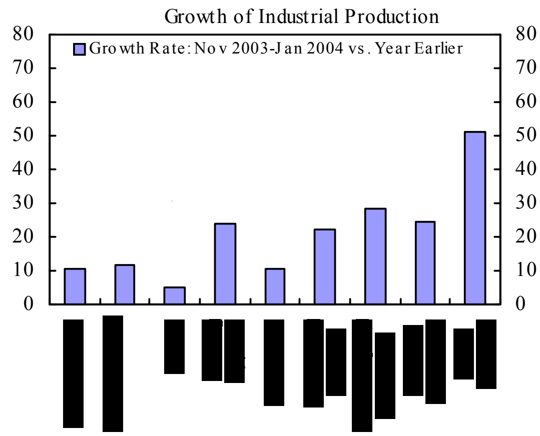
Figure 3. Turkey: Output and inflation, 2001-04
(in percent, unless otherwise indicated)



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

Box 1. Turkey's Economic Growth: Sources and Prospects

After falling close to 10 percent in 2001, GNP has since recovered strongly, growing by almost 8 percent in 2002, and close to 6 percent growth in 2003. What are the sources of this growth, and how likely is it to continue?



The most reliable indicator of domestic output is industrial production. Although making up close to 60 percent of the economy, estimates of services output are less reliable, derived largely from input-output tables, and survey data for tourism. Averaging over the last three observations (November 2003-January 2004), to abstract from changes in working days, industrial output has grown more than 10 percent year on year. The strongest contributions come from both consumption oriented products such as motor vehicles and clothing, and investment goods such as machinery and equipment. However, January's figures were lower than expected, and February's data will be affected by the long holiday, so output growth could be weakening. Capacity utilization has also increased steadily, by around three percentage points from a year ago, and is close to 2000 levels (though not as high as in the mid-1990s). However, in level terms it appears to have stabilized over the last six months.

Domestic Demand Indicators, 2001-03
(Year-on-year changes; in percent)

	2001	2002	2003
Consumption demand			
Production of durable consumption goods (Jan.-Dec.)	-14.6	50.2	23.4
Sales of durable consumption goods (Jan.-Dec.)	-14.3	50.8	24.2
Automobile sales (Jan.-Dec.)	-71.8	-31.1	150.6
Domestically produced	-71.5	-40.0	106.3
Imported	-72.1	-23.8	179.1
Consumption good imports (Jan.-Dec.)	-43.7	22.6	50.0
Capacity utilization (in percent) (January) 1/	73.9	74.9	77.2
Public sector	83.2	79.6	78.7
Private sector	67.8	71.9	76.1
Investment demand			
Investment good imports (Jan.-Dec.)	-38.6	21.9	32.1
Investment incentive certificates (Jan.-Dec.)	30.5	36.6	64.9
House construction licenses/permits (m2) (Jan.-Sept.)	-4.0	-60.5	40.6
Industrial building construction licenses/permits (m2) (Jan.-Sept.)	65.5	-60.2	11.2
Cement production (Jan.-Dec.)	-16.8	8.1	7.6
Machinery & equipment production index (Jan.-Dec.)	-20.2	21.6	32.0
Credit/deposit (in percent) (end-June)	30.6	24.8	33.2

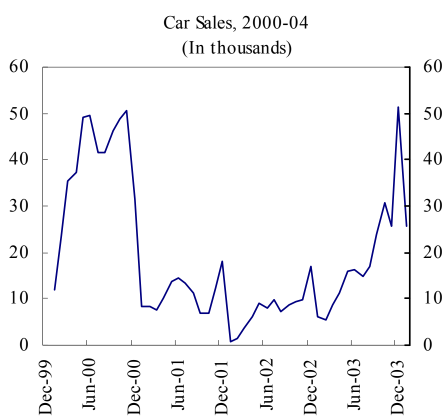
Sources: SIS; SPO; and Automobile Industry Association.
1/ The data are for 2002, 2003, and 2004, respectively.

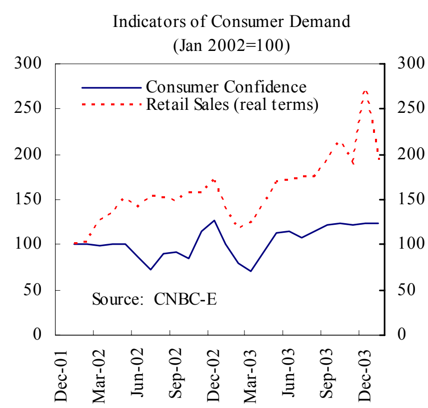
Box 1. Turkey's Economic Growth: Sources and Sustainability (concluded)

On the demand side, private consumption and investment are recovering strongly:

Private investment is growing rapidly. The clearest evidence comes from imports of investment goods, which closely track private fixed investment in the national accounts. In the last quarter, these rose 36 percent year on year.

In the last quarter of 2003, durable goods consumption grew strongly. Lower real interest rates, and the strong real exchange rate are all likely to keep consumption strong, especially for durable goods. Banks have chosen to expand consumer credit rapidly (from an extremely low base), seeing this as less risky than lending to indebted corporates. The temporary tax rebate scheme introduced last August is also boosting car sales. Although durable goods sales are volatile, they are correlated with consumption in the national accounts, which is thus likely to increase strongly this year.





Despite the gathering recovery, labor markets remain weak. Unemployment fell to 10.3 percent in the fourth quarter of 2003, but is still very high. The unemployment rate in urban areas (around 13 percent) is considerably higher than in rural areas (5 percent).

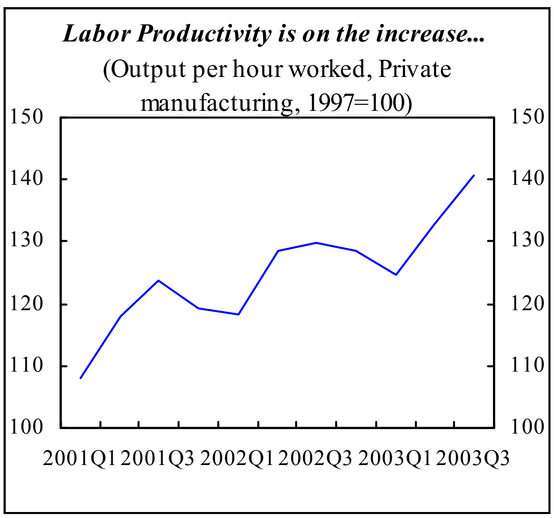
For the medium term, Turkey has considerable growth potential. Aside from the output gap still to be closed in the short run, growth in labor supply should be rapid, both because of Turkey's high population growth rate and underemployment in agriculture. As the economy recovers, the share of investment in GDP has the scope to increase from its current low of around 17 percent to the 24 percent it averaged in the 1990s, which would boost capital accumulation.

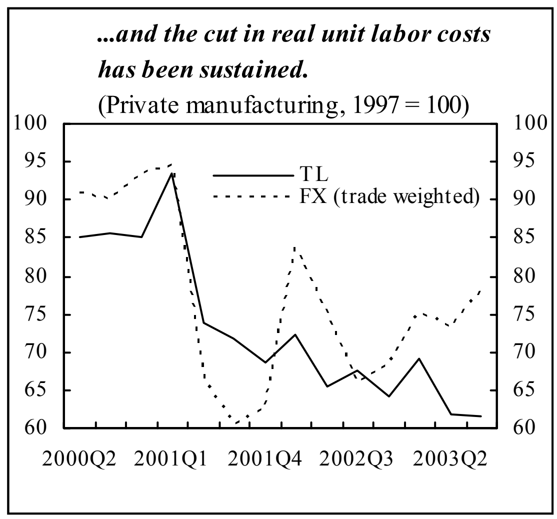
An increase in foreign direct investment could boost growth and total factor productivity by bringing in new ideas and new working practices. FDI is currently low at about US$1 billion per year (comparable to Bulgaria and Romania, which have much smaller economies). While there is considerable potential for growth in FDI, its realization would depend on improving the business climate (the focus of March's Investment Council meeting), or the presence of an external anchor, such as the prospect of accession to the EU.

- **Inflation came in well below the 20 percent target in 2003, and has continued to fall this year**. Consumer price inflation ended last year at 18.4 percent. With monthly increases averaging 0.6 percent this year, in February inflation fell further to 14½ percent. Despite large winter increases in agricultural prices, February wholesale price inflation fell to single digits for the first time in 25 years.

3. **Although the current account deficit increased in 2003, surging capital inflows have led to higher foreign exchange reserves (Figure 4, Table 5)**:

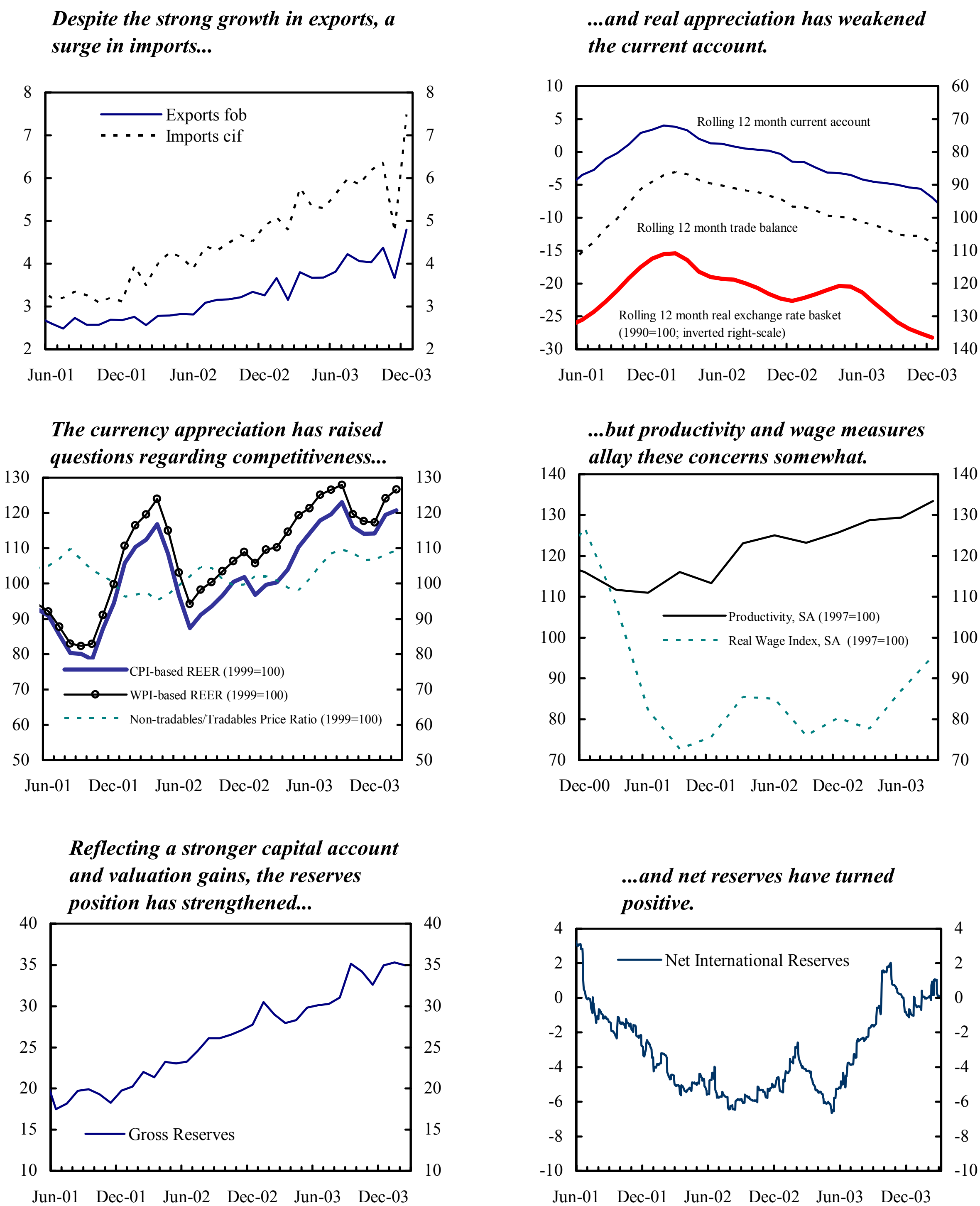
- **The current account deficit increased to 3 percent of GNP last year, just under program projections.** Despite appreciation of the CPI-based real effective exchange rate, rising productivity and declining unit labor costs helped sustain external competitiveness and export growth. Tourism receipts recovered strongly in the second half helping to deliver a better-than-expected current account balance. Imports have also grown rapidly, with higher oil prices, increased imports of machinery and equipment, and rising demand for imported consumption goods (particularly at year-end) being major contributors.





- **Continued market confidence has spurred a large improvement in the financial account.** Net capital and unidentified inflows helped increase the financial account balance to almost US$11 billion in 2003. The reopening of international interbank credit lines, net non-resident portfolio inflows (after three years of outflows) and private sector medium-term borrowing are the main inflows that can be identified. Again, foreign direct investors remained on the sidelines. Errors and omissions—about 2½ percent of GNP, well above the historical average—have become a key financing item. This most likely reflects a portfolio reallocation by domestic residents from foreign exchange assets (including currency holdings) to lira-denominated assets, particularly Turkish government securities.

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



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

- **Reflecting these developments, the CBT was able to purchase foreign exchange, keeping its gross and net international reserves comfortably above the program targets**.

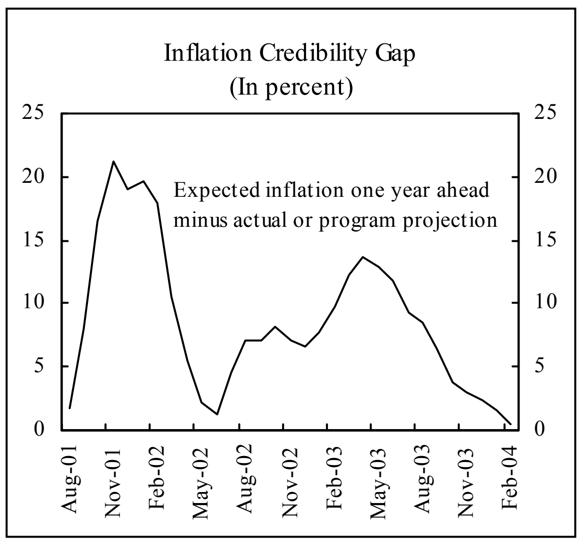
III. Policy Discussions

A. Macroeconomic Framework

4. **The authorities were confident of achieving their 2004 macroeconomic framework** (¶7):[1]

- **Growth should again meet the 5 percent target**. The authorities argued that carryover from last year's strong increase in industrial output, and a more normal harvest this year should deliver the target from the production side. On the demand side, the staff noted that, if anything the risks were on the upside. Confidence indicators are strengthening, and lower interest rates and easier credit are providing stimulus to the economy.

- **Inflation this year is already running below projection**. Although domestic demand is firming, there are strong prospects of meeting the inflation target for the third year in succession. For the first time, expectations for end-2004 inflation now coincide with CBT's target. Coming increases in public sector prices will make reducing inflation more difficult, but the CBT's relatively conservative interest rate policy and enhanced credibility should limit any pass-through to second rounds of wage and price increases. While there was little evidence that last December's minimum wage increase had raised inflation expectations or wage settlements in the private sector, the staff cautioned that any further increase this year might undermine the inflation target. Despite this, the authorities were not at this stage prepared to rule out a second increase in July (when the minimum wage commission next meets).



- **The current account deficit is expected to remain at 3 percent of GNP in 2004**. Improved terms of trade, increased external demand, and continued strong productivity growth (and competitive unit labor costs) should offset the effect of

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

higher domestic demand on imports. However, the authorities agreed that the projections were sensitive to shifts in domestic demand and private capital inflows.

B. Fiscal Policy and Reforms

5. **Although the authorities succeeded in generating a record public sector primary surplus in 2003, they fell short of meeting the 6.5 percent of GNP program target (¶3):**

- **Last year's public sector primary surplus is estimated at 6.2 percent of GNP, the largest ever recorded in Turkey,** and 2.1 percent of GNP greater than in 2002 (Table 6). Central government performance drove the improvement, with revenues rising by 2.1 percent of GNP while primary expenditures were contained.

Turkey: Public Sector Primary Surplus, 2001-03

	2001	2002	2003		
		Est.	Prog.	Est. 1/	Diff
Public Sector	5.5	4.1	6.6	6.2	-0.4
Central government	4.8	2.4	5.0	5.0	0.0
Total revenue	25.4	23.2	25.3	25.3	0.0
Tax revenue	22.5	21.8	24.3	23.6	-0.7
Nontax revenue 2/	4.5	3.4	3.4	4.0	0.6
Non-interest expenditure	20.6	20.7	20.3	20.3	0.0
Personnel	8.6	8.5	8.4	8.5	0.1
Other current	2.8	2.6	2.4	2.3	-0.1
Transfers	6.9	7.1	7.7	7.5	-0.2
Investment	2.2	2.7	1.8	2.0	0.2
Rest of the public sector	0.7	1.7	1.5	1.2	-0.3
Unemployment insurance fund	0.6	0.4	0.3	0.3	0.0
SEEs	0.1	1.1	1.1	0.7	-0.4
Social insurance institutions	-0.1	0.0	0.0	0.0	0.0
Others			0.1	0.2	0.1
Memorandum item:					
Primary surplus PC	...	...	6.4	6.0	-0.4

Sources: Turkish authorities; and Fund staff estimates

1/ The estimate for 2003 includes special revenues and expenditures. These are not included in the program column.

2/ Total revenues minus tax rebates

- **Despite this impressive performance, the authorities seem not to have met the 6.5 percent target**. In the last months of 2003 the authorities had detected some weakening in the performance of state enterprises and in tax revenues. However, they thought they could offset this shortfall by lower central government expenditure. Due to underspending, the primary surplus through November was in fact almost 0.3 percent of GNP above target. However, the authorities' inability to enforce spending control and weak coordination among agencies enabled line ministries to accelerate spending in December, largely eliminating the central government overperformance (¶5).

6. **Although the 2004 budget passed in December was consistent with the 6.5 percent primary surplus target, a sizeable fiscal gap quickly emerged.** Within weeks of passing the 2004 budget, the government announced above inflation increases in minimum wages (Box 2). To reduce the additional cost to employers, at the same time it cut contribution rates for social security. In addition, the government increased pensions by 20 percent, well above the budget assumption, for the second consecutive year overriding the automatic indexation formula set out in the 1999 reform law. These initiatives reduced the primary surplus by more than ¾ percent of GNP, and added to the already large deficit in the social security accounts. Further, shortfalls in tax revenue (which last year were compensated for by one-off increases in nontax revenues) relative to the Budget created an additional gap of close to 1 percent of GNP. Thus, at the very beginning of the budget year, the authorities faced a daunting fiscal gap of 1¾ percent of GNP.

7. **The authorities have responded with steps to close the fiscal gap:**

- **In March Parliament passed a supplementary budget that cuts discretionary spending by 13 percent across all ministries (¶8)**. This will save 1 percent of GNP.

- **The government also introduced measures to increase revenues by 0.7 percent of GNP (¶8)**. Prices and excises of petroleum, alcohol, tobacco, and gas were raised, and the Ministry of Finance committed to cut off-budget spending.

Fiscal Gap and Measures for 2004

	Trillion TL	% of GNP
Fiscal gap	**7,000**	1.7
Spending cuts	**3,900**	0.9
13% cut in supplementary budget	3,800	0.8
Blockage of investment incentives	100	0.0
Revenue measures	**3,100**	0.7
Petroleum and gas excises	1,050	0.3
Of which: gas excise	200	0.0
Tobacco revenues	1,100	0.3
Specific excise	235	0.0
Tekel price hike	865	0.2
Alcohol excises	200	0.0
Special revenues written over to budget	500	0.1
VAT (effect from excises)	250	0.0
Total measures	**7,000**	1.7

Sources: Turkish authorities; and Fund staff restimates.

Box 2. Minimum Wage

In January 2004 the minimum wage was raised by 34 percent. The decision was taken by the Minimum Wage Commission on which employers, employees, and government have equal representation, but with the government playing the pivotal role. For social reasons and to compensate for the setbacks during the crisis years the government sought a minimum wage increase well in excess of expected inflation. At the same time, social security contributions for minimum wage earners were lowered to limit labor cost increases to 20 percent. This effectively eliminated regressive features in social security contributions—a structural improvement, albeit at a fiscal cost of ¼ percent of GNP annually.

With the January 2004 adjustment, real minimum wages have recovered to pre-crisis levels (see Figure). Minimum wages have also gradually increased from about a quarter of the reported average industrial wage in 1996 to about a third in 2003.

Turkey: Evolution of Real Gross Minimum Wages, 1990 - 2004

Turkey: Earnings in Industry and Minimum Wage, 1996-2004

	Industry Wage	**Minimum Wage**	Minimum Wage
	(In millions of TL per month, gross)		(In percent of industry)
1996	41	11	27
1997	80	23	29
1998	140	48	34
1999	265	86	32
2000	403	114	28
2001	529	152	29
2002	715	236	33
2003	894 1/	306	34
2004	...	423	...

Sources: State Statistical Institute and State Planning Organization.
1/ IMF staff estimate.

The macroeconomic significance of the minimum wage is hard to gauge. According to official statistics some 3 million of Turkey's 20 million formal sector workers are paid at the minimum wage. However, this number could be exaggerated as under-reporting for tax and social security purposes is widespread. On the other hand, the minimum wage could also have relevance as a yardstick for wages in the large informal sector.

Further large minimum wage increases could, however, complicate the authorities' disinflation efforts. According to a recent CBT staff study, the January 2004 minimum wage increase adds a modest 0.6 to 1.4 percentage points to year-end inflation, a finding which appears to receive support from the absence of any discernible impact of the recent minimum wage decision on inflation expectations. These results rely crucially, however, on the assumption that minimum wage hikes have no ramifications for wider wage determination, which may not hold if further large minimum wage increases are granted. If the spillover effect on wages is large, Turkey's external competitiveness could in turn be damaged.

Minimum wages are not regarded as the best way of fighting poverty. While minimum wage earners who continue in employment are better off, this has to be weighed against job losses, including to the informal sector, in the wake of higher labor costs. Moreover, excessive minimum wage hikes can also fuel inflation, which tends to hurt the poor disproportionately.

