July 2006
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Turkey: First and Second Reviews Under the Stand-By Arrangement, and Request for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Turkey

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

- the staff paper for the First and Second Review Under the Stand-By Arrangement, and Request for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases, prepared by a staff team of the IMF, following discussions that ended on October 25, 2005, withthe officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 28, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of December 8, 2005 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its December 9, 2005 discussion of the staff report that completed the reviews and request.

- a statement by the Executive Director for Turkey.

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

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

First and Second Reviews Under the Stand-By Arrangement, and Requests for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases

Prepared by the European Department in consultation with other departments

Approved by Susan Schadler and Matthew Fisher

November 28, 2005

- **Stand-By Arrangement**. The Fund supports Turkey's economic program for 2005–08 with a three-year Stand-By Arrangement approved on May 11, 2005. Access under the arrangement is SDR 6.7 billion (691 percent of quota, approximately US$10 billion), of which SDR 555.2 million has been purchased so far (Appendix I). Outstanding Fund credit at end-November amounted to SDR 9.5 billion, and should fall to around SDR 6.0 billion by the end of the arrangement. A further SDR 1,110.3 million would become available upon the completion of the combined first and second reviews under the arrangement.
- **Last Board Meeting**. At the Board meeting approving the arrangement on May 11, 2005, Directors stressed the need to deepen reforms, particularly in the fiscal and financial sectors, and to reduce vulnerabilities linked to the structure of government debt and external financing.
- **Discussions**. During June 1–15, September 8–21, September 25−26 at headquarters, and October 11–25, the staff team met with Deputy Prime Ministers Şener and Şahin, State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Labor Minister Başesgioğlu, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Chairman Ertürk, Privatization Administration President Kilci, other senior officials, and representatives from the banking and business communities.
- **Staff**. Team members comprised Lorenzo Giorgianni (head), Mark Griffiths, Arend Kapteyn and Donal McGettigan (all EUR), Dale Hart, Mark Horton and Koshy Mathai (FAD), Mats Josefsson (MFD), Wes McGrew (PDR), Hugh Bredenkamp (senior resident representative), Christian Keller and Christoph Klingen (resident representatives), Ana Rosa Reyes and Sara Salimi (administrative assistants, EUR). Levent Veziroglu (OED) accompanied the missions.
- **Supplementary LOI**. The attached Letter of Intent supplements the policies set out in the authorities' April 26 Letter of Intent and Memorandum of Economic Policies.
- **Publication**. The staff report for the approval of the arrangement (Country Report 05/412) was published on November 18, 2005.

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Appendices

Attachment

I. EXECUTIVE SUMMARY

- **The pace of economic activity is moderating in line with program assumptions, but the current account deficit has continued to widen**. Growth is on track to reach 5 percent this year and next, though its composition is becoming more reliant on domestic demand than earlier envisaged. Meanwhile, the outlook for the current account has worsened, reflecting increasing import prices and a strengthening of the lira on the back of record levels of capital inflows.

- **The authorities have responded appropriately to the main macroeconomic policy challenge—a rising current account deficit with a strengthening exchange rate**. The 2006 budget submitted to Parliament provides for an effective fiscal tightening, while policy interest rates have been reduced gradually without endangering the inflation target. At the same time, the central bank has continued to build up a prudential reserve buffer, while respecting the floating exchange rate regime.

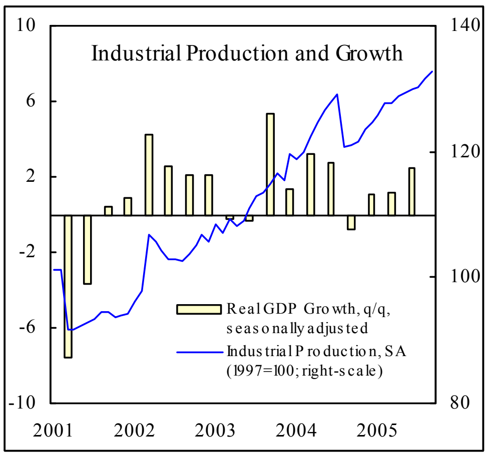
- **Adherence to the structural components of the Fund-supported program has been mixed, however, causing delays in completing program reviews** (Table 1). A major banking reform law was passed, and SDIF asset recoveries and privatization are proceeding well. However, implementation in other areas—especially those requiring legislative action—has been uneven, with delays encountered in the areas of social security reform, tax administration, and state banks.

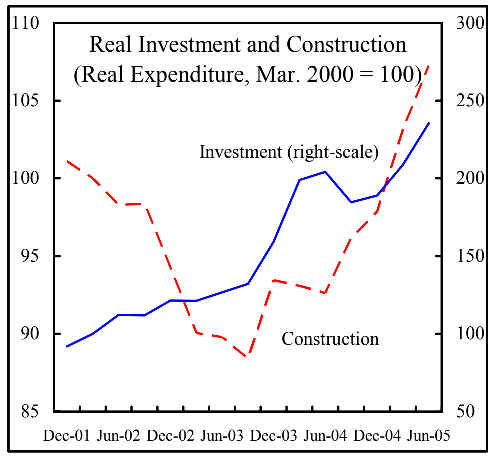
- **Looking ahead, sustaining the current good economic performance will require strong government ownership of the Fund-supported program**. The authorities have put together a comprehensive supplementary Letter of Intent that, if implemented consistently, will help regain momentum in the program. Key components include a commitment to pass the pension reform in early 2006, a new framework to strengthen social security contribution collections, major reforms of income taxes, the introduction of formal inflation targeting, and a further strengthening of bank supervision.

- **The main risks going forward relate to the increased reliance on volatile foreign savings**. While underlying vulnerabilities are lower than in the past, a global tightening of credit conditions leading to a sharp depreciation of the lira—possibly coupled with a further rise in oil prices—would worsen debt dynamics and weaken bank and corporate balance sheets. In light of these risks, the authorities should take every advantage of the current favorable global conditions to continue reducing domestic and external vulnerabilities.

II. Recent Developments

1. **Economic growth is moderating in line with program projections**. After jumping to almost 10 percent last year, growth this year was expected to slow to 5 percent, in line with potential. Following a cooling in the second half of last year, economic activity gathered momentum, with growth estimated at around 2½ percent (seasonally adjusted) in the first half of 2005. However, the switch towards more export-led growth expected under the program has not materialized. Instead, investment has been stronger than envisaged—reflecting buoyant construction activity and improving credit conditions—while consumption has evolved broadly in line with projections (Box 1).





2. **A deterioration of the terms of trade and a strong lira have contributed to the widening of the current account deficit** (Figure 1). Despite lower-than-expected import volume growth, the trade balance has worsened in the face of sharply higher oil prices and a strong lira (which, since May, has appreciated 8 percent in real terms, notwithstanding the central bank's accumulation of more than US$13 billion in reserves). In addition, textile and apparel exports, which account for 26 percent of total export earnings and contribute about 10 percent of output, have shown signs of stress following the elimination of international textile quotas earlier this year. As a result, this year's current account deficit is expected to reach 6 percent of GNP, some US$6 billion higher than programmed (Text Table).

Text Table: Sources of Current Account Deterioration

Revised Minus Program Projections 1/

	2005	2006
(In billions of U.S. dollars)		
Current Account	-6.0	-9.5
Exports (f.o.b.)	-3.4	-5.5
Due to changes in volumes	-3.3	-5.7
Due to changes in prices	0.7	0.9
Due to shuttle trade revision	-0.8	-0.8
Imports (f.o.b.)	-2.4	-4.1
Of which : Energy imports	-1.8	-4.4
Due to changes in volumes	1.1	1.6
Due to changes in prices	-3.4	-5.9
Services, income, and transfers	-0.3	0.2

1/ Minus indicates widening of current account deficit.

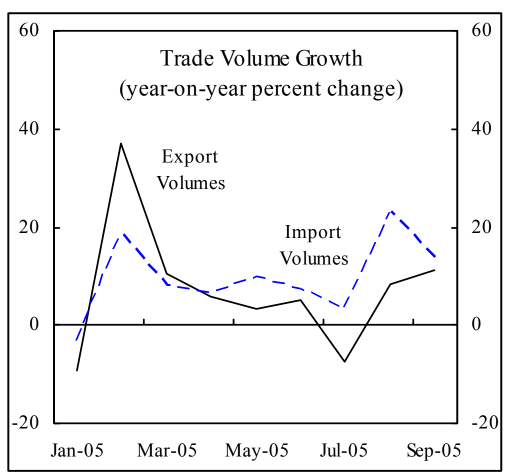
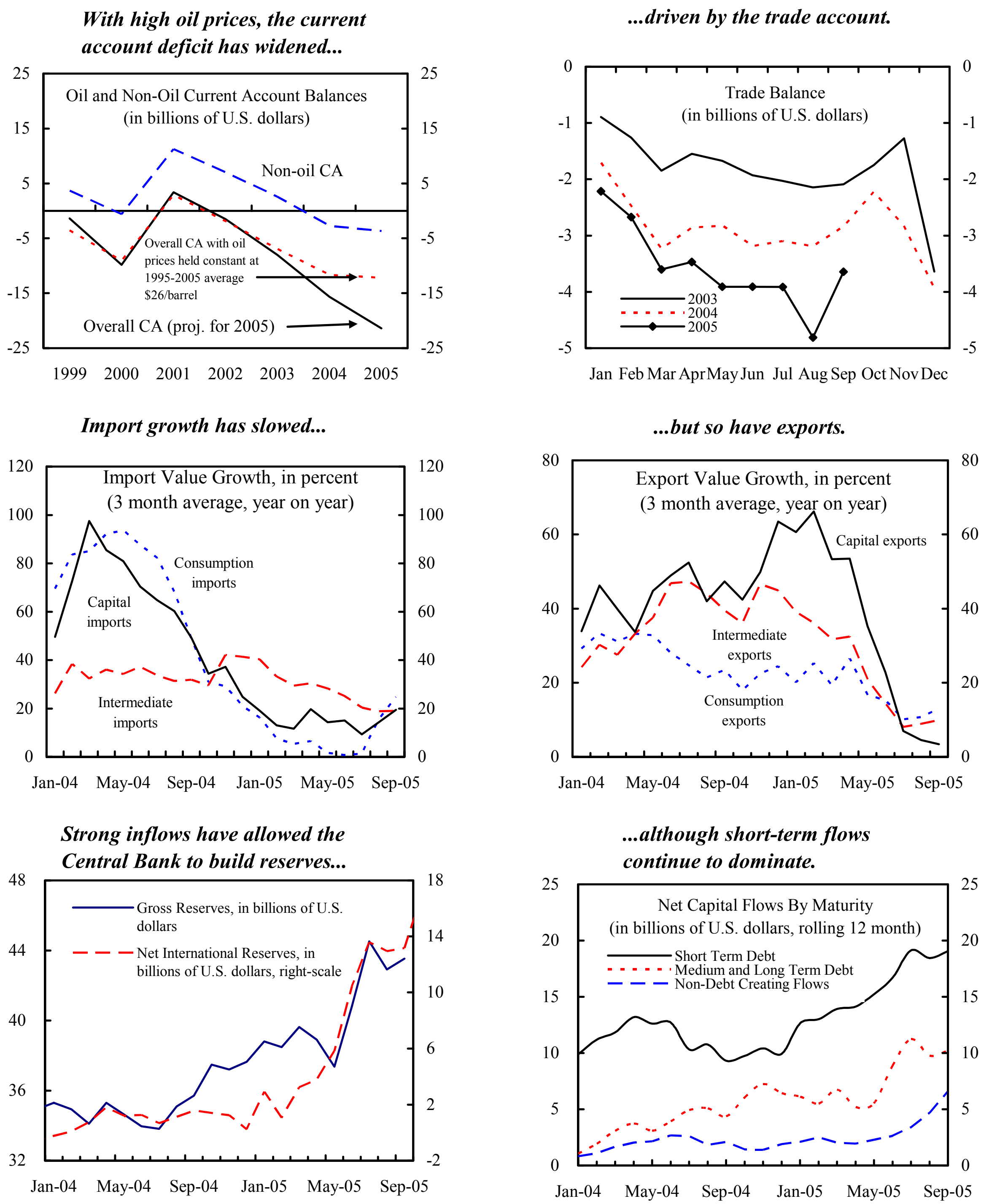
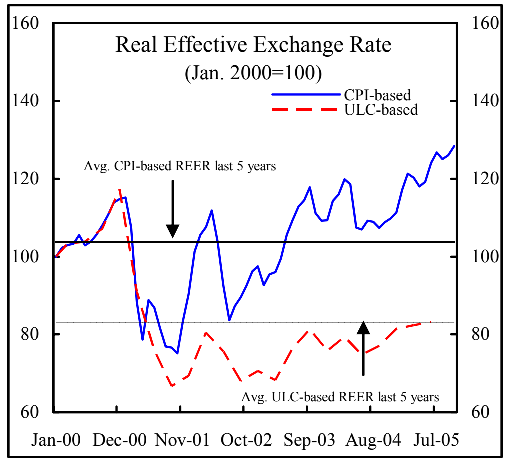


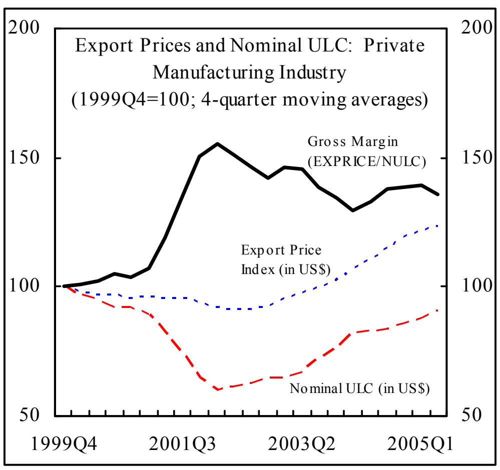
Figure 1. Turkey: External Developments, 1999–2005

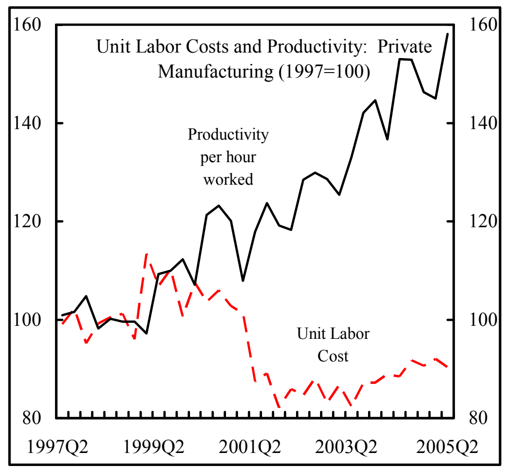


Source: Data from the Turkish authorities; and State Institute of Statistics.

3. **Despite the appreciation of the lira, export competitiveness has held up reasonably well**. Market estimates suggest that the lira may be above its long-run equilibrium value. However, while export profit margins—proxied by the ratio of export prices to U.S. dollar unit labor costs—have recently declined, they remain well above pre-crisis levels. In most sectors, adverse exchange rate effects have at least in part been offset by continued strong productivity growth and subdued wage dynamics, and there are no indications so far of a generalized decline in Turkish export market shares.







4. **The financing of the current account has so far been facilitated by record, albeit volatile, capital inflows**. Still attractive lira returns have played a key role in sustaining inflows, while the start of EU accession talks has provided a further boost to markets (Figure 2). The composition of inflows has also started to improve with increasing FDI flows. However, the foreign investor base does not yet contain significant participation from convergence funds or similar "buy and hold" investors, making inflows vulnerable to shifts in trading positions of more opportunistic investors. In addition, a substantial part of the flows remains short-term and debt-creating, with a large component of external financing remaining unidentified (Box 2).

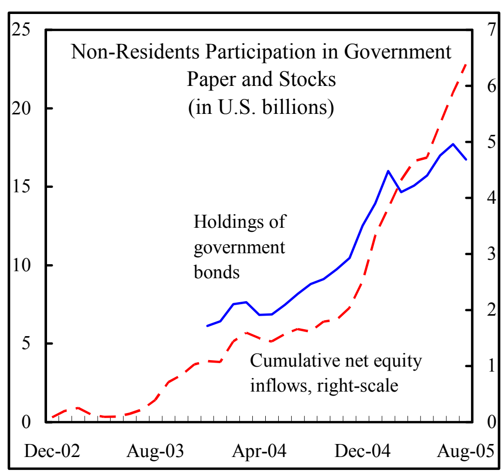
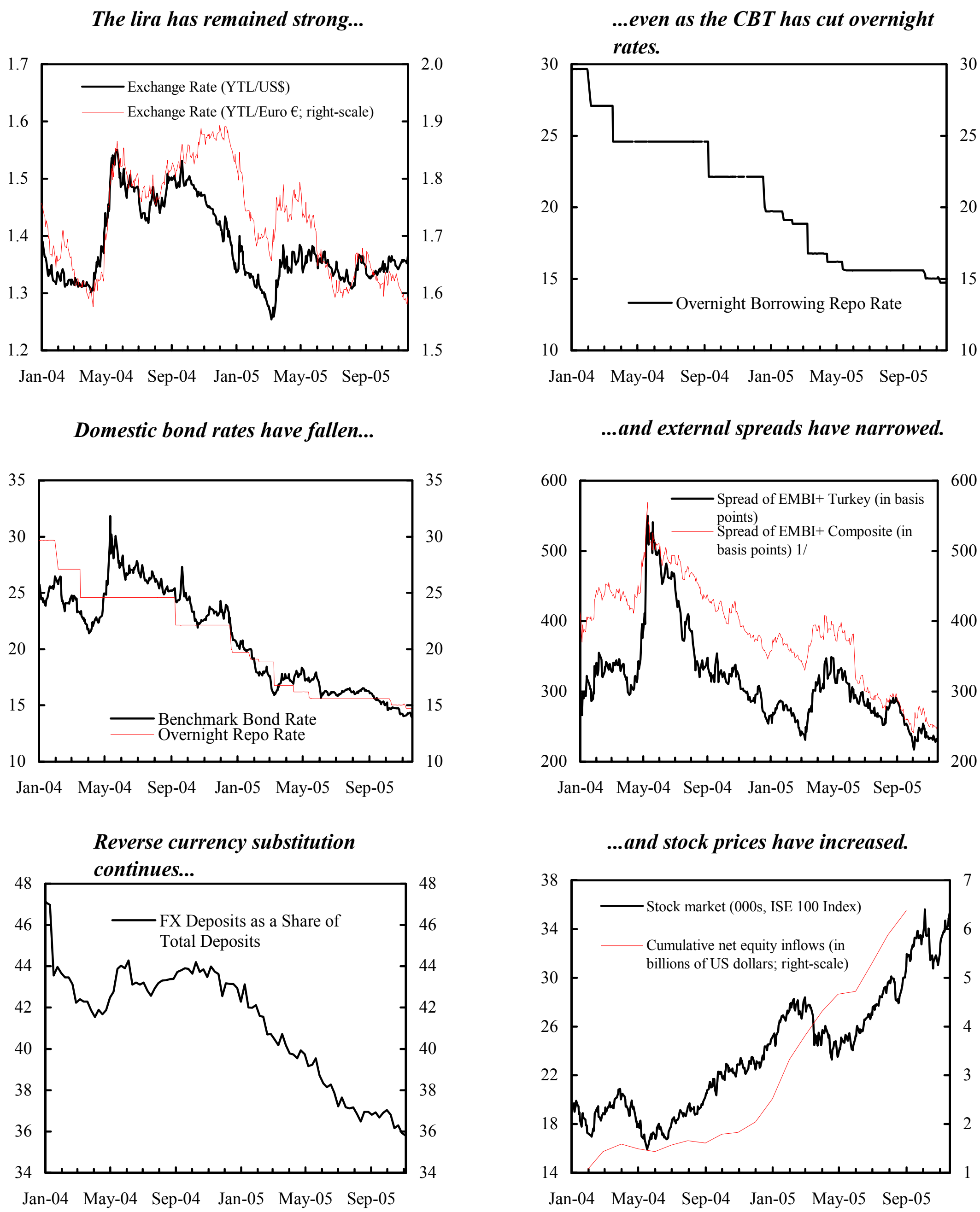
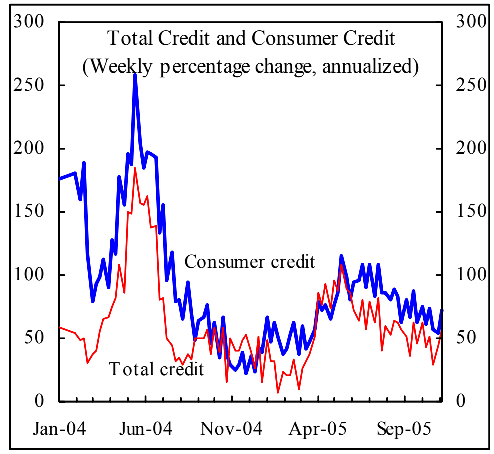


Figure 2. Turkey: Financial Indicators, 2004–05
(In percent, unless otherwise indicated)



Source: Data provided by the Turkish authorities.
1/ Decline in composite spreads on June 13, 2005 reflects the switch to swapped Argentina paper.

5. **Confidence in the Turkish economy has led to a strengthening of money demand** (Figure 3). Increased confidence in the lira is resulting in continued reverse currency substitution. This, together with further declines in interest rates and a move by households from government paper to deposits, has resulted in base money growth above program. After slowing in mid-2004, credit growth regained momentum earlier this year and continues at a rapid pace. Even so, cumulative inflation through end-October was less than 6 percent, and inflation is on track to meet the 8 percent end-year target.



6. **Fiscal performance in 2005 has been slightly weaker than programmed, though the primary surplus target for the year remains within reach**. Budget revenues through September were above program. This was, however, matched by substantial overspending, particularly on social security transfers (due to health spending overruns and lower-than-programmed contributions resulting from amnesty rumors earlier in the year) and, to a lesser extent, on agricultural subsidies. Nonetheless, assuming effective expenditure control in the final quarter, the primary surplus target of 6.5 percent of GNP remains attainable. In addition, a declining debt ratio and lower borrowing costs are expected to reduce the overall deficit much below program projections (Table 2).

7. **Against the backdrop of these generally positive developments, staff considers that the evolving domestic political environment is making reforms more difficult**. With parliamentary elections on the horizon (and speculation that these may be brought forward from late 2007), there is a risk of increased politicization of structural reforms. This, together with a risk of a diminished sense of urgency resulting from strong capital inflows and the start of EU accession talks, is complicating the task of ensuring timely implementation of structural reforms. Even so, the government remains committed to the Fund-supported program and has kept macroeconomic policies in line with program expectations.

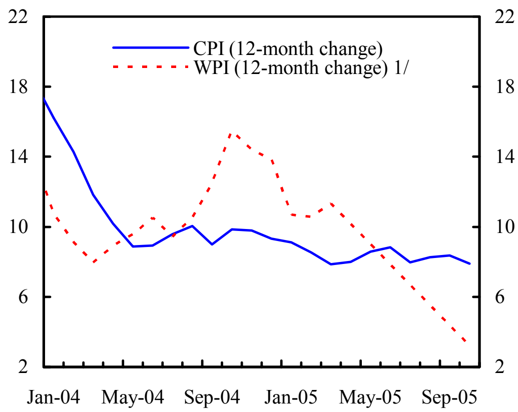
III. Policy Discussions

8. **Discussions focused on the policy response to the widening current account deficit and the requirements to bring structural reforms back on track**.

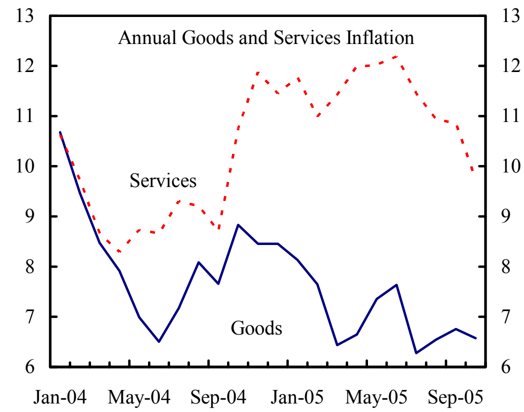
- It was agreed that fiscal tightening could help rein in the current account deficit. This would be accompanied by cautious monetary easing and continued reserve build-up.
- Fiscal tightening would be achieved by maintaining a public sector primary surplus of 6½ percent of GNP next year, notwithstanding the lost contribution of profitable state economic enterprises (SEEs) being privatized.

Figure 3. Turkey: Money and Inflation, 2004–05
(in percent, unless otherwise indicated)

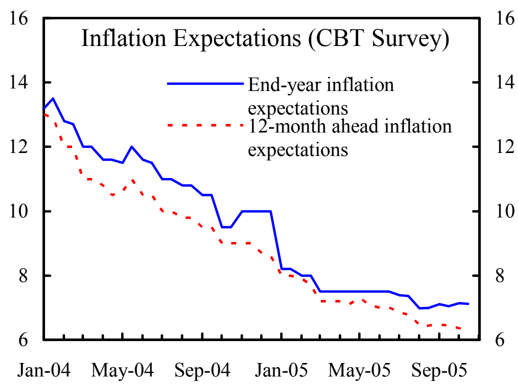
Although inflation has declined..



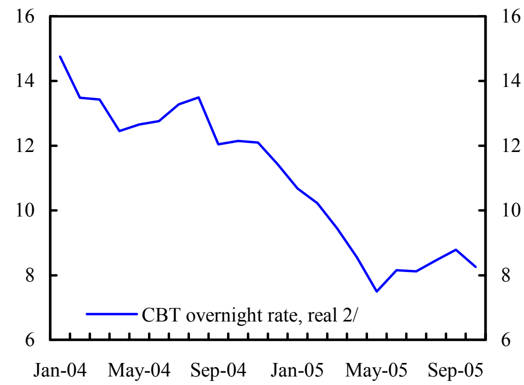
...services inflation remains high.



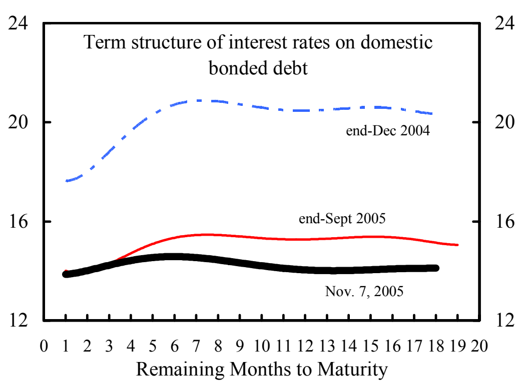
Inflation expectations have declined further...



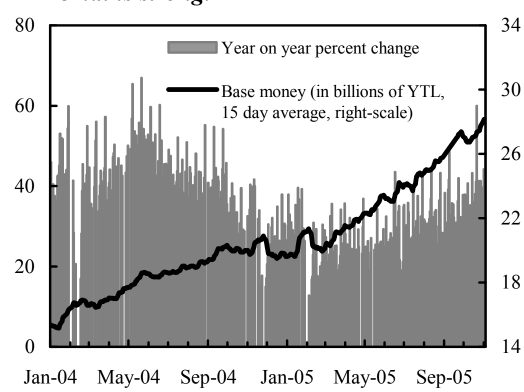
...but real interest rates have stabilized recently.



Nonetheless, the yield curve has continued to shift down.



Given these conditions, base money demand remains strong.



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

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

2/ CBT overnight borrowing interest rate divided by 12 month ahead rate of consumer price inflation.

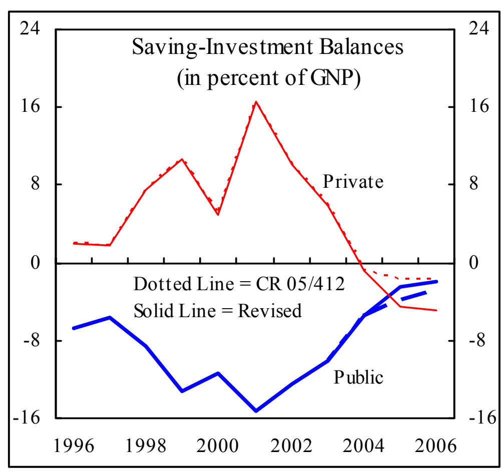
- Containing the rising social security deficit was seen as key to preserving fiscal sustainability and improving the structure of the budget. In this regard, the authorities decided to control health spending, keep pension increases in line with inflation, and strengthen social security collections.