8. **While welcoming the government's determination to adhere to the primary surplus target, the mission expressed concern over the composition of the adjustment.** Cutting capital expenditure (one quarter of the total savings) to offset permanent increases in current spending was regrettable, and there was also a risk of arrears accumulation. The authorities explained that across the board cuts were seen as fair by the ministries concerned and thus easier to implement than specific cuts. They also maintained that the acceleration of spending at the end of last year showed that there was considerable excess expenditure.

9. **Other ways of closing the fiscal gap were also debated.** The authorities considered increasing financial intermediation taxes, arguing that this would also help contain consumer credit. However, the staff cautioned that this would reduce the profitability of the banking system, which needed to increase its loans and reduce its dependence on government paper, and would add to the problem of disintermediation. The staff also argued that ending the temporary tax cut for purchases of new motor vehicles (due to expire at end-year) would have a more powerful effect in slowing the growth of consumer credit if this became a concern. For its part, the mission would have preferred measures to broaden the tax base. These could have included removing the VAT exemption for pensioners, taxing pensions, raising property taxes, or eliminating the 1 percent VAT rate, but the authorities thought these were not feasible.

10. **Despite the adjustment, the staff noted that considerable risks to the fiscal targets remain.** Lower than programmed inflation or a stronger exchange rate could reduce revenues, as could a second minimum wage increase (if accompanied like last year by a cut in social security contributions). The efficacy of some of the measures was contingent on private sector pricing policy; although private companies had agreed to raise tobacco prices in line with TEKEL (state tobacco company), if they were to cut prices in future, revenues could be lost. And the authorities would need to ensure that excises and public enterprise prices are adjusted this year in a timely manner (for example, if world energy prices rise), to maintain revenues and state enterprise profitability.

11. **However, the authorities believed that the risks were more finely balanced**. Excises will be adjusted in line with budget assumptions. A stronger exchange rate would reduce costs for state economic enterprises and allow savings in the investment budget. Both sides agreed to monitor these risks and to re-examine the fiscal outlook at the Eighth Review. They also agreed to set a benchmark on adjusting excises in line with budget assumptions, and a new performance criterion on the public sector balance excluding SEEs to allow more timely monitoring of the fiscal outlook.

12. **There was strong consensus that fiscal structural reforms were essential to help make the fiscal adjustment permanent.** The authorities therefore agreed to reforms aimed at broadening the tax base, tackling social security deficits, and reducing rigidities in the budget:

- **The authorities are embarking on a reform of the social security system (Box 3).** In December 2003, they completed their initial assessment of the fiscal implications of planned social security reforms (¶3). The authorities' proposals would achieve administrative savings through unifying the current four pension funds into one. Parametric changes harmonizing all pensions in the future would also yield savings in the long run. However, the mission argued that more ambitious reforms were needed to make the system sustainable. With assistance from the World Bank, the authorities will develop a range of reform options by mid-year, and presentation of a suitable reform package to Parliament will by set as a new performance criterion during the Eighth Review (¶9).

- **The authorities are strengthening tax administration to reduce tax evasion and deal with the informal economy (¶9)**. Turkey has a sizable unrecorded economy and tax compliance is weak. Consequently, tax rates are high and a key medium-term objective is to reduce them. However, the authorities agreed that tax enforcement needed to be addressed first. Drawing on FAD technical assistance, a comprehensive tax administration reform program is underway, with the necessary legislation to be passed by end-July 2004 (a new structural benchmark).

- **The authorities are planning a comprehensive review of expenditure to increase spending efficiency and find areas of short-term savings (¶9)**. They have requested technical assistance from the Bank and the Fund to assist in this process. As a first step the Fund will examine areas where short-term rationalization of programs could result in savings. This will be followed by a more detailed World Bank study that will identify long-term changes to programs that can yield further savings. Some of the initial recommendations from these exercises will help guide the authorities' 2005 budget.

13. **The authorities are also decentralizing the provision of public services in their Public Administration Framework law (¶10)**. This is a fundamental institutional change for Turkey (which is highly centralized), with the aim of improving accountability. The authorities are aware of the potential problems for fiscal management of transferring spending responsibilities without first building the right structure for intergovernmental relations. They therefore agreed that any increase in transfers will have to be gradual and tailored to the capacity of the local governments.

14. **In addition to the reform agenda looking ahead, the authorities have already taken a number of steps in structural fiscal reform since the Sixth Review:**

- **The second stage of the direct tax reform was passed in January 2004 (prior action for the Seventh Review, ¶4)**. The legislation gradually transforms free trade zones into export processing zones, reducing income tax holidays and aligning tax benefits with international practice. In addition it introduces a targeted and time-bound subsidy to stimulate employment in poorer regions.

Box 3. Social Security Reform

The government is embarking on a comprehensive package of social security reform to go into effect at the beginning of 2005 (¶9). On the administrative side, the currently fragmented system, with separate organizations in charge of different occupational groups, will be reorganized around a single Retirement Fund and a single Health Fund. On the benefit side, the pension formula will be unified with a view to improving the long-run financial sustainability of the system. Through a proposed Universal Health Insurance scheme, comprehensive health care services will be provided to the entire population, in line with the government's social objectives, as outlined in its Urgent Action Plan.

Given the magnitude of the reform task ahead, the government is proceeding cautiously. A variety of reform options are being evaluated and costed. By end-June 2004 the Council of Ministers is scheduled to select one reform option and subject it to the consultative process with wider civil society, with a view to presenting enabling legislation to Parliament this October.

Despite landmark reform in 1999, the current pension system is far from sustainable. At 3½ percent of GNP the deficit is currently large and is set to double in the long run as Turkey's demographics become less favorable. Although the 1999 reforms made important inroads, such as the introduction of a statutory retirement age, basing benefits on employment history rather than final salary for most occupational groups, and the indexation of pensions to inflation, the system is still overly generous. Replacement ratios remain high at up to 75 percent, minimum contribution periods of 19.4 years are short and statutory retirement age is low (58 years for females and 60 years for males applying only to new entrants), and neither pension contributions nor pensions are taxed. Moreover, the 1999 reform involved generous transitional arrangements, so that about two thirds of existing pensioners are younger than the statutory retirement age. The government has also, in the past two years, granted pension increases larger than inflation indexation alone would have called for.

Current pension reform proposals deal effectively with the problem of high replacement ratios thus containing the long-run deficit at 4 percent of GNP. Replacement ratios would come down as life-time earnings are discounted using inflation plus half of real GNP growth rather than inflation plus full GNP growth and civil servant benefits would no longer be based on final salaries.

Further reforms are needed, however. Sustainability could be better secured (i) in the long run if statutory contribution periods, retirement ages, and benefit rates were also adjusted, and (ii) in the short run if pensions or pension contributions were subjected to taxation. This could obviate the need for further social security reform in a few years' time thus making for a more predictable environment.

Health outcomes in Turkey are poor relative to both its income level and its spending on health care, thus underscoring the need for further reform. Infant and maternal mortality rates are especially high and vary widely across income groups and regions when compared with other countries with similar per capita GNP or health care spending. Health care spending in Turkey is equivalent to around 7 percent of GNP of which some 4¼ percent of GNP is borne by the public sector. Health-related activities of the social security system currently incur annual deficits of about 1 percent of GNP.

The introduction of Universal Health Insurance would likely help address the large disparities of health outcomes but the associated costs require offsetting measures. Potential cost estimates of wider insurance coverage, changing utilization patterns, and new provider payment methods lie between 1 and 2 percent of GNP. Key uncertainties relate to the number of currently uninsured, where estimates range from 11 to 33 percent of the population, and whether per capita health care expenditures, which currently differ significantly across social security institutions, will gravitate towards the high, middle, or low end of the spectrum under the envisaged unified system. As the reform is a comprehensive one it should be possible to calibrate an affordable package, e.g., by adjusting the benefit package and patient co-payments, addressing high pharmaceutical spending, currently accounting for about half of total health care expenditure, or introducing family medicine concepts.

- **The government has continued to reduce overstaffing in state economic enterprises**. Since the start of the program in January 2002, 56,000 redundant positions in state enterprises have been eliminated, with overall employment falling by 32,800 in 2003. Despite these efforts the authorities missed the end-December performance criterion for eliminating redundant state enterprise positions by 4,200, even though the overall reduction in positions (including some not included in the target) exceeded the program target by 14,500. The authorities agreed to consolidate these improvements through a strict employment policy for 2004 which limits new hiring to 10 percent of attritions. A new indicative target will help monitoring in this area (¶10).

C. Monetary and Exchange Rate Policy

15. **Although the success of monetary policy in reducing inflation has been a high point of the program, discussions focused on ways to improve the operating framework:**

- **With many factors raising the demand for base money, the staff and the authorities agreed to increase the targets for the rest of the year (¶11)**. Falling inflation and inflation expectations, and strengthening real activity had increased demand for currency and TL deposits. The transfer of TL 7 quadrillion in Imar bank deposits also increased banks' reserve requirements; any drawdown would increase currency in circulation. The strength of the exchange rate also indicated an increase in money demand. The mission therefore agreed to revise the base money targets to accommodate the increase through February, but projected increases for the rest of the year only in line with nominal activity. However, if disinflation continued and money demand increased, the mission accepted that the targets might have to be raised again.

- **Although successive revisions to targets had increased strains on the base money framework, the CBT was still not ready to introduce formal inflation targeting.** The CBT again cited concerns over fiscal dominance and outside shocks, associated with uncertainties over Cyprus and EU accession. While understanding their reluctance to announce a fixed timetable for formal IT, the staff suggested ways to improve the current approach of implicit inflation targeting. These include timing interest rate decisions to coincide with more regular monetary policy council meetings and upgrading the CBT's inflation report. As well as preparing for formal IT, such reforms could protect the CBT from outside attacks on interest rate policy and help preserve its independence. Reforms could also underpin next year's introduction of the new Turkish lira (re-denominating the existing currency by a factor of one million), with a permanent switch to lower inflation.

16. **The combination of sharply declining inflation and robust domestic demand had created tensions for monetary policy.** Interest rates are still quite high in real terms. And, for an (implicit) inflation targeting central bank, the rapid convergence of inflation expectations to the end-year target could suggest scope for further interest rate reductions. However, greater credit availability and last year's sharp fall in interest rates was stimulating domestic demand, even though the fiscal stance remained tight. Thus, although there did seem room to cut interest rates, the potential need to moderate domestic demand growth and to limit further widening of the current account deficit suggested that this be done cautiously.

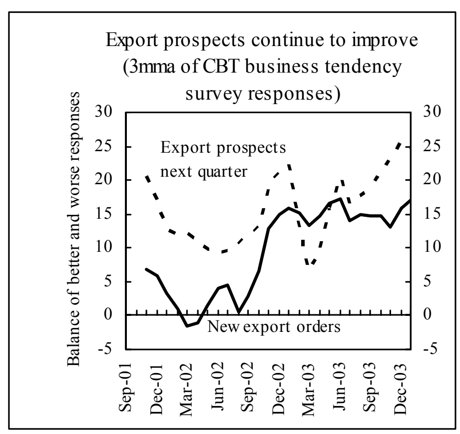
17. **The mission argued that continued sterilized intervention of inflows was needed to accumulate reserves:**

- **The authorities need to build up reserves ahead of the international payments coming due next year**. The CBT had already taken steps towards this goal, through its policy of reducing interest rates cautiously, and using sterilized intervention to purchase reserves. However, the Treasury also has payments coming due, and the mission advised it to consider taking greater advantage of current favorable market conditions and to overborrow now (which would also help in sterilization).

- **The staff and the authorities agreed that effective coordination between the Treasury and the CBT was needed to achieve this goal (¶13)**. Last year's sterilization had created significant losses for the CBT. Although the CBT's capital was sufficient to cover them, the situation needed to be kept under review to ensure that the CBT's operational effectiveness was not affected. The staff noted that overborrowing by the Treasury using longer-term instruments could help share sterilization costs, and make the accumulation of reserves less vulnerable to possible later reversals in capital flows. It would also help prepare the Treasury for next year's repayment obligations. Although the Treasury was concerned that overborrowing could result in higher interest rates for itself, the authorities agreed to meet again at the highest levels to consider this issue more fully. They would also consider the practicalities of the CBT issuing slightly longer maturity papers (up to one month) and whether reform of debt management regulations was needed to improve flexibility.

18. **Despite renewed real appreciation of the currency, resulting from strong capital inflows and reverse dollarization, the authorities believed that the floating exchange rate regime was working well, and external competitiveness was not significantly challenged.**

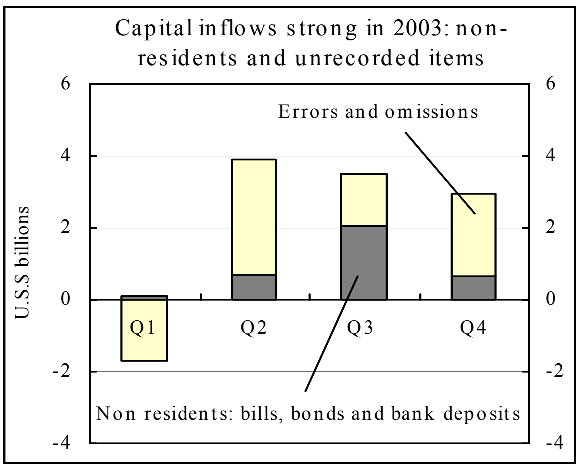
- **Pressures on the current account were viewed as manageable, as export performance remained strong**. Declining real unit labor costs and rising labor productivity, decreasing real interest rates along with an expansion of commercial and export credits, and the strength of European currencies against the dollar (with Turkish firms importing dollar denominated intermediate goods for export of finished goods to Europe) had all helped insulate exporters from the exchange rate appreciation. The authorities did not expect any marked reversal of recent developments ahead. The staff and the authorities concurred that the current account deficit was likely to stabilize in 2004 at around 3 percent of GNP, and then decline modestly over the medium term, in light of strengthening external demand, better terms of trade as well as good prospects for tourism receipts.

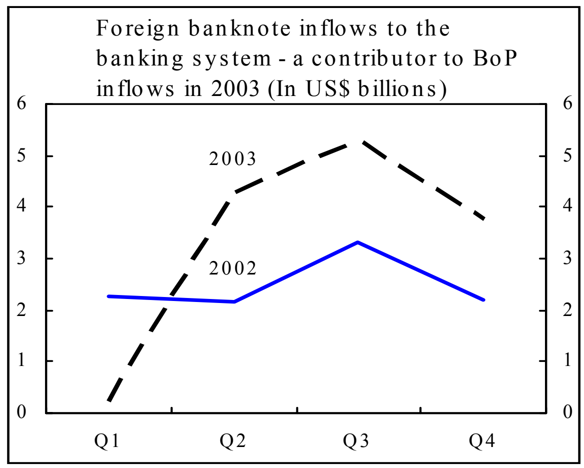


- **The strengthening lira and improving macroeconomic fundamentals had been accompanied by increased capital inflows**. The authorities emphasized the significance of large unrecorded capital inflows, predominantly the repatriation of residents' overseas assets—which could not be captured by statistical agencies since there was no provision by law to report these—and the conversion of foreign currency balances ("mattress money"). The staff agreed that the strength of non-resident inflows would likely continue as long as macroeconomic conditions remained favorable.

- **External financing conditions for the public sector, banks, and companies had also improved**, following ratings upgrades and improved corporate results. The authorities indicated that the anticipated increase in U.S. interest rates was having some impact on external liquidity. Even so, net flows remained strong, and the public sector had already met more than half its planned external bond issuance for the year.

19. **The staff generally agreed with the authorities that external sector developments remained positive** while cautioning that macroeconomic stability remained critical to sustaining





the necessary capital inflows and meeting NIR targets ahead. In light of continuing capital inflows and the CBT's sterilized intervention the prospects for exceeding the NIR floor remained good. However, a pickup in domestic demand could widen the current account deficit through more rapid import growth. This called for continued vigilance over developments in fiscal policy, credit and wage growth.

20. **The Treasury's policy of reducing short-term foreign currency debt will make it more difficult to meet the program's NIR targets, unless an adjuster is introduced**. To lower the vulnerability of the debt to exchange rate changes, the Treasury plans to reduce its rollover rate for domestic foreign currency denominated bonds this year. Although vulnerability is reduced, the resulting net payment of US$1.6 billion from the authorities to bond-holders (mainly domestic banks) will create an equivalent drain on NIR as banks will likely retain the foreign exchange to avoid opening up short foreign exchange positions. Therefore the staff and the authorities agreed on an adjuster to the NIR floor that would take into account this potential loss in reserves, but capped at the planned level of net payments from May onwards (US$1.1 billion).

21. **The Treasury has also started to swap US$3 billion in foreign exchange linked bonds into TL instruments (the bonds were issued as part of a swap operation in 2001 to strengthen banks' balance sheets during the crisis)**. This operation creates a short foreign exchange position for banks and increase their demand for foreign exchange. As the operation has no direct impact on NIR, the NIR floor is not being adjusted for this. However, the swaps could reduce banks' supply of foreign exchange to the CBT's preannounced purchase auctions.

D. Financial Sector Reform

Although the banking system's financial position improved significantly in 2003, the pace of banking reform slowed. Successive attempts to sell Pamukbank failed, while there was little progress in restructuring and privatizing the state banks. Asset resolution was set back in December when the SDIF allowed its first auction of commercial loans to fail. Finally, legal challenges to earlier interventions in insolvent banks could undermine the BRSA's effectiveness. Against this background, the authorities agreed to take steps to restructure the state banks (in cooperation with the World Bank), to develop a new strategy for SDIF asset resolution, and to bring the Banking Act more closely in line with EU standards. The authorities have also resolved the fate of Pamukbank, by announcing publicly that it will be integrated into Halk bank.

22. **The financial position of the banking system improved significantly in 2003.** Against a backdrop of favorable economic developments, an improvement in asset quality, combined with a sharp drop in interest rates and growth in lending improved banking system profitability (Table 7). In private banks, the capital adequacy ratio rose to 23.5 percent at end-2003; the ratio of nonperforming loans to total loans dropped to 6.5 percent from 8.9 percent at end-2002; and the level of provisions increased to 80 percent, up from 53 percent at end-2002. Net profits of private banks increased by 21 percent to US$2.2 billion in 2003. Looking ahead, as interest rates stabilize at lower levels, banks' margins should fall, and profitability will depend on increased fee income, loan growth, and success in improving operational efficiency.

23. **However, the profitability of the state banks can be attributed almost entirely to their large holdings of government securities.** Both Halk and Ziraat are vastly overcapitalized. Assuming a capital adequacy ratio of 15 percent, which should be acceptable for these banks, excess capital in Ziraat is some US$3.5 billion and in Halk about US$1.5 billion. The large liquidity available to these banks can distort the banking sector, as it allows them to extend credit at very favorable terms to borrowers, hurting the profitability of private banks. To provide a level playing field in the banking sector, the staff urged the authorities to reduce Ziraat's capital. For Halk, the amount of excess capital to be removed would depend on its merger with Pamukbank, which has a large negative net worth.

24. **After much delay, a strategy is being developed for restructuring and privatizing state banks (¶16).** The authorities are working with the World Bank to prepare Halk and Ziraat for privatization by scaling down and restructuring their balance sheets. These banks can only be privatized if their holdings of government securities (about 70 percent of total assets) are substantially reduced. The authorities plan to hire an investment firm to draw up the details of such a strategy and its implementation. The authorities note that Ziraat with its large branch network in rural areas also serves an important social function which needs to be taken into account in restructuring the bank. Therefore, the restructuring and privatization of these state

banks may be very lengthy, and Halk is unlikely to be put up for sale before June 2005, with Ziraat to follow later.

25. **With the banking sector restored to profitability, there is strong political support for replacing the blanket guarantee with a limited deposit protection scheme in mid-year.** The staff advised phasing out the guarantee over a 9–12 month period. However, the authorities thought it was important to adhere to the BRSA's announcement of a year ago that the blanket guarantee would be replaced by a limited deposit protection scheme on July 5, 2004 (¶18). They also pointed out that over 90 percent of the accounts (and 40 percent of total deposits) would be fully protected by the new scheme, which would guarantee deposits up to TL 50 billion (US$37,000). Before the guarantee is abolished, the BRSA will inform the government in detail about the condition of the banking system and any remaining risks, and publish a summary of these findings.

26. **Pending court cases threaten to undermine bank reform.** The former owner of Demir Bank has launched two court cases, one contesting BRSA's intervention (which took place at the height of the 2000 crisis), and the other arguing that despite the BRSA's intervention, he still retains a "golden share" in the bank which has now been bought by HSBC. The owner of Kent Bank is also seeking his bank's return. If the former owners were to win either of these cases, this would seriously undermine progress made in banking reform. So far, the BRSA has refused the offer, maintaining that the former owner fails the "fit and proper" test for being a bank owner.

27. **Against this background, the authorities also expressed their determination to move quickly to bring the Banking Act in line with EU standards (¶14).** The experience of crisis management over the last few years, the recent separation of the Boards of the BRSA and the SDIF, as well as the lessons from the Imar bank scandal, all indicate the need for a comprehensive review of the Banking Act. In addition to an array of supervisory issues, the staff pointed out the need to consider carefully the role of Sworn Bank Auditors who currently have an exclusive right to examine banks. The Imar banking scandal highlighted weaknesses in on-site inspections and the need for experts to examine banks in areas such as IT. The delineation of responsibility between BRSA and the SDIF is another key area.

28. **The SDIF will, at least initially, be in charge of the limited deposit protection scheme.** The revised Banking Act and regulations will define the exact responsibilities and the operational structure of deposit insurance fund, either within or outside the SDIF. The SDIF balance sheet is currently extremely weak as there is no possibility the SDIF will be able to recover the face value of the assets it holds either through asset resolution or collection of deposit insurance fees. The staff suggested that Treasury write off its claims on the SDIF before the introduction of the new limited deposit protection scheme. However, this process is likely to be completed only by end-2004 (¶17).

29. **The authorities agreed that an important priority for the new SDIF board will be to foster a better understanding of the recovery rates from the resolution of assets (¶17).** Last December's first auction of commercial loans was allowed to fail, because the SDIF set too high a reservation price. To avoid another asset auction failure, the Treasury, the BRSA, and the SDIF will undertake a reassessment of the value of the assets held by the BRSA. Unrealistic public

expectations have prevented completion of earlier asset sales. Another urgent task for the new SDIF Board is developing a detailed strategy for the resolution of the different assets and claims it holds (a new benchmark).

30. **Although delayed, the independent inquiry into Imar bank is finally getting underway (¶15).** As an action for completing this review, the authorities are preparing to announce the head of this inquiry. Since this appointment is only just being made, publication of the report will be delayed beyond the end-May date set as a structural benchmark in the Sixth Review. However, in light of the inquiry's importance, the authorities have agreed to make publication by end-August a new performance criterion.

E. Other Structural Reforms

31. **Both sides agreed that, while the pace of privatization had improved, further progress was needed** (¶¶19-20). With the recent successful TÜPRAŞ auction (petroleum refineries) for US$1.3 billion, and the sale of the alcohol unit of TEKEL, the pace of privatization had clearly picked up. The authorities reiterated their commitment to an ambitious privatization program, including such high profile cases as Türk Telekom, TEKEL's tobacco unit, PETKIM (petrochemicals), Turkish Airlines and the National Lottery. The authorities also agreed to introduce legislative amendments to allow more flexibility in the hiring of privatization consultants and expressed their commitment to achieving the privatization cash proceeds target of US$3 billion in 2004.

32. **The authorities have also taken further steps toward enhancing the business climate** (¶21). In addition to the authorities' commitment to an ambitious structural reform program over the remainder of the program, the staff welcomed the inaugural high level meeting of the Investment Advisory Council, which took place on March 15, 2004. They urged the authorities to follow up quickly on the meeting's proposals.

IV. Financing Issues

33. **Domestic debt management prospects have improved, although risks remain:**

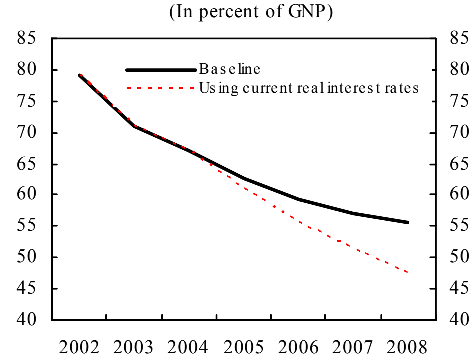
- **The Treasury is improving the structure of its debt.** Treasury has used favorable market conditions to enhance the structure of its debt, with the share of riskier foreign exchange debt falling from almost two-thirds at end-2002 to less than a half. Using its internal risk analysis, Treasury has decided to further reduce its reliance on domestic foreign exchange borrowing and floating rate notes. Reflecting more settled market conditions, Treasury also moved recently from single price to multiple price auctions of its debt.

- **Although challenging, near term rollover prospects remain strong.** Gross redemptions increase in real terms in 2004 and required rollover ratios have increased from the final quarter of 2003. Nevertheless, the Treasury managed to improve its borrowing terms in recent months given positive market conditions. In addition, the US$8.5 billion financing package remained available in case it was needed.

- **Despite these improvements, risks remain.** Turkey's public debt burden remains high and its structure remains risky, despite recent improvements. And, given its large sterilization needs, the CBT has a sizeable short-term (largely overnight) borrowing position with the market, also leaving it vulnerable. Both sides agreed to take further steps to help lower these risks, including through ways to improve coordination in sterilizing capital inflows (¶13).

34. **Turkey's debt sustainability outlook has improved considerably, although it remains sensitive to shocks** (Appendix II). The baseline projection is slightly better than in the Sixth Review, due to the strength of the Turkish lira. To preserve comparability and to remain on the conservative side, the analysis keeps the high real interest rates (around 17 percent) assumed in the Sixth Review; however, the debt dynamics would be considerably improved if current real interest rates (around 11 percent) were used instead. 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—and the associated flow vulnerabilities—are rising due to higher current account deficits and larger than expected short term inflows.

Net Public Debt Burden: Current and Sixth Review Interest Rate Assumptions, 2002-08
(In percent of GNP)



35. **Turkey is starting to make significant net repayments to the Fund (Tables 8–10).** Although purchases remaining under the Stand-By Arrangement still amount to US$2.5 billion, net repurchases begin in earnest in 2004 and should amount to approximately US$2.9 billion. Net payments to the Fund (including interest charges) amount to nearly US$4 billion or 11 percent of end-2003 gross reserves. With substantial gross reserves and strongly favorable macroeconomic indicators, the authorities are well placed to make such repayments, with net international reserves projected to continue increasing over the medium term.

36. **The staff have initiated discussions with the authorities on relations with the Fund after the present program expires.** Such discussions are expected to continue through mid-year as the authorities assess future financing needs, gauge the strength and stability of financial markets, and refine their medium-term economic program. The staff have outlined the options and the authorities are considering whether the conditions are right to graduate from Fund support, or whether a successor arrangement would be preferable.

V. Program Modalities

A. Program Monitoring

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

- The authorities request a waiver of applicability for the performance criterion on the cumulative primary balance of the consolidated government sector for end-March 2004 for which data will not be available until mid-May. (The waiver of applicability is temporary and the PC will still apply for the Eighth Review purchase.) In the view of the staff, there is no clear evidence that the performance criterion will not be met, and additional fiscal measures agreed to during the Seventh Review provide satisfactory assurances that the primary surplus targets in 2004 will be met.

- Treasury's new policy of lowering its domestic foreign currency debt rollover and issuing TL-denominated paper will make NIR targets harder to meet. Accordingly, the authorities request a capped adjuster to NIR to reflect the resulting reduction in external vulnerability (Annex H of the Letter of Intent). The authorities also request amendments to the definition of the performance criterion on the primary surplus of the consolidated government sector: (i) to introduce an adjuster for the amount of the projected surplus of state enterprises that are privatized during 2004, and (ii) to amend an existing adjuster to allow for a lower programmed level of Direct Income Support in view of budget cuts introduced in the context of this Review (LoI Annex D).

- In light of increased demand for Turkish lira deposits and currency holdings and the strong performance in reducing inflation, the authorities also request a waiver of nonobservance of the base money performance criterion for end-March 2004.

- The authorities' legislative schedule and delays in the completion of the Seventh Review (scheduled for January 2004) necessitate a reduction in the number of reviews remaining under the program. The authorities request these be reduced from four to three, with the outstanding access to be spread evenly, with a final test date of end-December 2004 and the Arrangement extended to February 3, 2005 (LoI Annex C).

- To facilitate more timely monitoring within the new phasing, the authorities request an additional performance criterion on the primary fiscal balance excluding SEEs applicable at end-April, end-August, and end-December (LoI Annex D).

- Annex B of the Letter of Intent outlines the updated fiscal and monetary program.

38. **Prior actions for completion of the Seventh Review are:**

- Implementation of corrective fiscal measures expected to yield TL 7 quadrillion over the remainder of 2004, including passage of legislation by Parliament implementing spending cuts as specified in paragraph 7 of this report and paragraph 8 of the LoI;

- Passage of legislation for the second phase of direct tax reform that progressively transforms free trade zones into export processing zones;

- Decision to sell, liquidate, or merge the intervened Pamukbank; and

- Starting Imar bank inquiry: head of inquiry appointed and terms of reference approved.

39. **Structural Performance Criteria.** The authorities request a waiver of nonobservance of the structural performance criterion for end-December on eliminating redundant positions at SEEs, in light of overall progress in reducing positions, including reduction in excess of the targets in certain enterprises.

B. Data Issues

40. **The authorities are making efforts to disclose in-kind foreign financed military spending** (whose exclusion from reported fiscal data for past test dates may have resulted in misreporting). They will estimate the spending from reported movements in the debt stock. The objective is to determine by end-July whether a noncomplying purchase may have taken place in the period January 2000 to June 2003.

VI. Staff Appraisal

41. **Macroeconomic performance has been impressive and the outlook is positive.** The economy is growing rapidly while inflation has fallen to its lowest level in more than a generation. The government's achievements of producing large primary surpluses and reducing debt ratios significantly have brought interest rates substantially lower. And after depreciating continuously for much of its life, the Turkish lira has emerged as a store of value. Finally, the government's strong aspirations for EU accession are helping to maintain the momentum of the reform process and provide an anchor to sustain recent achievements.

42. **This impressive performance has been achieved despite a mixed record on program implementation.** The decision to increase pensions and minimum wages only days after passing the 2004 budget, even though revenues were falling below target, represented a significant slippage in the program. Even if motivated by concern for the poor, better targeted and more cost-effective measures should have been debated when preparing the budget. Both the fiscal cost of these measures and their *ad hoc* nature have weakened Turkey's budget-making process. Luckily market reaction has been limited, in part because of the government's strong commitment to its primary surplus target.

43. **Despite this setback, the government should be commended for last year's record primary surplus, and its determination to put this year's budget back on track.** The authorities have taken steps to cut discretionary spending by 13 percent, and to raise revenues from petroleum, tobacco, alcohol and gas, amounting to 1.7 percent of GNP.

44. **While fiscal policy seems again on track to meet the target, the cost has been further deterioration in the composition of the budget**. Cutting investment to pay for permanent increases in consumption is not conducive to long-term growth. Cutting spending across-the-board means sacrificing better targeted social spending (direct income support, health and education) to finance a generalized pensions increase. Also, the rising share of non-discretionary spending in total spending will make future fiscal adjustment even more difficult. However, despite these drawbacks, the authorities deserve credit for taking such difficult and politically unpopular measures ahead of the end-March local elections.

45. **There are also risks to the fiscal outlook, which the next review will need to follow closely.** The deterioration in revenues at the end of last year needs to be carefully monitored,

particularly for any signs that earlier tax amnesty schemes and one-off measures have weakened the revenue base. Inflation could fall below budget assumptions, which would lower revenues. More timely reaction is needed to ensure that excises and state enterprise prices are raised in line with budget assumptions. Finally, coordination between the Ministry of Finance and line ministries needs to be improved, to prevent any repetition of last year's spending overruns. However, the authorities' willingness to revisit the fiscal outlook at the next review, as well as their record of taking additional measures when necessary, offers some hope that the fiscal targets can still be met.

46. **The government's adoption of a comprehensive structural fiscal reform strategy for the final year of the program is welcome.** Strengthened tax administration is a critical step toward combating tax evasion. And the decision to present social security reform to Parliament by the end of the year has the potential to play a major role in restoring the system to solvency, which can underpin fiscal stability in the medium term. The authorities' request for a public expenditure review, identifying spending programs that can be rationalized and improved, is also particularly appropriate given increasing rigidities in the budget's structure. Recommendations from this review should be included in the 2005 budget. Given the authorities' uneven track record in delivering on structural reforms, timely implementation of the agreed reform agenda could substantially increase policy credibility.

47. **Both the central bank and the government deserve credit for the dramatic reduction in inflation.** The central bank for its skilful conduct of monetary policy, the government for maintaining fiscal discipline. With market expectations of end-year inflation coinciding with the inflation target for the first time, the CBT's "credibility gap" has finally disappeared and may even have turned into a "credibility bonus." The authorities now need to ensure that next year's currency redenomination and creation of the new Turkish lira is a success. The best way will be through achieving and maintaining single-digit inflation.

48. **While the reduction in inflation has been a clear success, sustaining it may require a more flexible monetary framework.** With the fall in inflation, the demand for money has increased, weakening the link between base money and inflation. While targets have been adjusted flexibly to match shifts in demand, the very success of base money in reducing inflation may now have made it less effective as a nominal anchor. Although it can be debated whether the conditions for formal inflation targeting are yet in place, improvements to the current framework of implicit inflation targeting might still be considered, notwithstanding its successful track record. Interest rate policy decisions could be timed to coincide with regularly scheduled monetary policy meetings, transparency could be improved, and the status of inflation reports upgraded.

49. **Effective coordination between the CBT and the Treasury is needed to share the cost of accumulating reserves, and to prepare for future Fund repayments.** The policy response to continued capital inflows—re-introducing foreign exchange purchase auctions, allowing modest real appreciation, and gradually cutting interest rates—remains appropriate. However, the authorities should rely less on CBT overnight borrowing to sterilize the inflows and find more permanent solutions instead. The CBT could sterilize less through deposit auctions and more by issuing its own paper, while being careful to avoid competing with Treasury's debt issuance. The Treasury could help sterilize through over borrowing and building its deposit

buffer at the CBT—something it will anyway have to do next year for it to repay the Fund, and which would be better done in advance.

50. **While 2003 has been good for banking sector profitability, it has been less so for banking sector reform.** Last year's sharp fall in interest rates gave banks huge capital gains on their government bond portfolio, raising their profits. The improved health of the banking system should now be used to reinvigorate banking reform, which has stalled somewhat:

- More progress needs to be made in resolving the SDIF's bad assets, which has slowed after the failure of last December's loan auctions, and the appointment of a new SDIF Board. The authorities' intention to prepare more realistic valuations (which should defuse charges of selling at too low prices) should help. However, the first real test will come with the new asset resolution strategy (due to be prepared by end-April), which should propose transparent and rapid means of divestment.

- State bank reform has been slow and their operations need to be closely monitored. Their loan rates have been lowered quite aggressively, contributing to the rapid growth in consumer credit. To prevent this, the authorities need to remove the excess capitalization of state banks, limit their loan growth, and ensure that their (risk-adjusted) deposit rates are in line with the market.

- Legal challenges threaten to overturn the BRSA's earlier interventions in insolvent banks, and subsequent sales. Should adverse decisions be made by the courts, the effectiveness of the BRSA would be seriously undermined, and foreign direct investment set back. The government needs to stand firmly behind the BRSA during the court process.

- The authorities should be commended on their efforts to bring the Banking Act more closely into line with EU practice. In particular, this will require clarifying the scope of the Banking Act and more clearly delineating the respective responsibilities of the BRSA and SDIF, integrating on and off-site supervision, giving staff legal protection for carrying out their duties, strengthening provisions on related-party lending, and maintaining rigorous "fit and proper" standards for bank owners.

51. **The authorities should build on their recent success in privatization and improve the business climate.** Recent sales of the petroleum refinery and the alcohol unit of TEKEL hold out the hope that this government is making good on its privatization commitments. The 2004 sales program is appropriately ambitious, and the authorities need to make every effort to divest the targeted companies at realistic prices. The inaugural Investment Council held in mid-March should be followed by steps to deal with impediments to foreign and domestic investment. This will help support sustained private sector-led growth.

52. **Against this background of impressive macroeconomic performance, and commitments to a comprehensive reform agenda, the staff recommends completion of the Seventh Review**. The authorities have taken corrective actions to put the program targets and commitments on-track. They have also formulated a strong and appropriate program for 2004 aimed at continued prudent macroeconomic management and acceleration of structural reforms. Turkey has built a sound track record of program implementation, including the reforms it has

implemented for the current program review, and continues to deserve the support of the international community. Accordingly, the staff supports the granting of waivers for non-observance of the end-December 2003 performance criterion on the elimination of redundant SEE positions, and the end-March 2004 performance criterion on base money. The staff also supports the requested rephasing of the remaining purchases and the extension of the arrangement to February 3, 2005, and recommends the completion of the Seventh Review under the Stand-by Arrangement.

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

Action	Type 1/	Status As of April 1, 2004
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-March).	PC	All end-December targets were met, except for primary balance. End-March base money target expected to be missed.
II. Structural Conditionality		
Implement corrective fiscal measures expected to yield TL 7 quadrillion over the remainder of 2004, including passage of legislation by Parliament implementing spending cuts.	PA	Met
Pass legislation for the second phase of direct tax reform.	PA	Met
Decision to sell, merge or liquidate Pamuk bank.	PA	Met
Imar bank inquiry to start: head of inquiry appointed and TOR approved.	PA	Expected to be met shortly.
Eliminate 25,074 redundant state enterprise positions.	PC	Waiver requested. Overall elimination of positions—including positions not formally covered by the PC definition—exceeded target.
No new amnesties of arrears on public sector receivables (continuous).	PC	Met
Introduce regulations implementing new legislation covering pre-packaged bankruptcy provision (December 15).	BM	To be met with delay. Relevant legislation was passed in February; the law requires the regulations to be introduced by April 21.
Detailed assessment of fiscal implications of new social security reforms.	BM	Met

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

Table 2. Turkey: Selected Indicators, 1999-2005

						Projections	
	1999	2000	2001	2002	2003	2004	2005
	(In percent)						
Real sector							
Real GNP growth rate	-6.1	6.3	-9.5	7.8	5.0	5.0	5.0
GNP deflator	55.8	50.9	55.3	43.8	22.9	11.0	9.9
Nominal GNP growth rate	46.3	60.4	40.5	55.0	29.0	16.5	15.4
WPI (12-month, end-of-period)	62.9	32.7	88.6	30.8	13.9	12.0	8.0
CPI (12-month, end-of period)	68.8	39.0	68.5	29.7	18.4	12.0	8.0
Average nominal treasury bill interest rate	106.2	38.0	99.1	63.5	44.1	23.0	17.5
Average ex-ante real interest rate 1/	32.0	-9.5	35.5	30.3	28.6	11.2	10.6
	(In percent of GNP)						
Central government budget							
Primary balance 2/	2.5	4.6	4.8	2.4	5.0	5.0	5.0
Net interest payments 3/	13.1	15.8	24.7	17.6	16.3	13.1	9.2
Overall balance	-10.6	-11.2	-19.9	-15.2	-11.3	-8.1	-4.2
Consolidated public sector							
Primary balance	-0.2	3.0	5.5	4.1	6.2	6.5	6.5
Net interest payments 4/	22.1	21.9	26.6	16.2	16.2	13.1	9.7
PSBR (including CBT profits)	22.3	18.9	21.1	12.1	10.0	6.6	3.2
Operational balance	-12.4	-6.9	-4.7	-4.5	-4.9	-2.5	-0.5
Net debt of public sector	61.0	57.4	93.9	79.2	70.9	66.5	60.3
Net external	20.1	19.0	37.7	32.3	22.4	20.9	18.6
Net domestic	40.9	39.3	56.2	47.0	48.5	45.6	41.7
Net debt of public sector (in percent of centered GNP) 5/	48.6	52.4	74.7	69.4	66.9	62.2	54.9
External sector							
Current account balance	-0.7	-4.9	2.4	-0.8	-2.9	-3.0	-2.4
Gross external debt	55.0	59.0	79.0	72.3	60.6	48.4	45.1
Net external debt	33.6	38.8	53.8	54.1	44.1	36.8	34.1
Short-term external debt (by remaining maturity)	18.9	21.7	22.7	17.9	17.7	14.8	14.3
Monetary aggregates							
Seignorage 6/	3.2	1.8	1.1	1.0	1.3	1.1	0.5
Nominal growth of M2Y broad money (in percent)	100.7	40.2	87.5	25.4	10.6	20.3	13.4
	(In billions of U.S. dollars, unless otherwise indicated)						
Privatization proceeds	0.1	3.3	2.8	0.5	0.3	3.0	…
Net external financing of central government	1.4	4.1	-2.3	-1.4	-1.4	0.1	…
Amortization	6.0	6.2	7.8	6.8	8.9	8.6	…
Gross borrowing	7.4	10.3	5.5	5.3	7.5	8.6	…
Of which : Eurobond issues	5.0	7.5	2.2	3.3	5.3	5.0	…
GNP	187.4	201.3	144.0	181.7	235.9	…	…
GNP (in quadrillions of Turkish lira)	78.3	125.6	176.5	273.5	352.9	411.1	474.5

Sources: Data provided by Turkish authorities; and IMF staff estimates.
1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation.
2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds.
3/ Interest payments (including capitalization of interest) minus interest receipts plus profit transfers from the central bank.
4/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
5/ 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.
6/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

Table 3. Turkey: Monetary Aggregates, 2000-03
(In quadrillions of Turkish lira)

	2000	2001	2002	2003			
				Mar.	Jun.	Sep.	Dec.
						Projected	
Broad money (M2Y)	56.8	106.6	133.7	132.3	129.7	137.7	147.8
Lira broad money (M2)	31.9	47.2	61.9	63.8	67.8	75.0	80.4
Foreign exchange deposits 1/	24.9	59.3	71.8	68.5	61.9	62.7	67.4
Repos	6.0	2.8	2.8	3.9	2.4	3.0	3.1
Broad liquidity	62.8	109.4	136.4	136.2	132.1	140.7	150.9
Base money	5.8	7.8	10.4	12.2	12.9	14.0	14.9
Net foreign assets 1/	2.8	-1.9	-6.3	-15.5	-9.8	-4.6	-4.0
(in billions of U.S. dollars)	4.1	-1.3	-3.9	-9.1	-6.9	-3.4	-2.9
Net domestic assets	54.1	108.5	140.0	147.7	139.5	142.3	151.9
Net claims on government	31.6	89.7	122.8	130.9	129.0	127.2	135.7
Claims on business sector 2/	31.7	38.7	42.0	47.1	47.4	51.1	58.0
Turkish lira claims	22.3	23.1	24.5	26.6	29.5	33.6	39.7
Foreign exchange claims (est.) 1/	9.4	15.6	17.5	20.5	17.9	17.4	18.4
Other items (net)	-9.1	-20.0	-24.8	-30.3	-36.9	-36.0	-41.9
Memorandum items:			(annual percent change)				
Broad money (M2Y)	40.2	87.5	25.4	28.3	11.1	9.8	10.6
Lira broad money (M2)	42.5	48.0	31.0	28.8	27.7	33.4	29.9
Foreign exchange deposits 1/	37.3	137.9	21.0	27.9	-2.8	-9.4	-6.0
Claims on business sector 2/	73.0	22.3	8.4	31.3	38.0	33.4	38.3
			(billions of U.S. dollars)				
Broad money (M2Y)	84.6	74.0	81.8	77.8	91.2	100.0	105.9
Lira broad money (M2)	47.5	32.8	37.9	37.5	47.7	54.5	57.6
Foreign exchange deposits	37.1	41.2	43.9	40.3	43.5	45.6	48.3
Net claims on government	47.0	62.3	75.1	77.0	90.8	92.4	97.2
Credit to the private sector	47.1	26.9	25.7	27.7	33.3	37.1	41.6
			(in percent share)				
Base money/GNP 3/	4.6	4.4	3.8	4.2	4.1	4.2	4.2
Broad money (M2Y)/GNP 3/	45.3	60.4	48.9	45.5	41.5	41.1	41.9
Lira broad money (M2)/GNP 3/	25.4	26.8	22.6	22.0	21.7	22.4	22.8
Private credit/GNP	25.2	21.9	15.3	16.2	15.2	15.2	16.4
Foreign currency deposits/M2Y	43.9	55.7	53.7	51.8	47.7	45.6	45.6
Money multiplier							
Broad money (M2Y)	9.8	13.7	12.8	10.8	10.1	9.9	9.9
Lira broad money (M2)	5.5	6.1	5.9	5.2	5.3	5.4	5.4