- Staff noted that reinvigorating the structural reform program was critical to sustaining Turkey's good economic performance, and the authorities' comprehensive reform agenda, including on pension and state bank reforms, income taxes, bank supervision, and privatization, was key in this respect.

A. Macroeconomic Framework and the Widening Current Account Deficit

9. **Economic growth was seen as evolving broadly in line with program assumptions** (¶5 and Table 2).[1] The authorities and staff agreed that a number of factors (improving business and consumer confidence, rising industrial production, falling interest rates, and favorable base year effects) pointed to an acceleration of annual growth during the second half of 2005. Thus, the program target of 5 percent GNP growth should be achieved, though with a lower-than-expected contribution from the external sector. For 2006, it was agreed to retain the 5 percent growth projection, which, while consistent with market consensus, is at the lower end of the range of estimates of Turkey's potential growth rate.

10. **Yet the outlook for the current account was now worse than envisaged at the outset of the program** (¶6 and Table 3). The improvement in the external balance had been predicated on a narrowing of the public sector savings-investment imbalance outpacing an expected deterioration in private savings-investment balances. In the event, the improvement in the overall fiscal balance has materialized much faster than expected, with increased confidence leading to a significant drop in the government's net interest bill. However, this has been more than offset on the private side, as declining interest rates spurred private investment, and lower government interest payments reduced private disposable income and savings. With private investment levels likely to be sustained as the process of financial deepening continues, only a modest improvement in the overall savings-investment balance is now foreseen over the remainder of the program.



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

11. **The current account deficit is therefore now projected to stabilize at around 6 percent of GNP in 2006, declining only gradually to around 4½ percent in 2008**. As a result, the *gross* external debt dynamics have worsened, though the rapid reserve build-up means that *net* external debt is now lower than programmed (Appendix III). The new baseline for the current account is not without risk. If global liquidity remains high, further upward pressure on the real exchange rate and lower exports might be expected. By contrast, should inflows decline, this may bring about a lira correction, and the current account could potentially adjust more rapidly than shown in the new baseline projections. Finally, each dollar increase in the price of oil translates into a 0.1 percent of GNP deterioration of the current account.

Text Table. Changes in Key External Program Assumptions, 2005-08

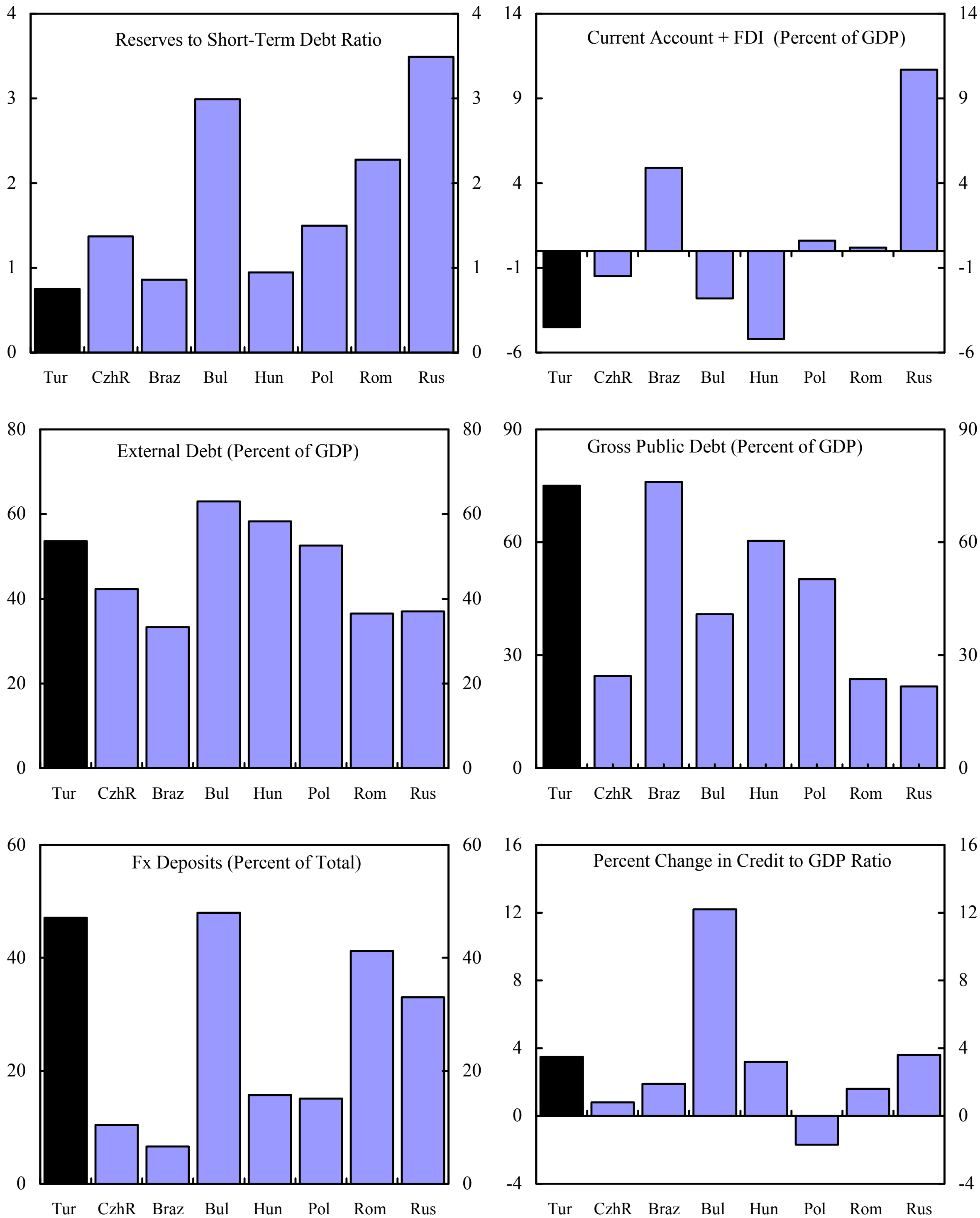
	2005		2006		2007		2008	
(In billions of U.S. dollars, unless otherwise noted)	CR/05/412	Rev.	CR/05/412	Rev.	CR/05/412	Rev.	CR/05/412	Rev.
Current account balance, percent of GNP	-4.4	-6.0	-3.5	-5.8	-2.8	-5.1	-2.5	-4.6
Export volume growth	11.9	7.2	12.0	9.1	10.4	10.1	10.0	9.8
Import volume growth	8.3	7.1	7.6	6.6	8.0	6.8	8.0	7.0
Gross international reserves	39.7	53.9	39.5	58.7	40.2	57.8	41.3	56.9
In percent of short term debt (residual maturity)	69.4	85.7	62.1	82.4	57.2	75.2	54.0	69.0
Gross external debt, as percent of GNP	48.3	50.8	48.0	51.9	46.3	50.9	44.8	50.0
Net external debt, as percent of GNP	36.3	30.3	35.6	31.9	34.1	32.8	33.0	33.5

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

12. **The staff argued that increased reliance on foreign savings had made the economy more vulnerable** (Tables 4−5). While a gradual unwinding of the recent strengthening of the lira would facilitate an orderly external adjustment, the staff noted that a sudden stop in capital inflows could lead to a sharp lira depreciation and a disorderly adjustment. In particular, government and private sector balance sheets could become seriously impaired—due to their high reliance on unhedged foreign currency borrowing and the presence of maturity mismatches—if the exchange rate correction was too rapid or went beyond that needed to unwind the existing misalignment. The authorities acknowledged these risks, while noting that they were mitigated by: (i) the floating exchange rate; (ii) improved public debt dynamics (Appendix IV); (iii) higher foreign exchange reserves and lower net external debt; (iv) improved quality of external financing; and (v) a well-capitalized banking system. Staff concurred that balance sheets had strengthened, but noted that vulnerabilities remained high (Figure 4).

13. **Against this backdrop, it was agreed to rebalance policies, with fiscal tightening making room for a gradual easing of the monetary stance and additional reserve buildup**. In the absence of undue domestic demand pressures, and with the widening current account deficit mainly attributable to a capital inflow-induced exchange rate appreciation and terms of trade deterioration, an overall policy tightening was not advisable. Moreover, the room for maneuver on fiscal policy was limited, and any monetary easing would have to be measured to avoid creating conflicts with the inflation target.

Figure 4. Cross-Country Vulnerability Indicators, 2004



Source: IMF, Fund staff estimates.

14. **The following policy response was therefore agreed**:

- **An effective fiscal tightening of ¼ percent of GNP of the primary surplus in 2006**. Given the continued expected reduction in net interest payments, the tightening of the overall fiscal balance is some ¾ percent of GNP. Revenue overperformance would be saved, with limited exceptions for high-priority investment (¶12).

- **Monetary policy easing to continue, but without compromising inflation targets**. Further policy rate cuts could reduce the attractiveness of Turkish assets and help with the current account, but this would need to be balanced against adverse pass-through effects to inflation.

- **A continued build-up of foreign reserves for prudential reasons**. Staff noted that this may help "lean against the wind" on the exchange rate. In order to ensure that foreign exchange purchases were adequately sterilized, however, even closer coordination between Treasury and the central bank would be needed.

B. Fiscal Policy

Budgetary policies: 2005–06

15. **The authorities confirmed their resolve to meet this year's public sector primary surplus target of 6½ percent of GNP** (¶9, ¶16 and Table 6). With baseline projections showing that the target could be missed by 0.2 percent of GNP, the authorities indicated they would take compensatory measures to meet the headline primary target. While welcoming this commitment, staff expressed concern about the social security deficit in excess of the 4½ percent of GNP indicative target and the introduction of unplanned agricultural subsidies. The authorities indicated that measures to improve contribution collections and control health spending were being implemented, but their effect would be felt mostly in 2006. Moreover, the *net* overrun on agricultural subsidies would be modest and the extra spending was viewed as socially necessary given rising fuel costs and lower than expected grain prices.

16. **The 2006 budget is consistent with maintaining a public sector primary surplus of 6½ percent of GNP** (¶10). With next year's budget having to do without the contributions from newly-privatized Türk Telekom and oil-refinery TÜPRAŞ to the primary surplus, the target implies an effective fiscal tightening of at least ¼ percent of GNP. Achievement of the budget target is predicated on a sharp improvement in the social security balances, driven by measures to control health spending and (conservatively estimated) one-off revenues from the restructuring of arrears (see Text Table below).

Text Table. Fiscal Tightening in 2006 1/
(Consolidated Public Sector, in percent of GNP)

Change in primary balance	0.3
o/w: Fiscal impulse ("-" is tightening)	-0.3
Change in overall balance	0.8
Change in operational balance 2/	0.0

1/ For comparability with 2005, the contribution of privatized enterprises to the primary surplus is added back to the 2006 fiscal figures.
2/ The operational balance is obtained by adding the real component of interest payments to the primary balance.

Text Table. Changes in Fiscal Program, 2005−06

	2005	2006	Change	Measure/Explanation
Public sector primary surplus, *of which:*	**6.50**	**6.58**	**0.08**	
Consolidated budget	**5.03**	**5.10**	**0.07**	
Revenues, of which:	25.28	25.45	0.16	
Direct taxes	7.45	7.39	-0.06	Reflects effect of falling interest rates on personal income tax collection.
Indirect taxes	17.21	17.16	-0.06	Reflects declining petroleum excises
Nontax revenue	3.23	3.56	0.33	Increase driven by SEE dividends, regulatory bodies' profit transfers, and one-off GSM-related revenues
Expenditures, of which:	20.25	20.35	0.09	
Personnel	7.90	7.94	0.05	Reflects wage agreement reached with unions
Social security transfers	4.83	4.31	-0.52	Improvement driven by arrears restructuring, savings in health spending, and restricting pension indexation to inflation
Agricultural subsidies	0.79	0.74	-0.05	
Capital expenditure and transfers	2.33	2.48	0.15	Policy decision to increase investment
Measures	-0.18	0.00	0.18	
Extrabudgetary funds	**0.00**	**0.23**	**0.23**	Improvement arising from the non-recurrence of the recapitalization of state tobacco monopoly (TEKEL), which depressed 2005 figures
State economic enterprises	**0.77**	**0.56**	**-0.21**	Privatization of profitable TÜPRAŞ and Telekom, offset slightly by increasing surpluses of other SEEs

Source: IMF staff estimates.

17. **The proposed budget does not, however, deliver fully the structural improvements envisaged under the program**. On the spending side, the already-high civil service bill was allowed to grow slightly faster than nominal GNP and farmer subsidies were kept above last year's budget in lira terms. At the same time, the adjustment in the social security deficit, while welcome, is achieved in part via one-off measures, without which the *underlying* deficit is slightly above 4½ percent of GNP. More positively, the budget allows for an increase in the ratio of capital transfers and expenditures to GNP, as well as a real decrease in high petroleum excises (¶11). And, for the first time, the budget is cast in the context of a medium-term fiscal framework, which extends the budget target through 2008.

Social security measures

18. **Looking further ahead, it was agreed that achieving budgetary objectives in 2006 and beyond depended critically on containing the large social security deficits** (¶13).

- Although the pension reform law had to be postponed, the authorities committed to ensure that **pension** increases will be consistent with the inflation objective and the social security envelope provided for in the 2006 budget.(see paragraph 20).

- To gain greater control over **health** spending by social security institutions, the authorities would introduce lump-sum budgeting for state hospitals and had introduced measures to limit pharmaceutical costs. Spending would be closely monitored and prompt corrective actions taken in the event of fresh overruns.

- The authorities have developed far-reaching reforms to strengthen **social security collections** and provide a comprehensive solution to outstanding arrears (6 percent of

- GNP, but with a large fraction being very old and not collectible). These reforms—developed with the support of Fund technical assistance—require recipients of subsidies to be current on tax and social security obligations, add collection staff, prioritize and outsource collection of arrears, streamline penalties and interest schedules to provide incentives to stay current, include a five-year statute of limitations for uncollectible arrears, and allow a one-time restructuring of collectible arrears.

- In justifying their proposed **restructuring of social security arrears**, the authorities explained that many debtors who found themselves in financial distress in the wake of the 2001 financial crisis could not later afford to regularize their arrears due to the high real interest rates (over 50 percent during 2002−03) and penalties applied on unpaid balances. Under the proposed restructuring, large debtors would be dealt with on a case-by-case basis, with write-downs linked mechanically to capacity to pay indicators and capped at 30 percent of accrued obligations. Given the large number of small debtors (including around 2 million low-income farmers and tradesmen), the authorities deemed it infeasible to restructure these arrears based on individual ability to pay. Instead, they proposed revaluing arrears using inflation—effectively waiving penalties and real interest and leading to a generalized write-down (between 20–40 percent) that is inconsistent with the performance criterion against new amnesties.

- Given the moral hazard involved with generalized write-downs, staff argued for revaluing arrears using non-punitive, though positive, real interest rates. The authorities, however, rejected this approach, arguing it would deter participation in the restructuring. They agreed, though, that all debtors be charged treasury borrowing rates during the repayment period with a discount for early repayment. Finally, the authorities expect that the policy measures taken to strengthen collections would prevent the recurrence of substantial arrears and, to underscore their commitment not to offer future generalized write-downs, they agreed to retain the continuous performance criterion against new amnesties.

C. Structural Fiscal Reforms

Social security reforms

19. **Responding to filibustering by the opposition in parliament and calls for more consultation, the authorities requested a delay in the passage of the pension reform law to early 2006** (¶17). They also stressed the importance of following a consultative approach, given that this reform will affect a large share of the population. The authorities therefore proposed making approval of the pension law (originally a structural performance criterion for end-June 2005) a performance criterion for the third review. It was understood that implementation of Universal Health Insurance, which results in additional costs to the budget and is covered in the same piece of law, would also be delayed.

20. **While agreeing to the proposed delays, staff stressed that the content of the pension reform needed to be preserved during the proposed round of new consultations**. As safeguards, and given that the parametric pension changes (and resulting savings) would now come into effect with a year delay (January 1, 2007), the authorities decided to keep pension increases in 2006 within the indexation formula envisaged in the pension reform law. They also agreed to make the social security deficit ceiling a performance criterion. The delay in implementing Universal Health Insurance would yield some additional savings. Staff stressed the urgency of putting in place the companion administrative social security law, needed to unify the three social security institutions and facilitate timely implementation of the parametric reform (an end-June structural benchmark). In response, the authorities agreed to make submission to Parliament of this law a prior action and to seek its early passage.

Tax reforms

21. **Good progress was made on tax policy reforms** (¶14). It was agreed to bring forward corporate income tax (CIT) reforms and to phase in gradually the more complex and far-reaching personal income tax (PIT) reforms.

- The **CIT reform** would entail a 10 percentage point reduction in the headline rate and the elimination of the investment tax allowance. The net cost of the CIT reform was estimated at 0.4 percent of GNP, absent compensatory measures. The authorities believed this cost could eventually be much lower given increased compliance and economic activity. Nonetheless, they agreed to implement a set of compensating measures for next year, including specific revenue and expenditure savings.

- The **PIT reform** would start with the simplification of the tax structure by end-2005. Additional reforms would be undertaken during 2006 to broaden the base and make the tax more progressive—including by streamlining existing allowances and exemptions and reforming the existing system of consumption credits.

- As regards the highly distortionary **financial transaction taxes**, the authorities noted that the budget situation precluded upfront action, but restated their commitment to phase out these taxes during the program, starting with the Banking and Insurance Transaction Tax (yielding annually 0.3 percent of GNP) by end-2006.

22. **Staff urged the authorities to accelerate tax administration reforms** (¶15). Despite passage of a new revenue administration law in April, progress in implementing the needed reforms had been slow. In particular, devolving tax policy to the Ministry of Finance, setting up a large taxpayer unit, reorganizing the new revenue administration entity along functional lines, and improving control over regional offices had seen little movement, mainly reflecting bureaucratic inertia. In response, the authorities committed to accelerating reforms in these areas, but, given delays to date, it was agreed that the setting up of a new large taxpayer unit be postponed to end-June 2006 (structural benchmark).

Other structural fiscal reforms

23. **Progress in other fiscal structural areas had not been satisfactory**. These reforms aim at improving the quality of fiscal management and maintaining fiscal discipline:

- The **SEE governance law** (end-September structural benchmark, ¶19) needed further consultation with related agencies to build consensus. The authorities were considering ways to meet the program objectives of streamlining the procedures and performance management of the SEEs.

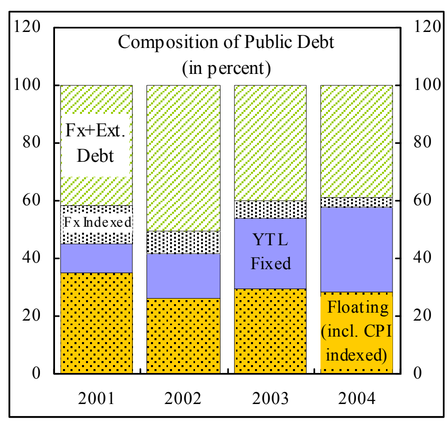
- Secondary legislation under the **Public Financial Management and Control Law** (end-September structural benchmark, ¶20) had been delayed as the authorities felt it was necessary to go back to Parliament and amend the law itself, *inter alia*, to introduce the concept of "internal control," in line with EU standards. The revised amendments were being discussed in Parliament, and it was expected that secondary legislation—not requiring Parliamentary approval—could be issued before the new financial management and control regime goes into effect at the start of 2006.

- The **restructuring of municipal debt** was still in progress and the planned end-September report on restructured debts had to be delayed (¶18).

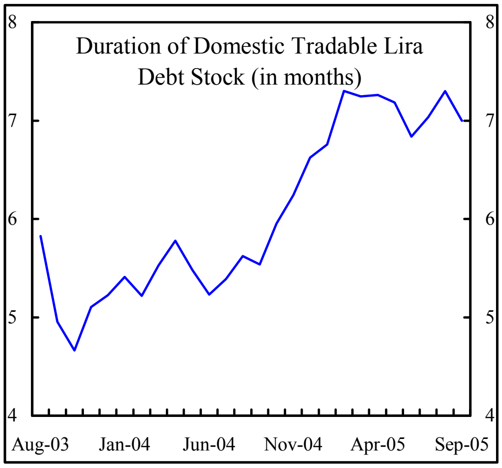
D. Debt Management

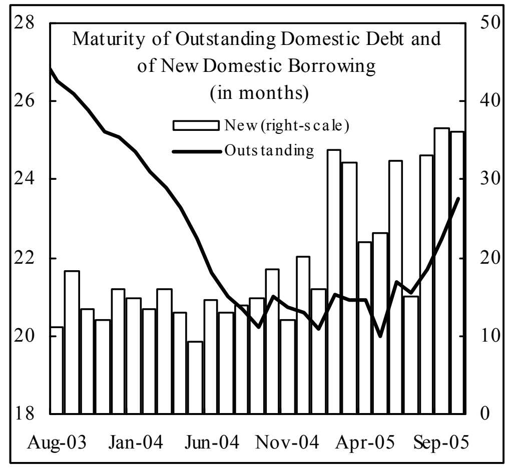
24. **The authorities were making further improvements in debt management**:

- **Treasury deposits at the central bank had increased in recent months**, aided by a stronger overall fiscal balance and high debt rollover rates. Treasury deposits now covered more than half of average monthly domestic redemptions, helping reduce rollover risk and providing support with the sterilization of lira liquidity emanating from the central bank's foreign exchange purchases.



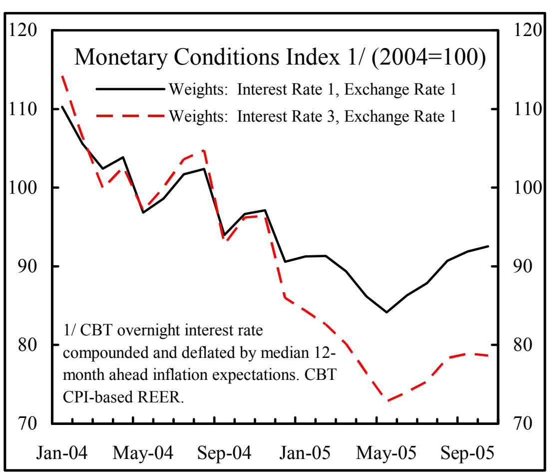
- **The composition of the public debt stock had also improved**. The authorities noted that the lengthening of maturities had reduced rollover risk. However, continued reliance on floating rate paper implied an interest rate risk similar to that of shorter-term paper. The authorities agreed that, with the formal start of EU accession talks, moving to longer-term fixed rate lira issues would be accorded priority. They also noted that the composition of debt would further improve with the substantial amounts of foreign exchange indexed debt being retired during 2006.

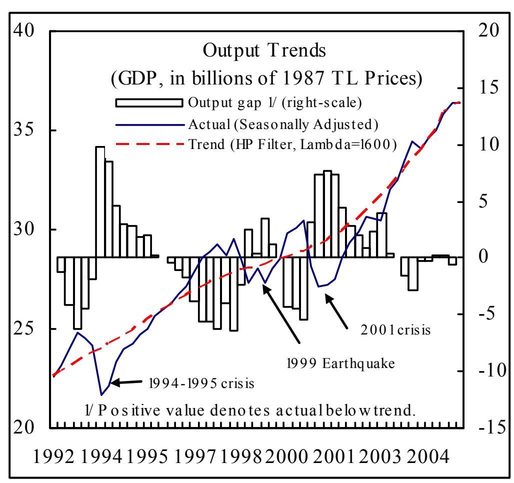




E. Monetary and Exchange Rate Policies (¶7–8)

25. **It was agreed that the 2005 inflation target would likely be met, but that next year's 5 percent target was more challenging.** Although underlying inflation and inflation expectations had edged down, services inflation remained sticky. High and volatile commodity prices also posed risks to the outlook. Here it was agreed that monetary policy should not react to the direct impact of higher oil prices on headline inflation—estimated at close to 1 percentage point in 2005—but rather focus on second round inflation effects. Staff also observed that other factors, including a broadly closed output gap and the lagged impact of past interest rate cuts, could weigh on next year's inflation performance. Against this backdrop, it was noted that, despite the interest rate and quantitative easing earlier this





year, monetary conditions had not loosened due to the appreciation of the lira. Going forward the central bank would continue with its cautious approach to easing policy interest rates so as not to endanger the inflation objective.[2]

26. **With regard to monetary policy implementation in 2005−06, it was agreed that:**

- **The central bank would target an ambitious international reserves build-up**. This year alone, the central bank had purchased US$21 billion in foreign exchange—leading to NIR overperformance of some US$13 billion. Given the still low reserve coverage of short-term external debt, it was agreed to lock in reserve overperformance and target an increase of US$8½ billion in net international reserves during 2006.

- **The end-2005 base money ceiling would be raised, though by less than the targeted NIR increase** (Tables 7−8). Staff and the authorities concurred that money demand would likely continue to increase rapidly, reflecting a variety of factors, including confidence in the lira and ongoing financial deepening. Accordingly, the end-year base money ceiling was raised to YTL 29.2 billion—a 17-percent increase relative to the original program ceiling.

Text Table. Analytical Balance Sheet of the Central Bank

(In billions of YTL, constant program cross exchange rates)

	End-2004	End-October 2005	Difference
Base money	20.2	28.9	8.7
Net foreign assets	11.0	31.1	20.1
Net domestic assets	9.2	-2.2	-11.3
Open market operations	-3.6	-4.3	-0.7
Net credit to government	16.1	5.3	-10.8
Credit	23.5	19.5	-4.0
Deposits	7.3	14.1	6.8
Other	-3.3	-3.2	0.1

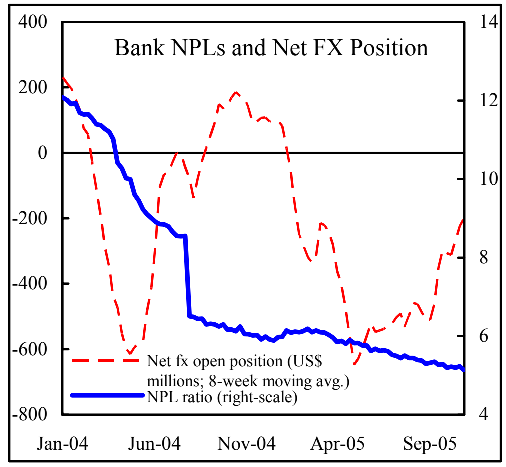
Source: Central Bank of Turkey.

The central bank would issue soon public statements to present the broad inflation targets (jointly with the government) and to disclose details of the new inflation targeting regime.

F. Financial Sector Reforms

27. **Although banks' financial conditions continued to improve, staff cautioned that rapid lending growth needed to be monitored carefully** (Table 9 and Box 3). Net profits had increased sharply, the share of nonperforming loans was being steadily reduced, and the capital adequacy ratio in the banking system remained high. The authorities noted that, in a clear sign that the financial system had been brought back to soundness, foreign investor interest in the banking sector was steadily increasing (with the share of the banking system

[2] Correspondingly, after a three-month pause, the central bank cut its interest rates by 25 basis points in October and again in November (to 13.75 percent).



under foreign control increasing from just 3 percent at end-2004 to 13 percent). However, rapid credit growth—loans increased by 22 percent in the first half of the year—while helping profitability in the near term, was a potential source of vulnerability. At the same time, lira funding remained mostly of short term maturity, while banks continued to rely on large scale foreign exchange borrowing to support balance sheet growth. And competition for deposits had led to a compression in banks' lending margins. The authorities concurred that these developments needed to be monitored closely, as banks' increased exposure to market risk meant that a financial shock could quickly erode profit margins. The staff, therefore, advised the BRSA to closely assess banks' loan approval procedures and monitor closely on- and off-balance sheet operations in foreign currency.

28. **The BRSA had begun drafting the regulations needed to implement the recently adopted banking law** (approval of this law was an end-June 2005 structural performance criterion, ¶21). Staff welcomed efforts in this area, but encouraged the BRSA to seek outside assistance, given the scale of the task involved. Staff also endorsed the BRSA's plan to complete by end-2005 the organizational changes required under the banking law, including reforms recommended by the Imar inquiry.

29. **The SDIF had made good progress in the resolution of assets in its portfolio** (end-2005 structural benchmark, ¶23). The institution has been widely praised for the efficiency and transparency of its asset sales, and the recovery rates have substantially exceeded expected valuations. Staff welcomed the authorities' commitment to resolve the bridge bank (Bayındır) once the asset resolution process had been completed in 2007.

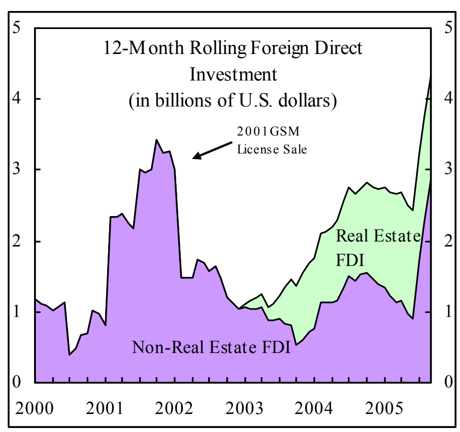
30. **The privatization of state banks faced further delays (**¶22). While the first IPO of Vakif bank was successfully completed ahead of its end-December 2005 deadline, a financial adviser for Halk was now expected to be hired only by January and the timetable for the bank's privatization was delayed until end-June 2006 (structural benchmark). The authorities insisted that a decision on Ziraat should be pushed back to later in 2006, so that due account could be taken of the experience with Vakif and Halk. They contended that, given the large size of Halk and Ziraat (jointly comprising over a third of the total banking sector), it was important to proceed sequentially. The authorities also requested that the adoption of a timetable for phasing out special privileges and obligations of state banks—which require a proper assessment of their balance sheets and long-term viability—be put back to end-March (structural benchmark), so as to incorporate input on how to proceed from the financial adviser to be retained for Halk.

31. **It was agreed that legislation establishing a framework for mortgage lending would be implemented gradually** (¶24). The Capital Markets Board had prepared a draft mortgage law, expected to be passed by Parliament by end-year. Besides setting the stage for mortgage lending and securitization, the law also defined rules for appraisers, and removed the existing limitation on variable rate consumer lending. While welcoming the new legislation, staff cautioned on the risks of mortgage lending taking off too rapidly. In response, the authorities agreed to phase in the implementation of the law gradually. Finally, while the draft law allocated primary supervisory responsibility of specialized mortgage institutions to the Capital Markets Board, staff argued that, as in other EU countries, the banking supervisor, in this case the BRSA, should take the lead.

G. Measures to Improve the Investment Climate (¶25–26)

32. **Staff welcomed the authorities' recent success in privatizing state enterprises and their intention to use privatization receipts to reduce debt**. During 2005, some 25 enterprises had been privatized, including some of the largest and most profitable. Tenders for Türk Telekom, oil refinery TÜPRAŞ, and steel manufacturer Erdemir were recently completed. Encouragingly, court rulings, which derailed past privatization efforts, had so far been supportive. Headline privatization revenues in 2005 are expected to exceed US$16 billion (4½ percent of GNP), though the actual financial flows will be spread out over several years, as payments may be made in installments. The privatization administration was expected to turn its attention next year to the remaining companies in its portfolio, including in the electricity distribution sector.

33. **The authorities planned to amend the law allowing real estate purchases by non-residents—an important source of FDI**. In March, the Constitutional Court overturned legislation, effectively prohibiting further real estate purchases by non-residents (this decision, which has been in force since end July 2005,did not affect legally-established foreign companies and was not applied retroactively to individuals). The government recently submitted a new draft law that addressed the earlier constitutional problems. Staff welcomed this move, as purchases of real estate by non-residents had amounted to US$1.3 billion in 2004, or almost half of total FDI.



IV. Program Modalities

A. Program Monitoring (¶1–4)

34. **The attached supplementary Letter of Intent describes progress in implementing the program supported by the Fund and sets out conditionality through end-2006**.

- **Quantitative conditionality** (Annex A). End-June and end-September quantitative performance criteria for which data are available were observed, with the exception of the end-September base money ceiling. Based on available data through August, the end-September floor on the cumulative primary balance of the consolidated government sector including SEEs is expected not to have been observed.[3] The indicative targets on the social security deficit and privatization proceeds were missed as well. Given its importance, the authorities proposed complementing the indicative targets on the social security deficit with semi-annual performance criteria (¶13). Monetary policy conditionality was also adjusted to reflect the adoption of inflation targeting. While net international reserve floors were retained, it was proposed that base money and net domestic asset ceilings be replaced in 2006 with a standard inflation consultation clause (Annex D).[4] Finally, the authorities proposed to modify the definition of the medium- and long-term debt performance criterion to allow for liability management operations to improve the debt profile.

- **Structural conditionality**. Table 1 summarizes progress in implementing structural conditionality. As a prior action, the social security administrative reform law will be submitted to Parliament. The authorities' Letter of Intent includes the following new structural performance criteria (Annex B): (i) personal income tax legislation will be submitted to Parliament by end-May 2006 and passed by end-September 2006 (¶14); (ii) the social security administrative reform law will be approved by Parliament by end-January 2006 (¶17); and (iii) parliamentary passage of pension reform legislation, which was originally a performance criterion for June 2005, will be reset as a performance criterion for mid-February 2006 (¶17). Given progress in labor shedding by the SEE sector and the need for additional flexibility at particular firms with aging workforces, it was proposed that the benchmark limiting new hires to 10 percent of attrition be redefined to apply to the sector as a whole, rather than on a firm-by-firm basis.

B. Phasing

35. **It is proposed that the December 2005 purchase subject to the completion of the third review be rephased evenly over the remaining purchases and that the number of scheduled reviews be reduced from eleven to ten** (Annex C). Due to delays in completing

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[3] The narrower target excluding SEEs was met by a margin of less than 0.01 percent of GNP. An updated assessment of performance in relation to the fiscal targets and the outlook for the remainder of the year will be provided prior to the Board meeting. It is expected that this will include figures on the end-September primary balance including SEEs.

[4] A forward-looking clause would be considered, once further experience under the new regime had been gained.

scheduled program reviews and drawing associated purchases, Fund exposure to Turkey (Table 10) has decreased at a faster pace than envisaged.

C. Data Issues

36. **The State Institute of Statistics is planning to release revised national account data in early 2006**. This is widely expected to lead to a substantial upward revision in nominal GDP. Although the revised data will include updated estimates for the unrecorded economy, the bulk of the revision will reflect improved estimation techniques and updated survey data (benefiting in part from the recently conducted Census). Staff has fielded several technical assistance missions and encouraged the authorities to explain the nature of revisions to key users and to publish the revised data only after all quality checks have been completed.

V. Staff Appraisal

37. **The economy continues to perform well, although the widening current account deficit is a growing concern**. Economic growth has moderated in line with program assumptions and this year's inflation target is likely to be undershot for the fourth year in a row. These positive outcomes are largely the result of the authorities' steady adherence to the macroeconomic policies contained in their Fund-supported program. The main risks to the outlook are linked to the continued widening of the current account deficit and the sizable appreciation of the lira on the back of heavy capital inflows.

38. **The authorities' response to the widening current account deficit has been appropriate**. Domestic demand does not appear to be the root cause of the widening deficit, suggesting that a rebalancing rather than overall tightening of the policy stance is called for, as the authorities propose. This should be accompanied by a further build up of a prudential reserve buffer. Given the uncertain evolution of the current account, the authorities will be best served by saving revenue overperformance, especially if high credit growth and rising domestic demand translate into a further worsening of the external position. In this case, the authorities may also have to consider a further outright tightening of fiscal policy.

39. **The commitment to a strong 2006 budget is welcome, and the authorities should resist calls to introduce initiatives that weaken its quality**. The strong budget will facilitate a further reduction in the public debt burden—still a key source of vulnerability—and should help rein in the widening current account deficit. From this perspective, as well as on structural grounds, the authorities should resist pressures to introduce policy initiatives outside the regular budget cycle and should promptly offset any emerging deviations from budget assumptions.

40. **Achieving the program's fiscal objectives in 2006 and beyond depends critically on containing the rising social security deficit**. The authorities' commitments to keep pension increases in line with inflation, control health spending, and introduce far-reaching reforms that strengthen collection of social security contributions are critical in this respect. Their full implementation is needed to keep the widening social security deficit under control

and create room over the medium term to eliminate tax distortions and increase investment spending. Thus, if further health or pension overruns emerge, it will be essential to take prompt corrective measures to ensure the success of next year's fiscal program.

41. **In this context, it is essential to avoid further setbacks in implementing the pension reform law**. Passage of this law is required to ensure the viability of the social security system. While more time is needed for parliamentary debate and public consultations before the law can be passed, the government should do its utmost to move ahead as early as possible in 2006. At the same time, calls to water down the content of the reform will need to be strongly resisted. Given its importance, passage of the law in a satisfactory form will be a key condition for the next program review. Early passage is also needed of the companion administrative social security reform law to make implementation of the parametric reform possible by the start of 2007.

42. **Rigorous implementation of the agreed solution to the social security arrears problem will be crucial in helping to avoiding another build-up of arrears**. The amnesty element embedded in the arrears restructuring of the predominantly low-income small debtors is regrettable. For large debtors the decision to mechanically link write-downs to payment capacity, together with enhanced collection enforcement measures, should limit moral hazard problems. More importantly, the complementary introduction of a comprehensive package of measures to strengthen collections should minimize the recurrence of arrears. The authorities will need to ensure that the associated legislation incorporates faithfully all the elements of the agreed framework, and follow through with their commitment to avoid new amnesties.

43. **The authorities' progress on tax policy reform is welcome, but needs to be complemented by greater efforts to strengthen tax administration**. Strengthening of tax administration could provide additional resources to improve the tax structure. Priorities in this area are to set up a large taxpayer unit and add resources for tax audits. The proposed acceleration of corporate income tax reforms, alongside a more gradual phasing in of personal income tax reforms is appropriate. Introducing an early sizeable cut in the headline corporate income tax rate should send a helpful signal to prospective investors, reduce informality, and increase competitiveness. At the same time, the proposed elimination of the generous investment tax allowances will remove a tax distortion in the allocation of factors of production and should encourage employment. The authorities' commitment to offset the initial cost of this reform with measures is welcome though, given the non- recurrent nature of the identified fiscal savings, additional measures may be required to ensure this reform does not open a fiscal gap beyond 2006. The proposed simplification of the personal income tax code is another welcome step, and the authorities are encouraged to make quick progress in implementing the promised, more fundamental, changes aimed at broadening the tax base and making the personal income tax system less regressive. Looking ahead, further delays in phasing out the highly distortionary financial transactions taxes should be avoided.

44. **Turning to monetary policy, further easing and reserve accumulation should be pursued as needed, but without endangering the inflation objective**. The central bank is correct to continue its cautious approach to interest rate cuts and the proposal to accommodate faster base money growth than programmed in 2005 is also appropriate, in

view of strong indications that this reflects an upward shift in the demand for lira assets. The central bank is to be commended for advancing its preparations for next year's introduction of formal inflation targeting. With regard to foreign exchange intervention policy, the central bank should continue to take advantage of favorable market conditions to further augment its reserves and increase Turkey's still low reserve coverage of short-term external debt.

45. **Steady progress should continue to be made to strengthen the institutional framework for bank supervision**. The BRSA should stick closely to its timetable for drawing up and implementing the new banking regulations. The internal organizational changes needed in the wake of the Imar inquiry findings and the new banking law should also be implemented promptly and in full. Bank supervisors will need to pay close attention to potential sources of vulnerability in the banking system, including increased foreign exchange borrowing, rising maturity mismatches, and rapid credit expansion. In this regard, it will be important to introduce the planned mortgage lending reforms in a phased manner, with the BRSA taking the lead in supervising mortgage lending.

46. **Continuing delays in state bank privatization are regrettable**. The latest delays mean that the timetable and modalities for Halk's privatization will now only be agreed by mid-2006, with the process for Ziraat starting even later. And, while the first IPO of Vakif bank was completed successfully, a follow-on strategy to bring full private sector control in the bank is yet to be defined. The authorities have also delayed a decision on the timetable for phasing out state bank privileges and obligations. The staff is not convinced that these delays were necessary, but deferred to the authorities' preference to have input from the investment advisers before making a decision. Given the checkered history of efforts at state bank privatization, it will be important to keep up the momentum by getting all aspects of the strategy in place as soon as possible.

47. **The authorities are to be commended for their recent successes in privatizing state enterprises and disposing of the assets in SDIF's portfolio**. The privatization of some of the largest and most profitable state enterprises, along with the high recovery rates achieved by the SDIF, are major achievements. Staff is also encouraged by the commitment of the privatization administration to press ahead with the sale of the remaining, less profitable, enterprises and with the liberalization of the energy sector.

48. **The authorities' commitment to implementing the revised program in full is welcome and is critical to sustaining Turkey's current good economic performance**. So far, the authorities' macroeconomic policies have been prudent, but structural reform implementation has been mixed. With parliamentary elections on the horizon, and a diminished sense of urgency given strong capital inflows and the start of EU accession talks, the political environment for reform is now more challenging. In this context, a key risk to the program is that reforms requiring legislative action—especially on social security—suffer further delays. To maintain market confidence and sustain good economic performance, the authorities are therefore urged to reinvigorate implementation of delayed structural measures under the program.

49. **Even with full program implementation, Turkey remains exposed to risks, owing to its high public debt and its continued reliance on short-term and foreign currency borrowing**. Although it has declined markedly, Turkey's public debt burden remains too high and its structure vulnerable. On the external side, large capital inflows and an overvalued currency have complicated economic management. The ongoing rapid credit expansion, albeit from a low base, and the sensitivity of the current account to oil price and exchange rate developments represent additional risks. The authorities should therefore take advantage of the current benign global environment to further increase reserves, lengthen borrowing maturities, and ensure policies are consistent with attracting foreign direct investment.

50. **In light of program implementation to date, and the undertakings in the authorities' supplementary Letter of Intent, staff supports the requests for completing the first and second reviews, modifying performance criteria, and rephasing purchases**. Staff also supports the requests for waivers of nonobservance of the end-September quantitative performance criteria on base money (which can be considered as a minor deviation in light of continued favorable inflation developments), and on the end-September cumulative primary balance of the consolidated government sector including SEEs (given the authorities' commitment to the primary surplus target for the year as a whole). It also supports the request for waivers of nonobservance of the structural performance criteria on the passage of the banking law (for which the deviation was temporary) and the pension reform law (given that the authorities are taking steps to prevent such a delay giving rise to budgetary overruns in 2006).

Box 1. Turkey: Growth (Cont.)

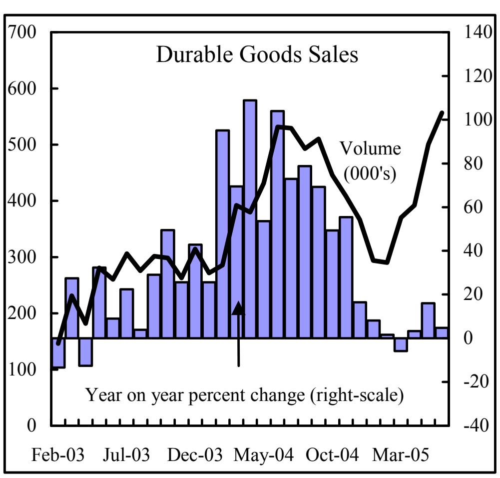
Data through the first six months of 2005 support the scenario of a soft landing. However, growth has become more reliant on domestic demand than earlier envisaged. Domestic demand is in turn mainly driven by investment, in particular in construction, while credit and confidence indicators also remain supportive. Combined with a pick-up in industrial production and capacity utilization in the second half of the year, growth of 5 percent in 2005 and 2006 remains achievable. Though these growth projections are in line with market consensus, a key risk to the outlook relates to the prospects for the external sector given the strength of the lira.

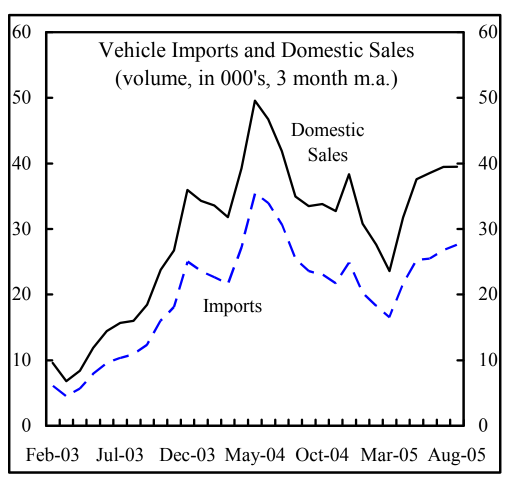
With the release of second quarter GNP numbers, Turkey has registered the fourteenth consecutive quarter of positive growth since the crisis (Text Table). For the first six months of 2005, GNP posted 4.3 percent year-on-year growth (GDP 4.5 percent) compared to the same period in 2004. On a seasonally adjusted basis, this implies that quarterly GNP growth will need to accelerate from 1.2 percent in the second quarter to 1.4 percent in the remaining two quarters to reach 5 percent on average for the year as a whole. 1/

Turkey - Quarterly Real Output and Expenditure 2004-2005

	Quarterly						Annual	
	Mar-04	Jun-04	Sep-04	Dec-04	Mar-05	Jun-05	2004	2005
	(year on year growth rate, in percent)							
Gross National Product	13.9	15.7	5.7	6.6	5.3	3.4	9.9	5.0
Gross Domestic Product (demand side)	11.8	14.4	5.3	6.3	4.8	4.2	9.0	5.0
Domestic Demand	20.6	21.4	8.1	8.5	4.4	6.4	14.1	5.1
Consumption	11.6	15.4	5.9	4.7	4.0	4.4	9.0	5.2
Private	12.4	18.4	7.3	3.6	4.0	4.4	10.1	5.4
Public	2.6	-7.8	-7.0	11.1	4.3	4.0	0.5	3.0
Gross Investment	47.9	33.5	14.6	17.8	5.2	9.9	27.4	5.1
Gross Fixed Investment	57.6	47.4	26.1	11.2	6.9	17.9	32.4	8.8
Private	65.5	63.1	38.9	17.7	4.8	15.8	45.5	9.0
Public	-5.9	-8.7	-10.8	0.9	36.6	31.1	-4.7	8.0
Change in Stocks	29.5	11.0	-23.2	48.7	1.2	-7.2	14.7	-6.0
External Balance	960.1	266.7	-31.2	-547.4	0.0	30.6	-360.1	8.7
Exports of g & nfs	10.9	17.2	8.2	14.4	11.3	4.7	12.5	7.3
Imports of g & nfs	31.3	32.7	16.1	19.6	9.3	9.2	24.7	7.4
	(Contribution to growth, in percent)							
Gross Domestic Product (demand side)	11.8	14.4	5.3	6.3	4.8	4.2	9.0	5.0
Domestic Demand	22.0	22.5	7.0	8.6	5.0	7.1	14.0	5.3
Consumption	9.3	10.8	3.9	3.3	3.2	3.1	6.4	3.7
Private	9.1	11.5	4.3	2.2	2.9	2.8	6.4	3.5
Public	0.2	-0.6	-0.4	1.1	0.3	0.3	0.0	0.2
Gross Investment	12.7	11.7	3.1	5.3	1.8	4.0	7.5	1.6
Gross Fixed Investment	10.0	10.2	4.3	2.7	1.7	5.0	6.4	2.1
Private	10.1	10.6	4.7	2.7	1.1	3.8	6.6	1.8
Public	-0.1	-0.4	-0.5	0.1	0.6	1.2	-0.2	0.4
Change in Stocks	2.7	1.5	-1.1	2.5	0.1	-0.9	1.1	-0.5
External Balance	-9.6	-7.8	-2.1	-2.2	0.0	-2.9	-4.9	-0.3

Source: State Institute of Statistics

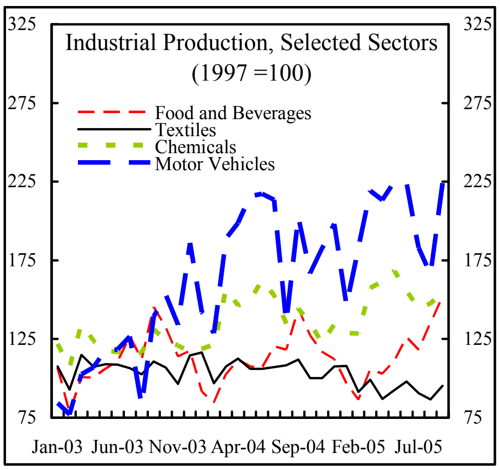


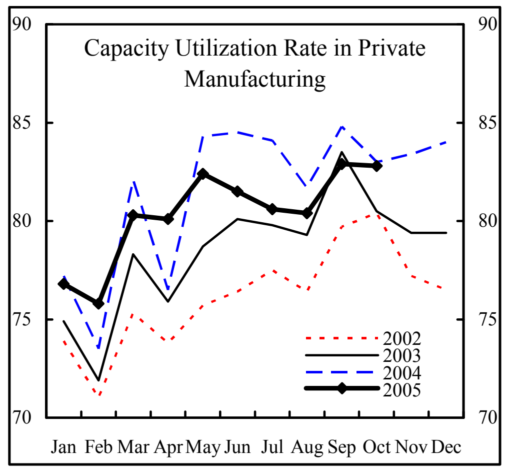


Box 1. Turkey: Growth (Concl.)

On the expenditure side, private consumption continues to be well behaved. Within consumption, there has been a shift from durable to semi-durable goods, although car sales have started to recover. The main contribution on the expenditure side, however, comes from gross fixed capital formation (particularly construction), aided by easier credit conditions.

Viewed from the production side, industrial output increased by 4½ percent (year-on-year) in the first half of 2005, with virtually all major sectors contributing positively. The three exceptions were (i) the textile sector, which is losing market share following the elimination of textile quota protection in Turkey's key export markets; (ii) refined petroleum, which has suffered from production problems in TÜPRAŞ and, in view of high oil prices, shifts to alternative forms of energy; and (iii) machinery and equipment, partly on account of increased import competition.





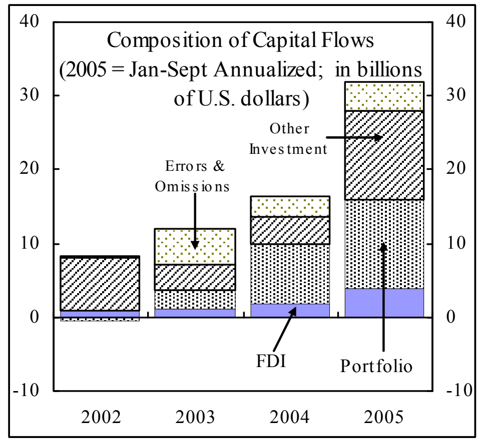
Looking ahead, there are a number of factors that should support growth in the second half of 2005:

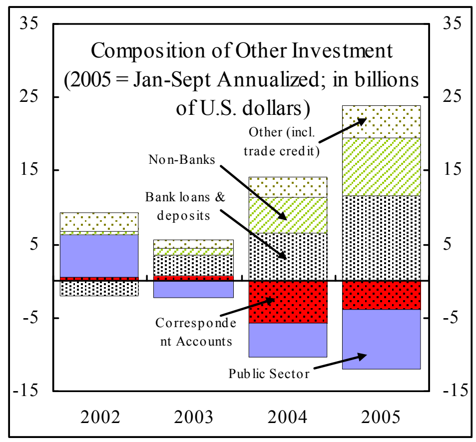
- **Ongoing rapid credit growth** to households and corporates, coupled with falling real interest rates.
- **Consumer spending**, most notably on cars and other durables, has started to recover.
- **Confidence indicators**, which until recently provided at best a mixed picture, turned positive in August. Although the reliability of these indicators is questionable, the business tendency survey conducted by the central bank nevertheless suggests that output, sales, and exports could all improve in the coming months. The latest consumer tendency survey suggests increased confidence about the general economic outlook and potential spending behavior.
- **Capacity utilization** is steadily increasing to last year's high levels, which should support investment going forward. Most notable was the increase in textiles and apparel—which may have benefited from the EU-China standoff (with imports from China blocked in European ports)— and automotive production.
- **Industrial production** growth increased strongly in August and September, following a small decline in July. These increases—concentrated in automobiles, plastics, office equipment and fabricated metals—mirror the September upturn in exports and suggest that investment demand remains strong.

1/ Seasonal adjustment is subject to a large margin of error given Turkey's past volatility and large data revisions.

Box 2. Turkey: Capital Account Developments

Capital inflows are expected to reach record levels in Turkey this year: almost $43 billion, double last year's level, including large increases in net foreign direct investment, portfolio investment, and other investment inflows.





On the supply side, these flows reflect ample global liquidity conditions. Low interest rates in the U.S. and other industrial countries have prompted investors to extend their search for yield and have led to very large inflows to dedicated emerging market funds. Turkey, as one of the higher yielding emerging market economies, has benefited from these moves. Recently, foreign investor positioning has rebalanced somewhat with exposure to foreign exchange risk reduced in favor of interest rate exposure, while equities continue to attract solid inflows.

Inflows have also been helped by improvements in Turkey's fundamentals. Macroeconomic and political stability have reduced the perceived risk on Turkish assets, with credit rating upgrades from S&P and Fitch (in late 2004 and early 2005, respectively) and credit default swap spreads declining by 60 basis points since the beginning of the year (and close to 200 basis points since end-April). With inflation declining and markets pricing in further policy rate cuts, the environment remains supportive of local fixed-rate instruments.

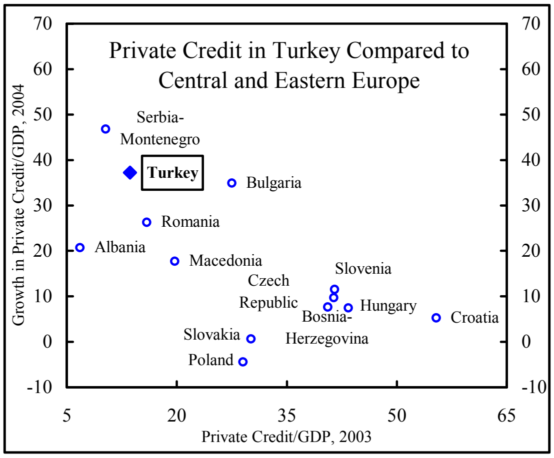
Although short-term debt-creating flows continue to dominate, the composition of capital inflows has improved in recent months. The privatization of profitable state enterprises, has set the stage for a large increase in foreign direct investment flows. There has also been substantial foreign interest in the banking sector. Bank borrowing, for its part, has increasingly moved to longer-term financing sources, in part by using securitized receivables as collateral. Domestic banks also appear to be supplementing deposit funding sources with international foreign exchange denominated loans, which are in turn swapped into Turkish lira with non-residents. This should allow banks to increase the volume of lira loans, while staying within prudential limits for open foreign exchange positions. However, staff does not have reliable data to confirm the magnitude and the precise nature of such transactions.