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

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

	2000	2001	2002	2003				2004			
	Dec Actual	Dec Actual	Dec Actual	Apr Actual	Jun Actual	Sep Actual	Dec Actual	Mar Projected	Apr Projected	Aug Projected	Dec Projected
Central bank balance sheet	(in quadrillions of Turkish lira) 1/										
Net foreign assets	3.3	-12.7	3.9	3.0	4.4	11.7	8.8	8.5	9.2	11.1	8.0
Gross foreign assets	15.6	28.6	37.7	36.3	38.1	45.4	42.5	41.2	41.9	43.3	39.1
Gross foreign liabilities	12.3	41.2	33.8	33.4	33.7	33.7	33.6	32.6	32.7	32.2	31.1
International reserve liabilities	3.1	20.7	11.5	11.4	11.2	10.6	9.8	8.3	8.3	7.6	6.3
Other reserve liabilities 2/	4.9	10.1	13.2	13.3	13.8	14.1	14.5	14.9	14.9	14.9	14.9
Banks' FX deposits with CBT	4.3	10.4	9.1	8.7	8.7	8.9	9.3	9.4	9.5	9.6	9.9
Net domestic assets	2.5	20.6	6.5	8.8	8.5	2.3	6.0	8.6	8.3	8.2	11.3
Base money	5.8	7.8	10.4	11.8	12.9	14.0	14.9	17.1	17.5	19.2	19.3
Currency issued	3.8	5.3	7.6	8.2	9.2	10.0	10.7	12.0	12.2	13.8	13.2
Banks' lira deposits at the CBT	2.0	2.5	2.8	3.6	3.7	3.9	4.2	5.2	5.3	5.5	6.1
	(in billions of U.S. dollars)										
CBT gross international reserves	23.2	19.8	26.2	25.2	26.4	31.5	29.5	28.6	29.1	30.1	27.2
At current cross rates:	…	19.8	28.1	28.3	30.0	35.2	35.2	…	…	…	…
CBT gross international liabilities	18.3	28.6	23.5	23.2	23.4	23.4	23.4	22.7	22.7	22.4	21.6
CBT net foreign assets	4.9	-8.8	2.7	2.1	3.0	8.1	6.1	5.9	6.4	7.7	5.5
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	9.3	9.6	9.8	10.1	10.4	10.4	10.4	10.4
minus Dresdner one year deposits	0.6	0.7	1.4	1.5	1.6	2.0	2.1	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	9.4	10.6	15.5	13.6	13.7	14.2	15.5	13.3
Treasury net international reserves 3/	...	-1.3	-14.7	-15.4	-14.4	-14.0	-14.2	-14.1	-14.5	-14.9	-15.8
Net international reserves (Treasury plus CBT)	...	-4.2	-4.6	-6.0	-3.9	1.5	-0.5	-0.3	-0.3	0.5	-2.4
	(in quadrillions of Turkish lira, program exchange rate)										
Net foreign assets (Treasury)	...	-1.8	-21.1	-22.1	-20.8	-20.1	-20.4	-20.2	-20.9	-21.5	-22.7
Net foreign assets (Treasury plus CBT)	...	-14.5	-17.2	-19.1	-16.4	-8.4	-11.6	-11.7	-11.7	-10.4	-14.7
Net domestic assets (Treasury) 4/	...	1.8	21.1	22.1	20.8	20.1	20.4	20.2	20.9	21.5	22.7
Net domestic assets (Treasury plus CBT)	...	22.4	27.6	30.9	29.3	22.4	26.4	28.8	29.2	29.7	34.0
Base money (Treasury plus CBT)	...	7.9	10.4	11.8	12.9	14.0	14.9	17.1	17.5	19.2	19.3
Exchange rate (TL per US dollar, in millions)	0.67	1.44	1.63	1.58	1.42	1.38	1.40	...	...	...	...

Sources: Central Bank of Turkey; and Fund staff projections.

1/ Although program targets for base money and NDA are five day averages, all observations in this table are end of period. 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, 2001-08
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
Current account balance	3.4	-1.5	-6.8	-9.1	-7.6	-7.5	-7.2	-6.6
Trade balance	-4.5	-8.3	-13.9	-16.8	-16.2	-17.4	-17.9	-18.3
Exports (f.o.b.)	34.4	39.8	50.8	60.4	66.6	73.1	80.5	88.7
Of which:								
Exports (f.o.b.) in trade returns	31.3	35.8	46.9	56.4	62.6	69.0	76.3	84.6
Shuttle trade	3.0	4.1	4.0	4.0	4.0	4.1	4.1	4.2
Imports (f.o.b.)	-38.9	-48.1	-64.8	-77.2	-82.8	-90.4	-98.3	-107.0
Of which:								
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.2	-68.7	-82.1	-88.1	-96.2	-104.6	-113.9
Energy imports (c.i.f.)	-8.3	-9.2	-11.4	-11.7	-11.1	-11.4	-11.9	-12.7
Services and Income (net)	4.1	3.3	3.5	3.6	4.3	5.1	5.7	6.6
Services and Income (credit)	18.8	17.3	19.7	22.7	24.8	26.6	28.1	30.1
Of which:								
Tourism receipts	8.1	8.5	9.7	10.8	11.6	12.4	13.3	14.2
Services and Income (debit)	-14.7	-13.9	-16.2	-19.1	-20.5	-21.5	-22.4	-23.5
Of which:								
Interest	-7.1	-6.4	-6.9	-7.9	-8.5	-8.8	-8.8	-9.1
Private transfers (net)	3.6	3.0	3.3	3.7	3.8	4.0	4.2	4.4
Official transfers (net)	0.2	0.5	0.3	0.4	0.5	0.7	0.7	0.7
Capital account balance	-14.6	1.4	5.7	9.2	10.0	12.1	12.2	12.4
(including errors and omissions)	-16.3	1.3	10.9	9.2	10.0	12.1	12.2	12.4
Direct investment (net) 1/	2.8	0.9	0.1	1.6	1.8	2.2	2.6	3.1
Portfolio investment in securities	-4.6	-1.2	1.0	2.4	1.8	1.6	1.7	1.9
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.9	1.7	2.5	2.1	1.8
Bonds (net)	0.1	1.0	1.5	1.6	2.8	3.3	2.7	2.2
Eurobond drawings	2.1	3.3	5.3	5.1	5.6	5.8	5.8	5.8
Eurobond repayments	-2.0	-2.3	-3.8	-3.5	-2.8	-2.5	-3.1	-3.6
Loans (net)	-2.0	-0.7	-2.2	-0.6	-1.1	-0.8	-0.6	-0.4
Loan disbursements	1.6	2.3	1.0	2.8	2.2	2.3	2.3	2.4
Loan repayments	-3.6	-3.0	-3.2	-3.5	-3.3	-3.1	-3.0	-2.8
Central Bank of Turkey, (Excl. reserve assets, liabilties)	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	1.7	1.2	1.5	1.4	1.3
Domestic money banks (FX deposits abroad, -: accumulation)	0.9	0.6	0.7	-0.2	-0.2	-0.3	-0.3	-0.3
Domestic money banks (other, net)	-10.3	-2.4	2.3	1.9	1.4	1.8	1.7	1.6
Other private sector (net)	-2.3	1.8	1.7	2.6	3.4	4.4	4.3	4.3
Other private sector (medium and long term, net)	0.3	2.7	1.6	2.5	3.0	4.8	5.3	5.4
Other private sector (short term, net)	-2.6	-0.9	0.2	0.1	0.4	-0.4	-0.9	-1.1
Errors and omissions	-1.7	-0.1	5.2	0.0	0.0	0.0	0.0	0.0

Table 5. Turkey: Balance of Payments, 2001-08
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
Overall balance	-12.9	-0.2	4.1	0.1	2.4	4.6	5.0	5.8
Overall financing (NIR change excl. ST liabilities, + denotes decline	12.9	0.2	-4.1	-0.1	-2.4	-4.6	-5.0	-5.8
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-0.1	-2.4	-4.6	-5.0	-5.8
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	2.8	4.5	7.0	-3.1	-4.9
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-2.9	-7.0	-11.6	-1.8	-0.9
Purchases	11.3	12.5	1.7	1.9	0.7	0.0	0.0	0.0
Repurchases	-1.1	-6.1	-1.7	-4.7	-7.6	-11.6	-1.8	-0.9
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, incl. shuttle trade	2.4	-0.8	-2.9	-3.0	-2.4	-2.2	-2.0	-1.7
Trade account balance, incl. shuttle trade	-3.2	-4.6	-5.9	-5.6	-5.1	-5.1	-4.9	-4.7
Exports of goods and non-factor services	36.1	31.0	29.6	27.4	28.3	28.8	29.2	30.5
Imports of goods and non-factor services	32.2	30.6	31.4	29.5	29.7	30.2	30.5	31.5
Percent change								
Value growth in exports of goods (incl. shuttle trade)	11.9	15.8	27.7	18.8	10.3	9.7	10.1	10.3
Value growth in exports of goods (excl. shuttle trade)	12.8	14.1	31.1	20.3	10.9	10.3	10.6	10.8
Value growth in imports of goods	-26.8	23.7	34.6	19.2	7.3	9.2	8.7	8.8
Volume growth in exports of goods	16.6	11.8	16.5	13.2	9.6	9.4	9.6	9.6
Volume growth in imports of goods	-22.9	21.2	18.2	13.1	7.1	8.9	8.1	7.8
Terms of trade	1.7	0.0	-0.9	0.7	1.1	0.5	0.4	0.1
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey)								
In billions of U.S. dollars	19.8	28.1	35.2	32.4	27.8	20.9	24.0	28.9
Months of goods & NFS imports	4.4	5.4	5.2	4.0	3.2	2.2	2.4	2.7
External debt (end-of-period)								
In billions of U.S. dollars	113.8	131.3	142.9	145.3	143.7	137.9	141.0	144.7
Percent of GNP	79.0	72.3	60.6	48.4	45.1	40.4	38.4	37.5
Percent of exports of goods & NFS	218.8	233.1	204.6	176.8	159.3	140.3	131.6	123.2
Net external debt (end-of-period) 2/								
In billions of U.S. dollars	77.5	98.3	104.1	110.4	108.9	97.9	95.6	93.0
Percent of GNP	53.8	54.1	44.1	36.8	34.1	28.7	26.0	24.1
Short-term debt (end-of-period)								
In billions of U.S. dollars	16.4	16.4	22.9	25.3	27.8	29.5	30.8	32.0
Ratio to foreign reserves	82.6	58.4	65.2	78.1	99.9	141.5	128.3	110.6
Short-term debt plus MLT repayments								
In billions of U.S. dollars	32.7	32.5	41.8	44.4	45.5	46.9	49.3	51.6
Ratio to foreign reserves	164.7	115.4	118.8	137.1	163.6	224.8	205.7	178.5
Debt service ratio 3/	41.3	37.3	34.9	31.1	27.6	25.2	24.2	23.3

Sources: Data provided by the Turkish authorities; and Fund staff estimates and projections.
1/ Including privatization receipts.
2/ Nonbank external debt less the NFA of the banking system.
3/ 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			2004	
			Est.	6th rev.	Est. 1/	Diff.	6th rev.	Proj. 2/
				(in trillions of TL)				
Public Sector	**3,760**	**9,741**	**11,156**	**23,437**	**21,945**	**-1,492**	**27,297**	**27,331**
Central government 3/	**5,831**	**8,420**	**6,644**	**17,987**	**17,954**	**-33**	**20,952**	**20,985**
Total revenue	30,346	44,766	63,369	90,493	90,445	-48	102,242	104,375
Tax revenue	26,514	39,768	59,634	86,797	84,335	-2,462	99,166	97,927
Direct taxes	10,849	16,080	20,077	27,935	27,800	-135	29,716	29,920
Indirect taxes	15,665	23,687	39,557	58,862	56,535	-2,327	69,450	68,007
Nontax revenue 3/	5,463	7,916	9,402	12,291	14,446	2,155	14,507	16,578
Tax rebates	-1,632	-2,918	-5,666	-8,595	-8,335	260	-11,431	-10,130
Non-interest expenditure	24,515	36,346	56,726	72,506	72,492	-14	81,290	83,390
Personnel	9,982	15,204	23,160	30,103	30,200	97	35,277	35,101
Other current	1,193	1,431	2,510	3,035	2,548	-487	3,810	3,432
Defense and security	2,327	3,591	4,485	5,435	5,668	233	5,800	5,845
Transfers	8,763	12,218	19,289	27,433	26,911	-522	28,820	32,113
Social security institutions	3,320	5,910	9,946	16,450	16,228	-222	15,995	19,468
State enterprises and banks 4/	1,280	1,777	2,245	1,991	1,971	-20	1,555	1,500
Agricultural subsidies	359	1,033	1,868	2,780	2,805	25	3,795	3,215
Other transfers	3,804	3,499	5,230	6,212	5,907	-305	7,475	7,930
Investment	2,251	3,902	7,282	6,500	7,165	665	7,583	6,899
Rest of the public sector	**-2,071**	**1,321**	**4,513**	**5,450**	**3,991**	**-1,459**	**6,346**	**6,346**
EBFs	-225	149	-249	-222	390	612	137	137
Unemployment insurance fund	334	1,098	962	1,217	1,228	11	1,760	1,760
Local governments	-284	94	338	-28	-28	0	0	0
SEEs 5/	-1,920	149	3,139	4,022	1,887	-2,135	4,099	4,099
Social insurance institutions	24	-170	-85	0	53	53	0	0
Revolving funds 6/	99	95	407	461	461	0	350	350
				(in percent of GNP)				
Public Sector	**3.0**	**5.5**	**4.1**	**6.6**	**6.2**	**-0.3**	**6.5**	**6.5**
Central government 3/	**4.6**	**4.8**	**2.4**	**5.0**	**5.1**	**0.0**	**5.0**	**5.0**
Total revenue	24.2	25.4	23.2	25.3	25.6	0.3	24.4	24.9
Tax revenue	21.1	22.5	21.8	24.3	23.9	-0.4	23.6	23.3
Nontax revenue 3/	4.4	4.5	3.4	3.4	4.1	0.7	3.5	4.0
Non-interest expenditure	19.5	20.6	20.7	20.3	20.5	0.2	19.4	19.9
Personnel	7.9	8.6	8.5	8.4	8.6	0.1	8.4	8.4
Other current	2.8	2.8	2.6	2.4	2.3	0.0	2.3	2.2
Transfers 4/	7.0	6.9	7.1	7.7	7.6	-0.1	6.9	7.7
Investment	1.8	2.2	2.7	1.8	2.0	0.2	1.8	1.6
Rest of the public sector	**-1.6**	**0.7**	**1.7**	**1.5**	**1.1**	**-0.4**	**1.5**	**1.5**
EBFs	-0.2	0.1	-0.1	-0.1	0.1	0.2	0.0	0.0
Unemployment insurance fund	0.3	0.6	0.4	0.3	0.3	0.0	0.4	0.4
Local governments	-0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
SEEs 5/	-1.5	0.1	1.1	1.1	0.5	-0.6	1.0	1.0
Social insurance institutions	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 6/	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1

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

1/ The estimate for 2003 includes special revenues and expenditures. These are not included in the 6th review column.

2/ Starting in 2004, the authorities have changed the public accounts classification to the new GFS format. This creates a discontinuity with earlier years.

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

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

5/ Excluding severance payments for retirees amounting to TL 201 trillion (0.1 percent of GNP).

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

Table 7. Turkey: Banking System—Selected Indicators, 1998-2003 1/
(in trillions of Turkish lira)

	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec. 1/	2002 Dec.	2003 June	2003 Dec.
				Banking System			
Total assets	**40,988**	**79,763**	**117,649**	**179,675**	**212,681**	**211,666**	**249,693**
Cash and claims on CBT	2,665	5,097	6,235	12,558	13,872	13,342	14,962
Claims on other banks	3,923	7,766	13,599	19,871	15,401	11,362	15,141
Securities portfolio	9,688	22,040	31,251	70,026	86,105	92,661	106,844
Loans, net	14,689	22,601	35,789	41,058	52,932	54,593	67,210
Other assets	10,024	22,258	30,775	36,162	44,371	39,708	45,536
Total liabilities	**40,988**	**79,763**	**117,649**	**179,675**	**212,680**	**211,666**	**249,693**
Deposits	24,194	48,272	68,143	110,298	137,973	133,197	155,312
Borrowing from banks	4,663	10,070	15,996	23,798	21,967	20,011	25,918
Repos	4,153	7,645	12,843	10,776	6,161	7,577	11,241
Other liabilities	4,689	9,539	12,207	20,527	21,351	20,738	21,683
Shareholders' equity (incl. profits)	3,290	4,234	8,461	14,276	25,228	30,144	35,539
Memorandum items:							
Capital adequacy ratio (%)	…	…	17.3	15.3	25.3	29.6	30.9
NPLs (%) total loans	6.7	9.7	9.2	29.3	17.6	15.3	11.5
Provisions (%) NPLs	44.2	61.9	59.8	47.1	64.2	70.5	88.5
Net profit (loss) after tax	760	-305	-888	-9,910	2,336	2,421	5,678
ROA (%)	1.9	-0.4	-0.8	-5.5	1.1	1.1	2.3
ROE (%)	23.1	-7.2	-10.5	-69.4	9.3	8.0	16.0
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	**23,596**	**42,165**	**56,179**	**97,930**	**119,471**	**117,389**	**142,270**
Cash and claims on CBT	1,514	2,707	3,362	8,434	9,356	8,192	9,868
Claims on other banks	2,688	5,386	9,769	10,494	7,623	5,111	6,369
Securities portfolio	6,478	14,335	13,491	27,146	39,819	41,872	51,485
Loans, net	8,793	12,445	19,587	26,506	35,752	37,414	46,402
Other assets	4,124	7,292	9,971	25,350	26,921	24,800	28,146
Total liabilities	**23,596**	**42,165**	**56,179**	**97,930**	**119,471**	**117,389**	**142,270**
Deposits	13,652	23,160	30,827	67,223	80,629	75,701	88,180
Borrowing from banks	3,006	6,508	10,045	15,585	13,703	12,965	18,158
Repos	2,633	4,654	3,918	1,803	4,074	4,695	8,103
Other liabilities	1,894	3,036	3,503	5,779	5,871	6,668	6,872
Shareholders' equity (incl. profits)	2,411	4,806	7,886	7,540	15,194	17,359	20,958
Memorandum items:							
Capital adequacy ratio (%)	…	…	18.3	9.0	19.64	22.2	23.5
NPLs (%) total loans	6.9	3.5	3.5	27.6	8.9	8.4	6.5
Provisions (%) NPLs	41.2	62.2	63.0	31.0	53.0	56.7	80.0
Net profit (loss) after tax	660	1,618	1,276	-7,383	2,410	1,055	2,917
ROA (%)	2.8	3.8	2.3	-7.5	2.0	0.9	2.1
ROE (%)	27.4	33.7	16.2	-97.9	15.9	6.1	13.9
Share in assets (%)	57.6	52.9	47.8	54.5	56.2	55.5	57.0
Share in deposits and repos (%)	57.4	49.7	42.9	57.0	58.8	57.1	57.8

Table 7. Turkey: Banking System—Selected Indicators, 1998-2003 1/
(in trillions of Turkish lira)

	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec. 1/	2002 Dec.	2003 June	2003 Dec.
				State Banks			
Total assets	**14,150**	**27,104**	**40,655**	**57,583**	**67,831**	**71,343**	**83,134**
Cash and claims on CBT	1,067	1,999	2,588	3,544	4,000	4,625	4,589
Claims on other banks	652	1,088	1,639	5,096	3,996	2,964	5,365
Securities portfolio	2,660	4,671	8,139	32,756	39,245	43,347	47,716
Loans, net	4,267	6,521	10,025	9,177	8,804	9,789	12,202
Other assets	5,503	12,825	18,265	7,011	11,786	10,618	13,263
Total liabilities	**14,150**	**27,104**	**40,655**	**57,583**	**67,831**	**71,343**	**83,134**
Deposits	9,838	19,204	27,606	37,258	48,489	50,538	59,862
Borrowing from banks	368	630	1,339	2,381	2,230	2,215	2,338
Repos	1,284	1,922	4,949	3,844	1,022	846	1,018
Other liabilities	2,116	4,317	5,659	9,707	9,343	9,491	10,342
Shareholders' equity (incl. profits)	544	1,031	1,101	4,393	6,747	8,252	9,574
Memorandum items:							
Capital adequacy ratio (%)	…	…	7.9	34.0	50.2	57.6	56.3
NPLs (%) total loans	5.3	9.1	11.1	37.3	37.4	34.3	26.2
Provisions (%) NPLs	30.2	35.1	30.3	63	74	78	98
Net profit (loss) after tax	78	284	-177	-681	1,056	700	1,790
ROA (%)	0.5	1.0	-0.4	-1.2	1.6	1.0	2.2
ROE (%)	14.3	27.6	-16.1	-15.5	15.7	8.5	18.7
Share in assets (%)	34.5	34.0	34.6	32.0	31.9	33.7	33.3
Share in deposits and repos (%)	39.2	37.8	40.2	33.9	34.4	36.5	36.6
				SDIF Banks			
Total assets	**667**	**5,480**	**12,912**	**11,035**	**9,310**	**7,256**	**7,075**
Cash and claims on CBT	9	248	103	45	62	52	52
Claims on other banks	47	211	535	874	619	377	456
Securities portfolio	351	2,511	8,572	8,451	4,655	4,875	4,964
Loans, net	158	1,052	2,533	602	1,889	1,096	910
Other assets	102	1,458	1,169	1,064	2,085	856	693
Total liabilities	**667**	**5,480**	**12,912**	**11,035**	**9,310**	**7,256**	**7,075**
Deposits	446	5,363	8,827	3,566	5,770	4,251	4,133
Borrowing from banks	29	263	819	2,020	1,274	495	837
Repos	226	1,426	3,993	5,023	1,024	1,940	2,025
Other liabilities	69	968	1,329	814	2,338	1,207	927
Shareholders' equity (incl. profits)	-104	-2,540	-2,056	-388	-1,096	-637	-847
Memorandum items:							
Capital adequacy ratio (%)	…	…	…	-17.8	-7.6	-11.6	-21.6
NPLs (%) total loans	49.7	61.9	41.4	67.3	69.4	59.3	53.8
Provisions (%) NPLs	80.9	75.3	80.3	89.1	60.5	76.1	75.4
Net profit (loss) after tax	-127	-2547	-2314	-2,344	-1,677	458	272
ROA (%)	-19.0	-46.5	-17.9	-21.2	-18.0	6.3	3.8
ROE (%)	…	…	…	…	-153.0	-72.0	-32.1
Share in assets (%)	1.6	6.9	11.0	6.1	4.4	3.4	2.8
Share in deposits and repos (%)	2.4	12.1	15.8	7.1	4.7	4.4	3.7