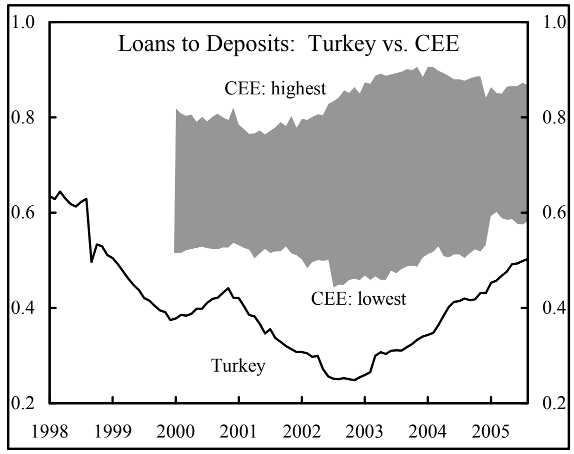
Large errors and omissions have been another important source of "financing" this year. Measured against GDP (1.1 percent) or the volume of trade (2.1 percent), Turkey's errors and omissions are large, but not out of the ordinary. Potential explanations for these errors include underreported tourism revenues, unrecorded exports to Iraq, workers remittances, and "mattress money." The central bank has been studying this issue, but has not yet found concrete support for any of those explanations.

Despite this positive backdrop, Turkey's large current account deficit and its remaining vulnerabilities leave it exposed to a sudden reversal of capital flows. Even with a US$2½ billion increase projected in foreign direct investment, non-privatization related FDI remains very low (less than 1 percent of GNP annually), and more than two-thirds of financing remains short term. This highlights the importance of persevering with structural reforms (to provide greater incentives for long-term financing), continuing to increase reserve coverage of short-term liabilities, and monitoring closely the foreign exchange exposure taken on by corporates and the banking system.

Box 3: Turkey. Private Credit Growth—Regional Perspectives and Policy Responses

Paralleling earlier developments in Central and Eastern Europe, Turkey has experienced rapid private sector credit growth in recent years. However, the ratio of private credit to GDP—currently around 25 percent—remains significantly lower than the CEE average, while its rapid growth (46 percent since end-2003) is among the highest in the region. Financial intermediation has recovered to 1999 levels, though it continues to lag behind CEE countries.





While financial deepening is important for economic growth, excessive credit growth carries risks. These include widening current account deficits, inflationary pressures, asset price bubbles, non-performing loan problems, and, in a worst case scenario, a possible financial crisis as a result of overlending. While it is difficult to gauge precisely the risks involved, research shows that a relatively high proportion of credit booms—35 percent according to some studies—end in a banking crisis. Against this backdrop, CEE countries have attempted to stem the rapid private credit growth using the following types of measures (Text Table):

- **Fiscal** tightening has been used to slow credit growth by reining in domestic demand. Some countries, such as Poland and Estonia, also removed tax distortions that encourage borrowing, such as mortgage interest deductions.
- **Monetary policy** measures have included raising policy interest rates and increasing reserve requirements for lending institutions. In the CEE economies, monetary policy measures have limited efficacy due to fixed exchange rate regimes (including in the form of Currency Board Arrangements, CBA) and open capital accounts. Reserve requirements have had little impact on lending, as deposit growth has been rapid, and funds from abroad readily available to satisfy demand for loanable funds. An additional problem with using monetary policy to reduce credit growth is that it may conflict with monetary policy's main objective, which is to control inflation.
- Several countries have also tightened **prudential and supervisory frameworks**, begun to monitor loan underwriting procedures, and restricted the extent of foreign currency mismatches on bank balance sheets. However, in most countries prudential regulations were already strong, and room for further improvement thus limited. Furthermore, the effectiveness of prudential measures is limited in the absence of sound macro policies.

Policy Measures to Contain Credit Growth in Selected CEE countries

	Monetary Measures		Fiscal Measures		Prudential Measures
	interest rate tightening	reserve requirements	budget tightening	eliminating tax distortions	
Bosnia-Herzegovina	(CBA)	X	X		X
Bulgaria	(CBA)	X			X
Croatia	X	X	X		X
Poland	X			X	X
Romania	X		X		X
Serbia-Montenegro	X	X	X		X

Turkey's challenge is to ensure that (needed) financial deepening occurs at a pace that does not endanger financial stability. Fiscal policy has been modestly tightened in the context of next year's budget, helping to contain demand, but with foreign inflows constituting the primary source of (base money and) credit growth the scope for using monetary policy is limited (though the floating exchange rate regime affords CBT flexibility, higher policy rates could attract more inflows rather than slow domestic credit growth). In this context, responsibility falls primarily on the BRSA to ensure that risks are being properly managed and prudential norms adhered to by banks.

Table 1. Turkey: Structural Conditionality 2005–06 1/

Action	PC/SB	Status
Fiscal Measures		
1. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19)	Continuous PC	Will not be observed. Proposed arrear rescheduling contains amnesty element.
2. At most, 10 percent of those leaving through attrition in each state enterprise will be replaced, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (¶17)	Continuous SB	Although new hires by the SEE sector as a whole were well below 10 percent, two enterprises exceeded their individual limits
3. Maintain excise taxes and SEE prices in line with 2005 program assumptions (¶10)	SB. End-June 2005	Observed
4. Parliamentary approval of pension reform legislation (¶15)	PC. End-June 2005	Not observed. Reset to mid-February 2006. Waiver needed
5. Parliamentary approval of administrative social security reform (¶14)	SB. End-June 2005	Not observed. Reset to end-January 2006, with submission to parliament made a prior action
6. Put in place secondary legislation required under the Public Financial Management and Control Law (¶20)	SB. End-September 2005	Not observed. Reset to end-December 2005
7. Parliamentary submission of legislation strengthening state enterprise governance (¶22)	SB. End-September 2005	Not observed. Further consultation is needed with stakeholders before law can be submitted
8. Develop a quantitative framework for monitoring health expenditure and assessing medium-term trends (¶16)	SB. End-September 2005	Observed
9. Prepare legislation to reform the personal income tax (¶18)	SB. End-September 2005	Not observed. Reset to end-December 2005 for first stage of reform. Second stage envisages submission to Parliament by end-May 2006 (PC) and approval by end-September 2006 (SB)
10. Establish a large-taxpayers unit within the Revenue Administration (¶19)	SB. End-December 2005	Pending. Reset to end-June 2006 because of ongoing administrative delays
11. Complete comprehensive review of civil service wage and employment structure (¶17)	SB. End-December 2005	On track
Financial Sector Measures		
12. Parliamentary approval of the banking law (¶26)	PC. End-June 2005	Initially passed on July 2, subsequently vetoed. Re-approved on October 19, and signed into law on November 1. Waiver needed
13. Adoption of state bank specific strategies by both the government and the boards of the state banks (¶29)	SB. End-June 2005	Done with delay. Strategies approved June 30, but related TOR for hiring financial advisor not agreed until Sep.
14. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶29)	SB. End-June 2005	Not observed due to delays in hiring financial advisor. SB reset to end-March 2006
15. Publication by BRSA of its planned reforms taking into account the findings of the Imar inquiry (¶27)	SB. End-September 2005	Done with small delay. Published on October 11
16. SDIF to sell all remaining non-related-party loans by auction (¶31)	SB. End-December 2005	On track
17. Launch of first IPO for Vakifbank (¶30)	SB. End-December 2005	Observed
18. Set up a committee to assess whether integrated financial sector supervision is warranted, with findings to be presented (¶28)	SB. End-March 2006	Pending
19. Completion of implementing regulations for the Banking Law (¶26)	SB. End-June 2006	Reset to end-September 2006 due to delay in passing the Banking Law

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the April 26, 2005 Memorandum of Economic Policies.

Table 2. Turkey: Selected Indicators, 2001–06

					Projections			
					2005		2006	
	2001	2002	2003	2004	CR/05/412	Revised	CR/05/412	Revised
				(In percent change)				
Real sector								
Real GNP growth rate	-9.5	7.9	5.9	9.9	5.0	5.0	5.0	5.0
GNP deflator	55.3	44.4	22.5	9.5	6.8	7.7	6.0	6.0
Nominal GNP growth rate	40.5	55.8	29.7	20.3	12.1	13.1	11.3	11.3
WPI (12-month, end-of-period)	88.6	30.8	13.9	15.3	8.0	8.0	5.0	5.0
CPI (12-month, end-of period)	68.5	29.7	18.4	9.4	8.0	8.0	5.0	5.0
Average nominal treasury bill interest rate	99.1	63.5	45.4	24.9	16.4	16.4	..	..
Average ex-ante real interest rate 1/	35.5	38.2	36.8	16.5	9.4	9.8	..	..
				(In percent of GNP)				
Central government budget								
Primary balance 2/	4.8	2.4	5.0	5.1	5.1	5.0	5.2	5.1
Net interest payments 3/	22.2	17.3	16.1	12.3	11.3	9.0	9.3	8.3
Overall balance	-17.4	-14.9	-11.0	-7.2	-6.2	-4.0	-4.1	-3.2
Consolidated public sector								
Primary balance	5.5	4.1	6.4	7.1	6.5	6.5	6.5	6.6
Net interest payments	22.6	17.6	15.4	11.7	11.1	8.4	8.8	7.9
Overall balance	-17.1	-13.6	-9.0	-4.7	-4.6	-1.9	-2.3	-1.3
Net debt of public sector	90.5	78.6	70.4	63.5	60.0	57.7	57.3	53.1
Net external	37.7	32.3	22.1	17.5	16.4	16.4	15.4	14.1
Net domestic	52.8	46.3	48.3	46.0	43.6	41.3	41.9	39.0
External sector								
Current account balance	2.4	-0.8	-3.4	-5.2	-4.4	-6.0	-3.5	-5.8
Gross external debt	78.9	71.3	61.0	53.6	48.3	50.8	48.0	51.9
Net external debt	54.1	48.7	40.6	34.0	36.5	30.3	35.8	31.9
Short-term external debt (by remaining maturity)	22.7	17.9	17.5	16.7	16.4	17.6	17.5	18.7
Monetary aggregates								
Seignorage 4/	1.1	1.0	1.2	1.2	1.0	1.7	...	1.0
Nominal growth of M2Y broad money (in percent)	87.5	25.4	13.0	22.1	16.7	18.3	...	16.2
				(In billions of U.S. dollars, unless otherwise indicated)				
Privatization proceeds	2.8	0.5	0.2	1.3	1.5	3.8	1.5	10.9
Net external financing of central government	8.4	6.7	0.7	1.7	0.0	-0.6	-2.4	-0.7
Amortization	-6.7	-11.4	-7.2	-7.2	-12.2	-11.6	-14.5	-13.8
Gross borrowing	15.0	18.1	8.0	8.9	12.2	11.0	12.1	13.1
Of which : Eurobond issues	2.2	3.3	5.3	5.8	5.5	6.0	...	5.5
GNP	144.0	182.7	238.5	301.7	349.0	357.8	364.2	380.7
GNP (in billions of Turkish lira)	176.5	275.0	356.7	428.9	481.0	485.1	535.3	540.0

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

Table 3. Turkey: Balance of Payments, 2003−10 (Cont.)

			Projections					
	2003	2004	2005	2006	2007	2008	2009	2010
			(In billions of U.S. dollars)					
Current account balance	-8.0	-15.6	-21.3	-22.0	-20.9	-20.1	-18.9	-17.4
Trade balance	-14.0	-23.9	-32.0	-34.3	-33.9	-33.6	-33.1	-32.4
Exports (f.o.b.)	51.2	67.0	76.1	82.7	90.7	99.2	109.6	121.6
Of which:								
Exports (f.o.b.) in trade returns	47.3	63.1	72.5	79.1	87.1	95.6	106.0	117.9
Shuttle trade	4.0	3.9	3.6	3.6	3.6	3.6	3.6	3.6
Imports (f.o.b.)	-65.2	-90.9	-108.1	-117.0	-124.5	-132.8	-142.6	-154.0
Of which:								
Imports (c.i.f.), incl. non-monetary gold	-69.3	-97.5	-115.0	-124.4	-132.5	-141.2	-151.7	-163.8
Energy imports (c.i.f.)	-11.6	-14.4	-20.3	-23.8	-23.7	-23.5	-23.8	-24.1
Services and income (net)	4.9	7.2	9.3	10.7	11.5	12.1	12.8	13.6
Services and income (credit)	21.3	26.7	31.7	35.0	37.2	39.0	41.1	43.4
Of which:								
Tourism receipts	13.2	15.9	18.5	20.4	21.5	22.6	23.9	25.3
Services and Income (debit)	-16.3	-19.5	-22.3	-24.3	-25.7	-27.0	-28.4	-29.8
Of which:								
Interest	-6.9	-7.2	-8.1	-9.3	-9.8	-10.1	-10.5	-10.8
Private transfers (net) 1/	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.7
Official transfers (net)	0.3	0.3	0.6	0.8	0.6	0.6	0.6	0.6
Capital account balance	7.1	17.6	38.9	30.7	22.5	20.9	21.7	22.2
(including errors and omissions)	12.1	20.0	42.9	30.7	22.5	20.9	21.7	22.2
Direct investment 2/	1.2	1.9	4.2	4.3	4.6	3.2	3.5	4.0
Portfolio investment in securities	1.1	6.1	8.7	5.6	4.4	4.7	4.9	5.1
Public sector (central & local governments & EBFs)	-0.7	0.8	1.7	3.2	1.3	1.0	2.9	2.4
Bonds (net)	1.5	2.0	2.8	2.7	1.8	2.1	3.8	3.0
Eurobond drawings	5.3	5.8	6.0	5.5	5.5	5.8	5.8	5.8
Eurobond repayments	-3.8	-3.8	-3.2	-2.8	-3.7	-3.7	-2.0	-2.7
Loans (net)	-2.2	-1.2	-1.0	0.5	-0.5	-1.1	-0.9	-0.7
Loan disbursements	1.0	2.0	2.5	3.9	3.0	2.1	2.2	2.3
Loan repayments	-3.2	-3.2	-3.6	-3.4	-3.4	-3.3	-3.1	-3.0
Central Bank of Turkey (excl. reserve assets, liabilities)	0.6	-0.1	-0.2	0.0	0.1	0.1	0.1	0.1
Domestic money banks (net)	3.0	1.2	13.2	8.4	7.5	7.9	7.3	7.6
Domestic money banks (FX deposits abroad, -=accumulation)	0.7	-6.0	0.0	2.2	1.0	1.0	0.0	0.0
Domestic money banks (other, net)	2.3	7.2	13.2	6.1	6.5	6.9	7.3	7.6
Domestic money banks (medium and long-term, net)	-0.2	2.4	6.7	4.1	4.7	5.1	5.4	5.8
Domestic money banks (short-term, net)	2.5	4.8	6.5	2.0	1.8	1.8	1.8	1.8
Interbank credit lines from foreign commercial banks	2.0	3.3	2.7	2.0	1.8	1.8	1.8	1.8
Other private sector (net)	1.8	7.7	11.3	9.3	4.7	4.1	3.0	3.0
Other private sector (medium and long term, net)	1.6	5.3	7.7	6.8	3.4	3.1	2.1	2.2
Other private sector (short term, net)	0.2	2.5	3.5	2.5	1.2	1.0	0.9	0.8
Errors and omissions	5.0	2.3	4.0	0.0	0.0	0.0	0.0	0.0
Overall balance	4.1	4.3	21.5	8.7	1.6	0.9	2.8	4.8
Overall financing (NIR change excl. ST liabilities, + denotes decline	-4.1	-4.3	-21.5	-8.7	-1.6	-0.9	-2.8	-4.8
Change in net international reserves (+ denotes decline)	-4.1	-4.3	-21.5	-8.7	-1.6	-0.9	-2.8	-4.8
Change in gross official reserve assets (+ denotes decline)	-4.0	-0.8	-16.3	-4.8	0.9	0.9	0.9	-1.8
Change in reserve liabilities (IMF)	-0.1	-3.5	-5.2	-3.9	-2.5	-1.8	-3.7	-2.9
Purchases	1.7	1.2	2.5	3.7	2.8	0.9	0.0	0.0
Repurchases	-1.7	-4.7	-7.7	-7.6	-5.3	-2.7	-3.7	-2.9

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

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

2/ Including privatization receipts.

Table 3. Balance of Payments, 2003–10 (Concl.)

	2003	2004	Projections 2005	2006	2007	2008	2009	2010
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, incl. shuttle trade	-3.4	-5.2	-6.0	-5.8	-5.1	-4.6	-4.0	-3.5
Trade account balance, incl. shuttle trade	-5.9	-7.9	-8.9	-9.0	-8.3	-7.6	-7.0	-6.4
Exports of goods and non-factor services	30.1	30.8	29.9	30.6	30.9	31.1	31.5	32.6
Imports of goods and non-factor services	31.3	34.2	34.2	34.7	34.3	33.9	33.8	34.4
Percent change								
Value growth in exports of goods (incl. shuttle trade)	27.6	30.8	13.6	8.7	9.6	9.4	10.5	11.0
Value growth in exports of goods (excl. shuttle trade)	31.0	33.6	14.9	9.1	10.0	9.8	10.8	11.3
Value growth in imports of goods	37.6	39.4	18.9	8.2	6.4	6.6	7.4	7.9
Volume growth in exports of goods	19.1	15.2	7.2	9.1	10.1	9.8	10.4	10.4
Volume growth in imports of goods	24.6	25.0	7.1	6.6	6.8	7.0	7.1	7.3
Terms of trade	2.0	3.0	-2.6	-1.5	0.3	0.4	0.1	0.2
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey) 3/								
In billions of U.S. dollars	35.2	37.6	53.9	58.7	57.8	56.9	56.0	57.8
Months of goods & NFS imports	3.8	3.5	4.6	4.7	4.3	4.0	3.7	3.5
External debt (end-of-period)								
In billions of U.S. dollars	145.4	161.7	181.9	197.5	208.7	220.2	231.3	243.4
Percent of GNP	61.0	53.6	50.8	51.9	50.9	50.0	48.8	48.4
Percent of exports of goods & NFS	202.3	174.0	170.1	169.5	164.8	160.7	154.7	148.5
Net external debt (end-of-period) 4/								
In billions of U.S. dollars	96.7	102.5	108.4	121.3	134.4	147.8	159.9	170.1
Percent of GNP	40.6	34.0	30.3	31.9	32.8	33.5	33.7	33.9
Short-term debt (end-of-period)								
In billions of U.S. dollars	23.0	31.9	41.6	47.1	51.6	56.1	60.8	65.8
Reserves to short-term debt ratio	152.8	118.0	129.7	124.7	111.9	101.3	92.0	87.9
Short-term debt plus MLT repayments								
In billions of U.S. dollars	41.8	50.2	62.9	71.3	76.9	82.5	86.5	92.9
Reserves to short-term debt ratio	84.1	75.0	85.7	82.4	75.2	69.0	64.7	62.2
Debt service ratio 5/	35.1	27.0	27.1	28.3	27.2	26.2	23.9	22.9

Sources: Data provided by the Turkish authorities; and Fund staff estimates and projections.
3/ Projections exclude year-to-date valuation changes in 2005 (approximately minus US$2.7 billion).
4/ Non-bank external debt minus the net foreign assets of the banking sector and the central bank.
5/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excluding official transfers).

Table 4. Turkey: External Financing Requirements and Sources, 2003–10

	2003	2004	2005	2006	2007	2008	2009	2010
			Projections					
			(In billions of U.S. dollars)					
Gross financing requirements	47.3	62.1	75.1	83.3	86.6	89.7	90.7	93.7
Current account deficit (excluding official transfers)	8.3	16.0	21.9	22.8	21.5	20.7	19.5	18.0
Amortization on debt securities	3.9	3.8	3.6	2.8	3.7	3.7	2.0	2.7
Of which:								
Public sector	3.8	3.8	3.2	2.8	3.7	3.7	2.0	2.7
Medium and long-term debt amortization	14.9	14.6	17.8	21.4	21.6	22.7	23.7	24.4
Of which:								
Public sector 1/	3.2	3.2	3.6	3.4	3.4	3.3	3.1	3.0
Private sector	10.3	10.3	12.0	16.0	15.9	17.0	18.0	18.6
Deposit money banks	1.4	1.2	2.2	2.0	2.2	2.4	2.6	2.8
Short-term debt amortization	20.1	27.7	31.8	36.4	39.8	42.7	45.5	48.5
Public sector (net)1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade credits 2/	22.4	31.4	35.2	38.7	41.9	44.7	47.5	50.6
Banks and other private (net)	-2.3	-3.7	-3.3	-2.3	-2.0	-2.0	-2.0	-2.0
Available financing	47.3	62.1	75.1	83.3	86.6	89.7	90.7	93.7
Foreign direct investment (net)	1.2	1.9	4.2	4.3	4.6	3.2	3.5	4.0
Portfolio flows	7.8	13.2	16.0	12.3	10.7	11.2	11.5	11.9
Public sector	5.3	5.8	6.0	5.5	5.5	5.8	5.8	5.8
Deposit money banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector (net)	2.5	7.5	10.0	6.8	5.2	5.4	5.8	6.1
Medium and long-term debt financing	14.1	20.8	31.0	32.7	28.8	29.4	30.0	31.4
Of which:								
Public sector 1/	0.7	1.7	2.1	3.9	3.0	2.1	2.2	2.3
Short-term trade credits, currency and deposits	23.0	27.9	40.8	42.0	43.5	46.2	47.7	50.6
Official transfers	0.3	0.3	0.6	0.8	0.6	0.6	0.6	0.6
Other 3/	5.0	2.3	4.0	0.0	0.0	0.0	0.0	0.0
Net reserves (+/- = decrease/increase)	-4.1	-4.3	-21.5	-8.7	-1.6	-0.9	-2.8	-4.8
Accumulation of gross reserves	-4.0	-0.8	-16.3	-4.8	0.9	0.9	0.9	-1.8
IMF (net)	-0.1	-3.5	-5.2	-3.9	-2.5	-1.8	-3.7	-2.9
Purchases	1.7	1.2	2.5	3.7	2.8	0.9	0.0	0.0
Repurchases	-1.7	-4.7	-7.7	-7.6	-5.3	-2.7	-3.7	-2.9
Memorandum item:								
Net public sector financing (incl. IMF, excl. reserves)	-0.7	-2.7	-3.3	0.1	-0.5	-0.2	-0.2	0.1

Sources: Data provided by the Turkish authorities; and IMF staff estimates and projections.
1/ General government and Central Bank of Turkey.
2/ Series reflects gross flows of short-term trade credits, and stocks of credits to the banking sector.
3/ Errors and omissions.
4/ Projections exclude year-to-date valuation changes in 2005 (approximately minus US$2.7 billion).

Table 5. Turkey: Vulnerability Indicators, 2000−05

	2000	2001	2002	2003	2004	2005 Proj.
	(In percent, unless otherwise noted)					
CPI inflation (end year)	39.0	68.5	29.7	18.4	9.4	8.0
Overall Balance Public Sector (percent of GNP)	-13.0	-17.1	-13.6	-9.0	-4.7	-1.9
Public sector borrowing requirement (percent of GNP) 1/	12.0	26.5	66.3	50.7	36.0	32.0
Net debt of the public sector (percent of GNP)	58.3	90.5	78.5	70.4	63.5	57.7
Export volume (percent change)	9.2	15.7	17.2	19.1	15.2	7.2
Import volume (percent change)	28.2	-23.8	26.1	24.6	25.0	7.1
Current account balance, in percent of GNP	-4.9	2.4	-0.8	-3.4	-5.2	-6.0
Capital account balance (in billions of U.S. dollars)	6.8	-16.3	1.3	12.1	20.0	42.9
Of which : Foreign direct investment	0.1	2.8	0.9	1.2	1.9	4.2
Foreign portfolio investment	-5.2	-4.6	-1.2	1.2	6.1	8.7
Gross official reserves, in billions of U.S. dollars 2/	23.2	19.8	28.1	35.2	37.6	53.9
In months of imports of goods and NFS	4.1	4.5	5.5	3.8	3.5	4.6
In percent of broad money	27.4	26.7	34.3	32.5	27.4	30.0
Gross total external debt, in billions U.S. dollars	118.6	113.7	130.2	145.4	161.7	181.9
In percent of GNP	58.9	78.9	71.3	61.0	53.6	50.8
In percent of exports of goods and NFS	224.8	218.5	230.0	202.3	174.0	170.1
Gross short-term external debt, in billions of U.S. dollars 3/	43.7	32.7	32.6	41.8	50.2	62.9
In percent of gross total external debt	36.9	28.8	25.1	28.8	31.0	34.6
In percent of gross official reserves	188.9	165.1	116.2	118.9	133.3	116.7
Debt service 4/	37.2	41.9	38.1	35.1	27.0	27.1
REER appreciation (CPI based, period average)	10.9	-17.2	12.7	10.3	6.0	...
REER appreciation (CPI based, end of period)	15.9	-21.2	7.8	12.1	1.8	...
Capital adequacy ratio 5/	17.3	15.3	25.3	30.9	28.8	...
State banks	7.9	34.0	50.2	56.3	41.5	...
SDIF banks	..	-17.8	-7.6	-21.6	-42.0	...
Private banks	18.3	9.0	19.6	23.5	22.3	...
Foreign banks	29.4	41.0	48.4	60.8	56.0	...
Nonperforming loans (in percent of total)	11.1	25.2	17.6	11.5	6.0	...
Real broad money, percentage change 6/	0.8	11.2	-3.3	-4.6	11.7	12.5
Real credit to the private sector, percentage change 6/	24.5	-27.5	-16.5	20.1	38.5	27.8
Banks' net open exchange position, in billions of U.S. dollars	-5.4	-0.1	-0.4	0.3	-0.1	...
EMBI Global bonds spread (in basis points)	800.0	707.0	693.0	309.0	265.0	...

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

1/ Consists of the public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

2/ Projection excludes year-to-date valuation changes in 2005 (approximately minus US$2.7 billion).

3/ By residual maturity.

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

5/ For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank. 2004 data for SDIF banks are as of end-September.

6/ Deflated by the CPI.

Table 6. Turkey: Public Sector Finances, 2002–06 (Cont.)

	2002	2003	2004	2005 Prog.	2005 Proj.	2006 Prog.
			(In millions of Turkish Lira)			
Public sector primary balance	**11,246**	**22,682**	**30,365**	**31,315**	**31,539**	**35,517**
Central government 1/	6,644	17,954	21,876	24,490	24,398	27,542
Primary revenue	63,369	90,445	105,049	121,441	122,654	137,403
Tax revenue	59,634	84,335	101,058	118,585	119,651	132,570
Direct taxes, *of which* :	20,077	27,800	31,146	32,121	36,138	39,920
Personal income taxes	13,724	17,062	19,689	20,981	22,736	24,720
Corporate income taxes	5,578	8,646	9,619	8,890	11,002	12,420
Indirect taxes, *of which* :	39,557	56,535	69,912	86,464	83,513	92,649
VAT	20,401	27,028	34,324	40,445	38,300	43,450
SCT	13,651	22,299	26,288	34,939	33,723	36,419
Nontax revenue 1/	9,402	14,446	15,147	15,370	15,694	19,233
Tax rebates	-5,666	-8,335	-11,156	-12,514	-12,724	-14,400
Primary expenditure	56,726	72,492	83,173	96,951	98,257	109,861
Personnel	23,160	30,200	35,433	39,031	38,312	42,887
Goods and services, *of which:* 2/	6,995	8,216	9,486	10,636	10,354	11,420
Defense and security	4,485	5,668	5,479	6,541	6,304	6,745
Transfers, *of which* : 2/	19,289	26,911	30,282	36,554	40,651	44,325
Social security institutions	9,684	15,883	18,830	20,900	23,446	23,285
Agricultural subsidies	1,868	2,805	3,079	3,457	3,813	4,000
Capital transfers	1,423	917	437	1,088	1,514	2,184
Capital expenditure	7,282	7,165	7,972	10,731	9,807	11,230
Measures needed	...	...	...	...	-873	...
Rest of the public sector	4,603	4,728	8,489	6,825	7,141	7,976
Extrabudgetary funds	-358	594	934	379	-4	1,251
Revolving funds 3/ 4/	407	933	976	76	809	840
Social security institutions	-85	53	-293	0	186	0
Unemployment insurance fund	962	1,228	1,557	1,804	1,710	2,088
Local governments 4/	538	-567	766	515	702	761
State economic enterprises 5/	3,139	2,487	4,548	4,051	3,738	3,036
Public sector overall balance	**-37,270**	**-32,089**	**-19,974**	**-22,085**	**-9,381**	**-7,095**
Interest expenditure (net)	48,516	54,771	50,339	53,400	40,920	42,613
Domestic	48,358	50,547	44,283	43,284	33,852	33,012
External	159	4,224	6,056	10,116	7,068	9,600
Public sector financing	**37,270**	**32,089**	**19,974**	**22,085**	**9,381**	**7,095**
Amortization	170,216	113,949	137,486	155,489	144,042	150,145
External	19,438	11,519	12,655	17,089	15,257	20,980
Domestic	150,779	102,430	124,830	138,400	128,785	129,165
Borrowing	206,798	146,268	159,421	178,537	153,761	146,360
External	30,917	11,706	11,293	16,813	13,655	16,306
Domestic 6/	175,881	134,562	148,127	161,724	138,290	130,054
Deposits decrease	-120	-529	-3,809	-3,030	-3,690	-3,304
Privatization	808	299	1,848	2,067	5,168	14,184

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

1/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).

2/ Green card scheme classified under transfers starting with 2004.

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

4/ Excluded from consolidated government sector subject to quantitative conditionality.

5/ Excluding severance payments for retirees. Some minor SEEs excluded from consolidated government sector subject to quantitative conditionality. Figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).

6/ Including statistical discrepancy.

Table 6. Turkey: Public Sector Finances, 2002–06 (Concl.)

	2002	2003	2004	2005 Prog.	2005 Proj.	2006 Prog.
	(In percent of GNP; unless otherwise indicated)					
Public sector primary balance	**4.1**	**6.4**	**7.1**	**6.5**	**6.5**	**6.6**
Central government 1/	**2.4**	**5.0**	**5.1**	**5.1**	**5.0**	**5.1**
Primary revenue	23.0	25.4	24.5	25.2	25.3	25.4
Tax revenue	21.7	23.6	23.6	24.7	24.7	24.6
Direct taxes, of which:	7.3	7.8	7.3	6.7	7.4	7.4
Personal income taxes	5.0	4.8	4.6	4.4	4.7	4.6
Corporate income taxes	2.0	2.4	2.2	1.8	2.3	2.3
Indirect taxes, of which:	14.4	15.9	16.3	18.0	17.2	17.2
VAT	7.4	7.6	8.0	8.4	7.9	8.0
SCT	5.0	6.3	6.1	7.3	7.0	6.7
Nontax revenue 1/	3.4	4.1	3.5	3.2	3.2	3.6
Tax rebates	-2.1	-2.3	-2.6	-2.6	-2.6	-2.7
Primary expenditure	20.6	20.3	19.4	20.2	20.3	20.3
Personnel	8.4	8.5	8.3	8.1	7.9	7.9
Goods and services, of which: 2/	2.5	2.3	2.2	2.2	2.1	2.1
Defense and security	1.6	1.6	1.3	1.4	1.3	1.2
Transfers, of which: 2/	7.0	7.5	7.1	7.6	8.4	8.2
Social security institutions	3.5	4.5	4.4	4.3	4.8	4.3
Agricultural subsidies	0.7	0.8	0.7	0.7	0.8	0.7
Capital transfers	0.5	0.3	0.1	0.2	0.3	0.4
Capital expenditure	2.6	2.0	1.9	2.2	2.0	2.1
Measures needed	...	...	...	...	-0.2	...
Rest of the public sector	**1.7**	**1.3**	**2.0**	**1.4**	**1.5**	**1.5**
Extrabudgetary funds	-0.1	0.2	0.2	0.1	0.0	0.2
Revolving funds 3/ 4/	0.1	0.3	0.2	0.0	0.2	0.2
Social security institutions	0.0	0.0	-0.1	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.4	0.4	0.4	0.4
Local governments 4/	0.2	-0.2	0.2	0.1	0.1	0.1
State economic enterprises 5/	1.1	0.7	1.1	0.8	0.8	0.6
Public sector overall balance	**-13.6**	**-9.0**	**-4.7**	**-4.6**	**-1.9**	**-1.3**
Interest expenditure (net)	17.6	15.4	11.7	11.1	8.4	7.9
Domestic	17.6	14.2	10.3	9.0	7.0	6.1
External	0.1	1.2	1.4	2.1	1.5	1.8
Public sector financing	**13.6**	**9.0**	**4.7**	**4.6**	**1.9**	**1.3**
Amortization	61.9	31.9	32.1	32.3	29.7	27.8
External	7.1	3.2	3.0	3.6	3.1	3.9
Domestic	54.8	28.7	29.1	28.8	26.5	23.9
Borrowing	75.2	41.0	37.2	37.1	31.7	27.1
External	11.2	3.3	2.6	3.5	2.8	3.0
Domestic 6/	63.9	37.7	34.5	33.6	28.5	24.1
Deposits decrease	0.0	-0.1	-0.9	-0.6	-0.8	-0.6
Privatization	0.3	0.1	0.4	0.4	1.1	2.6
Memorandum item:						
GNP (in millions of YTL)	275,032	356,681	428,932	480,963	485,145	539,966

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

1/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).

2/ Green card scheme classified under transfers starting with 2004.

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

4/ Excluded from consolidated government sector subject to quantitative conditionality.

5/ Excluding severance payments for retirees. Some minor SEEs excluded from consolidated government sector subject to quantitative conditionality. Figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).

6/ Including statistical discrepancy.

Table 7. Turkey: Monetary Aggregates, 2001−06

	2001	2002	2003	2004	2005 Mar.	2005 Jun.	2005 Sep.	2005 Dec. Proj.	2006 Mar. Proj.	2006 Jun. Proj.	2006 Sep. Proj.	2006 Dec. Proj.
					(In billions of Turkish Lira)							
Broad money (M2Y)	106.6	133.7	151.0	184.4	185.3	197.5	212.9	224.0	233.6	237.8	246.4	260.1
Lira broad money (M2)	47.2	61.9	82.7	108.5	113.7	126.4	137.7	145.0	151.2	154.3	160.0	169.0
Foreign exchange deposits 1/	59.3	71.8	68.3	75.9	71.6	71.1	75.2	79.0	82.4	83.5	86.3	91.2
Repos	2.8	2.8	3.1	1.7	1.7	1.7	1.5	1.6	1.7	1.7	1.7	1.8
Broad liquidity	109.4	136.4	154.1	186.1	187.0	199.2	214.5	225.6	235.3	239.5	248.1	262.0
Base money	7.8	10.4	14.9	20.2	23.0	24.6	27.7	29.2	30.4	31.9	33.5	35.4
Net foreign assets 1/	-1.9	-6.3	-6.8	-0.1	0.1	5.4	11.6	23.0	26.7	29.1	29.9	32.7
(in billions of U.S. dollars)	-1.3	-3.9	-4.8	-0.1	0.1	4.0	8.5	16.2	18.7	20.8	21.1	22.6
Net domestic assets	108.5	140.0	157.8	184.5	185.2	192.2	201.3	201.0	207.0	208.7	216.4	227.4
Net claims on government	89.7	122.8	139.1	151.4	151.0	148.7	153.9	148.7	150.4	151.4	155.8	160.3
Claims on business sector 2/	38.7	42.0	59.6	90.3	98.1	109.4	118.8	124.6	129.9	131.6	135.9	143.4
Turkish lira claims	23.1	24.5	40.7	71.2	77.6	88.2	98.8	103.7	108.1	109.5	113.1	119.3
Foreign exchange claims (est.) 1/	15.6	17.5	18.9	19.1	20.5	21.2	19.9	20.9	21.8	22.1	22.8	24.1
Other items (net)	-20.0	-24.8	-40.9	-57.2	-63.9	-66.0	-71.3	-72.3	-73.3	-74.3	-75.3	-76.3
					(Annual percent change)							
Memorandum items:												
Broad money (M2Y)	87.5	25.4	13.0	22.1	20.5	19.7	20.5	21.5	26.1	20.4	15.7	16.2
Lira broad money (M2)	48.0	31.0	33.7	31.2	22.9	29.8	33.8	33.6	33.0	22.0	16.2	16.5
Foreign exchange deposits 1/	137.9	21.0	-4.9	11.1	16.9	5.1	1.9	4.1	15.1	17.4	14.7	15.4
Claims on business sector 2/	22.3	8.4	42.1	51.4	49.4	39.6	40.6	38.0	32.5	20.3	14.5	15.1
					(In billions of U.S. dollars)							
Broad money (M2Y)	74.0	81.8	108.2	137.4	135.2	147.3	155.1	158.4	164.2	169.9	173.5	179.7
Lira broad money (M2)	32.8	37.9	59.3	80.9	83.0	94.2	100.3	102.6	106.3	110.2	112.7	116.7
Foreign exchange deposits	41.2	43.9	48.9	56.5	52.2	53.0	54.8	55.9	57.9	59.7	60.8	63.0
Net claims on government	62.3	75.1	99.6	112.8	110.2	110.9	112.1	105.2	105.7	108.2	109.8	110.7
Credit to the private sector	26.9	25.7	42.7	67.3	71.6	81.6	86.5	88.2	91.3	94.0	95.8	99.1
					(In percent share)							
Base money/GNP 3/	4.4	3.8	4.2	4.7	5.2	5.4	5.9	6.0	6.1	6.3	6.4	6.6
Broad money (M2Y)/GNP 3/	60.4	48.6	42.3	43.0	42.0	43.4	45.2	46.2	47.2	46.8	47.0	48.3
Lira broad money (M2)/GNP 3/	26.8	22.5	23.2	25.3	25.8	27.8	29.2	29.9	30.5	30.4	30.5	31.4
Private credit/GNP	21.9	15.3	16.7	21.0	22.2	24.0	25.2	25.7	26.2	25.9	25.9	26.6
Foreign currency deposits/M2Y	55.7	53.7	45.2	41.1	38.6	36.0	35.3	35.3	35.3	35.1	35.0	35.0
Money multiplier												
Broad money (M2Y)	13.7	12.8	10.2	9.1	8.1	8.0	7.7	7.7	7.7	7.5	7.4	7.3
Lira broad money (M2)	6.1	5.9	5.6	5.4	4.9	5.1	5.0	5.0	5.0	4.8	4.8	4.8

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

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

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

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

Table 8. Turkey: Central Bank Balance Sheet, 2001–06 1/

	2001	2002	2003	2004	2005				2006			
					Mar	Jun	Sep	Dec Proj.	Mar Proj.	Jun Proj.	Sep Proj.	Dec Proj.
(In billions of Turkish lira) 1/												
Net foreign assets	-12.7	3.9	8.8	11.0	18.5	24.2	26.2	39.5	42.9	45.6	45.8	47.8
Gross foreign assets	28.6	37.7	42.5	53.0	57.5	63.0	65.8	77.4	80.6	83.3	82.7	84.5
Gross foreign liabilities	41.2	33.8	33.6	42.0	39.0	38.8	39.6	37.9	37.7	37.7	36.9	36.8
International reserve liabilities	20.7	11.5	9.8	5.7	4.2	2.8	2.0	1.6	1.6	1.6	1.6	1.6
Other reserve liabilities 2/	10.1	13.2	14.5	22.3	22.2	22.0	21.5	21.8	21.3	21.0	19.9	19.4
Banks' FX deposits with CBT	10.4	9.1	9.3	14.0	12.6	14.0	16.1	14.4	14.8	15.2	15.4	15.8
Net domestic assets	20.6	6.5	6.0	9.2	4.4	0.4	1.5	-10.3	-12.5	-13.7	-12.3	-12.3
Base money	7.8	10.4	14.9	20.2	23.0	24.6	27.7	29.2	30.4	31.9	33.5	35.4
Currency issued	5.3	7.6	10.7	13.5	14.6	16.3	18.6	20.1	20.9	22.2	23.5	24.9
Banks' lira deposits at the CBT	2.5	2.8	4.2	6.7	8.4	8.3	9.1	9.1	9.5	9.7	10.0	10.6
(In billions of U.S. dollars)												
CBT gross international reserves	19.8	26.2	29.5	35.4	38.4	42.0	44.0	51.7	53.8	55.6	55.2	56.4
At current cross rates:	19.8	28.1	35.2	37.7	39.7	41.6	43.6	…	…	…	…	…
CBT gross international liabilities	28.6	23.5	23.4	28.1	26.0	25.9	26.5	25.3	25.2	25.2	24.6	24.5
CBT net foreign assets	-8.8	2.7	6.1	7.4	12.4	16.1	17.5	26.4	28.7	30.5	30.6	31.9
Plus CBT forward position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Minus other reserve liabilities	7.1	9.2	10.1	14.9	14.8	14.7	14.3	14.6	14.2	14.0	13.3	13.0
Minus Dresdner one year deposits	0.7	1.4	2.1	3.0	3.0	3.0	2.9	2.7	2.4	2.1	1.4	1.1
Minus defense fund	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
CBT net international reserves	-2.9	10.0	13.6	18.9	23.8	27.5	28.6	38.0	40.2	42.0	42.2	43.4
Treasury net international reserves 3/	-1.3	-14.7	-14.2	-17.6	-17.6	-17.1	-15.4	-15.2	-14.2	-13.3	-12.5	-11.5
Net international reserves (Treasury plus CBT)	-4.2	-4.6	-0.5	1.3	6.3	10.5	13.2	22.7	26.0	28.7	29.6	31.9
(In billions of Turkish Lira) 1/												
Net foreign assets (Treasury)	-1.8	-21.1	-20.4	-26.3	-26.3	-25.5	-23.0	-22.8	-21.3	-20.0	-18.7	-17.3
Net foreign assets (Treasury plus CBT)	-14.5	-17.2	-11.6	-15.3	-7.8	-1.4	3.2	16.7	21.6	25.7	27.1	30.5
Net domestic assets (Treasury) 4/	1.8	21.1	20.4	26.3	26.3	25.5	23.0	22.8	21.3	20.0	18.7	17.3
Net domestic assets (Treasury plus CBT)	22.4	27.6	26.4	35.5	30.8	26.0	24.6	12.5	8.8	6.2	6.4	4.9
Base money (Treasury plus CBT)	7.9	10.4	14.9	20.2	23.0	24.6	27.7	29.2	30.4	31.9	33.5	35.4
Exchange rate (TL per US dollar, in millions) 5/	1.44	1.63	1.40	1.34	1.37	1.34	1.37	...	...	...	...	...

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

1/ Through December 2003, all foreign currency aggregates are valued at end-December 2001 program exchange rates. For 2004 onwards end-September 2004 program exchange rates are used.

2/ Deposits of Turkish citizens living abroad.

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.

5/ Actual end-of-period figures. Millions until 2004, units thereafter with the introduction of the New Turkish Lira.

Table 9. Turkey: Banking System—Selected Indicators, 2002−05 (Cont.)

	2002 Dec.	2003 Dec.	2004 Mar.	2004 June	2004 Sept.	2004 Dec.	2005 March	2005 June
	(In millions of Turkish Lira; unless otherwise indicated)							
	Banking System							
Total assets	**212,681**	**249,693**	**255,974**	**274,839**	**294,208**	**306,448**	**313,722**	**337,267**
Cash and claims on CBT	13,872	14,962	14,941	17,616	19,543	20,819	20,988	21,559
Claims on other banks	15,401	15,141	12,159	15,264	19,450	21,044	15,130	20,769
Securities portfolio	86,105	106,844	113,159	114,081	120,449	123,681	129,196	131,394
Loans, net	52,932	67,210	72,407	88,243	93,984	100,101	108,529	122,505
Other assets	44,371	45,536	43,308	39,635	40,783	40,803	39,879	41,038
Total liabilities	**212,680**	**249,693**	**255,974**	**274,839**	**294,208**	**306,448**	**313,722**	**337,267**
Deposits	137,973	155,312	158,756	170,959	182,549	191,065	192,552	204,607
Borrowing from banks	21,967	25,918	25,508	32,543	34,201	33,765	34,757	42,890
Repos	6,161	11,241	10,698	12,062	13,397	10,596	12,836	14,996
Other liabilities	21,351	21,683	22,134	23,672	24,130	25,055	26,255	27,873
Shareholders' equity (incl. profits)	25,228	35,539	38,878	35,603	39,930	45,966	47,322	46,900
Memorandum items:								
Capital adequacy ratio (percent)	25.3	30.9	32.1	25.4	26.6	28.8	28.4	25.6
NPLs (percent of total loans)	17.6	11.5	10.2	6.3	6.1	6.0	5.8	5.4
Provisions (percent of NPLs)	64.2	88.5	89.8	86.6	88.6	88.1	89.2	88.4
Net profit (loss) after tax	2,336	5,678	921	2,403	4,626	6,451	2,182	4,212
ROA (percent)	1.1	2.3	0.4	1.0	1.8	2.3	0.7	1.4
ROE (percent)	9.3	16.0	2.4	6.7	12.6	16.4	5.2	9.5
Share in assets (percent)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Share in deposits and repos (percent)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Private Banks							
Total assets	**119,471**	**142,270**	**142,621**	**157,643**	**169,816**	**175,924**	**182,743**	**202,506**
Cash and claims on CBT	9,356	9,868	9,488	11,718	12,789	14,149	13,856	14,945
Claims on other banks	7,623	6,369	5,420	6,774	8,822	9,483	6,244	9,861
Securities portfolio	39,819	51,485	50,174	51,937	55,780	56,445	60,039	63,695
Loans, net	35,752	46,402	49,759	60,991	65,729	69,011	75,330	86,367
Other assets	26,921	28,146	27,781	26,223	26,696	26,836	27,274	27,636
Total liabilities	**119,471**	**142,270**	**142,621**	**157,643**	**169,816**	**175,924**	**182,743**	**202,506**
Deposits	80,629	88,180	85,518	95,386	101,225	105,195	106,422	115,906
Borrowing from banks	13,703	18,158	18,141	22,152	23,651	23,920	25,672	31,882
Repos	4,074	8,103	7,870	8,714	10,336	8,954	11,077	13,698
Other liabilities	5,871	6,872	7,902	8,690	9,259	10,455	11,749	12,995
Shareholders' equity (incl. profits)	15,194	20,958	23,191	22,700	25,346	27,399	27,823	28,023
Memorandum items:								
Capital adequacy ratio (percent)	19.6	23.5	24.7	21.1	22.1	22.3	21.3	19.5
NPLs (percent of total loans)	8.9	6.5	6.2	4.6	4.5	4.9	4.9	4.5
Provisions (percent of NPLs)	53.0	80.0	81.1	80.3	83.6	83.5	85.3	84.0
Net profit (loss) after tax	2410	2917	772	1371	2320	2825	1113	2148
ROA (percent)	2.0	2.1	0.5	1.0	1.6	1.8	0.7	1.2
ROE (percent)	15.9	13.9	3.3	6.6	10.4	11.8	4.4	8.0
Share in assets (percent)	56.2	57.0	55.7	57.4	57.7	57.4	58.2	60.0
Share in deposits and repos (percent)	58.8	57.8	55.1	56.9	56.9	56.6	57.2	59.0

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

Table 9. Turkey: Banking System—Selected Indicators, 2002−05 (Concl.)

	2002 Dec.	2003 Dec.	2004 Mar.	2004 June	2004 Sept.	2004 Dec.	2005 March	2005 June
	(In millions of Turkish Lira; unless otherwise indicated)							
	State Banks 1/							
Total assets	**67,831**	**83,134**	**89,335**	**89,954**	**96,859**	**108,841**	**108,496**	**111,318**
Cash and claims on CBT	4,000	4,589	4,912	5,264	6,130	6,000	6,477	5,855
Claims on other banks	3,996	5,365	3,894	4,614	6,000	6,689	4,821	6,263
Securities portfolio	39,245	47,716	55,104	54,126	56,366	63,333	64,781	63,482
Loans, net	8,804	12,202	14,325	17,439	18,060	21,057	22,711	24,642
Other assets	11,786	13,263	11,099	8,511	10,303	11,763	9,706	11,074
Total liabilities	**67,831**	**83,134**	**89,335**	**89,954**	**96,859**	**108,841**	**108,496**	**111,318**
Deposits	48,489	59,862	66,098	67,659	72,759	81,156	81,265	83,426
Borrowing from banks	2,230	2,338	2,103	2,982	3,123	4,249	2,676	4,142
Repos	1,022	1,018	897	1,308	1,471	1,231	1,085	999
Other liabilities	9,343	10,342	9,825	10,360	10,588	10,865	11,277	11,435
Shareholders' equity (incl. profits)	6,747	9,574	10,411	7,646	8,918	11,340	12,193	11,314
Capital adequacy ratio (percent)	50.2	56.3	56.2	34.9	37.9	41.5	45.2	39.1
NPLs (percent of total loans)	37.4	26.2	23.5	12.4	12.0	10.7	10.0	9.5
Provisions (percent of NPLs)	73.9	97.6	97.8	96.0	96.1	95.2	96.1	96.4
Net profit (loss) after tax	1,056	1,790	182	916	2,000	3,069	808	1,521
ROA (percent)	1.6	2.2	0.2	1.0	2.3	3.2	0.8	1.4
ROE (percent)	15.7	18.7	1.7	12.0	21.7	31.9	8.0	14.3
Share in assets (percent)	31.9	33.3	34.9	32.7	32.9	35.5	34.6	33.0
Share in deposits and repos (percent)	34.4	36.6	39.5	37.7	37.9	40.9	40.1	38.4
	SDIF Banks 1/							
Total assets	**9,310**	**7,075**	**6,825**	**7,146**	**6,048**	-	-	-
Cash and claims on CBT	62	52	35	35	35	-	-	-
Claims on other banks	619	456	545	762	403	-	-	-
Securities portfolio	4,655	4,964	4,942	4,904	4,287	-	-	-
Loans, net	1,889	910	655	614	523	-	-	-
Other assets	2,085	693	647	831	800	-	-	-
Total liabilities	**9,310**	**7,075**	**6,825**	**7,146**	**6,048**	-	-	-
Deposits	5,770	4,133	3,994	4,019	4,082	-	-	-
Borrowing from banks	1,274	837	837	1,133	1,010	-	-	-
Repos	1,024	2,025	1,896	1,980	1,063	-	-	-
Other liabilities	2,338	927	995	957	1,036	-	-	-
Shareholders' equity (incl. profits)	-1,096	-847	-897	-943	-1,144	-	-	-
Memorandum items:								
Capital adequacy ratio (percent)	-7.6	-21.6	-25.6	-27.0	-42.0	-	-	-
NPLs (percent of total loans)	69.4	53.8	28.6	27.5	31.8	-	-	-
Provisions (percent of NPLs)	60.5	75.4	67.9	67.5	78.3	-	-	-
Net profit (loss) after tax	-1,677	272	6	-28	-219	-	-	-
ROA (percent)	-18.0	3.8	0.1	-0.4	-3.6	-	-	-
ROE (percent)	-153.0	-32.1	-0.7	3.0	19.1	-	-	-
Share in assets (percent)	4.4	2.8	2.7	2.6	2.1	-	-	-
Share in deposits and repos (percent)	4.7	3.7	3.5	3.3	2.6	-	-	-
	Foreign and Investment Banks							
Total assets	**16,068**	**17,213**	**17,194**	**20,097**	**21,484**	**21,683**	**22,483**	**23,442**
Cash and claims on CBT	454	454	506	600	556	629	594	696
Claims on other banks	3,164	2,951	2,300	3,113	4,224	4,871	4,064	4,645
Securities portfolio	2,386	2,680	2,939	3,114	4,015	3,903	4,376	4,215
Loans, net	6,487	7,695	7,668	9,200	9,672	10,034	10,489	11,495
Other assets	3,577	3,434	3,781	4,070	3,017	2,246	2,960	2,389
Total liabilities	**16,068**	**17,213**	**17,194**	**20,097**	**21,484**	**21,683**	**22,483**	**23,442**
Deposits	3,086	3,137	3,145	3,895	4,483	4,714	4,866	5,275
Borrowing from banks	4,761	4,585	4,427	6,276	6,417	5,596	6,409	6,864
Repos	40	95	36	61	527	411	674	298
Other liabilities	3,798	3,542	3,412	3,665	3,248	3,735	3,229	3,442
Shareholders' equity (incl. profits)	4,383	5,854	6,173	6,200	6,810	7,226	7,306	7,561
Memorandum items:								
Capital adequacy ratio (percent)	48.4	60.8	63.1	53.8	52.4	56.0	54.3	49.4
NPLs (percent of total loans)	4.3	3.8	3.8	3.1	3.0	3.2	3.2	3.1
Provisions (percent of NPLs)	69.3	85.5	86.0	85.5	85.9	81.5	83.1	80.7
Net profit (loss) after tax	548	698	-39	144	526	557	260	543
ROA (percent)	3.4	4.1	-0.2	0.7	2.9	2.9	1.2	2.4
ROE (percent)	12.5	11.9	-0.6	2.3	8.5	8.6	3.8	7.6
Share in assets (percent)	7.6	6.9	6.7	7.3	7.3	7.1	7.2	7.0
Share in deposits and repos (percent)	2.2	1.9	1.9	2.2	2.6	2.5	2.7	2.5

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

1/ Data for SDIF banks not provided beyond September 2004 as they cover only a single bank, Bayındırbank, which has been classified as a state bank since September 2004.

Table 10. Turkey: Indicators of Fund Credit, 2003−10 1/

			Projections					
	2003	2004	2005	2006	2007	2008	2009	2010
Outstanding Fund credit (end of period)								
In billions of SDRs	16.2	13.8	10.4	7.8	6.1	4.9	2.4	0.5
In percent of quota	1681.7	1436.4	1074.1	806.0	632.0	506.6	250.0	47.6
In percent of exports of G&NFS	31.6	22.1	14.5	9.9	7.2	5.3	2.4	0.4
In percent of GNP	9.5	6.8	4.3	3.0	2.2	1.7	0.8	0.1
In percent of public sector external debt	24.2	21.5	17.1	12.8	10.2	8.2	4.1	0.8
In percent of overall external debt	15.6	12.7	8.5	5.9	4.4	3.3	1.6	0.3
In percent of end-period foreign reserves 2/	64.6	54.5	28.8	19.7	15.7	12.8	6.4	1.2
Repurchases of Fund credit								
In billions of SDRs	1.2	3.2	5.2	5.1	3.6	1.8	2.5	2.0
In percent of quota	127.0	327.6	535.1	528.2	368.4	190.2	255.6	202.5
In percent of exports of G&NFS	2.4	5.0	7.2	6.5	4.2	2.0	2.5	1.8
In percent of GNP	0.7	1.6	2.2	2.0	1.3	0.6	0.8	0.6
In percent of public sector external debt service	11.3	27.3	38.3	38.3	29.0	17.6	25.1	20.2
In percent of overall MLT external debt service	6.2	15.6	21.1	18.8	13.4	7.1	9.4	7.3
In percent of start period foreign reserves 2/	6.1	13.3	20.6	14.1	9.0	4.7	6.5	5.2
In percent gross public sector ext. financing 3/	7.3	16.0	10.6	15.7	18.5	12.6	15.4	10.2
Net Fund resource flows 4/								
In billions of SDRs	-0.7	-3.0	-4.1	-3.0	-2.0	-1.5	-2.6	-2.0
In percent of quota	-71.6	-312.4	-426.9	-315.1	-205.8	-150.9	-271.4	-207.7
In percent of exports of G&NFS	-1.3	-4.8	-5.8	-3.9	-2.3	-1.6	-2.6	-1.8
In percent of GNP	-0.4	-1.5	-1.7	-1.2	-0.7	-0.5	-0.8	-0.6
In percent of public sector external debt service	-6.4	-26.0	-30.6	-22.9	-16.2	-14.0	-26.7	-20.8
In percent of overall MLT external debt service	-3.5	-14.9	-16.9	-11.2	-7.5	-5.7	-10.0	-7.5
In percent start period foreign reserves 2/	-3.4	-12.7	-16.4	-8.4	-5.0	-3.8	-6.9	-5.3
In percent gross public sector ext. financing 3/	-4.1	-15.3	-8.4	-9.4	-10.3	-10.0	-16.3	-10.5

Sources: 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, as well as all 2006 repurchase expectations, which are projected on an obligations basis.

2/ Projections exclude year-to-date valuation changes in 2005 (approximately minus US$2.7 billion).