Table 7. Turkey: Banking System—Selected Indicators, 1998-2003 1/
(in trillions of Turkish lira)

	1998 Dec.	1999 Dec.	2000 Dec.	2001 Dec. 1/	2002 Dec.	2003 June	2003 Dec.
			Foreign and Investment Banks				
Total assets	**2,576**	**5,014**	**7,903**	**13,126**	**16,068**	**15,679**	**17,213**
Cash and claims on CBT	75	143	182	535	454	473	454
Claims on other banks	536	1,082	1,657	3,408	3,164	2,910	2,951
Securities portfolio	199	523	1,049	1,673	2,386	2,567	2,680
Loans, net	1,471	2,583	3,645	4,773	6,487	6,295	7,695
Other assets	295	683	1,370	2,738	3,577	3,434	3,434
Total liabilities	**2,576**	**5,014**	**7,903**	**13,126**	**16,068**	**15,679**	**17,213**
Deposits	258	546	882	2,252	3,086	2,707	3,137
Borrowing from banks	1,259	2,670	3,792	3,812	4,761	4,335	4,585
Repos	10	-357	-17	105	40	96	95
Other liabilities	609	1,218	1,716	4,227	3,798	3,371	3,542
Shareholders' equity (incl. profits)	439	937	1,529	2,730	4,383	5,169	5,854
Memorandum items:							
Capital adequacy ratio (%)	…	…	29.4	41.0	48.4	54.4	60.8
NPLs (%) total loans	2.1	2.1	1.8	9.3	4.3	4.6	3.8
Provisions (%) NPLs	54.0	31.3	51.8	81.2	69.3	82.6	85.5
Net profit (loss) after tax	150	340	328	498	548	207	698
ROA (%)	5.8	6.8	4.1	3.8	3.4	1.3	4.1
ROE (%)	34.1	36.3	21.4	18.2	12.5	4.0	11.9
Share in assets (%)	6.3	6.3	6.7	7.3	7.6	7.4	6.9
Share in deposits and repos (%)	0.9	0.3	1.1	1.9	2.2	2.0	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, 2000–08
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Gross financing requirements	58.9	49.0	43.9	54.7	61.7	61.1	63.3	65.8	67.4
Current account deficit (excluding official transfers)	10.0	-3.2	2.0	7.1	9.5	8.0	8.2	7.9	7.3
Amortization on debt securities	1.7	2.1	2.7	3.9	3.5	3.2	2.6	3.2	3.7
Of which:									
Public sector	1.4	2.0	2.3	3.8	3.5	2.8	2.5	3.1	3.6
Deposit money banks	0.4	0.0	0.4	0.2	0.0	0.4	0.1	0.1	0.1
Medium and long-term debt amortization	13.8	14.3	13.4	15.0	15.6	14.6	14.8	15.4	15.9
Of which:									
Public sector 1/	3.6	3.6	3.0	3.2	3.5	3.3	3.1	3.0	2.8
Private sector	7.9	8.9	8.8	10.4	11.0	9.9	10.2	10.7	11.2
Deposit money banks	2.3	1.9	1.6	1.4	1.1	1.4	1.5	1.7	1.9
Short-term debt amortization	33.3	35.8	25.8	28.7	33.1	35.3	37.7	39.3	40.5
Public sector 1/	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector 2/	20.2	17.9	17.9	22.3	23.4	24.4	25.4	25.6	25.4
Deposit money banks	13.2	16.9	8.0	6.3	9.7	10.9	12.3	13.7	15.1
Available financing	58.9	49.0	43.9	54.7	61.7	61.1	63.3	65.8	67.4
Foreign direct investment (net)	0.1	2.8	0.9	0.1	1.6	1.8	2.2	2.6	3.1
Portfolio flows	3.4	-1.7	4.2	7.9	8.1	8.5	8.7	8.7	8.6
Public sector	7.5	2.1	3.3	5.3	5.1	5.6	5.8	5.8	5.8
Deposit money banks	0.5	0.0	0.0	0.0	0.1	0.2	0.2	0.2	0.2
Private sector (net)	-4.6	-3.8	0.9	2.6	2.9	2.7	2.7	2.6	2.6
Medium and long-term debt financing	18.1	13.2	15.7	14.1	16.8	14.8	15.4	16.2	17.0
Of which:									
Public sector 1/	3.4	3.2	2.9	0.7	2.8	2.2	2.2	2.3	2.3
Private sector	12.8	9.2	11.5	11.9	12.1	10.9	11.2	11.8	12.3
Deposit money banks	1.9	0.9	1.3	1.4	1.9	1.8	2.0	2.2	2.3
Short-term debt financing, currency and deposits	36.9	23.3	22.6	31.3	35.0	37.9	40.9	42.6	43.8
Official transfers	0.2	0.2	0.5	0.3	0.4	0.5	0.7	0.7	0.7
Other 3/	-2.8	-1.7	-0.1	5.2	0.0	0.0	0.0	0.0	0.0
Net reserves (+/- = decrease/increase)	3.0	12.9	0.2	-4.1	-0.1	-2.4	-4.6	-5.0	-5.8
Accumulation of gross reserves	-0.4	2.7	-6.2	-4.0	2.8	4.5	7.0	-3.1	-4.9
IMF (net)	3.4	10.2	6.4	-0.1	-2.9	-7.0	-11.6	-1.8	-0.9
Purchases	3.4	11.3	12.5	1.7	1.9	0.7	0.0	0.0	0.0
Repurchases	-0.1	-1.1	-6.1	-1.7	-4.7	-7.6	-11.6	-1.8	-0.9

Sources: Data provided by the Turkish authorities; and Fund staff estimates.
1/ General government and Central Bank of Turkey.
2/ Series revised from 1999 to reflect gross flows of short term trade credits.
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	26	16	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	25	24	17	4	1	0
In percent of overall external debt	4	13	16	16	15	10	2	1	0
In percent of foreign reserves	18	72	75	65	66	52	13	4	0
Debt service due to the Fund									
(charges and repurchases)									
In billions of SDRs	0.1	1.2	5.5	1.9	3.7	5.8	8.1	1.3	0.6
In percent of quota	11	125	575	196	387	603	844	126	62
In percent of exports of G&NFS	0	3	13	4	7	10	12	2	1
In percent of GNP	0	1	4	1	2	3	4	1	0
In percent of public sector external debt service	1	12	41	17	32	44	53	14	7
In percent of overall MLT external debt service	1	7	25	10	18	26	34	7	3
In percent of foreign reserves	1	7	36	9	16	27	44	9	4
In percent gross public sector ext. financing 2/	1	30	23	11	25	36	43	7	3
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	-5	-9	-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	-34	-7	-3
In percent foreign reserves	14	42	29	-3	-11	-25	-44	-9	-4
In percent gross public sector ext. financing 2/	18	193	19	-4	-17	-33	-43	-7	-3
	(In percent of total)								
Public debt to preferred creditors/public debt	13	27	32	32	...	...	...	...	...
Collateralized & securitized public debt/public debt	35	30	28	30	33	38	47	51	53
Debt service: public debt to preferred creditors/public debt	8	18	44	21	...	...	...	...	...
Debt service: collateralized and securitized public debt/public debt	28	30	24	40	36	29	25	50	57

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

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. Includes prospective drawings on the schedule shown in Annex C to the Letter of Intent.

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

3/ Net purchases less repurchases and charges.

Table 10. Turkey: Indicators of External Vulnerability, 1999–2005 1/
(In percent, unless otherwise noted)

						Projections	
	1999	2000	2001	2002	2003	2004	2005
CPI inflation (end year)	68.8	39.0	68.5	29.7	18.4	12.0	8.0
Public sector borrowing requirement (percent of GNP)	22.3	18.9	21.1	12.1	10.0	6.6	3.2
Net debt of the public sector (percent of GNP)	61.0	58.3	93.9	79.2	70.9	66.5	60.3
Export volume (percent change)	1.9	6.6	16.6	11.8	16.5	13.2	9.6
Import volume (percent change)	-10.4	29.5	-22.9	21.2	18.2	13.1	7.1
Current account balance, in percent of GNP	-0.7	-4.9	2.4	-0.8	-2.9	-3.0	-2.4
Capital account balance (in billions of US$)	6.6	6.8	-16.3	1.3	10.9	9.2	10.0
Of which: Foreign direct investment	0.1	0.1	2.8	0.9	0.1	1.6	1.8
Foreign portfolio investment	0.2	-5.2	-4.6	-1.2	1.0	2.4	1.8
Gross official reserves, in billions of US$ 2/	24.3	23.2	19.8	28.1	35.2	32.4	27.8
In months of imports of goods and NFS	5.3	4.0	4.4	5.4	5.2	4.0	3.2
In percent of broad money	32.2	27.4	26.8	34.4	33.2	26.4	21.2
Gross total external debt, in billions US$	103.0	118.7	113.8	131.3	142.9	145.3	143.7
In percent of GNP	55.0	59.0	79.0	72.3	60.6	48.4	45.1
In percent of exports of goods and NFS	219.5	225.0	218.8	233.1	204.6	176.8	159.3
Gross short-term external debt, in billions US$ 3/	35.3	43.7	32.7	32.5	41.8	44.4	45.5
In percent of gross total external debt	34.3	36.8	28.7	24.7	29.2	30.5	31.7
In percent of gross official reserves	145.6	188.4	164.7	115.4	118.8	137.1	163.6
Debt service 4/	33.8	36.9	41.3	37.3	34.9	31.1	27.6
REER appreciation (CPI based, period average) 5/	3.9	10.9	-17.6	11.4	8.9	22.2	...
REER appreciation (CPI based, end of period) 6/	5.3	15.9	-21.2	7.8	12.1	21.1	...
Capital adequacy ratio 7/	...	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) 7/	9.7	9.2	29.3	17.6	15.3	...	...
Real broad money, percentage change 8/	18.9	0.8	11.2	-3.3	-6.6	7.4	5.1
Real credit to the private sector, percentage change 8/	-10.7	24.5	-27.5	-16.5	16.9	6.9	5.1
Banks' net foreign asset position, in billions of US$	-2.9	-5.8	2.4	3.1	2.0	...	...
Banks' net open exchange position, in billions of US$ 9/	-2.6	-5.4	-0.1	-0.4	-0.1	-0.6	...
Spread on Turkish dollar Eurobonds (in basis points) 10/	420	800	707	693	309	341	...

Sources: Data provided by the Turkish authorities; and IMF staff estimates and projections.
1/ For 2004-05, program projections.
2/ As of February 2004, reserves stood at US$35.0 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, January-February 2004.
6/ For 2004, February 2004.
7/ For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank.
8/ Deflated by the CPI.
9/ For 2004, as of February 27, 2004
10/ For 2004, as of March 10, 2004.

TURKEY: FUND RELATIONS
(As of February 29, 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	16,585.66	1,720.50
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	4.18	3.73

IV.

Outstanding Purchases and Loans:	**Millions of SDRs**	**Percent of Quota**
Stand-by Arrangements	15,598.87	1,618.14
First credit tranche	135.56	14.06

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved**	**Amount Drawn**
			In millions of SDRs	
Stand-By	02/04/02	12/31/04	12,821.20	11,120.20
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00
Stand-By	07/08/94	03/07/96	610.50	460.50

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	2,679.88	5,158.07	7,471.15	425.33	
Charges/Interest	425.52	437.53	152.19	7.37	1.87
Total	3,105.40	5,595.60	7,623.34	432.70	1.87

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

Projected Payments to Fund (Obligations Basis)[3]

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	412.71	5,586.95	6,930.55	2,378.90	425.33
Charges/Interest	451.57	538.54	254.30	37.25	7.08
Total	864.28	6,125.48	7,184.85	2,416.15	432.40

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.

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.

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

X. **ROSCs**

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 26, 2000	(6/27/2000, www.imf.org)
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

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

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 sustainability. Additional non-standard tests, specially tailored to Turkey, show that while the public debt burden would likely remain sustainable as long as policies are kept on track, any prolonged deviation from sound policies could jeopardize 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 11). 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 continued 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 54 percent of GNP by 2009.

2. **For the purposes of the debt sustainability exercise, assumptions remain unchanged from the Sixth Review.** 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 will remain at above 17 percent. While the latter assumption is conservative, with real interest rates now at about 11 percent, the underlying assumptions will be revisited at the time of the combined Article IV/Eighth Review mission.

3. **While the standard alternative scenario tests show that Turkey's public debt burden is sustainable under a variety of scenarios, setting key parameters to their historical averages gives rise to an unsustainable debt burden over the medium term** (Table 11, 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.

Table 11. Turkey: Public Sector Sustainability Framework, 1999-2009

I. Baseline Medium-term Projections

							Projections						
		t-5	t-4	t-3	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5	Increase
		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2003-2009
2	**Public debt/GNP (staff baseline)**	61.0	57.4	93.9	79.2	70.9	66.5	62.6	59.2	57.1	55.5	53.8	-17.1
3	Change in public debt/GNP	17.3	-3.6	36.5	-14.7	-8.3	-4.4	-3.9	-3.4	-2.1	-1.6	-1.7	
4	Net debt-creating flows/GNP (lines 5+8+11)		-1.6	1.0	-10.5	-9.9	-4.3	-3.4	-3.6	-3.3	-2.9	-3.0	
5	Primary deficit/GNP	2.0	-2.4	-5.6	-4.1	-6.1	-6.5	-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	-1.1	-1.1	-1.0	-1.0	-0.9	-0.9	
9	Change in reserve money/GNP		0.8	1.4	1.5	1.0	0.7	0.6	0.5	0.5	0.4	0.4	
10	Privatization receipts/GNP		0.0	1.9	0.3	0.1	0.4	0.5	0.5	0.5	0.5	0.5	
11	(r-g-(pi+gpi))/(1+g+pi+gpi))debt (lines 13/12)		1.6	10.0	-4.6	-2.7	3.3	4.3	3.9	4.2	4.5	4.4	
12	Adjustment factor: 1+g+pi+gpi		1.6	1.4	1.5	1.3	1.2	1.2	1.1	1.1	1.1	1.1	
13	(r-g-(pi+gpi))debt/GNP (lines 14+15+16)		2.6	14.0	-7.2	-3.5	3.9	4.9	4.5	4.7	5.0	4.9	
14	r (interest rate) times debt/GNP		39.6	37.4	44.5	19.5	15.6	15.2	12.9	11.3	10.8	10.6	
15	minus g (real GNP growth rate) times debt/GNP		-3.8	5.4	-7.3	-4.0	-3.5	-3.3	-3.1	-3.0	-2.9	-2.8	
16	minus (pi+gpi) (pi = GNP deflator, growth rate) times debt/GNP		-33.2	-28.8	-44.3	-19.0	-8.2	-6.9	-5.3	-3.7	-3.0	-2.9	
17	Residual, incl. change in assets/GNP (lines 3-4)		-2.0	35.5	-4.2	1.6	-0.1	-0.5	0.2	1.2	1.4	1.3	
	Key Macroeconomic and Fiscal Assumptions												
	Real GNP growth	-6.1	6.3	-9.4	7.8	5.0	5.0	5.0	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	43.8	22.9	11.0	9.9	8.0	6.0	5.0	5.0	
	Effective nominal interest rate on government debt		64.9	65.4	29.3	19.9	24.0	21.6	19.5	18.8	19.0	19.1	
	Benchmark bond rate	106.2	38.0	99.1	63.5	44.1	29.0	27.7	24.6	22.9	22.9	22.9	
	memo: Ex-ante real rate (using GNP deflator)	36.4	-11.2	38.5	33.0	29.8	17.4	18.2	17.5	17.0	17.0	17.0	
	Nominal TL rate on dollar debt		112.1	32.7	7.3	-1.8	17.7	13.9	12.4	12.4	12.4	12.4	
	memo: Nominal dollar rate on dollar debt		8.0	8.0	8.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	
	Share of FX-linked debt (average)		36.3	50.7	60.9	52.6	44.4	43.8	41.7	38.3	36.4	35.5	
	Effective real interest rate on government debt (using GNP deflator)		6.1	15.0	5.2	8.1	12.8	12.6	12.7	13.2	13.4	13.4	
	A. Alternative Scenarios												
	A1. Key variables are at their historical averages in 2004-08 1/						72.6	76.4	81.5	89.3	99.5	103.4	32.5
	A2. Primary balance under no policy change in 2004-08						66.9	63.4	60.5	58.9	57.8	56.7	-14.2
	A3. Country-specific shock in 2004, with reduction in GDP growth (relative to baseline) of one standard deviation						80.1	77.1	74.6	73.6	73.3	73.1	2.2
	A4. Selected variables are consistent with market forecast in 2004-09 2/						67.5	64.7	62.4	61.5	61.3	61.1	-9.8
	B. Bound Tests												
	B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005						73.2	83.5	89.3	89.3	90.3	91.4	20.5
	B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						80.1	92.8	91.3	91.5	92.6	93.9	23.0
	B3. Primary balance is at zero in 2004 and 2005						73.0	76.0	73.5	72.4	72.0	71.7	0.8
	B4. Combination of B1, B2, B3 using one standard deviation shocks						84.7	107.6	113.0	114.7	117.6	120.9	50.0
	B5. One time 30 percent real depreciation in 2004						77.2	74.8	71.8	70.5	69.9	69.4	-1.6
	B6. 10 percent of GDP increase in other debt-creating flows in 2004						76.5	73.2	70.5	69.2	68.6	67.9	-3.0
	C. Tailored Tests												
	C1. External shock: Growth slowdown initially, followed by lower primary surplus, higher real interest rates, and real depreciation 3/						75.2	78.5	77.2	76.3	76.2	76.1	5.2
	C2. Internal shock: Lower primary surplus, loss of confidence, higher real interest rates, real depreciation, followed by growth slowdown and banking costs 4/						81.2	85.8	95.1	100.4	104.0	106.1	35.2
	C2. Prolonged growth slump 5/						72.2	74.4	77.6	82.7	89.3	96.6	25.7

Sources: Data provided by the Turkish authorities; Fund staff estimates; Consensus Economics Inc.
1/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
2/ Assumes growth of 5.0 percent and primary balances of 5.5 percent of GNP over the medium term. Real interest rates are assumed to be those in the program.
3/ Assumes zero growth in 2004 and 4 percent growth in 2005; a primary balance of 5 percent of GNP in 2004 and 3.5 percent in 2005; historical average real interest rates in 2005; and a 10 percent real depreciation.
4/ Assumes a primary surplus of 2.5 percent of GNP in 2004, only returning gradually to baseline target by 2008; growth of just 2 percent in 2005, returning to the original growth path by 2008; historical real interest rates in 2005-07; assumed contingent liabilities of 5 percent of GNP in 2006; and a 30 percent real depreciation.
5/ Assumes growth of 2 percent in 2004-09 and primary balance of 3 percent of GNP over same period.

- **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 (more than double 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 11, 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 90 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 120 percent of GNP over the medium term.

5. **Specially tailored tests also show that Turkey's public debt burden leaves it vulnerable to shocks, especially if policies are allowed to slip** (Table 11, panel C, see footnotes for further details).

- **External shock.** In the first tailored test, it is assumed that Turkey is hit with an external growth shock in the first year. This is followed in later years by a fiscal relaxation, higher real interest rates, and a weaker currency. It is assumed, however, that the authorities bring policies quickly back on track to restore market confidence. Under this scenario, net public debt quickly rises to almost 80 percent of GNP, before declining as better policies take hold.

- **Internal shock.** In the second tailored test, it is assumed that policies (in the first instance fiscal policy) move off track for an extended period. This leads, after a lag, to the familiar problems of higher real interest rates (traditionally high in Turkey, reflecting concerns over the mounting public debt burden), lower growth, and a weaker currency. And, after a further lag, Treasury is assumed to take on additional debt, reflecting contingent liabilities, which in turn reflects the continued close interaction between Turkish banks and Treasury. Under this test, the public debt burden rises rapidly, exceeding 100 percent of GNP over the medium term.

- **Prolonged growth slump.** In the final tailored test, it is assumed that structural reforms fail to take hold with a consequent impact on medium-term growth. It is also assumed that the weaker growth performance leads to a weakening of fiscal effort. Even assuming no impact on real interest rates, Turkey's debt burden rises to almost 100 percent of GNP over the medium term.