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

4/ Net purchases less repurchases and charges.

TURKEY: FUND RELATIONS
(As of September 30, 2005)

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

II.	**General Resources Account:**	**Millions of SDRs**	**Percent of Quota**
	Quota	964.00	100.00
	Fund holdings of currency	11,499.96	1,192.94
	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	14.80	13.18

IV.	**Outstanding Purchases and Loans**:	**Millions of SDRs**	**Percent of Quota**
	Stand-By Arrangements	10,648.74	1,104.64

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved**	**Amount Drawn**
			In millions of SDRs	
Stand-By	05/11/05	05/10/08	6,662.04	555.17
Stand-By	02/04/02	02/03/05	12,821.20	11,914.00
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

VI. **Projected Payments to Fund (Expectations Basis)**[1]
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	1,403.29	5,092.25	3,481.67	532.74	138.79
Charges/Interest	149.18	388.66	107.17	20.06	4.90
Total	1,552.47	5,480.91	3,588.84	552.79	143.70

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

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	1,132.70	5,362.84	2,520.65	961.02	532.74
Charges/Interest	149.18	403.45	124.00	52.41	19.81
Total	1,281.88	5,766.29	2,644.65	1,013.42	552.55

VII. **Safeguard Assessments**:

Under the Fund's safeguards policy, the CBT is subject to a full safeguards assessment with respect to the new SBA. The new assessment (completed on June 29, 2005) uncovered no material weaknesses in the CBT's safeguard framework, but made a few recommendations to address some remaining vulnerabilities in the areas of internal audit and controls.

VIII. **Exchange Rate Arrangement**:

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

IX. **Article IV Consultations**:

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

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

X. **ROSCs**

Standard or Code Assessed	**Date of Issuance**	**Document Number**
Fiscal Transparency	June 26, 2000	Report on the Observance Of Standards and Codes
Corporate Governance (prepared by the World Bank)	December 11, 2000	
Data ROSC	March 14, 2002	Country Report No. 02/55
Fiscal ROSC	May 20–June 3 (mission)	Report in preparation

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

Dept.	**Timing**	**Purpose**
MAE	Jul. 94	Banking sector reform
MAE	Jul. 95	Inflation accounting
FAD	Sep. 95	Taxation of petroleum products
FAD		Assistance to IBRD Public Financial Managing Project: 8 FAD missions since 1994, assignment of 5 resident experts mainly focused on customs modernization
STA	Feb. 97	Balance of payments compilation
PDR/EU1/MAE	Dec. 98	Short-term debt monitoring
MAE	Jun. 99	Basel core principles
MAE	Aug. 99	Debt management policies
MAE	Oct. 99	Banking sector reform
MAE	Mar. 00	Banking sector reform
FAD	Apr. 00	Fiscal transparency
FAD	Apr. 00	Tax policy
MAE	Apr. 00	Banking sector reform
MAE	May 00	Banking sector reform
MAE	Jul. 00	Inflation targeting
STA	Sept. 00	Balance of payments statistics

Dept.	Timing	Purpose
MAE	Sept. 00–Apr. 01	Banking sector reform
MAE	Apr. 01	Debt management
FAD/STA	May 01	Fiscal accounting and reporting
MAE/RES	Sept. 01	Inflation targeting
STA	Oct. 01	Data ROSC
STA	Apr. 02	National accounts statistics
MAE/RES	Apr.–May 02	Inflation targeting
STA	Jul. 02	Public finance statistics
FAD	Jul. 03	Social security contribution collections
FAD/MFD	Sept. 03	Taxation of financial intermediation /Direct tax reform
MFD	Dec. 03	Banking reform
FAD	Dec. 03	Informal sector and tax administration reform
MFD	Mar. 04	Currency reform
STA	Apr. 04	Consumer and wholesale price indices
STA	May 04	National accounts statistics
FAD	May 04	Public expenditure analysis
FAD	Jun. 04	Tax reform strategy
MFD	Oct. 04	Currency reform
FAD/MFD	Feb. 05	Treasury cash management and state bank reform
MFD	Apr.–May 05	Inflation targeting
ICM	May 05	Investor relations office
STA	Jun. 05	National accounts statistics
FAD	Jul. 05	Tax policy
FAD	Aug. 05	Social security contribution arrears
FAD	Sep. 05	Collection of taxes and social contributions

TURKEY: IMF–WORLD BANK RELATIONS[1]

Partnership in support of Turkey's Development Strategy

1. The IMF and World Bank teams have collaborated closely in Turkey, and standard working arrangements follow broadly the guidelines for enhanced Bank-Fund collaboration. The IMF has taken the lead in macroeconomic stabilization and the World Bank in social and structural areas, with collaboration in structural areas that may have a substantial 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

2. The objectives of the Country Assistance Strategy (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 European Union (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.

3. Under the program to promote sound macroeconomics and governance, the first priority has been the final loan in the Programmatic Financial and Public Sector Adjustment Loan (PFPSAL) series, the Third Programmatic Financial and Public Sector Adjustment Loan (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 the 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 studying the impact of the financial sector on growth and employment within a Computable General Equilibrium (CGE) model

[1] Prepared by World Bank staff.

framework; a Country Economic Memorandum (CEM) on EU accession; and a new Public Expenditure Review (PER).

4. The EU accession decision has generated new demand for the Bank's services in Turkey. The Bank has gained experience with the other candidate countries during the accession process that is highly valued in Turkey. In this context, the Bank has agreed to accelerate the preparation of a new series of CEMs on EU accession. The EU accession process also has the potential for the Bank to maintain a strong lending program in Turkey, in part because the EU's pre-accession assistance will increasingly focus on the areas where Turkey is to adopt the acquis, which leaves many other areas requiring Bank assistance, and in part because of the need to help the absorption of EU funds, which will not start to arrive in large amounts until after 2007.

5. One of Turkey's biggest economic and political challenges in convergence with the EU is to increase employment. With the essential macroeconomic factors now in place, the Bank is preparing to address promoting faster job creation through sustained high growth. A set of reforms, which would improve labor market flexibility and reduce informality, remove constraints to private sector development, including Small and Medium Scale Enterprises (SMEs), increase access to finance, reduce barriers to Foreign Direct Investment (FDI), and enhance the skills of the labor force, is under preparation.

6. Bank support for equitable human and social development will focus on secondary and tertiary 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. Diagnostic work on tertiary education is also underway. 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.

7. 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. The real sector is being supported through a series of export finance loans (EFIL 1, 2 and 3). The International Finance Corporation (IFC) will continue to finance viable private sector export-oriented projects including small and medium enterprises, and the Multilateral Investment Guarantee Agency (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 have been approved. Analytical work will be on financial sector reform and a rural development strategy. The

Bank is currently conducting a study to assess the investment climate in Turkey. The objective of the *Investment Climate Study* is to evaluate constraints on investment and private sector growth in Turkey. Its findings will help authorities in promoting both foreign and domestic investment.

8. Environmental management is a high priority since Turkey is seeking to adopt European Union environmental standards. Bank lending support currently focuses on micro-watershed management and a contribution to a regional effort to reduce chemical run-off into the Black Sea, the reduction of ozone-depleting substance (ODS) and a new approach towards management of biodiversity resources. The Bank will also continue to support disaster management through projects designed to mitigate seismic risks.

9. As of October 31, 2005, the portfolio of World Bank financed projects in Turkey comprises 21 operations, including one adjustment loan and two grant-financed projects, with total net commitments of about US$6 billion. IFC has been active in the financial sector, manufacturing, oil and gas, infrastructure and health and education. As of June 30, 2005, IFC's total portfolio in Turkey was about US$1.1 billion. With a gross exposure of US$135 million as of June 2005, Turkey is an important country for MIGA.

IMF-World Bank collaboration

Areas in which the World Bank leads.

10. The Bank leads 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.

Areas in which the Fund leads.

11. The Fund leads in macroeconomic stabilization including macro-fiscal policy, monetary policy, exchange rate policy and financial stability and risk management.

Areas of shared responsibility.

12. The work on public sector management and governance has focused on strengthening public expenditure management systems while maintaining fiscal discipline. The Fund has taken the lead in the short-term measures needed for fiscal adjustment such as income 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 the process for privatization of state banks, the 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. 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.

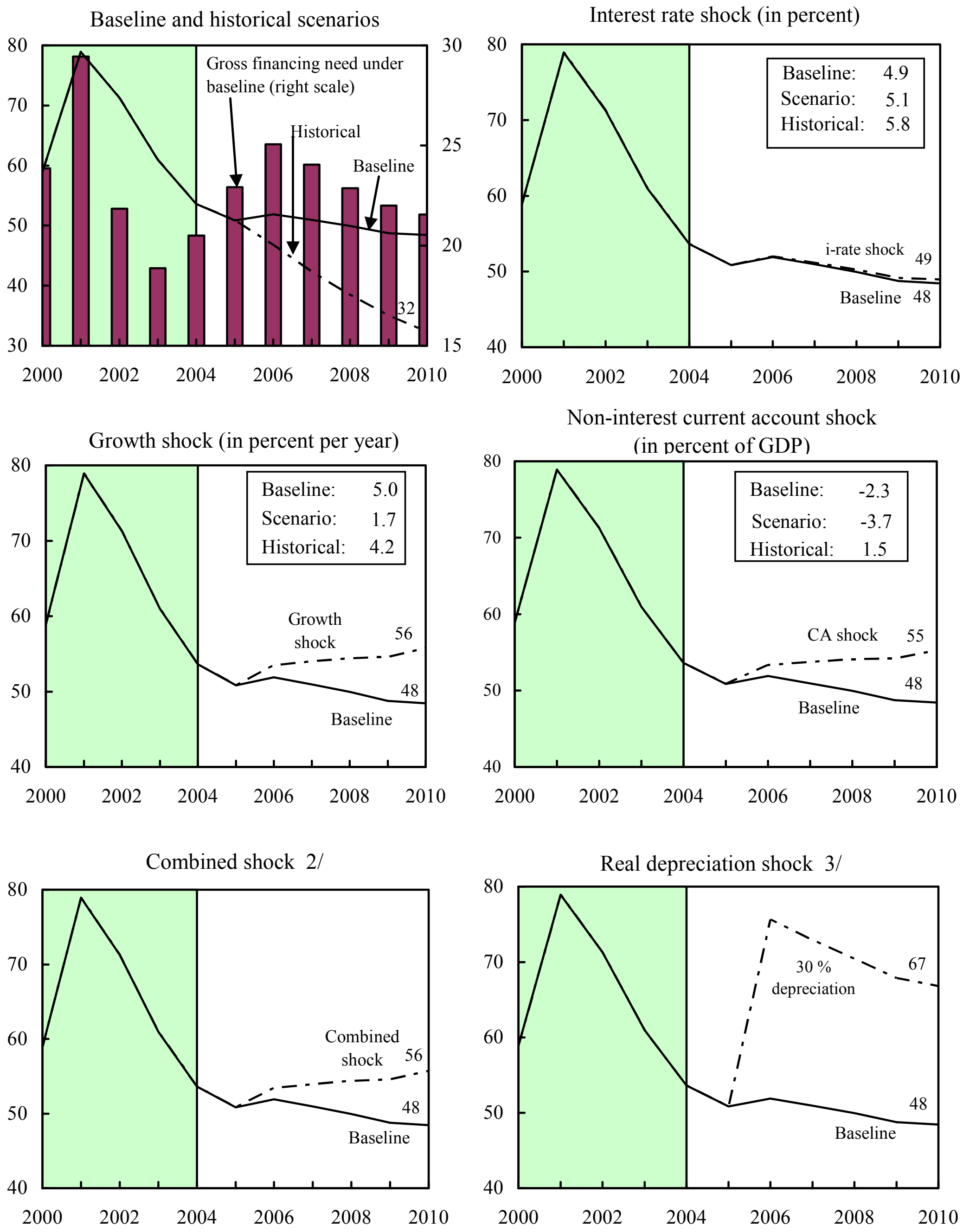
TURKEY: EXTERNAL DEBT SUSTAINABILITY

1. **Turkey's projected external debt ratios have worsened somewhat compared to the program baseline, primarily reflecting a deterioration in the current account balance**.[1] Over the 2005–10 period, the cumulative current account deficit is now some US$55 billion higher than under the original program. As a result, gross external debt is now higher than assumed earlier, though the increase is in part mitigated by an upward revision in non-debt creating flows (especially privatization-related foreign direct investment, on which original program assumptions had been conservative) Even so, higher than programmed international reserve accumulation means that the external debt position on a net basis has improved compared to the original program assumptions. Under the program, the gross external debt ratio was expected to fall sharply in 2005 (mostly due to exchange rate appreciation) and to continue falling over the medium term. Under the revised projections, gross debt also falls in 2005 (again, due mostly to exchange rate effects), but the gross external debt ratio rises in 2006 before settling into a shallower downward trajectory that leaves it 5.5 percentage points of GDP above the program levels in 2009. The medium-term debt stabilizing current account (excluding interest) rises from 2.1 to 2.2 percent of GDP (Table III.1).

2. **External debt remains vulnerable to standardized shocks** (Figure III.1). Turkey's history of macroeconomic volatility implies that the "standardized" bound debt sustainability tests are particularly demanding in comparison to most countries. A permanent one-half standard deviation growth shock would put the debt ratio on an upward trajectory over 2006–10 and lead to an increase of 8 percentage points in the gross external debt ratio by 2010. A permanent current account shock of one-half standard deviation would have a similar effect, as would a one-quarter standard deviation joint shock to growth, the current account, and interest rates. A real depreciation shock of 30 percent in 2006 would cause the gross external debt ratio to jump more than 24 percentage points to almost 76 percent, before declining gradually over the medium term. The sensitivity of external debt to exchange rate shocks is notable in light of widespread perceptions that the lira is overvalued.

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

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Table III.1. Turkey: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	58.9	78.9	71.3	61.0	53.6	**50.8**	**51.9**	**50.9**	**50.0**	**48.8**	**48.4**	**-2.2**
2	Change in external debt	3.9	20.0	-7.6	-10.3	-7.3	-2.8	1.1	-1.0	-1.0	-1.2	-0.3	
3	Identified external debt-creating flows (4+8+9)	1.1	19.2	-16.1	-13.8	-8.9	0.6	1.4	0.8	0.7	0.1	-0.4	
4	Current account deficit, excluding interest payments	1.7	-7.3	-2.7	0.5	2.8	3.7	3.3	2.7	2.2	1.8	1.3	
5	Deficit in balance of goods and services	7.2	-0.3	2.2	3.8	5.6	6.3	6.2	5.5	4.9	4.3	3.7	
6	Exports	26.8	36.9	31.4	30.4	31.1	30.1	30.9	31.2	31.4	31.8	32.8	
7	Imports	34.0	36.6	33.6	34.2	36.6	36.5	37.1	36.7	36.2	36.0	36.6	
8	Net non-debt creating capital inflows (negative)	-0.3	-1.9	-0.2	-0.5	-1.1	-3.1	-2.0	-1.9	-1.5	-1.5	-1.6	
9	Automatic debt dynamics 1/	-0.3	28.4	-13.2	-13.8	-10.6	0.0	0.1	0.0	-0.1	-0.1	-0.1	
10	Contribution from nominal interest rate	3.2	5.0	3.5	2.9	2.4	2.3	2.4	2.4	2.3	2.2	2.2	
11	Contribution from real GDP growth	-3.3	7.9	-4.9	-3.2	-4.7	-2.3	-2.4	-2.4	-2.4	-2.3	-2.3	
12	Contribution from price and exchange rate changes 2/	-0.2	15.6	-11.8	-13.5	-8.2	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	2.8	0.8	8.5	3.5	1.5	-3.3	-0.3	-1.7	-1.7	-1.3	0.1	
	External debt-to-exports ratio (in percent)	219.9	213.8	226.9	200.5	172.7	168.8	167.8	163.2	159.3	153.5	147.5	
	Gross external financing need (in billions of US dollars) 4/	48.0	42.4	39.9	45.0	61.8	82.0	95.4	98.5	100.8	104.4	108.3	
	in percent of GDP	23.9	29.4	21.8	18.9	20.5	22.9	25.1	24.0	22.9	22.0	21.6	
	Scenario with key variables at their historical averages 5/						**50.8**	**47.4**	**43.2**	**39.3**	**35.9**	**33.1**	**-1.6**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	6.3	-9.5	7.9	5.9	9.9	5.0	5.0	5.0	5.0	5.0	5.0	
	GDP deflator in US dollars (change in percent)	0.4	-20.9	17.5	23.3	15.6	12.9	1.3	2.5	2.5	2.5	0.8	
	Nominal external interest rate (in percent)	6.1	6.0	5.6	5.3	5.0	5.0	5.1	5.0	4.9	4.8	4.7	
	Growth of exports (US dollar terms, in percent)	12.4	-1.4	8.0	26.3	29.3	15.0	9.2	8.6	8.1	9.0	9.5	
	Growth of imports (US dollar terms, in percent)	26.3	-23.0	16.3	32.9	35.5	18.1	8.3	6.3	6.3	7.1	7.5	
	Current account balance, excluding interest payments	-1.7	7.3	2.7	-0.5	-2.8	-3.7	-3.3	-2.7	-2.2	-1.8	-1.3	
	Net non-debt creating capital inflows	0.3	1.9	0.2	0.5	1.1	3.1	2.0	1.9	1.5	1.5	1.6	

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

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

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

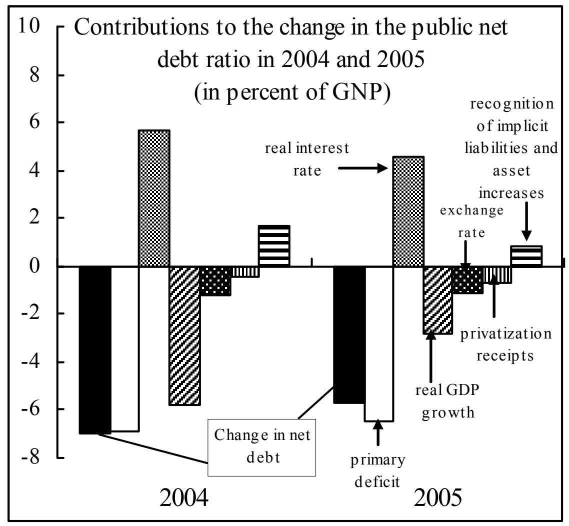
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

TURKEY: PUBLIC DEBT SUSTAINABILITY

While sustainability is achieved under most standard shock scenarios, a combination of large shocks could set the debt ratio on an unsustainable trajectory. Tests tailored to Turkey's particular circumstances highlight the importance of maintaining fiscal discipline in response to adverse global developments or Turkey-specific exogenous shocks.



1. **The public sector net debt ratio is declining faster than assumed under the program**. On the back of strong fiscal performance, high economic growth, declining domestic interest rates and an appreciation of the currency, the net public debt ratio fell from over 90 percent of GNP in 2001 to less than 64 percent in 2004 (equivalent to a gross debt ratio of 75 percent of GNP and a "Maastricht" ratio of 80 percent of GNP). While at the time of the program's approval the net debt ratio was projected to decline to 60 percent of GNP by end-2005, it is now estimated to fall to less than 58 percent, mainly due to a more rapid decline in interest rates and higher-than-expected privatization receipts (Table IV.1).

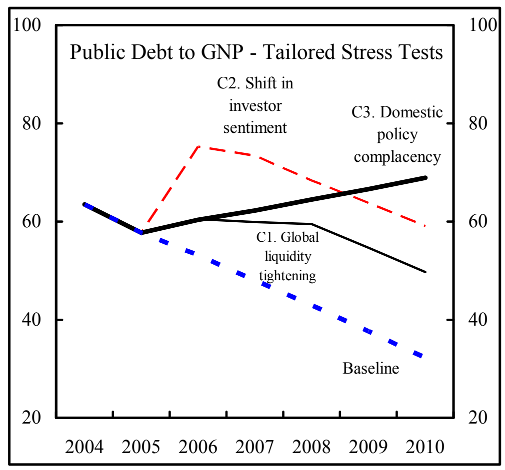
2. **Improvements in baseline assumptions will further accelerate the projected decline in the public sector debt burden over the medium term**. With a primary surplus of 6.5 percent of GNP, real growth of 5 percent, real interest rates of around 10 percent and privatization receipts of close to ½ percent of GNP each year, Turkey's net public debt was expected to fall by about 10 percentage points over the program period. However, recent developments would argue for less conservative real interest rate assumptions (the medium-term real interest rate is now projected at 8 percent each year) and higher privatization receipts. With other parameters unchanged, the programmed 10 percent reduction in the net debt ratio would already be achieved by end-2006; the ratio would then drop further to below 50 of GNP by end-2007 and to less than one third of GNP by the end of the decade.

3. **Debt dynamics remain sustainable under most standard *alternative scenarios,* but become unsustainable when setting all key variables at their historical averages** (Table IV.1, panel A). Under the low growth shock scenario (A3), the net debt ratio still falls to about 34 percent of GNP by 2010. The market forecast (A4) scenario yields a similar result under the assumption that the primary surplus would be reduced slightly in absence of an IMF program in the outer years of the projection. The no policy change (A2) scenario is identical to the baseline. In sharp contrast, where key variables return to historical averages (A1), net debt ratio increases to more than 97 percent of GNP by 2010, reflecting the fact that the historical averages cover a period with two financial crises.

4. **The standardized *bound tests* show that Turkey could cope with most of the isolated shocks, but a combination of large shocks would undermine sustainability** (Table IV.1, panel B, and Figure IV.1). Isolated shocks on the exchange rate (B5) and contingent liabilities (B6) would create one-time increases in net debt followed by a decline back to the initial ratios after two years. When shocking real growth (B2) or the primary balance (B3) the net debt ratio rises rapidly over the first two years, peaking at close to 70 percent, before returning to a declining path. While the interest rate shock (B1) and the combination shock (B4) result in a similar path, the net debt ratios under these scenarios would rise much higher to 92 and 106 percent, respectively, and the subsequent decline would be much slower. Debt sustainability under such circumstances would be at risk.

5. ***Tailored tests* assess particular risks to Turkey's debt dynamics** (Table IV.1, panel C).

- **Global liquidity tightening** (C.1). This test assumes that in 2006–08 interest rates in advanced markets rise much faster than currently anticipated, sharply reducing the capital flowing into emerging markets and also slowing world demand for their exports. This would weaken the currency and at the same time cause higher real interest rates and lower growth in those three years. As a result, the net debt ratio increases in the first year of the shock. Assuming an unchanged fiscal policy, the ratio then starts to decline in subsequent years, albeit at a slower pace, ending the decade at about one half of GNP rather than at the baseline's one third of GNP.

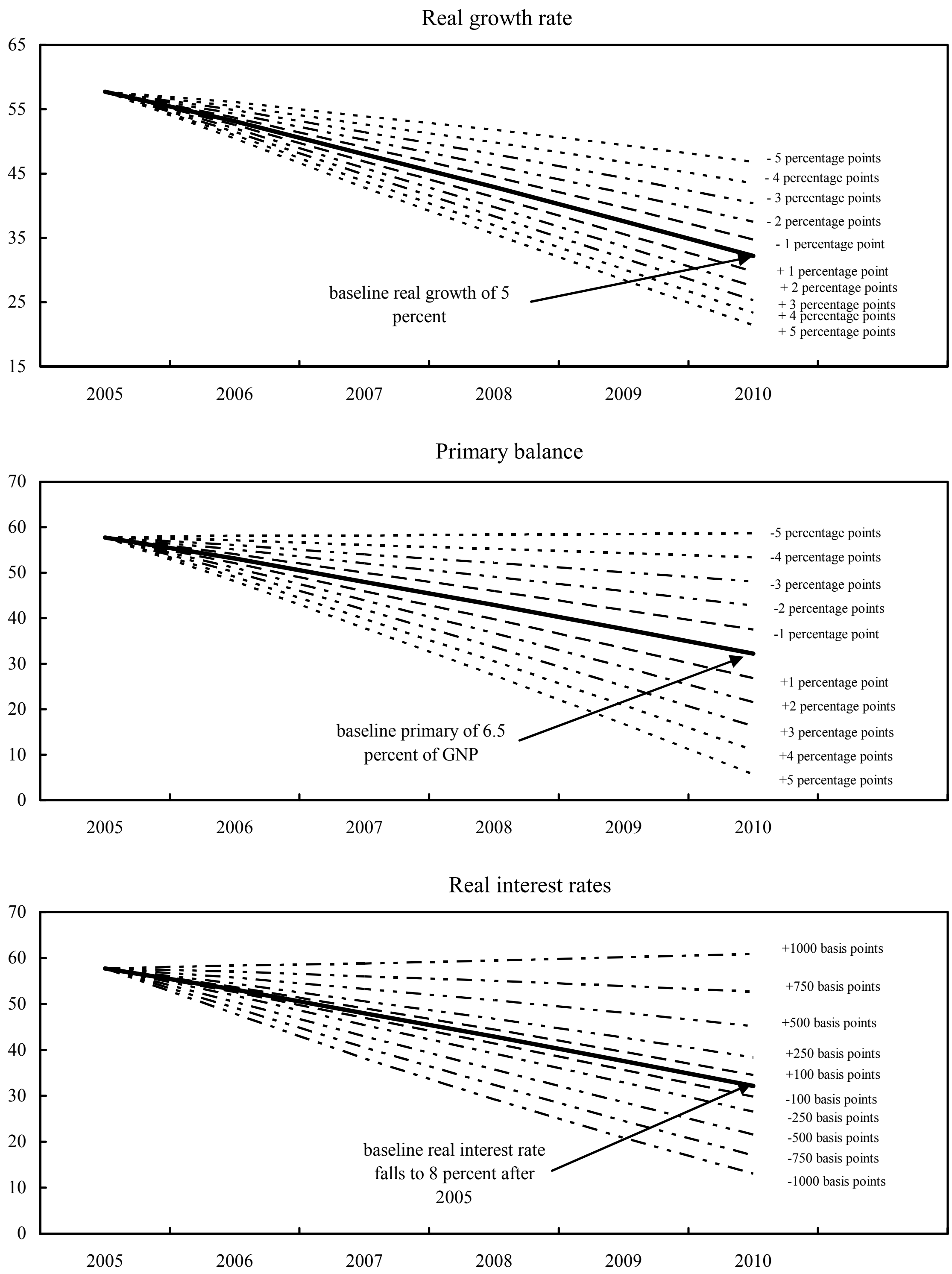


- **Shift in investor sentiment** (C.2). Triggered by a Turkey-specific event, investors are assumed to abandon Turkish assets, causing a sudden sharp exchange rate depreciation (30 percent). In the initial year of the shock (2006) growth is zero and interest rates return to their historic average, causing the public net debt ratio to jump by over 18 percentage points of GNP—thus reversing a large part of the improvement seen in recent years. Assuming an unchanged fiscal policy, however, confidence is restored and interest rates gradually return to the baseline over the next two years, accompanied by a strong rebound in economic activity. By 2010, the net debt ratio falls to around current levels.

- **Domestic policy complacency** (C.3). It is assumed that the primary surplus is lowered to 4 percent of GNP each year and that structural reforms are no longer pursued, including an immediate halt of privatization (zero receipts). This causes a permanent increase (400 basis points) in the real interest rate; and while the initial fiscal stimulus helps to maintain output in the first year, growths then falls to a lower trend rate (2.5 percent) in the following period. Taken together, this sets debt dynamics on a steadily increasing path, raising the net debt ratio by over 11 percentage points by the end of the decade.

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

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



Source: Fund staff calculations, based on DSA exercise.

Table IV.I. Turkey: Public Sector Debt Sustainability Framework, 2001–10

(In percent of GNP, unless otherwise indicated)

	Actual						Projections					
	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010
							I. Baseline Projections					
1 **Public sector debt 1/**	90.5	78.6	70.4	63.5			**57.7**	**53.1**	**48.0**	**42.9**	**37.6**	**32.2**
Of which: foreign-currency denominated	60.0	48.6	33.2	25.7			21.4	19.1	17.3	15.4	13.5	11.6
2 Change in public sector debt	33.4	-12.0	-8.1	-6.9			-5.7	-4.6	-5.1	-5.1	-5.3	-5.4
3 Identified debt-creating flows (4+7+12)	26.3	-12.5	-15.0	-8.8			-5.4	-7.7	-5.6	-5.7	-5.6	-5.7
4 Primary deficit	-5.5	-4.1	-6.4	-7.1			-6.5	-6.5	-6.5	-6.5	-6.5	-6.5
5 Revenue and grants	26.1	24.8	26.7	26.9			27.9	27.5	27.5	27.5	27.5	27.5
6 Primary (noninterest) expenditure	20.6	20.6	20.3	19.8			21.4	21.0	21.0	21.0	21.0	21.0
7 Automatic debt dynamics 2/	31.7	-8.1	-8.5	-1.3			1.8	1.4	1.4	1.3	1.1	1.0
8 Contribution from interest rate/growth differential 3/	6.1	-14.8	-2.6	-0.1			1.8	1.4	1.4	1.3	1.1	1.0
9 *Of which:* contribution from real interest rate	2.3	-10.2	0.9	5.6			4.6	4.0	3.8	3.5	3.1	2.7
10 *Of which:* contribution from real GDP growth	3.9	-4.6	-3.6	-5.8			-2.8	-2.6	-2.4	-2.2	-2.0	-1.7
11 Contribution from exchange rate depreciation 4/	25.6	6.7	-5.9	-1.2			...	...	...	...	...	...
12 Other identified debt-creating flows	0.0	-0.3	-0.1	-0.4			-0.7	-2.6	-0.5	-0.5	-0.2	-0.2
13 Privatization receipts (negative)	0.0	-0.3	-0.1	-0.4			-0.7	-2.6	-0.5	-0.5	-0.2	-0.2
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3) 5/	7.2	0.5	6.8	1.9			-0.3	3.1	0.5	0.6	0.3	0.3
Key Macroeconomic and Fiscal Assumptions					10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	-9.5	7.9	5.9	9.9	4.2	6.6	5.0	5.0	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 7/	55.6	30.4	25.4	20.0	68.2	34.1	16.2	14.0	12.5	11.5	11.0	11.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	11.2	7.9	15.9	12.3	20.1	12.1	8.5	8.0	8.0	8.0	8.0	8.0
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-53.6	-11.8	17.7	4.3	-26.7	23.7	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	55.3	44.4	22.5	9.5	56.0	25.6	7.7	6.0	4.5	3.5	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-15.3	8.1	4.3	6.8	4.0	6.8	13.9	2.9	5.0	5.0	5.0	5.0
Primary deficit	-5.5	-4.1	-6.4	-7.1	-2.8	3.3	-6.5	-6.5	-6.5	-6.5	-6.5	-6.5
							II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2006-10							**57.7**	**63.7**	**70.2**	**78.0**	**86.8**	**96.9**
A2. No policy change (constant primary balance) in 2006-10							**57.7**	**53.1**	**48.0**	**42.9**	**37.6**	**32.2**
A3. 2006 GDP growth is reduced (relative to baseline) by one standard deviation							**57.7**	**56.7**	**51.2**	**45.8**	**40.1**	**34.3**
A4. Selected variables are consistent with market forecast in 2006-10							**57.7**	**53.1**	**48.0**	**43.4**	**39.1**	**35.2**
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2006 and 2007							**57.7**	**72.3**	**91.9**	**88.2**	**84.2**	**80.0**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007							**57.7**	**62.3**	**67.1**	**62.6**	**57.9**	**53.0**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007							**57.7**	**63.3**	**68.7**	**64.2**	**59.5**	**54.7**
B4. Combination of B1-B3 using one standard deviation shocks							**57.7**	**78.3**	**105.8**	**102.4**	**98.8**	**95.1**
B5. One time 30 percent real depreciation in 2006 8/							**57.7**	**63.7**	**58.9**	**54.2**	**49.2**	**44.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2006							**57.7**	**63.1**	**58.3**	**53.5**	**48.5**	**43.4**
C. Tailored Tests												
C1. Global liquidity tightening 9/							**57.7**	**60.5**	**59.9**	**59.5**	**54.6**	**49.7**
C2. Shift in investor sentiment 10/							**57.7**	**75.2**	**73.4**	**68.3**	**63.8**	**59.1**
C3. Domestic policy complacency 11/							**57.7**	**60.4**	**62.2**	**64.5**	**66.6**	**68.9**

1/ Consolidated nonfinancial public sector, net debt.

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

3/ The real interest rate contribution is derived from the denominator in footnote 2 as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2 as $\alpha\varepsilon(1+r)$.

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

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

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

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

9/ Assumes a 10-percent real depreciation in 2006, an increase in real interest rates by 5 percentage points in 2006−08 and reduced annual GNP growth of 2.5 percent in 2006−08. Baseline assumptions for 2009−10.

10/ Assumes a 30-percent real depreciation, an increase in interest rates to historical average and zero growth in 2006; in 2007−08 interest fall gradually back to baseline, and growth rebounds with 8 percent per annum. Baseline assumptions for 2009−10.

11/ Assumes that starting in 2006 the primary fiscal balance is permanently reduced to 4 percent, privatization are cancelled (zero receipts) and real interest rates permanently rise by 4 percentage points. In 2007, annual growth drops permanently to 2.5 percent.

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

Ankara, November 24, 2005

Dear Mr. de Rato,

1. Economic performance under our program remains strong. Inflation is in single digits and growth, though moderating, remains robust. Financial markets have performed well, supported by favorable global credit conditions, the timely start of EU accession negotiations, and successful privatization of key state economic enterprises. Benefiting from these developments and from continued fiscal discipline, the overall fiscal deficit has dropped below the 3 percent of GNP Maastricht criterion and net public debt has fallen below 60 percent of GNP.

2. These achievements reflect confidence in Turkey's economic prospects as well as strong policy implementation under our program (Annexes A and B).

- With respect to the *quantitative performance criteria*, the end-September targets for external debt and net international reserves were met. And while there was an overrun in the overall balance of the social security institutions, the primary surplus target of the consolidated government sector (excluding SEEs) was met by a small margin. Given continued increases in currency demand and further financial deepening, the end-September base money ceiling was exceeded.

- As regards *fiscal reforms* envisaged in the program, we have submitted to Parliament a budget for 2006 consistent with a public sector primary surplus target of more than 6½ percent of GNP, a linchpin of the program. However, approval of legislation introducing universal health insurance and making parametric changes to the pension formula across occupational groups faced a significant delay, mainly because of the summer recess of Parliament and the need to extend the consultation process to ensure its broad support. We also recently submitted to Parliament legislation improving social security contribution collections. To further improve fiscal control, a quantitative framework was developed for monitoring health expenditures and secondary legislation required under the Public Financial Management and Control Law is expected to be put in place shortly. However, legislation strengthening state enterprise governance could not yet be submitted to Parliament as more time is needed to find consensus on a draft law.

- In the area of *financial sector reforms*, Parliament has re-approved legislation that will bring the supervisory framework more closely in line with EU standards, and the

BRSA has published, with a small delay, planned reforms to strengthen its organizational and governance structures. We have also recently adopted a restructuring and privatization strategy for state banks, and are expecting to adopt soon a timetable for phasing out the special privileges and obligations of these banks.

3. In light of this performance, we request the completion of the First and Second Reviews under the Stand-By Arrangement. On the basis of our strong disinflation performance, we are requesting a waiver of the end-September base money performance criterion. We are also requesting a waiver of nonobservance for the end-September target on the primary balance of the consolidated government sector including SEEs, given that through August the cumulative surplus of state enterprises was below programmed levels (we remain on track to meet the end-year targets). We are also requesting waivers for the end-June performance criteria for the banking law (passed with a slight delay on July 2) and the pension reform law, which is now expected to be approved by mid-February (structural performance criterion).

4. We are confident that the policies set out in the April 26, 2005 Memorandum of Economic and Financial Policies and this supplementary Letter of Intent are adequate to achieve the objectives of our program, and we stand ready to take further measures that may become appropriate for this purpose. We will continue to consult the Fund on the adoption of these measures and in advance of revisions to policies contained in this letter in accordance with the Fund's policies on such consultation.

Macroeconomic framework 2005−06

5. The economy is on track to grow by 5 percent this year and next and inflation is likely to come in somewhat below the 8 percent end-2005 target. As expected, growth has been moderating this year, but remains well supported by investment and construction activity. Non-agricultural employment has also picked up, with over 1 million new jobs created in the last 12 months, notwithstanding continued productivity increases. Inflation remains firmly under control—with both consumer and producer price inflation in single digits—though possible second round effects from high oil prices and stickiness in non-tradable prices will require continued vigilance in order to achieve next year's target.

6. The current account deficit has continued to widen and is now projected to reach 6 percent of GNP this year and to drop to 5.8 percent next year. Although this partly reflects outside factors—notably higher oil prices and the lifting of international quota restrictions on textiles—buoyant capital inflows and the resulting strong lira have also played a role. Importantly, the quality of external financing is improving, aided by successful privatization of state-owned enterprises, increased foreign direct investment, and borrowing at longer maturities. At the same time, the floating exchange rate will continue to serve as an important safety valve, and continued foreign exchange purchases by the central bank will allow a further build-up in international reserves. We will continue to review current account developments during the year and adjust policies as needed. The ¼ percent of GNP tightening embedded in the 2006 fiscal program goes in this direction.

Monetary policy

7. We will continue to pursue a prudent monetary policy, guided by our inflation targets. While inflation has fallen in line with expectations, base money growth has been stronger than expected, owing to declining interest rates and growing confidence in the lira. To reflect these developments, and since inflation remains under control, we are proposing base money targets for end-December that are slightly higher than the indicative targets envisaged at the outset of the program. To help improve our reserve coverage ratios, we also propose to lock in the much higher than programmed reserve build-up, and request that the floors for net international reserves be raised accordingly. We will continue to build reserves through the daily foreign exchange purchase auctions and we retain the option of using discretionary sterilized intervention to prevent excessive exchange rate volatility.

8. To further support disinflation, the CBT continues to prepare carefully for its move to formal inflation targeting in January 2006, including by improving its forecasting and policy analysis model and making the necessary organizational changes. The CBT recently hosted a regional workshop on inflation targeting and will make a detailed announcement on the operational framework in December. With the planned move to formal inflation targeting, the CBT plans to replace base money and net domestic asset ceilings—though these will continue to be monitored carefully—with an inflation consultation clause (Annex D).

Fiscal policy

9. Fiscal policy has remained prudent in 2005. Central government revenues are projected to be somewhat better than programmed, though expenditures have been under pressure mainly on account of additional transfers to the social security institutions (SSIs). These reflect the greater than expected costs of expanded access to drugs and medical services, administrative complications related to hospital and pharmacy reform, and contribution shortfalls linked to earlier rumors about an amnesty. Both of these latter effects we view as transitional and likely to subside over time. Thus, while the 4½ percent of GNP indicative ceiling on the SSI deficit is likely to be breached this year, we are confident that it is achievable in 2006. In addition, we remain committed to achieving the 6.5 percent of GNP primary surplus target in 2005 and, if needed, we will adjust budget allocations to ensure this target is met.

10. Looking ahead, fiscal discipline remains a cornerstone of the program and is essential to underpin our medium-term debt reduction targets, reduce Treasury's rollover rates, and ease pressure on the external current account deficit. Our 2006 budget, submitted to Parliament in mid-October, is fully consistent with these objectives. The consolidated budget and extrabudgetary funds are expected to deliver a combined primary surplus of 5.3 percent of GNP, which corresponds to a tightening of the fiscal stance when compared to this year's expected outturn of 5.0 percent of GNP. This adjustment will allow the government to maintain the primary surplus target for the public sector at just over 6½ percent of GNP, notwithstanding the privatization of Türk Telekom and TÜPRAŞ, which will reduce the contribution of the state enterprise sector to the overall primary target. The overall public sector deficit (program definition) is expected to improve further by ½ percentage point next

year, falling to around 1 percent of GNP, helped by lower interest rates and a declining debt burden.

11. Our fiscal program for 2006 also includes a number of steps aimed at improving the composition of revenues and expenditures. On the revenue side, these include: (i) initiating reforms of the personal and corporate income taxes; (ii) harmonizing the withholding tax regime for financial investment income; and (iii) permitting a real decline in petroleum excises. In terms of expenditures (relative to GNP), the budget: (i) reduces social security transfers, both by controlling health costs and by improving collections; and (ii) allows investment spending and capital transfers to increase over 2005 levels.

12. During the year, we will monitor closely macroeconomic developments and the implementation of our fiscal program. In the event that strong economic performance allows higher than expected revenue collection, we intend to spend additional revenues on high priority investment projects, provided that the overall primary surplus, the social security deficit, and the external current account position are evolving in line with program projections. Revenue overperformance will otherwise be saved.

13. Achieving the objectives of the 2006 budget depends crucially on our ability to contain the social security deficit. Consequently, we propose to replace the indicative targets on the social security deficit with semiannual performance criteria.

- To gain greater control over health spending, we have prepared a realistic annual lump-sum budget for the state hospitals under which each hospital will be expected to finance all of its patient expenditures. This lump-sum budget will be granted at the beginning of the year and it will be set as an upper limit for the total payments of social security institutions to public hospitals. At the same time, we plan to strengthen the auditing and payment mechanisms of the social security institutions as well as the management of public hospitals to preserve the amount and quality of services provided. We are conscious that containing health spending is key to preserving a sound budgetary position. To this end, we intend to monitor closely developments in this area and, if overruns emerge early next year, we stand ready to take additional measures.

- We are also introducing a new framework to strengthen social security contribution collections and provide a permanent solution to the problem of past arrears. These reforms include the following key components: (i) introducing a uniform statute of limitations of five years for all arrears; (ii) requiring recipients of government subsidies to be current on their tax and social security obligations; (iii) improving collection through prioritizing arrears by age and size and substantially increasing the number of employees in Bağ-Kur and SSK dedicated to collections; (iv) outsourcing collection of arrears on a commission basis, starting no later than June 2006; (v) reforming the penalty and interest regime so as better to discourage late filing and payment; and (vi) introducing an installment payment facility to clear the existing stock of arrears.

- To benefit from the installment payment facility, and to ensure that payments under the scheme are not diverted from other obligations, participants must remain current on their tax and social security obligations. The length of repayments will be linked to the age of the debt, and the size of repayments to contributors' ability to pay (at least in the case of large SSK debtors, whose capacity to pay is feasible to assess). To ensure fairness and transparency, this facility will not apply to payment arrears accumulated since end-March 2005. We recently submitted supporting legislative and regulatory frameworks to Parliament. Implementation will begin immediately following enactment of the supporting legislation and will be closely monitored under the program.

- Pending the implementation of the new pension law, we will ensure that pension increases and any changes to tax rebates to pensioners will be consistent with the inflation objective and the social security envelope provided for in the 2006 budget.

Structural fiscal reforms

14. We are making further progress in the area of tax policy reform, with the stage set for important changes that will simplify the tax structure, broaden the tax base and align tax policy more closely with EU practices.

- The *corporate income tax* will be overhauled by lowering the tax rate and phasing out exemptions and allowances, including to remove a significant anti-employment bias in the tax code. The reduction in the headline rate will make Turkey more competitive with its neighbors, while weakening taxpayers' motivation to engage in tax avoidance schemes. We believe that in the long run this reform will be revenue neutral but we have already identified expenditure savings that will be immediately put in place in case shortfalls emerge in the near term. We stand ready to take additional policy measures to ensure that the budget targets are preserved. We aim to make effective the proposed changes to the corporate income tax for fiscal year 2006. To this end, legislation will be submitted to Parliament soon.

- The *personal income tax* will be reformed in two steps: (i) by end-December 2005, legislative changes will be adopted to streamline the structure of the tax by unifying the schedules for wage and nonwage income and reducing the number of tax brackets, (structural benchmark). These changes are expected to be revenue neutral. (ii) We are planning to introduce additional reforms later in 2006 aimed at broadening the base and increasing the efficiency of the personal income tax. To this end, we are considering streamlining existing allowances and exemptions and reforming the existing system of consumption credits to make the tax structure more progressive. Any changes will be designed so as to increase—or at least, leave unchanged—the overall revenue yield. As these reforms are far-reaching and technical preparations are at an early stage, their introduction has been phased as follows: legislation will be submitted to cabinet by end-April 2006 and to Parliament by end-May 2006 (structural performance criterion). With extensive lead time needed for taxpayer education, parliamentary approval of the law is expected by end-September 2006 (structural performance criterion).

- We remain committed to phasing out the financial transaction taxes during the program period, starting with the *Banking and Insurance Transaction Tax* by end-2006 as budgetary conditions permit.

- Finally, from January 1, 2006, interest and capital gains—including on government securities—will be subject to a flat 15 percent final *withholding tax*, helping to further harmonize, simplify, and broaden the base of the income tax system.

15. To strengthen tax administration, we plan to: (i) establish a tax policy unit in the Ministry of Finance by end-December 2005 (structural benchmark); (ii) complete the functional restructuring of the newly established Revenue Administration by end-April 2006 (structural benchmark); and (iii) establish a large taxpayer unit, although this will now be possible only by end-June 2006 (structural benchmark). We are also improving coordination between the new Revenue Administration and the social security institutions (Bağ-Kur and SSK), in line with our intention to give increasing responsibility for social security contribution collection to the Revenue Administration.

16. To support these tax reforms, and in line with program objectives, we will refrain from introducing targeted incentives and sectoral tax cuts. In particular, we will continue to preserve the structure of the VAT and avoid introducing exemptions. To assist poorer (registered) farmers, we have, however, introduced subsidies on diesel fuel, fertilizer and on grain, resulting in a net overrun in the agricultural budget of less than 0.1 percent of GNP. We remain committed to controlling strictly the overall envelope for agricultural subsidies.

17. Passage of the pension reform law had to be delayed to ensure additional consultations with social partners and is now expected to be approved by mid-February (structural performance criterion). Submission to Parliament of the social security administrative reform law is expected by end-November (prior action), with passage by end-January 2006 (structural performance criterion).

18. A key fiscal objective in the area of decentralization is to improve spending efficiency and accountability, while ensuring strict financial discipline and local government fiscal sustainability. Sustainability of municipal finances going forward will be ensured by adherence to the newly established legal limits on personnel spending, borrowing, and debt stocks, improved financial management and accountability and, where needed, additional revenue or spending measures. We are mindful that the devolution of spending and the provision of transfers and revenue authority must proceed in tandem to avoid fiscal imbalances. Debt restructuring of municipalities is underway, although progress has been slower than expected, and a comprehensive report of municipalities' restructured debts will be made available by end-June 2006.

19. We have drafted legislation on governance of the state economic enterprises, but further consultations with stakeholders are needed to garner the necessary consensus before the draft law can be submitted to Parliament.

20. We are in the process of amending the Public Financial Management and Control Law to define internal audit and internal control requirements adequately and consistently with EU requirements. These amendments—which are consistent with our commitment to respect budget appropriations—have been submitted to Parliament and implementing regulations are expected to be adopted by year-end (structural benchmark). Finally, the comprehensive review of civil service wage and employment structure is on track to be completed by end-2005 (structural benchmark).

Financial sector reforms

21. We are further strengthening BRSA's supervision by bringing it closer to best international practices. To this end, Parliament has re-approved the banking law originally passed in early July. Given that more than 50 supporting regulations have to be issued within one year of the passage of the banking law (structural benchmark), the BRSA has prepared an action plan setting out the timetable and priorities for their drafting and implementation, and will publish on its web site a quarterly report on progress made in this area. Taking into account the findings of the Imar inquiry, on October 11 the BRSA published a set of actions to strengthen its organizational structure, including by merging onsite and offsite supervision, creating auditing teams and adopting a number of far-reaching measures to improve transparency and accountability. Implementation of the BRSA's organizational changes envisaged in the banking law will be completed by year-end. The transfer of supervision of non-bank financial institutions from the Treasury to the BRSA will also be completed before end-2005. The committee to assess whether further integration of financial sector supervision is warranted will soon be formed with a view to present its findings by end-March 2006 (structural benchmark).

22. Further progress is being made on preparations for the possible privatization of state banks. On June 30, 2005, bank-specific strategies were adopted by both the government and the boards of the state banks. Terms of reference for the hiring of a financial advisor for Halk were agreed in September and the relevant authorization by the High Privatization Council was obtained in November. The financial advisor will be hired by early January and an announcement setting out a timetable and modalities is expected by end-June 2006 (structural benchmark). In this context, and to take into account the input of the financial advisor, we are delaying to end-March 2006 the adoption of a timetable for phasing out special privileges and obligations of the state banks (structural benchmark). We intend to follow a similar process for Ziraat during 2006. In addition, Vakifbank completed successfully its first IPO in November 2005 (end-December 2005 structural benchmark).

23. SDIF is making good progress on the resolution of assets in its portfolio (end-2005 structural benchmark). The SDIF recently successfully auctioned the remaining non-related-party loans through profit sharing arrangements, which ensure that the recovery rate will be

substantially above that achieved in the previous auction. Reflecting asset sales to date, the SDIF has already repaid US$2 billion of its debt to the Treasury. Looking forward,

- Following the successful sale of 9 cement factories, and several media companies during September and October, the SDIF is on track to complete the sale of assets seized from the former owner of the failed Imar bank before end-2005.

- By end-2007, the SDIF will dispose through competitive bids its holdings of shares in companies and other assets. A strategy for its operational restructuring will be developed as assets are sold, but no later than end-September 2007.

- The resolution of Bayındırbank will be concluded by end-2007.

- The Treasury will, by end-March 2006, resolve its receivables from the SDIF that arise from the earlier costs of restructuring the banking system.

24. As part of our efforts to strengthen the financial sector and deepen financial intermediation, we plan to introduce new legislation establishing a framework for mortgage lending and securitization. Given the large expected increase in lending resulting from this reform, we plan to phase in gradually the implementation of the law, including by adapting the supervisory framework and prudential regulations as needed. It is envisaged that during a transitional period only banks will be allowed to extend mortgage loans and that loans will be restricted to purchases of dwellings, and a prudent limit for the size of the loan relative to the purchasing price will be set in implementing regulations.

Enhancing the investment climate

25. Our efforts to raise the quality of the investment climate have gained further momentum after the second meeting of the Investment Advisory Council (IAC) on April 29, 2005. We have also made some modifications to the Coordination Council for the Improvement of the Investment Climate (CCIIC) with a view to enable this platform to achieve quick results. To this end, in July 2005 we amended the Law on Municipalities and the Law on Organized Industrial Zones to streamline procedures for certain business permits and, in August 2005, we put in place the regulation on Opening Business and Operating Permits to further simplify and decentralize required procedures. In the period ahead, we intend to continue building on IAC advice to strengthen the investment climate, including in priority areas such as corporate governance and the social security system.

26. We are making good progress in our privatization program. As a result of the sale of 23 state-owned enterprises, US$3.2 billion in privatization revenues has been raised this year, of which US$2.7 billion has been transferred to the Treasury. This includes an initial payment for Türk Telekom (telecommunications), for which the tender process has been completed at a sale price of US$6.55 billion, bringing the total value of privatizations completed in 2005 to US$16 billion. The technical work on TÜPRAŞ (refineries) and Erdemir (steel) has also been concluded, and we expect to finalize these privatizations by

early 2006. Looking further ahead, we aim to complete the privatization of the remaining state-owned companies under the portfolio of the Privatization Administration by end-2006.

Very truly yours,

/s/	/s/
Ali Babacan Minister of State for Economic Affairs	Süreyya Serdengeçti Governor of the Central Bank of Turkey

Attachments

Turkey: Quantitative Performance Criteria and Indicative Targets for 2005−06

	May 31, 2005 2/		June 30, 2005		Sept. 30, 2005		Dec. 31, 2005	Mar. 31, 2006	June 30, 2006	Sept. 30, 2006	Dec. 31, 2006
	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Ceiling/ Floor	Ceiling/ Floor	Ceiling/ Floor	Ceiling/ Floor
I. Quantitative Performance Criteria 1/	(In millions of YTL, unless otherwise stated)										
1. Floor on the cumulative primary balance of the consolidated government sector 3/	8,779	12,336	15,745	17,320	25,995	n.a.	30,460	7,550	17,250	28,550	33,500
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 3/	8,079	9,879	14,145	16,023	23,295	23,331	26,660	7,250	16,350	26,950	30,800
3. Ceiling on contracting or guaranteeing of new external pubic debt with original maturities of more than one year (in millions of US$)	7,000	4,527	10,000	5,795	13,000	6,855	16,000	8,500	14,000	18,000	21,500
4. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	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$)	2.0	5.8	2.0	10.5	2.8	13.2	14.0	17.2	19.9	20.3	22.6
6. Ceiling on base money (in billions of YTL)	23.6	23.0	23.6	22.6	24.7	27.7	29.2	...	...	...	...
7. Ceiling on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 4/	-7,200	-7,303	-10,500	-11,224	-16,500	-17,792	-21,500	-6,100	-12,000	-18,400	-24,300
II. Inflation Consultation Bands											
Outer Band (upper limit)	...	...	...	...	...	...	...	9.4	8.5	7.8	7.0
Inner Band (upper limit)	...	...	...	...	...	...	...	8.4	7.5	6.8	6.0
Central Point	...	...	...	...	...	...	...	7.4	6.5	5.8	5.0
Inner Band (lower limit)	...	...	...	...	...	...	...	6.4	5.5	4.8	4.0
Outer Band (lower limit)	...	...	...	...	...	...	...	5.4	4.5	3.8	3.0
III. Indicative Targets											
1. Floor on the cumulative overall balance of the consolidated government sector 3/	-8,121	-817	-8,755	562	-10,205	n.a.	-19,590	-3,650	-4,050	-6,900	-7,800
2. Ceiling on the stock of net domestic assets of the CBT and Treasury combined	37.7	31.3	37.7	24.0	37.8	23.7	25.5	...	...	...	...
3. Privatization Proceeds (in millions of US$)	...	...	300	886	1,250	1,200	1,900	1,900	2,800	3,200	4,200

1/ Cumulative targets are set from January 1, 2005 for targets within 2005 and from January 1, 2006 for targets within 2006. The targets through June 30, 2006 are performance criteria; the remaining targets are indicative.
2/ End-April for floor on the cumulative primary balance of the consolidated government sector and for floor on the cumulative primary balance of the consolidated government excluding SEEs, and for the fiscal indicative target.
3/ After being adjusted for program adjusters.
4/ Indicative targets, except for end-June 2006 figure, which is a performance criterion.

Turkey: Structural Conditionality 2005–06 1/	
Action	Timing
Prior Action	
1. Parliamentary submission of social security administrative reform law (¶17)	Five days before Board meeting
Fiscal Measures	
2. No new amnesties of arrears on public sector receivables as defined in Annex F, with the exception of companies in the privatization administration's portfolio (¶19 April 26 LOI)	Continuous PC
3. At most, 10 percent of those leaving through attrition in the state enterprise sector will be replaced (¶17 April 26, LOI)	Continuous SB
4. Maintain excise taxes and SEE prices in line with program assumptions (¶11)	Continuous SB
5. Adopt implementing regulations for the Public Financial Management and Control Law (¶20)	SB. End-December 2005
6. Establish tax policy unit at Ministry of Finance (¶15)	SB. End-December 2005
7. Complete comprehensive review of civil service wage and employment structure (¶20)	SB. End-December 2005
8. Adopt legislative changes to streamline the structure of the PIT by unifying the schedules for wage and nonwage income and reducing the number of tax brackets (¶14)	SB. End-December 2005
9. Parliamentary approval of the administrative social security reform law (¶17)	PC. End-January 2006
10. Parliamentary approval of pension reform legislation (¶17)	PC. February 15, 2006
11. Complete functional restructuring of Revenue Administration, including reorganization of local tax offices (¶15)	SB. End-April 2006
12. Submit to parliament legislation to reform the personal income tax (¶14)	PC. End-May 2006
13. Establish a large-taxpayers unit within the Revenue Administration (¶15)	SB. End-June 2006
14. Parliamentary approval of legislation to reform the personal income tax (¶14)	PC. End-September 2006
Financial Sector Measures	
15. SDIF to sell all remaining non-related-party loans by auction (¶23)	SB. End-December 2005
16. Set up a committee to assess whether integrated financial sector supervision is warranted, with findings to be presented by end-March 2006 (¶21)	SB. End-March 2006
17. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶22)	SB. End-March 2006
18. Announcement of detailed state bank privatization strategies and timetables (¶22)	SB. End-June 2006
19. Completion of implementing regulations for the Banking Law (¶21)	SB. End-September 2006

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the Supplementary Letter of Intent.