External debt sustainability[4]

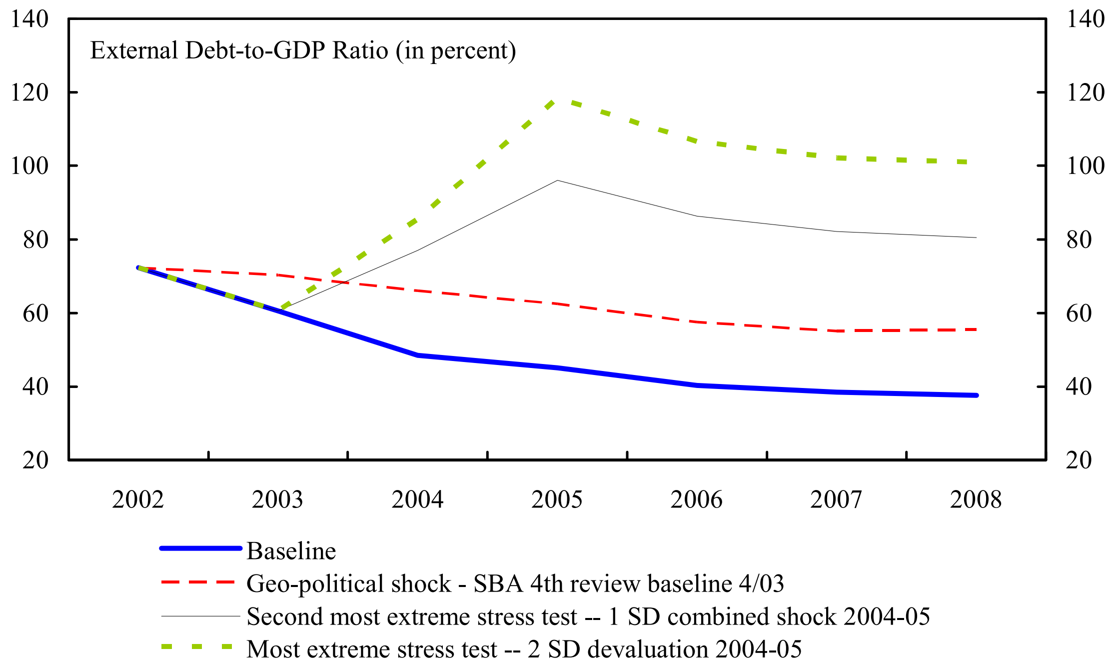
6. **As Turkey's adjustment program takes hold, projected external debt sustainability is improving markedly in stock terms but somewhat weakening in terms of vulnerabilities to flow reversals.** The stronger than expected recovery in the level of the real exchange rate (proxied by the U.S. dollar GNP deflator) is sharply reducing the value of external debt in relation to output valued in U.S. dollars, while exports are also above earlier program projections, thus reducing stock-related vulnerability indicators. At the same time, external gross financing needs—and associated flow vulnerabilities—are rising on account of a widening current account deficit and larger than expected short-term debt flows.

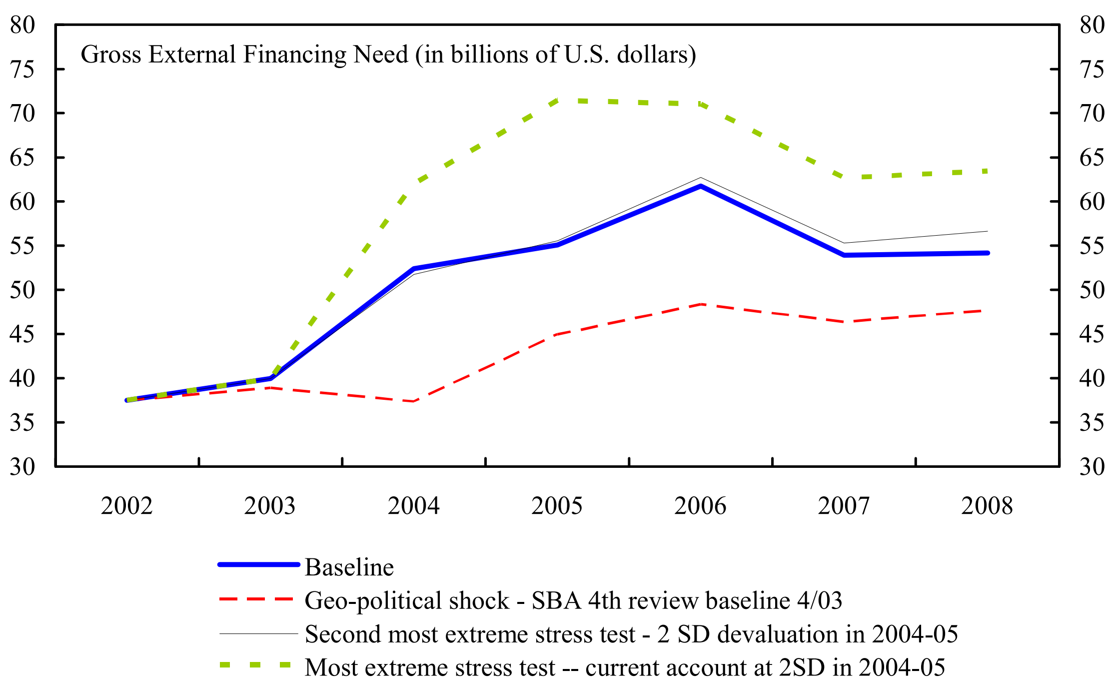
7. **These developments are well illustrated by a comparison of external debt sustainability projections for this review with that of the Fourth Review last April.** External debt/GNP ratios in 2004 have fallen from 66 percent projected a year ago to 48 percent in the Seventh Review projections, while annual gross external debt financing needs for 2004, (current account deficit plus all debt service including short-term debt stock amortization), have increased by nearly 40 percent to US$51 billion (Figure 5 and Table 12). However, put into perspective, the unexpected strength of real lira appreciation means that gross financing needs remain unchanged in terms of GNP. The increase in dollar denominated gross financing needs is also heightened by a weakening of the U.S. dollar against third currencies (for point of reference, some 40 percent of external debt is denominated in euros, excluding IMF credit).

8. **Changes in external debt vulnerabilities are principally linked to global market developments, and an improving domestic geo-political environment**. With the authorities' economic program on track in terms of growth and inflation, domestic economic factors are not key to explaining changes in external debt dynamics. First our comparison against a year ago was an environment of significant geo-political tension at the outset of the U.S. occupation of neighboring Iraq, and a temporarily depreciated real exchange rate. Associated risks have since much diminished. Second, global liquidity conditions over the past year has favored high-yield emerging markets, and greatly reduced external borrowing costs and increased the supply of loanable funds. This combination of lowered risk and improved credit conditions has boosted both the exchange rate and capital inflows, including private sector medium-term financing, and short-term bank and trade financing, by a greater extent than had been anticipated on the strength of improving macroeconomic performance alone.

[4] External debt in general refers to current, non contingent 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 5. Turkey: External Debt Ratio and Gross External Financing Need, 2002-08





Source: Fund staff calculations.

Table 12. Turkey: External Debt Sustainability Framework, 1998-2008

(In percent of GNP, unless otherwise indicated)

	Actual							Projections						
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
1 **External debt**	46.9	55.0	59.0	79.0	72.3			**60.6**	**48.4**	**45.1**	**40.4**	**38.4**	**37.6**	**-0.6**
2 Change in external debt	3.5	8.1	4.0	20.1	-6.8			-11.7	-12.2	-3.4	-4.7	-1.9	-0.8	
3 Identified external debt-creating flows (4+8+9)	-3.7	5.0	1.1	19.2	-15.8			-0.3	-0.2	-0.8	-0.8	-0.9	-1.2	
4 Current account deficit, excluding interest payments	-3.3	-2.2	1.7	-7.3	-2.7			-0.1	0.4	-0.3	-0.4	-0.4	-0.6	
5 Deficit in balance of goods and services	1.8	3.5	7.5	0.3	2.8			4.4	4.4	3.7	3.6	3.3	3.0	
6 Exports	27.4	25.6	26.8	36.9	31.4			29.9	27.7	28.7	29.2	29.6	30.9	
7 Imports	29.3	29.1	34.3	37.2	34.2			34.3	32.1	32.4	32.8	32.9	33.9	
8 Net non-debt creating capital inflows (negative)	-0.2	-0.3	-0.3	-1.9	-0.2			-0.4	-0.8	-0.9	-0.9	-1.0	-1.1	
9 Automatic debt dynamics 1/	-0.2	7.5	-0.3	28.4	-12.9			0.2	0.2	0.4	0.5	0.5	0.5	
10 Contribution from nominal interest rate	2.3	2.9	3.2	5.0	3.5			2.9	2.6	2.7	2.6	2.4	2.4	
11 Contribution from real GNP growth	-1.6	3.1	-3.3	7.9	-4.9			-2.8	-2.4	-2.3	-2.1	-1.9	-1.8	
12 Contribution from price and exchange rate changes 2/	-1.0	1.5	-0.2	15.6	-11.5			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	7.2	3.1	2.8	0.8	9.0			-11.4	-12.0	-2.6	-3.9	-1.0	0.4	
External debt-to-exports ratio (in percent)	170.8	214.6	220.1	214.1	229.9			202.7	174.9	157.3	138.3	129.9	121.7	
Gross external financing need (in billions of US dollars) 4/	23.8	33.0	46.6	40.3	37.5			40.0	52.4	55.1	61.7	53.9	54.2	
in percent of GNP	11.6	17.6	23.2	28.0	20.6			16.9	17.4	17.3	18.1	14.7	14.1	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GNP growth (in percent)	3.9	-6.1	6.3	-9.5	7.8	2.8	7.1	5.0	5.0	5.0	5.0	5.0	5.0	5.0
GNP deflator in US dollars (change in percent)	2.3	-3.0	0.4	-20.9	17.0	-0.1	15.8	23.7	21.2	1.2	2.0	2.3	-0.1	8.4
Nominal external interest rate (in percent)	5.7	5.7	6.1	6.0	5.6	6.0	0.3	5.3	5.5	5.9	6.1	6.4	6.4	5.9
Growth of exports (US dollar terms, in percent)	4.7	-15.0	12.4	-1.4	7.4	8.6	11.5	23.5	17.8	10.0	9.1	8.9	9.5	13.1
Growth of imports (US dollar terms, in percent)	-1.1	-9.4	26.5	-22.3	16.0	9.6	22.1	30.3	19.0	7.3	8.4	7.8	8.2	13.5
Current account balance, excluding interest payments	3.3	2.2	-1.7	7.3	2.7	2.3	2.8	0.1	-0.4	0.3	0.4	0.4	0.6	0.2
Net non-debt creating capital inflows	0.2	0.3	0.3	1.9	0.2	0.7	0.5	0.4	0.8	0.9	0.9	1.0	1.1	0.9
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2004-08 5/								**60.6**	**57.8**	**54.1**	**48.9**	**47.4**	**46.4**	**0.4**
A2. Geo Political Shock -- 4th Review baseline								**70.3**	**66.0**	**62.4**	**57.5**	**55.1**	**55.5**	**-0.3**
A3. Selected variables are consistent with market forecast in 2004-08								**60.6**	**47.6**	**44.3**	**39.8**	**37.5**	**36.2**	**-0.5**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								**60.6**	**49.0**	**46.0**	**41.3**	**39.3**	**38.5**	**-0.6**
B2. Real GNP growth is at historical average minus two standard deviations in 2004 and 2005								**60.6**	**57.3**	**63.3**	**56.9**	**54.3**	**53.4**	**-0.8**
B3. Change in US dollar GNP deflator is at historical average minus two standard deviations in 2004 and 2005								**60.6**	**85.5**	**118.4**	**106.6**	**102.2**	**101.0**	**-1.5**
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005								**60.6**	**51.2**	**51.4**	**46.6**	**44.6**	**43.9**	**-0.5**
B5. Combination of 2-5 using one standard deviation shocks								**60.6**	**76.9**	**96.1**	**86.3**	**82.2**	**80.4**	**-1.2**
B6. One time 30 percent nominal depreciation in 2004								**60.6**	**75.2**	**70.2**	**63.0**	**60.2**	**59.3**	**-0.9**

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

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = 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 a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r 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 the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

9. **Turkey's financial crises over the past decade (1994 and 2001) and the associated volatility in macroeconomic indicators mean that the "standardized" bound tests are particularly demanding in comparison to most countries**. The most extreme stress test on external debt/GNP, a two standard deviation shock to the GNP deflator implies two successive years of 31 percent real devaluations, compared to 29 percent in 1994 and 21 percent in 2001 (previous crisis years)—and in both of these cases 75 percent of the real devaluation was reversed in the following year. Accordingly, it is not surprising that a permanent shock of twice the magnitude of previous temporary shocks raises debt levels to clearly unsustainable levels of 100 percent of GNP. Similarly, a combination of one standard deviation shocks—a shock significantly more severe than previous financial crises—raises external debt to GNP close to 100 percent.[5] Notwithstanding high historical vulnerability, the external 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.

10. **Projections based on medium-term market expectations for growth and the current account deficit are almost identical to program baseline projections.** Market projections from March 2004 *Consensus Economics Inc.* long range forecasts assume 5 percent GNP growth over the projection period, the same as program projections and ¼ percent of GNP weaker non-interest current account balance. Accordingly the implied market debt to GNP ratios are within 1–2 percent points of program baseline projections. An increase of ½ percent in market expectations of annual average growth has narrowed differences in the debt outlook.

[5] The one standard deviation combination shock cuts U.S. dollar GNP by 52 percent relative to the baseline by 2008. Specifically it involves a permanent real depreciation of 29 percent, a reduction in U.S. dollar GNP growth (and GNP path) by 18 percent relative to the baseline, a two-year increase of the current account deficit by US$7 billion per year and a two-year increase in external interest rates by 1 percent.

TURKEY: IMF–WORLD BANK RELATIONS

Partnership in support of Turkey's Development Strategy

1. Turkey's vision is of a modern and secular participatory democracy, fully integrated into the European community, playing a critical role in the regional context, with an export-oriented, highly competitive production structure. The priorities of the government are spelled out in the program presented to parliament in March 2003 and in the associated Urgent Action Plan.

2. The IMF and World Bank teams have collaborated closely in Turkey, and standard working arrangements already broadly follow the guidelines for enhanced Bank-Fund collaboration. This has included regular participation of Bank staff in the meetings with government of the Fund's program review missions, and IMF staff invited to Bank review meetings and meetings with government. The IMF has taken the lead in macroeconomic stabilization and the World Bank in social and structural areas, with close collaboration in structural areas that have a particular impact on macroeconomic stability. The Bank's dialogue and conditionality has maintained consistency with the macroeconomic framework endorsed by the IMF.

World Bank Country Assistance Strategy

3. The objectives of the CAS, discussed by the Executive Directors on November 6, 2003, are to help Turkey reduce economic vulnerability and achieve high and stable growth, and continue the process of addressing some long neglected social and environmental problems. The last CAS focused heavily on crisis management. This CAS aims at reducing the risk of reemergence of crises and helping Turkey address the many economic challenges of preparing for EU membership. The planned assistance program for FY04–06 is structured around four development themes: (i) sound macroeconomics and governance; (ii) equitable human and social development; (iii) attractive business climate and knowledge; and (iv) strong environmental management and disaster prevention.

4. Under the program to promote sound macroeconomics and governance, the first priority 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 February 29, 2004, the portfolio of World Bank financed projects in Turkey comprised 12 active projects with total net commitments of about US$3.8 billion. Net IBRD commitments are currently lower than in the last three years reflecting closure of large loans in FY04. However, if planned projects in health, energy and a programmatic adjustment loan are approved and loan closings go forward as planned, net commitments should exceed US$4.1 billion by the end of the FY04.

9. The International Finance Corporation (IFC) has been active in the financial sector, manufacturing, oil and gas, infrastructure and health and education. As of June 30, 2003, IFC's total portfolio in Turkey was US$805 million. With a gross exposure of US$214 million as of June 2003, Turkey is an important country for MIGA. The total amount of foreign direct investment facilitated by MIGA is estimated at approximately US$1 billion.

IMF-World Bank collaboration

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.

Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Ankara, April 2, 2004

Dear Ms. Krueger,

1. **Following a year of successful macroeconomic management under our Fund-supported program, the economy is now at its strongest in a generation.** Last year, annual inflation fell to 18½ percent—below target for the second year running—with further declines in the first few months of this year. The economy grew by around 6 percent in 2003 exceeding the 5 percent growth projection, and is now in its third year of strong recovery, with key indicators showing continued strength. Financial markets remain positive, with benchmark bond yields halving last year to stand now at close to 20 percent.

2. **To build on the achievements of 2003, we are deepening and advancing the economic reform agenda.** Therefore, in addition to continuing with the macroeconomic policies that have yielded impressive results, we have formulated a comprehensive agenda for structural reform in 2004 (Annex A). These reforms are guided by our strong commitment to convergence towards European Union standards. The reforms that are detailed in this letter are aimed at putting the fiscal accounts on a more sustainable medium-term footing, moving the banking sector further in line with best international practice, and facilitating private sector development and investment.

3. **With regard to recent policy implementation, we have continued to make good progress under the program, although there have been some delays.**

- The program's **fiscal and monetary** targets were broadly met. We increased the public sector primary surplus to more than 6 percent of GNP in 2003—the highest ever recorded in Turkey and 2 percent of GNP higher than the 2002 outturn. All monetary performance criteria and indicative targets for end-December were met.

- On the **structural** side, we assessed the fiscal implications of planned social security reforms (meeting an end-December benchmark). While the end-2003 performance criterion on state enterprise redundant positions was missed, the *overall* reduction of positions—including positions not formally covered by the performance criterion definition—far exceeded the target.

- Due to a heavy legislative workload, legislation on the civil servant code of conduct and state enterprise governance has seen delays, as has the introduction of legislation and accompanying regulations covering pre-packaged bankruptcy provision (all December benchmarks). The code of conduct legislation has been submitted to Parliament and is expected to be passed shortly. Bankruptcy legislation was approved by Parliament in February, and the accompanying regulations are expected to be put in place shortly. We also refrained from introducing any new amnesty on public receivables, meeting a continuous performance criterion.

4. **We have also met several prior actions for this review to illustrate our commitment to take decisive steps to maintain the momentum of the program.** We have introduced remedial fiscal measures to secure this year's 6½ percent of GNP primary surplus target. We have also passed legislation for the second phase of direct tax reform, which progressively transforms free trade zones into export processing zones in line with international best practice, and targets regional incentives at employment generation in lower income regions. On the banking side we have decided to resolve Pamuk bank by integrating it with Halk bank. We will also start the Imar bank inquiry shortly.

5. **Against this favorable backdrop, we request the completion of the Seventh Review under the Stand-By Arrangement.** Last year's central government surplus, of more than 5 percent of GNP, exceeded our target, although the state enterprise surplus monitored under the program fell somewhat short. The overall consolidated government sector balance was, however, better than the indicative target. Corrective fiscal measures have now been taken to ensure the achievement of the 2004 fiscal targets; accordingly, we request a waiver of applicability for the end-March 2004 performance criterion on the consolidated government primary balance. Based on our strong performance in reducing inflation and the resulting increase in currency demand, we request a waiver of nonobservance for end-March 2004 base money performance criterion. The base money targets for the remainder of the year are being revised upwards to reflect the increased money demand to date. We also request a waiver of nonobservance for the end-December 2003 performance criterion on the elimination of redundant SEE positions, in light of our strong record in reducing overall redundant positions in state enterprises.

6. **We also request a rephasing of remaining purchases.** In light of the period of time available before the arrangement expires, we request the number of remaining reviews be reduced from four to three. The outstanding access is to be spread evenly, with a final test date of end-December 2004 (Annex C). The arrangement would now expire on February 3, 2005. The associated fiscal and monetary program is set out in Annex B. To facilitate more timely monitoring within the new phasing, we have introduced an additional performance criterion on the primary fiscal balance excluding SEEs. 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

7. **We remain confident that our macroeconomic objectives for 2004 will be achieved.** With lower real interest rates and increasing confidence, we expect private consumption and investment to be the main drivers of growth. Building on the recent impressive inflation performance, we believe that continued prudent macroeconomic policy will bring Turkey closer to achieving single digit inflation by meeting the program's

12 percent inflation target by end-year. On the external side, we expect the current account balance to be broadly unchanged as a percent of GNP (with strong exports and tourism receipts offsetting higher imports due to robust domestic demand) and increased net capital inflows (as market confidence continues). Our net international reserves position will be maintained.

Fiscal policy

8. **The 6.5 percent of GNP public sector primary surplus target remains a cornerstone of our program.** The recent minimum wage and pension increases—motivated by our concerns for the most vulnerable segments of Turkish society—created challenges for meeting this year's target, as have weaker-than-anticipated revenues. We are therefore implementing a package of corrective fiscal measures that are expected to yield TL 7 quadrillion (1.7 percent of GNP) over the remainder of 2004 (a prior action for the Seventh Review). Many of these measures are permanent to help secure not only this year's target but also the medium-term fiscal position.

- While protecting key social spending programs, we recently passed legislation cutting **discretionary expenditures** by 13 percent and reduced investment incentives, saving some TL 3.9 quadrillion (1 percent of GNP). In addition, we will write over to the budget an additional TL 0.5 quadrillion (0.2 percent of GNP) of special **revenues** during 2004, not appropriating them for the associated special expenditures. To help underpin the spending cuts, we will monitor public sector arrears carefully during the course of the year and will take early action if any pickup is detected. No further increases for pensions (other than the already announced 10 percent increase in July) are planned this year.

- Petroleum, tobacco, alcohol and gas **excises** have all been increased to yield TL 2.4 quadrillion (0.5 percent of GNP). Looking ahead, we will also ensure that state enterprise prices and excises are adjusted promptly in line with budget assumptions during the year (see Annex A).

9. **We are also committed to a comprehensive structural reform program to support a sustained improvement in Turkey's fiscal performance.** Many of these reforms are designed to control expenditures, broaden the tax base, and shrink the unregistered economy over the medium term.

- We plan to upgrade revenue collection through **tax administration reform**. Planned legislation will transform the tax administration office into a semi-autonomous body within the Ministry of Finance with its Head reporting directly to the Minister. Importantly, the new body will be reorganized along functional lines and tax policy will be transferred to the Ministry of Finance. In addition, all local tax administration offices will be transferred to the new entity.

We will submit draft tax administration legislation to Parliament by end-May and expect parliamentary passage by end-July (both new structural benchmarks). We have already set up a steering committee to oversee the implementation of these reforms and to prepare an action plan with clear delineation of responsibilities and targets by end-April 2004. The committee will then coordinate the implementation of the plan until the restructured tax office commences its operations in January 2005.

- Social security deficits will be addressed to put the system on a sustainable path. We are updating our assessment of the fiscal implications of planned **social security** reforms as well as analysis aimed at identifying additional savings. In the area of pensions, this would include institutional reform of the three existing systems and parametric reform, to move the system to long-run sustainability. By end-June, we will develop a range of ambitious reform options, run the associated simulations, and present the findings to the Council of Ministers. Moving forward, we will adopt a rules-based approach to increasing pensions based on the new social security framework.

  Regarding the planned introduction of universal health insurance, we will put together a coherent and affordable reform package that seeks to offset the costs from wider insurance coverage by end-July. Also, by end-June we will abolish the minimum social security contribution base. Submission to Parliament of draft social security reform legislation consistent with sustainability objectives, along with separate legislation for compensatory measures, will be set as a new performance criterion during the Eighth Review.

- We intend to improve the quality of our fiscal adjustment efforts to help place our medium-term fiscal targets on a stronger footing. To this end, we have sought technical assistance from the Bank and the Fund for a **Public Expenditure Review.** We expect to receive a preliminary study on short-term expenditure rationalization by the Eighth Review, followed by a more comprehensive assessment in the second half of the year. Preliminary recommendations, especially from the short-term study, will help guide the budget process, beginning with the 2005 budget. In the meantime, to help improve expenditure control, we have tightened existing regulations governing the use of the contingency account.

10. **Our agenda includes several other ongoing fiscal structural reforms.**

- We remain committed to containing the **state enterprise** employment. Building on last year's reduction of redundant positions, we will adhere to our policy of strictly limiting new hiring in state enterprises. At most 10 percent of those leaving through attrition will be replaced at each state enterprise, with limited exemptions for specialist positions (a new indicative target). An enterprise-by-enterprise workforce monitoring system was put in place in 2002. This will be used to help ensure strict compliance with the hiring policy.

- We are committed to further improve the **transparency** of public sector accounts. To this end, we will submit to Parliament by end-April 2004 legislation that will, effective January 1, 2005, result in the termination of "special" off-budget accounts and appropriations and expect passage by end-May 2004. Starting from April 2004, we are also providing details on a monthly basis on the primary surplus outcomes on Treasury's website, including the aggregate accounts of extra-budgetary funds, social security accounts and, on a quarterly basis, state enterprises.

- Further improving **public sector governance** is an important program goal. The civil service code of conduct legislation was sent to Parliament and is expected to be passed by end-June (a structural benchmark). After extensive consultation across government agencies, we have set up a committee, which will prepare a report by end-May 2004 on the key elements of our state enterprise governance strategy, including on audits and controls and state enterprise accountability (a new structural benchmark). The committee's findings will be used to decide on a legislative agenda to strengthen state enterprise governance.

- The **Public Administration Framework (PAF) Law**, setting out the principles of public governance, including decentralization, and clarifying the relevant responsibilities of central agencies and local governments, consistent with the Public Financial Management and Control (PFMC) law, is expected to be passed by Parliament shortly. We have set up a working group to look into fiscal intergovernmental relations to facilitate the decentralization process. We are also preparing framework legislation for regulatory agencies consistent with the PFMC and PAF laws.

Monetary policy

11. **The CBT's monetary policy remains focused on achieving this year's 12 percent inflation target**. Last year, we met all monetary targets and succeeded in reducing inflation to 18½ percent, well below our 20 percent target. In light of increased real currency demand due to the fall in inflation and the increase in banks' required reserves, we propose raising our base money targets for the remainder of the year (Annex B). The targets will continue to be kept under close review and further modification would be proposed if there is strong evidence of a shift in base money demand. The strength of the Turkish lira, the decline in inflation expectations, and the deceleration of inflation in recent months mean that prospects for meeting this year's 12 percent target are very good. To mark this success in disinflation and strengthened confidence in the Turkish lira, in January Parliament passed a law introducing a new redenominated currency next year (dropping six zeros from the currency).

12. **We remain committed to the floating exchange rate regime**. In light of the strength of the balance of payments, in January we re-introduced daily foreign exchange purchase auctions and in March and April increased the purchase amounts. This will further bolster our international reserves. While we have intervened on a few occasions to dampen

excessive exchange rate volatility, such discretionary intervention will continue to be strictly limited.

13. **The success of our policies has induced capital inflows and reverse currency substitution, creating a challenge for monetary policy.** We have used this opportunity to accumulate reserves. However, the sterilization associated with reserve accumulation has created losses for the central bank in 2003. During 2004, the Treasury and the CBT will continue to coordinate closely in their respective areas of debt management and monetary policy. Relevant laws, regulations and procedures will also be reviewed to remove any impediment to effective coordination.

Financial sector reform

14. **We are undertaking a comprehensive review of the Banking Act.** By end-April we will complete the review of the Banking Act and prepare draft amendments to strengthen the Act in line with EU standards. Areas that will receive particular attention include: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections; (iii) legal protection of BRSA and SDIF staffs for actions taken during the course of their duties; and (iv) delineation of responsibilities between BRSA and SDIF. We will submit a revised Banking Act to the Council of Ministers by mid-May 2004 and to Parliament by the summer recess (a new structural benchmark). Adoption of the Act will be set as a new performance criterion during the Eighth Review.

15. **Further progress is being made on the Imar bank case.** Upfront cash payments were made to depositors in January, and passbooks, which will be repaid according to the announced schedule over the next 36 months, have been issued for the remaining deposits. The Imar bank inquiry will start shortly with the appointment of its chairman and approval of its terms of reference (prior action for the Seventh Review), and we will make public its findings by end-August 2004 (a new performance criterion). The SDIF has taken over several companies and other assets of the former Imar bank owners to help offset the cost of compensating depositors.

16. **We are currently working on a strategy and detailed action plan on how to prepare Halk bank and Ziraat bank for privatization.** The strategy would aim to increase the operational efficiency of these banks while ensuring a level playing field for competition in the banking sector. We will make public key elements and a timetable for the action plan by mid-June 2004 (a new structural benchmark). We have already announced that Pamuk bank will be integrated with Halk bank (prior action). The integration will be completed by end-September 2004. If needed, Treasury will provide securities to facilitate the integration. For Vakif bank, the due diligence has been delayed as it will be based on audited end-2003 financial accounts. The due diligence will be completed by end-June 2004, and will be used to determine how to increase private participation in the bank.

17. **We are pressing ahead with reforms to facilitate asset collections:**

- The separation of the Boards of the **SDIF** and **BRSA**—designed to facilitate asset recovery and allow greater focus by the BRSA on its supervisory responsibilities—has now been completed. The new SDIF board took office in late January.

- SDIF did not complete the first auction of assets of intervened banks last December since the highest bid fell short of the Board's reference price. The new SDIF board is reconsidering the strategy for selling **SDIF assets** and will, by end-April 2004, announce revised strategies for the resolution of assets of intervened banks, including claims against former bank owners, and shares and companies taken over including those seized from the former owners of Imar bank (a new structural benchmark). The first asset disposal auction will be completed by end-July 2004.

- We will reassess 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, by end-June 2004, 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.

- Treasury has already issued debt to cover all **liabilities of the SDIF**. As of end-December 2003 SDIF liabilities amounted to US$36.2 billion, including US$13.6 billion of accrued interest. After the revaluation of assets and expected future recoveries, the SDIF and Treasury will, by end-December 2004, agree on the resolution of Treasury receivables from the SDIF.

18. **We are also making progress in other important areas of banking reform:**

- As previously announced, we intend to replace the **blanket guarantee** with a limited deposit protection scheme, in line with EU practices, on July 5, 2004. In preparation for this step, the BRSA will, by end-April 2004 present to the government a thorough assessment of the banking system (a new structural benchmark) and publish at the same time a summary of the presentation. In parallel, the CBT will also assess the effect of the abolition of the blanket guarantee on the Turkish payments system.

- We will submit, by the summer recess, legislation to Parliament enabling the transfer of the regulation and supervision of **nonbank financial institutions** from the Treasury to the BRSA, effective by January 1, 2005.

- Following the recent amendments to the **Execution and Bankruptcy Law**, implementing regulations are expected to be introduced shortly (a December 2003 structural benchmark).

Private sector development

19. **Privatization is accelerating.** A good start to the year has been made with the recent successful TÜPRAŞ auction (petroleum refineries), facilitated by Parliamentary approval, in December, of a new Petroleum Market Law. The winning bid for the 66 percent stake, of US$1.3 billion, was approved by the Privatization High Council in February and we expect the sale to be completed by mid-April. The sale of the alcohol unit of TEKEL, worth some US$300 million, was completed in February.

20. **We are determined to build further momentum in this area and have announced a comprehensive privatization strategy for the remainder of the year.** Having secured cabinet approval of a privatization plan for Türk Telekom last November, we expect to move ahead with the block sale of 51 percent of the shares by end-May 2004. We plan to announce a new strategy for the sale of TEKEL's tobacco unit by end-April 2004, and we will shortly hold fresh talks with potential investors in PETKIM (petrochemicals). This year we also plan to proceed with the privatization of ŞEKER (sugar refineries), up to a 15 percent stake in Turkish Airlines, and the National Lottery. We have adopted an electricity reform and privatization strategy, which envisages the launch of privatization tenders in energy distribution by March 2005. To expedite the privatization process, we will amend the public procurement and public contract legislation to allow for success fees and underwriting, and more flexibility in the hiring of consultants. We expect cash proceeds from privatizations to reach US$3 billion in 2004 (see Annex J).

21. **To encourage foreign direct investment, an inaugural Investment Advisory Council (IAC) meeting was held on March 15.** This high-level meeting included the participation of CEOs of a number of leading multinational companies, and developed many proposals that will help attract FDI in Turkey. We are carefully considering these proposals, and will draw up an action plan with the aim of presenting concrete results to the next meeting of the IAC.

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

Action	Type 1/	Status
December 2003		
Eliminate 25,074 redundant state enterprise positions.	PC	Waiver requested. Overall elimination of positions—including positions not formally covered by the PC definition—exceeded target.
Introduce regulations implementing new legislation covering pre-packaged bankruptcy provision (December 15).	BM	To be met with delay. Relevant legislation was passed in February; the law requires the regulations to be introduced by April 21.
Detailed assessment of fiscal implications of new social security reforms.	BM	Met
Prior actions for the Seventh Review		
Implement corrective fiscal measures expected to yield TL 7 quadrillion over the remainder of 2004, including passage of legislation by Parliament implementing spending cuts.	PA	Met
Pass legislation for the second phase of direct tax reform.	PA	Met
Decision to sell, merge or liquidate Pamuk bank.	PA	Met
Imar bank inquiry to start: head of inquiry appointed and TOR approved.	PA	Expected to be met shortly.
April 2004		
Announcement by the SDIF of a new strategy for asset resolution.	BM	
Assessment of the banking system prior to lifting of blanket deposit guarantee.	BM	
May 2004		
Submission to Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance.	BM	
Prepare report outlining key elements of state enterprise governance strategy.	BM	Inter-agency committee is operational and expected to report by end-May deadline.
June 2004		
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	Legislation has been submitted to Parliament.
Make public key elements of the new strategy for state banks and a timetable for the action plan (mid-June).	BM	
All excises will be adjusted to be brought in line with budget assumptions.	BM	
July 2004		
Passage by Parliament of tax administration reform legislation, making the GDR a semi-autonomous agency within the Ministry of Finance.	BM	
Submission to Parliament of amendments to the Banking Act (by parliamentary summer recess). See paragraph 14 of Letter of Intent for details.	BM	
August 2004		
Publication of final report on the independent inquiry into the Imar bank case in accordance with the terms of reference.	PC	
Date yet to be specified		
Submission to Parliament of social security reform legislation.	PC	
Passage by Parliament of amendments to the Banking Act (to be specified during Eighth Review).	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 2003

	Ceiling/ Floor	Adj. Floor	Outcome	Ceiling/ Floor	Adj. Floor	Outcome	Ceiling/ Floor	Adj. Floor	Outcome	Ceiling/ Floor	Adj. Floor	Outcome
I. Quantitative performance criteria	Aug. 31, 2003			Sept. 30, 2003			Oct. 31, 2003			Dec. 31, 2003		
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)	18,180	18,113	17,240				21,490	21,135	20,190	22,900	22,406	20,980
2. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$) 1/	11,000		5,048				13,000		7,042	15,000		7,269
3. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$) 2/	1,000		0				1,000		0	1,000		0
4. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)				-6.0		1.5				-2.0		-0.5
5. Ceiling on base money (in quadrillions of Turkish lira)				14.1		13.9				14.9		14.7
II. Indicative targets							Nov. 30, 2003					
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)				20,580	20,287	18,448	24,190	23,862	22,513			
							Oct. 31, 2003					
2. Floor on the cumulative overall balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)	-24,190	-24,257	-24,159				-27,000	-27,355	-26,638	-36,320	-36,814	-33,791
3. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in quadrillions of Turkish lira)				33.8		23.0				28.4		26.0
4. Privatization proceeds cumulative from January 1, 2003 (in millions of US$)				790		168				2,100		257

1/ Applies to nonconcessional external debt with an original maturity of more than one year from end-December 2002. 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: Quantitative Performance Criteria and Indicative Targets for 2004

	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome
I. Quantitative performance criteria 1/	March 31, 2004		April 30, 2004		June 30, 2004		August 31, 2004		September 30, 2004		December 31, 2004	
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2004 (in trillions of TL)	5,420		...		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		...		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$) 2/	7,000		...		13,000		...		16,000		17,500	
4. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$) 3/	1,000		...		1,000		...		1,000		1,000	
5. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	-2.00	0.7	-2.00		...		-2.00		...		-2.00	
6. Ceiling on base money (in quadrillions of Turkish lira)	16.1	16.9	17.5		...		19.2		...		19.3	
II. Indicative targets												
1. Floor on the cumulative overall balance of the consolidated government sector since January 1, 2004 (in trillions of Turkish lira)	-11,420		...		-20,000		...		-29,300		-35,440	
2. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in quadrillions of Turkish lira)	29.6	27.3	31.6		...		33.3		...		33.4	
3. Privatization proceeds cumulative from January 1, 2004 (in millions of US$)	100		...		500		...		1,000		3,000	
4. Number of employees hired at non-financial state enterprises	...		...		...		...		...		4,000	

1/ Targets for August 31, 2004, September 30, 2004 and December 31, 2004 are indicative.

2/ 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.

3/ 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: Revised Performance Criteria Test Dates and Review Schedule, 2004

Review	Purchase (SDR millions)	PC Test Dates: Primary balance of the CGS and external debt	PC Test Dates: Primary balance of CGS minus SEEs	PC Test Dates: NIR, Base Money	Review Date and Earliest Possible Purchase Date
			5th Review Schedule		
7th Review	340.2	October 31, 2003	...	December 31, 2003	January 15, 2004
8th Review	340.2	December 31, 2003	...	March 31, 2004	April 15, 2004
9th Review	340.2	March 31, 2004	...	June 30, 2004	July 15, 2004
10th Review	340.2	June 30, 2004	...	September 30, 2004	October 15, 2004
11th Review	340.2	September 30, 2004	...	November 30, 2004	December 15, 2004
			Proposed Revised Schedule		
Actual purchases	11,120.2				
7th Review 1/	340.2	March 31, 2004	...	March 31, 2004	...
8th Review	453.6	...	April 30, 2004	April 30, 2004	June 15, 2004
9th Review 2/	453.6	June 30, 2004	August 31, 2004	August 31, 2004	October 15, 2004
10th Review 2/	453.6	September 30, 2004	December 31, 2004	December 31, 2004	January 15, 2005
Total Purchases	12,821.2				

1/ Owing to deferred completion of this review the controlling test dates shift to March 31, 2004

2/ The June 30, 2004 test date floor for the CGS primary balance performance criterion becomes applicable for purchases 45 days after the actual test date in view of the time required to report comprehensive monitoring data.

PRIMARY BALANCE OF THE CONSOLIDATED GOVERNMENT SECTOR

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

	Floor (In trillions of Turkish lira)
Cumulative primary balance from January 1, 2004, to:	
March, 31 2004 (performance criterion)	5,420
June, 30 2004 (performance criterion)	14,100
September, 30 2004 (indicative target)	22,950
December, 31 2004 (indicative target)	26,200
Cumulative primary balance (excluding SEEs) from January 1, 2004, to:	
April, 30 2004 (performance criterion)	6,300
August, 31 2004 (indicative target)	19,000
December, 31 2004 (indicative target)	22,900

The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the 3 extra budgetary funds (EBFs) identified below, the 12 state economic enterprises (SEEs) identified below, the social security institutions (SSIs), and the unemployment insurance fund. In 2004 the SEEs definition will be expanded to 27 as listed in paragraph six. SEEs are excluded from the cumulative consolidated government primary balance performance criterion for April, August and December. The floors on the primary balance of the CGS will be monitored:

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

For the purposes of the program, the primary revenues will exclude interest receipts of the consolidated central government (including on tax arrears), SEEs, and of the unemployment insurance fund, profit transfers of the Central Bank of Turkey (CBT) and proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof). Revenues of the CGS from sales of immovables below TL 500 trillion will be included. Interest receipts of EBFs and SSIs will not be excluded. As well, the floor on the primary balance will be adjusted upwards for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments.

For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks.

Net lending of any component of the CGS will be considered as a non-interest expenditure item. Payment of guaranteed debt by treasury on behalf of non-CGS components of the public sector will not be treated as net lending up to the baseline reported in Annex F.

Extra budgetary funds

The three EBFs included in the definition of the performance criterion for 2004 are: the defense fund, the privatization fund, and the social aid fund. The balance of the promotion fund—which does not have the legal authority to borrow, and will not be given such authority during the duration of the stand-by arrangement—is excluded from the definition of the performance criterion.

State economic enterprises

The 12 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal company), TSFAS (sugar company), TMO (soil products office), TEKEL (tobacco and alcoholic beverages company), TCDD (state railways), Telekom (telecommunications), BOTAS (natural gas), TEDAS (electricity distribution), EUAS (electricity generation), TETAS (electricity trade), TEIAS (electricity transmission), and TPAO (petroleum exploration and extraction). Starting in 2004 the SEEs for the purpose of the definition of the performance criterion will include in addition to those listed above the following enterprises: ETİ Maden, MKEK, TKİ, CAYKUR, DHMI, PTT, PETKIM, THY, TUPRAS, TIGEM, KIYEM, TDI, IGSAS, TUGSAS, DMO.

The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing from the banking system (excluding pre-export financing from the Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

Net financing from the banking system (excluding pre-export financing from the Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2002 the stock of net banking claims on SEEs as defined above stood at TL 92 trillion, valued at the exchange rates on that day.

Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2002 the stock of external loans stood at TL 11,200 trillion, valued at the exchange rates on that day.

Social security institutions

The deficits of the social security institutions (SSIs) will be covered by transfers from the central government budget, and they are thus expected to be in primary balance in 2004.

Adjusters

The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as the sum of (i) overdue pension payments; (ii) medicine payments overdue by more than 30 days (from the date of invoice receipt); and (iii) other payments overdue by more than 30 days (from the date of invoice receipt). In the case of Bag Kur they exclude arrears to the common retirement fund. The stock of arrears for Bag Kur stood at TL 296 trillion; for SSK stood at TL 314 trillion; and for ES stood at TL 0 trillion on December 31, 2002. These stocks of arrears will be used for the purpose of calculating the adjustor in 2004.

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

- for any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;
- for any lower-than-programmed Direct Income Support as of December 31, 2004 (payments during 2004 are programmed at TL 2.6 quadrillion); and
- for any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).

The floor on the primary surplus of the CGS will be adjusted upwards (downwards) in line with the projected surplus (deficit) of the primary balance of any fund or entity that is incorporated in the CGS after January, 1 2003.

The floor on the primary surplus of the CGS will be adjusted downwards (upwards) by the primary surplus (deficit) projected at the time of the Sixth Review for any state economic enterprise (included in the performance criterion) when due to privatizations there is a change of control. The adjustor will be calculated as the difference between the primary surplus generated by the company while in public control and the annual projection. This adjustor does not apply to the primary surplus of the CGS excluding SEEs.

OVERALL BALANCE OF THE CONSOLIDATED GOVERNMENT SECTOR

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

	Floor (In trillions of TL)
Cumulative overall balance from January 1, 2004 to:	
March 31, 2004	-11,420
June 30, 2004	-20,000
September 30, 2004	-29,300
December 31, 2004	-35,440

1. The overall balance of the consolidated government sector (CGS), Table 1, comprises (i) the primary balance of the CGS as defined in Annex D, (ii) the net interest payments of the central government, the UIF, and the SEEs, (iii) the interest payments of SSIs and EBFs, and (iv) the profit transfers from the CBT to the consolidated central government.

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

3. All definitions and adjusters specified in Annex D to apply to the primary balance of the CGS will also apply to the overall balance of the CGS. In particular, the overall balance will be adjusted for the overall balance of any new government funds and institutions established after January 1, 2004.

PROGRAM BASELINE FOR TREASURY NET LENDING

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US$)	Baseline (In trillions of TL)
Cumulative net lending from January 1, 2004 to:		
March 31, 2004	110	175
April 30, 2004	172	275
June 30, 2004	282	452
August 31, 2004	355	569
September 30, 2004	401	643
December 31, 2004	527	845

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

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

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

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

MONETARY TARGETS

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

(In quadrillions of Turkish lira)

	Ceilings	Actual
Outstanding base money as of December 31, 2002	10.85	10.72
April 30, 2003 (performance criterion)	12.8	11.9
June 30, 2003 (performance criterion)	13.2	13.0
September 30, 2003 (performance criterion)	14.1	13.9
December 31, 2003 (performance criterion)	14.9	14.7
March 31, 2004 (performance criterion)	16.1	16.9
April 30, 2004 (performance criterion)	17.5	...
August 31, 2004 (indicative target)	19.2	...
December 31, 2004 (indicative target)	19.3	...

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

1. This Annex sets out performance criteria for base money, and indicative targets for net domestic assets of the Central Bank of Turkey (CBT) and Treasury combined.

2. Base money is defined as currency issued by the CBT, plus the banking sector's deposits in Turkish lira with the CBT. The net domestic assets (NDA) of the CBT are defined as base money less net foreign assets of the CBT. The net domestic assets of the CBT and Treasury combined are defined as net domestic assets of the CBT plus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.