Turkey: Proposed Schedule of Purchases

Existing schedule				Proposed schedule with rephasing 1/				Earliest possible
Review	SDR millions	Percent of quota	Test date		SDR millions	Percent of quota	Test date	purchase date
Approval	555.2	57.6		**Approval**	555.2	57.6		
2005				**2005**				
1st Review	555.2	57.6	31-May-05					
2nd Review	555.2	57.6	30-Jun-05	1st & 2nd Reviews	1,110.3	115.2	30-Sep-05	Upon fulfillment of prior action
3rd Review	555.2	57.6	30-Sep-05					
2006				**2006**				
4th Review	555.2	57.6	31-Dec-05	3rd Review	624.6	64.8	31-Dec-05	1-Mar-06
5th Review	555.2	57.6	31-Mar-06	4th Review	624.6	64.8	31-Mar-06	1-Jun-06
6th Review	555.2	57.6	30-Jun-06	5th Review	624.6	64.8	30-Jun-06	1-Sep-06
7th Review	555.2	57.6	30-Sep-06	6th Review	624.6	64.8	30-Sep-06	1-Dec-06
2007				**2007**				
8th Review	555.2	57.6	31-Dec-06	7th Review	624.6	64.8	31-Dec-06	1-Mar-07
9th Review	555.2	57.6	30-Apr-07	8th Review	624.6	64.8	30-Apr-07	1-Jul-07
10th Review	555.2	57.6	30-Aug-07	9th Review	624.6	64.8	30-Aug-07	1-Dec-07
2008				**2008**				
11th Review	555.2	57.6	31-Dec-07	10th Review	624.6	64.8	31-Dec-07	1-Mar-08
Total	6,662.04	691.1			6,662.04	691.1		

1/ Due to rounding amounts do not add up exactly to total.

MONETARY TARGETS

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

(In billions of YTL)

	Ceilings	Actual
Outstanding base money as of September 30, 2005		27.7 2/
December 31, 2005 (performance criterion)	29.2	

1/ These ceilings are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.
2/ Base money outturn at September 30, 2005.

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. These remain applicable until December 31, 2005, after which monetary policy will be monitored through consultation bands (see below).

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

3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex E), medium- and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange). As of September 30, 2005, net foreign assets of the CBT amounted to US$17.5 billion, net domestic assets of the CBT YTL 24.6 billion, and base money YTL 27.7 billion.

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 September 30, 2005, these amounted to US$15.4 billion, or YTL 23.0 billion (evaluated at program exchange rates).

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

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

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

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

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

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

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

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

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

(In billions of YTL)

	Ceilings	Actual
Outstanding NDA as of September 30, 2005:		23.7
December 31, 2005	25.5	

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.

Consultation mechanism on the 12-month rate of inflation

The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the State Institute of Statistics), are specified as follows:

	March 2006	June 2006	September 2006	December 2006
Outer band (upper limit)	9.4	8.5	7.8	7.0
Inner band (upper limit)	8.4	7.5	6.8	6.0
Central point	7.4	6.5	5.8	5.0
Inner band (lower limit)	6.4	5.5	4.8	4.0
Outer band (lower limit)	5.4	4.5	3.8	3.0

Inflation prospects will be an important part of each review under the arrangement. In line with our accountability principles, we are committed to report to the public the reasons for any breach of the outer bands, and our policy response. In this vein, should the observed year-on-year rate of CPI inflation fall outside the outer bands specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the CBT will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

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, 2005:		13.2	28.6
December 31, 2005 (performance criterion)	14.0		...
March 31, 2006 (performance criterion)	17.2		...
June 30, 2006 (performance criterion)	19.9		...
September 30, 2006 (indicative target)	20.3		...
December 31, 2006 (indicative target)	22.6		

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

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

3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the September 30, 2004 average London fixing market price of US$414 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US$0.33 billion on September 30, 2005). Reserve assets as of September 30, 2005 amounted to US$43.62 billion (evaluated at program exchange rates).

4. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL/YTL-denominated liabilities indexed to any exchange rate) to residents and non-residents with an original maturity of up to and including one year (including reserves against foreign currency deposits of the banking sector), claims from central bank letters of credit, overdraft obligations of the central bank, and central bank liabilities arising from balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On September 30, 2005 reserve liabilities thus defined amounted to US$15.07 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of September 30, 2005 these amounts were zero.

6. As of September 30, 2005 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$15.38 billion.

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

8. The projected Net International Reserves path from the fourth quarter of 2005 to the fourth quarter of 2006 is based, inter alia, on the following projections for foreign exchange receipts resulting from privatization:

	Privatization receipts, in $ millions, cumulative from 2005 Q4
2005 Q4	800
2006Q1	2,800
2006 Q2	3,700
2006 Q3	4,200
2006 Q4	5,200

9. Privatization receipts are defined in this context as the proceeds from sale or lease of (all or a portion of) entities and properties held by the public sector, including the Privatization Authority and the Savings Deposit and Insurance Fund, that are deposited in foreign exchange at the Central Bank of Turkey, either directly, or through Treasury.

10. In the event that realized foreign exchange receipts resulting from privatization depart from projected receipts, the NIR floor for each quarter will be revised upward (downward) by the excess (shortfall) of cumulative realized receipts compared to the projected cumulative receipts in paragraph 8 above.

Fiscal Targets

A. Primary Balance of the Consolidated Government Sector

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

	Floor (In millions of YTL)
Cumulative primary balance from January 1, 2005, to:	
December 31, 2005 (performance criterion)	30,460
Cumulative primary balance from January 1, 2006, to:	
March 31, 2006 (performance criterion)	7,550
June 30, 2006 (performance criterion)	17,250
September 30, 2006 (indicative target)	28,550
December 31, 2006 (indicative target)	33,500
Cumulative primary balance (excluding SEEs) from January 1, 2005, to:	
December 31, 2005 (performance criterion)	26,660
Cumulative primary balance (excluding SEEs) from January 1, 2006, to:	
March 31, 2006 (performance criterion)	7,250
June 30, 2006 (performance criterion)	16,350
September 30, 2006 (indicative target)	26,950
December 31, 2006 (indicative target)	30,800

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the 3 extra budgetary funds (EBFs) identified below, the 25 state economic enterprises (SEEs) identified below, the social security institutions (SSIs), and the unemployment insurance fund. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

a) For the central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported transfers to social security institutions will be replaced by cash transfers reported by the social security institutions.

b) For the EBFs from above the line on a modified cash basis, counting non-transferred shared tax revenues, to the extent these are not already recorded as reserves by other elements of the CGS.

c) For the SSIs, and the unemployment insurance fund from above the line on a cash basis.

d) For the SEEs, from below the line as described in paragraph 6.

2. For the purposes of the program, the primary revenues will exclude interest receipts of the consolidated central government (including on tax arrears, although combined penalty/interest charges associated with tax payments will be counted as primary revenues starting with the March 2006 test date), SEEs, and of the unemployment insurance fund (UIF), profit transfers of the Central Bank of Turkey (CBT) and net special revenues of the Turkish mint, proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof), and state bank dividend payments. Late payment penalties of the UIF will be understood to be part of UIF interest receipts (and thus excluded from primary revenues) in 2005, but not in 2006, when they will be included as primary revenues. Revenues of the CGS from sales of immovables will be included up to an aggregate cap of YTL 500 million. Interest receipts of EBFs and SSIs will not be excluded. As well, the floor on the primary balance will be adjusted upwards for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments.

3. For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. Privatization-related expenditure of the Privatization Fund will not be excluded, starting with the March 2006 test date. Current carryover appropriations are not included as expenditures when constructing the program targets, while spending against such appropriations will count as primary expenditures for the purposes of calculating both primary and overall balances.

4. Net lending of any component of the CGS will be considered as a non-interest expenditure item. (If this net lending is negative, it will be considered as a non-interest revenue item.) Payment of guaranteed debt by treasury on behalf of non-CGS components of the public sector will not be treated as net lending up to the baseline reported in Annex G.

Extrabudgetary funds

5. The three EBFs included in the definition of the performance criterion are the Defense Industry Support Fund, the Privatization Fund, and the Social Aid and Solidarity Incentive Fund.

State economic enterprises

6. The 25 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal), T. ŞEKER FAB (sugar), TMO (soil products office), TEKEL (tobacco), TCDD (railways), Türk Telekom (telecommunications), BOTAŞ (natural gas), TEDAŞ (electricity distribution), EÜAŞ (electricity generation), TETAŞ (electricity trade), TEİAŞ (electricity transmission), TPAO (petroleum exploration and extraction), ETİ

Maden İŞL., MKEK, TKİ, ÇAYKUR, DHMİ, PTT, PETKİM, THY, TÜPRAŞ, TİGEM, KIYEM, TDİ, and DMO.

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

8. Net financing from the banking system (excluding pre-export financing from Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2004 the stock of net banking claims on SEEs as defined above stood at YTL 499 million, valued at the exchange rates on that day.

9. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2004 the stock of external loans stood at YTL 8,207 million, valued at the exchange rates on that day.

Social security institutions

10. The three social security institutions (SSIs) included in the definition of the performance criterion are SSK, Bağ-Kur, and Emekli Sandığı. The deficits of the SSIs will be covered by transfers from the central government budget, and they are thus expected to be in primary balance.

Adjusters

11. The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as the sum of (i) overdue pension payments; (ii) medicine payments overdue by more than 45 days for both imported and domestic medicine (from the date of invoice receipt); (iii) other payments overdue by more than 30 days and payments to hospitals overdue by more than 60 days (from the date of invoice receipt). In the case of Bağ-Kur they exclude the arrears to the common retirement fund. The stock of arrears for Bağ-Kur stood at YTL 0 million; for SSK stood at YTL 0 million; and for ES stood at YTL 0 million on September 30, 2005. These stocks of arrears will be used for the purpose of calculating the adjustor.

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

a) For any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;

b) For any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).

c) For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 100 million.

13. The floor on the primary surplus of the CGS will be adjusted upwards (downwards) in line with the projected surplus (deficit) of the primary balance of any fund or entity that is incorporated in the CGS after January 1, 2004.

14. The floor on the primary surplus of the CGS will be adjusted by the primary balance projected at the time of approval of the program for any state economic enterprise (included in the performance criterion) when there is a change of control due to privatizations. The adjustor will be calculated as the difference between the primary surplus generated by the company while in public control and the annual projection. This adjustor does not apply to Türk Telekom or TÜPRAŞ in 2006.

B. Overall Balance of the Consolidated Government Sector

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

	Floor (In millions of YTL)
Cumulative overall balance from January 1, 2005 to:	
December 31, 2005	-19,590
Cumulative overall balance from January 1, 2006 to:	
March 31, 2006	-3,650
June 30, 2006	-4,050
September 30, 2006	-6,900
December 31, 2006	-7,800

15. The overall balance of the consolidated government sector (CGS), Table 1, comprises (i) the primary balance of the CGS as previously defined in this annex, (ii) the net interest payments of the central government (excluding in 2006 those combined penalty/interest charges associated with tax payments and already included as primary revenues), the UIF, and the SEEs, (iii) the interest payments of SSIs and EBFs, (iv) transfers of profits from the

CBT and net special revenues of the Turkish Mint to the consolidated central government, and (v) state bank dividends payments and expenditures under the risk account (net lending).

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

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

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

Table 1. Turkey: Performance Criteria and Indicative Floors on the Cumulative Overall Balance (before transfers) of the Social Security Institutions

	Floor (In millions of YTL)
Cumulative overall balance (before transfers) from January 1, 2005 to:	
December 31, 2005 (indicative target)	-21,500
Cumulative overall balance (before transfers) from January 1, 2006 to:	
March 31, 2006 (indicative target)	-6,100
June 30, 2006 (performance criterion)	-12,000
September 30, 2006 (indicative target)	-18,400
December 31, 2006 (indicative target)	-24,300

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

D. Amnesties and Public Sector Receivables

19. Amnesties will be understood as a reduction in the net present value of a public receivable, without any reference to individual ability to pay, or attempt to enforce individual payment. A public receivable will be understood as an obligation to general government (GFS definition) or to a state economic enterprise or state bank.

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

PROGRAM BASELINE FOR TREASURY NET LENDING

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US$)	Baseline (In millions of YTL)
Cumulative net lending from January 1, 2005 to:		
December 31, 2005	770	1,100
Cumulative net lending from January 1, 2006 to:		
March 31, 2006	95	140
June 30, 2006	180	265
September 30, 2006	265	390
December 31, 2006	335	490

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

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

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

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

SHORT-TERM EXTERNAL DEBT CEILINGS

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

	Ceilings (In millions of US$)
December 31, 2005 (performance criterion)	1,000
March 31, 2006 (performance criterion)	1,000
June 30, 2006 (performance criterion)	1,000
September 30, 2006 (indicative target)	1,000
December 31, 2006 (indicative target)	1,000

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

MEDIUM- AND LONG-TERM DEBT CEILINGS

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

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

1. The limits specified in Table 1 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex F) of new, nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the International Monetary Fund on August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The term "nonconcessional" means containing a grant element of less than 35 percent on the basis of the currency-specific discount rates based on the OECD commercial interest reference rates in place at the time at which the contract is entered into, or guarantee issued.

2. Excluded from this performance criterion are credits extended by the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank of Turkey and sales of treasury bills and bonds denominated in TL/YTL or FX to nonresidents in either the domestic primary market or the secondary market. Also excluded from this performance criterion is debt or the guaranteeing of debt if the proceeds from that debt have been used to retire other debt as part of a liability management operation that results in an improvement of the debt profile, either through a lengthening of maturity or a reduction in net present value of the debt stock; this could include direct swaps of one debt instrument for another and new debt issues whose proceeds are used to retire other debt; to qualify for exclusion from the PC, the debt that has been retired pursuant to such liability management operations must have a maturity date at least one year past the contract date of the new debt that has been undertaken.

3. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

PROGRAM EXCHANGE RATES

Table 1. Cross Exchange Rates for Program Purposes

	TL value	YTL value	U.S. dollars per currency unit
Program exchange rates			
U.S. dollar	1,497,696	1.497696	1.0000
Euro	1,845,162	1.845162	1.2320
Japanese yen	13,469	0.013469	0.0090
Swiss franc	1,186,643	1.186643	0.7936
U.K. pound	2,707,645	2.707645	1.8086

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period May 31, 2005–May 31, 2008. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of September 29, 2004.

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

INTERNATIONAL MONETARY FUND

TURKEY

First and Second Reviews Under the Stand-By Arrangement, and Requests for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Matthew Fisher

December 8, 2005

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

Economic developments

1. **Recent inflation data remain consistent with achieving the 8 percent end-year target**. In November, the consumer price index rose by 1.4 percent—largely reflecting seasonal food and clothing price increases—bringing cumulative year-to-date inflation to 7.3 percent. Meanwhile, the producer price index, which is more skewed towards tradables, declined by 1 percent, largely as a result of declining oil prices.

2. **Trade data pointed to continued weakness on the external side**. While the October trade deficit (US$3½ billion) was lower than in previous months, the improvement was less marked than programmed. A continuation of import buoyancy in the last two months of the year could result, *ceteris paribus*, in a current account deficit slightly above staff projections.

3. **Fiscal performance improved slightly in October**.[1] The primary surplus at the consolidated budget level was about 0.1 percent of GNP above target, helped by strong revenues (particularly from direct taxes) and lower than programmed spending (especially on capital projects and defense).

4. **Treasury continued to make efforts to lengthen borrowing maturities**. This week, Treasury raised (i) Euro 350 million by re-opening its 2012 Eurobond, thus bringing this year's international bond borrowings to US$6½ billion (well above the programmed level of US$5½ billion); and (ii) YTL 3.7 billion from the domestic market by issuing a fixed-rate lira bond with a 5-year maturity—the first long-term fixed rate issue in lira since the

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[1] Final end-September fiscal data for state economic enterprises remain unavailable. (The authorities have committed to delivering such data in a more timely fashion in the future.) Preliminary information suggests some underperformance, driven largely by greater-than-anticipated grain purchases by the government grain agency, whose costs were only partly offset by overperformance in other state enterprises.

beginning of the year—and carrying a record-low yield of 12¼ percent. On December 6, Fitch revised its outlook on Turkey's BB *minus* rating from stable to positive.

Policy implementation

5. **The authorities have identified measures to achieve this year's 6.5 percent of GNP primary surplus target**. To this end, they have blocked up to 0.2 percent of GNP in budget appropriations, with nearly half of the cuts borne by investment and the remainder spread across transfers and goods & services.

6. **On December 5, the central bank announced the details of its inflation targeting framework**. Specifically: (i) inflation targets for the headline CPI are to be jointly decided by the central bank and the government and will be announced at three-year horizons—the targets for end-2006 was retained at 5 percent, and the 2007 and 2008 targets were set at 4 percent; (ii) the central bank will attach an uncertainty range of plus or minus 2 percentage points around the inflation targets; (iii) quarterly Inflation Reports will replace the current monetary policy reports; (iv) responsibility for interest rate decisions will transfer from the central bank governor to the Monetary Policy Committee (MPC); (iv) the calendar of MPC meetings will be announced 12 months in advance; and (v) MPC decisions will be made public on the same day of the meeting, with a summary of the discussion published within 5 business days.

7. **Consistent with the objective of accelerating reserve build-up, the central bank has announced that it will increase the size of scheduled daily foreign exchange purchases**. Starting January 2, 2006, daily minimum purchases are to be increased from US$15 million to US$20 million. The optional amount that banks can sell will increase in tandem, bringing the daily maximum purchases of foreign exchange through auctions from US$45 million to US$60 million.

8. **The social security administrative reform law was submitted to parliament on December 8 (prior action)**. The law will allow the three social security institutions to be unified and will facilitate timely implementation of the parametric pension reform. Although the normal working practice of ensuring that prior actions are met five days before the Board meeting was not observed, Fund and World Bank staffs have reviewed the draft law and found that it conforms to the understandings reached with the authorities.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
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IMF Executive Board Completes First and Second Reviews Under Stand-By Arrangement for Turkey

The Executive Board of the International Monetary Fund (IMF) today completed the first and second reviews under the three-year SDR 6.66 billion (about US$9.46 billion) Stand-By Arrangement with Turkey approved on May 11, 2005 (see Press Release No. 05/104). The Board also granted Turkey's request to waive the nonobservance of end-September performance criteria pertaining to base money and the primary balance of the consolidated government sector, as well as end-June structural performance criteria relating to passage of the banking and pension reform laws.

Completion of the review will enable Turkey to draw immediately an amount equivalent to SDR 1.11 billion (about US$1.58 billion).

Following the Board's discussion, Ms. Anne O. Krueger, First Deputy Managing Director and Acting Chair, made the following statement:

"Turkey's economy continues to perform well. Growth has moderated in line with program assumptions, inflation is in single digits, and the public debt burden is being reduced steadily. The authorities' adherence to prudent macroeconomic policies has played a key role in supporting these developments. The main challenge to the economic outlook is the widening current account deficit, which has been driven by increasing oil prices and strengthening of the lira.

"The authorities' response to the current account developments—a strong 2006 budget, a gradual easing of monetary policy, and stepped-up reserve accumulation—has been appropriate. Given uncertainties to the external outlook, the authorities should ensure that fiscal policy implementation remains consistent with achieving the public sector primary surplus target of 6½ percent of GNP and that revenue overperformance is saved. Should the current account deficit not stabilize as expected, the authorities will need to respond with an appropriate set of policies, including fiscal tightening.

"The authorities' structural reform agenda will complement these prudent macroeconomic policies and should help sustain economic growth and reduce vulnerabilities. In this regard, efforts to rein in the rising social security deficit will be key. In the short run, priorities are to address growing health spending and implement in full the agreed framework for strengthening social security collections. Ensuring the long-run viability of the social security system will require fundamental changes to the pension system. While delays in this area are unfortunate, the authorities' commitment to accelerating social security reforms is welcome. Elsewhere, progress on improving both the personal and corporate income tax structures is commendable, but greater efforts are needed to strengthen tax administration. On the financial sector side, while steady progress is being made to strengthen bank supervision and resolve Saving Deposit Insurance Fund assets, state bank privatization needs to keep pace.

"The central bank's cautious approach to interest rate cuts is appropriate given next year's more challenging inflation outlook. In this context, the central bank's adoption of formal inflation targeting is welcome. The central bank should also continue to take advantage of favorable market conditions to augment further its international reserves, while remaining fully committed to a flexible exchange rate.

"The authorities' commitment to implementing the revised program in full is welcome and should help sustain Turkey's current good economic performance. However, taking into account Turkey's still high public debt and its relatively short maturity, the authorities should continue to take advantage of the current benign global environment to lengthen borrowing maturities further and ensure that policies are consistent with attracting foreign direct investment. The authorities' strong efforts deserve the continued support of the international community," Ms. Krueger said.

Statement by Willy Kiekens, Executive Director for Turkey and Levent Veziroglu. Senior Advisor to Executive Director
December 9, 2005

Turkey's economic program has delivered encouraging results over the last four years. As economic fundamentals and investor confidence have become stronger, the economy is experiencing the fastest growth and the lowest rate of inflation in several decades. This economic performance is underpinned by sustained high primary surpluses and a floating exchange rate regime. Turkey was also helped by ample external liquidity. The EU decision of October 3, 2005, to start accession negotiations with Turkey changed the perception of economic agents, in particular foreign investors, with respect to the country's medium-term outlook and investment opportunities. Because these negotiations are a strong anchor for continued disciplined policies, they equally anchor investor confidence.

Completion of the first and second reviews would strengthen the momentum of the economy, boost confidence and help the authorities in implementing the remaining critical reforms.

1. Macroeconomic Performance

With 5 percent output growth, the economy has continued to expand, but at a more sustainable pace. In the last four years, the cumulative increase in labor productivity was 35 percent. Higher total factor productivity will have a major impact on Turkey's growth potential in the coming years.

Inflation expectations declined significantly. Recent market surveys suggest that end-year inflation will be below 8 percent. For the third year in a row, inflation would be better than the program target.

This year's current account deficit is expected to reach 6 percent of GNP, mainly because of high oil prices. This deterioration is a concern, and the authorities are aware of its risks and are monitoring developments carefully. So far, net capital inflows have exceeded the current account deficit. Structural changes in the economy, particularly in production, contributed to the behavior of the current account. Total domestic investment is on an upward trend because of prudent policies. Trade data suggest that raw material and intermediary goods constitute the bulk of Turkey's imports. This is partly due to the fact that imports of some intermediary goods became cheaper with the appreciation of the Turkish lira. However, data also indicate that industries have been stock piling these goods.

2. Fiscal Consolidation

The 2006 budget aims at a primary surplus for the general government of 6.6 percent of GNP, excluding the expected profits of the recently privatized Turk Telecom and Tupras, which amounted to 0.2 percent of GNP last year. Thus, compared to previous years, the fiscal stance has been tightened, *inter alia* in response to the growing current account deficit.

Because of a lower public sector borrowing requirement and a projected decline in interest rates, the overall deficit of the 2006 budget is expected to drop below 1 percent of GNP. And, because this year's budget is for the first time part of a three-year medium-term fiscal framework, fiscal policy will gain predictability and credibility.

3. Fiscal Structural Reforms

The approval of legislation introducing universal health insurance and making parametric changes to the pension formula across occupational groups is facing delays, mainly because of the summer recess of Parliament and the need to extend consultations to ensure broad public support. To this end, the government has started discussions about major aspects of the reforms with all social and political partners. One strong outcome of these discussions was that all parties have agreed on the need for a reform of the social security system. Parliament will resume discussions of the social security reform legislation after the adoption of the 2006 budget.

To contain the social security deficit, last October the government submitted to Parliament a draft legislation for improving the collection of social security contributions. In addition, lump-sum budgets for the state hospitals, and improved auditing and payment mechanisms will help better control health care spending, which is one of the major causes of the social security deficit.

In June 2005, the new legislation restructured the tax administration as part of larger tax reforms aimed at widening the tax base, reducing the informal economy and improving the business climate. With these objectives, the government recently announced the reduction of the corporate income tax (CIT) rate from 30 percent to 20 percent. Changes in the personal income tax (PIT) include the elimination of the top rate of 40 percent and the merger of the different taxation schemes for wage and non-wage personal income. To offset the costs of these reforms, investment incentives have been abolished in CIT and the tax brackets in the PIT have been aligned, making the tax rate reductions possible without compromising overall fiscal objectives.

4. Monetary Policy

The relatively low levels of inflation, the assurances of fiscal discipline and the completion of the technical work have allowed the central bank to pursue formal inflation targeting from 2006 onwards. This will provide a reliable nominal anchor and further enhance the credibility of the central bank's commitment to price stability.

The central bank closely monitors the exchange rate behavior and smoothes excessive volatility with preanounced exchange purchase auctions. The ample capital inflows have allowed the central bank to build international reserves to a comfortable level without compromising the commitment to the floating exchange rate regime.

5. Financial Markets

The rehabilitation of the banks, comprehensive reforms in the financial sector and the reduction of the public borrowing requirement have resulted in a large increase in bank credit, mainly for housing. Even so, the volume of housing loans in Turkey is still very low compared to other countries with similar income levels. The significant decline in long-term interest rates will further support the credit expansion and domestic demand. Needless to say, the authorities are closely monitoring these developments in order to ensure monetary and financial stability.

With the – delayed – enactment of the new banking law, banking supervision will be further improved. The Banking Regulatory and Supervisory Authority (BRSA) should soon adopt the needed secondary legislation and adjust its operations according to best practice.

The Savings Deposit Insurance Fund (SDIF) has sold assets acquired from closed banks for US$ 5 billion. This significantly reduces the burden of the financial costs on the government of the recent banking crisis.

6. Privatization and FDI

This year a number of large public enterprises were sold and, so far, privatization receipts amount to US$ 3.2 billion. Strong foreign interest in these enterprises reflects confidence in Turkey's macroeconomic stability. Privatization will continue with Turkish Airlines and Petkim – a petrochemical company - next on the list.

The negotiations for the EU accession will result in further improvements for foreign and domestic investment. Because of its relatively low labor cost and the improved institutional framework and business environment, Turkey has significant potential of attracting large volumes of foreign direct investment (FDI). In the first nine months of 2005, FDI reached US$ 2.8 billion. This is encouraging in light of the past experience, but admittedly still low when compared with other emerging-market countries. We are confident that FDI will become a major source of international capital if Turkey maintains macroeconomic stability and implements further reforms to ensure a favorable business environment.

Although public investment is recovering, its current level, particularly in infrastructure, is still insufficient to support robust growth over the medium term. Given the limited room in the budget to boost public investments, the authorities will work toward better prioritization and rationalization of investment expenditures.

7. External Vulnerability and Debt Management

In recent years, the historically low interest rates in advanced economies have caused global funds to flow into emerging-market economies, particularly those with improved policies. We concur with the staff that reversal of this trend could cause fluctuations in financial markets. Hence, monetary policy should be conducted with vigilance and the debt management strategy should be forward-looking. The authorities' medium-term debt management strategy aims at lengthening maturities and reducing vulnerability to interest and exchange rate shocks. The current favorable economic outlook provides a welcome opportunity to advance more rapidly towards these goals.

Improved macroeconomic fundamentals have increased the resilience of the economy to external shocks. The prominent role of the private sector, strong productivity growth, sustained high output growth and continued fiscal consolidation, all are part of a virtuous circle of lower interest rates, output growth, buoyant tax revenues and sound public finances.