3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex H), medium- and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange). As of December 31, 2002, net foreign assets of the CBT amounted to TL 3.93 quadrillion, net domestic assets of the CBT TL 6.50 quadrillion, and base money TL 10.43 quadrillion.

4. Net domestic assets of the Treasury are equal to treasury liabilities to the International Monetary Fund and treasury foreign exchange denominated borrowing with an original maturity of less than one year. As of December 31, 2002, these amounted to US$14.66 billion, or TL 21.10 quadrillion (evaluated at program exchange rates).

All assets and liabilities denominated in foreign currencies will be converted into Turkish lira at program exchange rates (Annex I).

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

$$\Delta NDA = R^{*}\Delta B,$$

where: R denotes the 6 percent reserve requirement and ΔB denotes the change in base generated by a change in the definition of the reserve aggregate, or due to any change in the averaging period.

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

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

where: B is the level of the base to which the reserve requirement applies on the test date and ΔR is the change in the reserve requirement coefficient and the liquidity requirement coefficient.

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

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

(In quadrillions of Turkish lira) 1/

	Ceilings	Actual
Outstanding NDA as of December 31, 2002:	33.1	28.6
April 30, 2003	32.8	31.0
June 30, 2003	34.1	29.4
September 30, 2003	33.8	23.0
December 31, 2003	28.4	26.0
March 31, 2004	29.6	27.3
April 30, 2004	31.6	...
August 31, 2004	33.3	...
December 31, 2004	33.4	...

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

TARGETS FOR NET INTERNATIONAL RESERVES

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

(In billions of U.S. dollars)

	Floor on level of NIR	Actual	Memo Item: NIR of the CBT
Outstanding stock as of September 30, 2003:	-6.0	1.5	15.5
December 31, 2003 (performance criterion)	-2.0	-0.5	13.6
March 31, 2004 (performance criterion)	-2.0	0.7	14.9
April 30, 2004 (performance criterion)	-2.0	…	…
August 31, 2004 (indicative target)	-2.0	…	…
December 31, 2004 (indicative target)	-2.0	…	…

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

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

3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the December 31, 2001 average London fixing market price of US$276.5 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US$0.426 billion on December 31, 2002). The special Dresdner portfolio (amounting to US$0.771 billion on December 31, 2002) is also encumbered, but is not subtracted from foreign reserves given the overlap with one-year foreign currency denominated liabilities (see below). Reserve assets as of December 31, 2002 amounted to US$25.79 billion (evaluated at program exchange rates).

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

payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On December 31, 2002 reserve liabilities thus defined amounted to US$15.75 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of December 31, 2002 these amounts were zero.

6. As of December 31, 2002 the sum of: (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year amounted to US$14.66 billion.

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

Adjusters

8. The floor on the level of net international reserves as specified in Table 1 will be adjusted:

- Upwards in the amount of one half of the cumulative loan disbursements under the United States–Turkey Financial Agreement of September 2003;
- Downwards in the amount of principal and interest of domestically issued foreign exchange denominated bonds (original maturity longer than one year) not rolled over starting from May 1, 2004, capped at 20 percent of the principal and interest due May 1, 2004 to December 31, 2004 (equivalent to US$1,070 million).

PROGRAM EXCHANGE RATES

Table 1. Cross Exchange Rates for Program Purposes

	Turkish lira value	U.S. dollar value
Program exchange rate		
U.S. dollar	1,439,567	1
Euro	1,268,115	0.8809
Japanese yen	10,972	0.0076
Swiss franc	854,490	0.5945
U.K. pound	2,081,497	1.4465

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period December 31, 2001–December 31, 2004. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of December 31, 2001.

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

PRIVATIZATION

Table 1. Turkey: Indicative Target on Cumulative Privatization Proceeds of the Consolidated Government Sector

	Floor (In millions of U.S. dollars)	Actual
Cumulative privatization proceeds from end-December 2002 to:		
March 31, 2003	30	23
June 30, 2003	90	50
September 30, 2003	790	168
December 31, 2003	2,100	257
Cumulative privatization proceeds from end-December 2003 to:		
March 31, 2004	100	...
June 30, 2004	500	...
September 30, 2004	1,000	...
December 31, 2004	3,000	...

1. The consolidated government sector is defined in Annex D above.

2. Privatization proceeds are measured in cash terms, except in the case of conversion of an exchangeable bond (proceeds exclude amounts realized from the sale of convertible bonds).

3. Privatization proceeds exclude sales of immovables and movables, and any other items already captured in the performance criteria for the consolidated public sector (see Annex D, referenced above).

4. Privatization proceeds exclude any sale of assets to entities in the consolidated government sector, to the local governments, or to state economic enterprises not captured in the program definition of the consolidated government sector.

5. Privatization proceeds exclude receipts from the sale of transfer of operating rights (TOORs).

SHORT-TERM EXTERNAL DEBT CEILINGS

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

	Ceilings (In millions of US$)	Actual (In millions of US$)
October 31, 2003 (performance criterion)	1,000	0
December 31, 2003 (performance criterion)	1,000	0
March 31, 2004 (performance criterion)	1,000	...
June 30, 2004 (performance criterion)	1,000	...
September 30, 2004 (indicative target)	1,000	...
December 31, 2004 (indicative target)	1,000	...

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

Medium- and Long-Term Debt Ceilings

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

	Limits (In millions of US$)	Actual (In millions of US$)
Cumulative flows from end-December 2002		
October 31, 2003 (performance criterion)	13,000	7,042
December 31, 2003 (performance criterion)	15,000	7,269
Cumulative flows from end-December 2003		
March 31, 2004 (performance criterion)	7,000	...
June 30, 2004 (performance criterion)	13,000	...
September 30, 2004 (indicative target)	16,000	...
December 31, 2004 (indicative target)	17,500	...

1. The limits specified in Table 1 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex D) of new, nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the International Monetary Fund on August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The term "nonconcessional" means containing a grant element of less than 35 percent on the basis of the currency-specific discount rates based on the OECD commercial interest reference rates in place at the time at which the contract is entered into, or guarantee issued. Excluded from this performance criterion are credits extended by the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank of Turkey and sales of treasury bills and bonds denominated in TL or FX to nonresidents in either the domestic primary market or the secondary market. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

INTERNATIONAL MONETARY FUND

TURKEY

Seventh Review Under the Stand-By Arrangement, Requests for Waiver of Applicability and Nonobservance of Performance Criteria, Rephasing of Purchases, and Extension of Arrangement
Supplementary Information

Prepared by the European Department in consultation with other departments

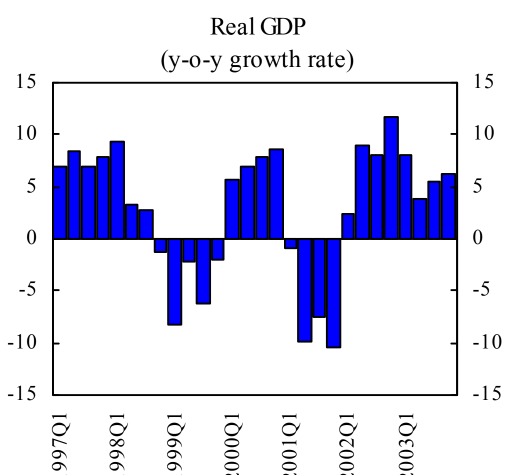
Approved by Michael Deppler and Liam P. Ebrill

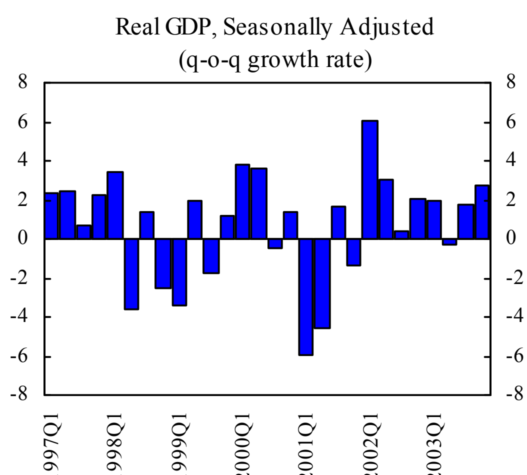
April 12, 2004

This supplement provides an update on developments and on the implementation of program measures since the circulation of the staff report. The staff appraisal remains unchanged.

Recent developments

1. **National accounts data released at the end of March confirm that economic growth in 2003 was strong, outperforming both program projections and market expectations:**



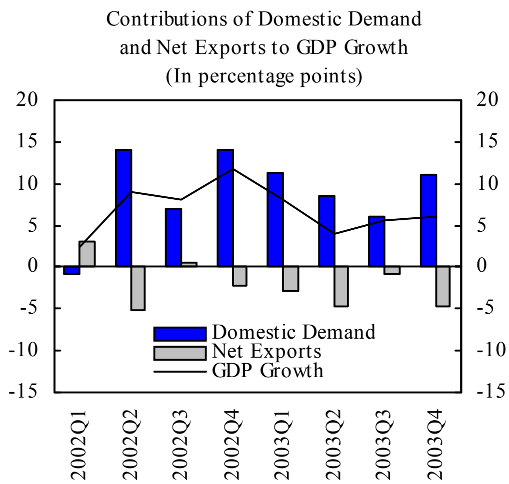


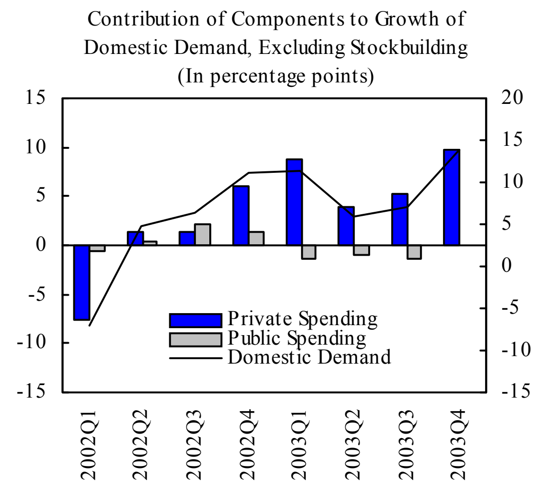
- **In the fourth quarter of 2003 real GNP increased by 7.2 percent year on year, and real GDP by 6.1 percent, bringing growth for the whole year close to 6 percent** (Table 1). In seasonally adjusted terms, the economy grew at an annualized rate of around 8 percent during the second half of the year. Carryover from this will help in meeting this year's 5 percent growth target.

Table 1. Turkey - Quarterly Real Output and Expenditure, 2002-2003

	2002				2002	2003				2003
	March	June	Sept.	Dec.		March	June	Sept.	Dec.	
	(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
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
Agriculture	-1.2	1.9	5.8	16.2	6.9	2.0	-0.8	-0.6	-9.6	-2.5
Industry	2.8	12.6	10.5	11.4	9.4	8.8	4.2	9.1	9.2	7.8
Other, including services	2.4	8.1	7.8	11.0	7.5	8.2	4.5	6.5	8.0	6.7
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
Domestic Demand	-0.7	14.8	8.2	14.9	9.3	10.9	8.5	7.0	11.3	9.3
Consumption	-1.5	3.1	3.5	4.4	2.5	6.9	2.3	5.2	8.0	5.6
Private	-1.9	3.2	2.7	4.4	2.1	7.8	2.9	5.8	10.3	6.6
Public	2.2	2.6	12.0	4.5	5.4	-2.3	-2.0	-0.7	-4.2	-2.4
Gross Investment	2.1	58.9	27.7	57.9	35.9	25.2	23.9	13.1	20.5	20.4
Gross Fixed Investment	-28.5	-2.0	5.6	20.5	-1.1	11.7	6.3	3.0	19.2	10.0
Private	-30.6	-3.8	-3.2	31.0	-5.3	22.6	14.2	16.4	30.1	20.3
Public	-18.4	3.0	27.9	9.2	8.8	-34.8	-14.6	-22.7	5.0	-11.5
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
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
	(contribution to year on year GDP growth (production side), in percentage points)									
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
Agriculture	-0.1	0.2	1.4	1.9	0.9	0.1	-0.1	-0.1	-1.2	-0.3
Industry	0.9	3.9	2.5	3.2	2.7	2.9	1.3	2.2	2.6	2.2
Other, including services	1.5	4.9	4.1	6.6	4.3	5.1	2.7	3.4	4.7	3.9
Statistical Discrepancy	-0.1	-0.1	0.4	-0.1	0.1	-0.4	0.0	0.4	-0.1	0.0
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
Domestic Demand	-0.8	14.1	7.1	14.0	8.8	11.4	8.6	6.0	11.0	8.9
Consumption	-1.3	2.3	2.4	3.3	1.9	5.6	1.6	3.4	5.6	4.0
Private	-1.4	2.1	1.7	2.8	1.4	5.8	1.8	3.5	6.1	4.2
Public	0.2	0.2	0.8	0.6	0.5	-0.2	-0.2	0.0	-0.5	-0.2
Gross Investment	0.5	11.8	4.6	10.7	6.9	5.8	7.0	2.6	5.3	4.9
Gross Fixed Investment	-6.9	-0.5	1.0	4.1	-0.2	2.0	1.3	0.5	4.2	1.9
Private	-6.1	-0.7	-0.4	3.2	-0.8	3.1	2.2	1.8	3.7	2.6
Public	-0.7	0.2	1.4	0.9	0.5	-1.1	-0.8	-1.3	0.5	-0.7
Change in Stocks	7.3	12.2	3.7	6.5	7.1	3.8	5.6	2.1	1.2	3.0
External Balance	3.2	-5.1	0.5	-2.1	-0.9	-2.8	-4.7	-0.9	-4.8	-3.1
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
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

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





- **Growth was led by a rapid increase in private sector demand**. Private investment grew by 30 percent year on year in the fourth quarter, and private consumption by more than 10 percent. In contrast, government spending was weak, reflecting tight incomes policy and attempts to meet the primary surplus target. Inventory accumulation continues to be reported as an important component of growth, even though this most likely represents measurement error. However, its importance has become steadily less significant through the year.

2. **The authorities continue to make progress in disinflation.** In March, consumer prices increased 0.9 percent month on month, in line with market forecasts and program projections. The bulk of the increase came from volatile food prices, which increased by 3 percent. With the high inflation months of last year dropping out, year on year inflation fell to 11.8 percent, already below the 12 percent end-year target. Although wholesale prices increased by 2.1 percent month on month, driven by a 3 percent increase in public sector prices, the year on year rate has fallen to 8 percent.

3. **Good progress is also being made in building international reserves.** End-March net international reserves exceeded the program target by US$2¾ billion, due to higher-than-anticipated purchases by the CBT at its foreign exchange purchase auctions and bringing forward the Treasury's international bond issues to the first few months of the year. Reflecting the gathering strength of the balance of payments, the CBT has twice increased its maximum purchases at its daily foreign exchange purchase auctions in recent weeks, to US$140 million effective April 7.

4. **The fiscal program targets remain within reach.** While expenditures remained under tight control in the first two months, revenues were below target, with shortfalls on personal income tax, VAT and excises, in part due to the shift in payment dates from February to March. Reflecting these shifts, and remedial measures taken during the Seventh Review discussions, the March outturn appears to have exceeded program projections, with preliminary outturns suggesting that the central government primary target was also exceeded in the first quarter.

5. **Banca Intesa, Italy's largest bank, entered into exclusive talks to purchase a majority stake in Garanti, Turkey's third-largest private bank.**

6. **On April 10, the World Bank and the authorities announced progress on loan discussions.** The Bank board is expected to consider, by end-April, the US$375 million second tranche of the Economic Reform Loan (ERL) to Turkey. The ERL provides support for public sector reform, energy sector restructuring, and privatization. Bank staff has also reached agreement in principle with the authorities on the matrix of policy conditions under the US$1 billion Programmatic Financial and Public Sector Loan (PFPSAL 3). Discussions should be finalized by end-April, with Board consideration expected in June.

7. **Against this generally favorable background, financial markets have remained broadly stable.** Key financial indicators, including benchmark bond interest rates and the Turkish lira exchange rate, have been stable.

8. **A number of significant political developments have taken place since the review discussions:**

- The governing AKP dominated the **local elections**, held on March 28. In doing so, it increased its share of the vote by 8 percentage points compared to the November 2002 general election, to more than 40 percent. The main opposition party, CHP, saw its share of the vote fall slightly to 18 percent. Both the MHP (a partner in the previous government coalition) and DYP (in power for much of the 1990s), made modest gains, closing in on the 10 percent threshold they would require in parliamentary elections to attain representation.

Table. Turkey: Election Outcomes, 2002-04

	General Election (November 2002)	Local Election (March 2004)
AKP (Justice and Development Party)	34	42
CHP (Republican's People Party)	19	18
MHP (Nationalist Action Party)	8	10
DYP (True Path Party)	10	10
DEHAP (People's Democratic Party)	6	5
Other	23	15

Sources: Turkish authorities.

- Formal negotiations on **Cyprus** have been completed. The Turkish government has informed the United Nations that it has accepted the Annan Plan being put to referenda in Cyprus on April 24. It has also committed to signing the Plan by April 29 should it be passed in the referenda.

- While the European Council Parliamentary Assembly recently recommended that Turkey be taken off its monitoring list, the **European Parliament** adopted a report on April 1, 2004 containing a more mixed message. While the report praised recent reforms in Turkey, it indicated that Turkey was not yet in accord with the Copenhagen political criteria and called for revisions to the constitution.

Program implementation

9. **As a prior action for the Seventh Review, the authorities have now appointed the chairman of the Imar inquiry and approved its terms of reference.** Mr. Jean-Louis Fort, former Director General of the Banking Commission in France, has been appointed as the chairman of the inquiry. The terms of reference for the inquiry confirm that the findings are expected to be made public by end-August 2004 (a new performance criterion, ¶15).[1]

10. **The authorities have confirmed the implementation of the agreed measures to close the TL 7 quadrillion fiscal gap.** The staff has raised concerns regarding ad hoc adjustments in petroleum excises to smooth pump prices, and delays in adjustment of excises in line with the budget assumptions, which could jeopardize the fiscal targets. In response, the authorities have proposed a new structural benchmark aimed at ensuring that excises are adjusted in line with the WPI prior to the completion of the next review (¶8). They have also agreed to review the mechanism for pass through of world oil prices to pump prices before the next review.

11. **Progress has been made on state bank reform.** The authorities have agreed to reduce the excess capital of Ziraat bank by the end of April, based on its final 2003 accounts. The authorities have also instructed state banks to bring their deposit rates in line with the average in the private banks.

12. **The authorities have completed ahead of schedule their action plan for the implementation of tax administration reform.** The plan, which has been shared with Fund staff, sets clear objectives and a timeline for key elements of the reforms, including the preparation of enabling legislation, revenue department functional reform, and the launch of a Large Taxpayers Unit.

13. **Finally, the authorities observed the end-March performance criteria on contracting and guaranteeing of new external public debt and on the stock of short-term external public debt outstanding.** At end-March the stock of short-term public external debt was zero, compared with the US$1 billion program ceiling. US$3.382 billion of medium- and long-term public external debt had been contracted, well below the program's US$7 billion ceiling.

[1] ¶ refers to the relevant paragraph in the authorities' Letter of Intent, dated April 2, 2004.

Press Release No. 04/76
FOR IMMEDIATE RELEASE
April 16, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Seventh Review and Approves US$495 Million Disbursement Under Stand-By Arrangement with Turkey

The Executive Board of the International Monetary Fund (IMF) today completed the seventh review of Turkey's economic performance under the Stand-By Arrangement and approved the disbursement of an amount equivalent to SDR 340 million (about US$495 million).
In completing the review, the Executive Board also granted Turkey's request for waivers, and approved the rephasing of the remaining program reviews and an extension of the Arrangement through February 3, 2005 to allow time for the final disbursement under the program.

Turkey's Stand-By Arrangement was approved on February 4, 2002 (see Press Release No. 02/7) in a total amount of SDR 12.8 billion (about US$18.6 billion). So far, Turkey has drawn SDR 11.1 billion (about US$16.2 billion) under the Arrangement.

Following the Executive Board discussion, Anne Krueger, Acting Managing Director and Chair, said:

"Turkey's economic program has continued to deliver impressive results. Economic growth has exceeded program targets for the second year running, interest rates have fallen sharply, helping Turkey's debt dynamics, inflation has declined to its lowest rate in a generation, and confidence in the Turkish lira has been restored.

"The government's commitment to meeting its primary surplus target of 6½ percent of GNP in 2004 has played an important role in this success. The government's recent corrective measures, including cutting discretionary spending by 13 percent and raising excises, demonstrate its commitment to meeting the 2004 program target, and the government should remain vigilant to avoid slippages.

"The adoption of a comprehensive structural fiscal reform strategy in 2004 should help sustain this fiscal adjustment in the medium term and lead to a better composition of the budget. Stronger tax administration will aid in combating tax evasion, planned social security reforms will help underpin medium-term fiscal stability, and the forthcoming public expenditure review should provide guidance on reducing rigidities in the budget structure. Timely implementation of this ambitious reform agenda is needed to help boost policy credibility.

"The Central Bank of Turkey's handling of monetary policy has continued to be impressive, with inflation rates falling sharply. The government's continued fiscal discipline has played a key role in this accomplishment.

"The current policy response to capital inflows—reintroducing foreign exchange purchase auctions, allowing modest real appreciation of the exchange rate, and cutting interest rates gradually—is appropriate. Closer coordination between the Central Bank and the Treasury in sharing the cost of accumulating reserves should help strengthen monetary and debt management.

"The authorities' intention to reinvigorate banking reform is welcome. The Banking Act is being brought more closely in line with European Union practice, while the inquiry into Imar bank should help strengthen banking supervision. Needed further steps include accelerating asset recovery by the Savings Deposit and Insurance Fund (SDIF) and reform of state banks. Firm support of the Banking Regulation and Supervision Agency (BRSA) will continue to be important.

"The Turkish authorities have continued to make strong efforts to adhere to their ambitious program, including by implementation of fiscal measures ahead of the March elections to help meet the primary surplus targets. They have also adopted an ambitious structural reform agenda for the remainder of the program. The result has been a marked improvement in market confidence and economic performance. These strong efforts deserve the continued support of the international community," Ms. Krueger said.