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Turkey: Third and Fourth Reviews Under the Stand-By Arrangement and Request for Waiver of Performance Criteria—Staff Report; Staff Supplement, Press Release on the Executive Board Discussion; and Statement by the Executive Director for Turkey

In the context of the third and fourth reviews under the Stand-By Arrangement and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the Third and Fourth Reviews Under the Stand-By Arrangement and Request for Waiver of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on June 9, 2006, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 17, 2006. 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 Press Release summarizing the views of the Executive Board as expressed during its July 28, 2006 discussion of the staff report that completed the reviews and request; and

- a statement by the Executive Director for Turkey.

The document listed below has been 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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TURKEY

Third and Fourth Reviews Under the Stand-By Arrangement, and Request for Waiver of Nonobservance and Applicability of Performance Criteria and Modification of Performance Criteria

Prepared by the European Department in consultation with other departments

Approved by Susan Schadler and Matthew Fisher

July 17, 2006

- **Stand-By Arrangement**. A three-year SBA was approved in May 2005, with access of SDR 6.7 billion (691 percent of quota, approximately US$9.9 billion). Cumulative purchases amount to SDR 1.666 billion (Appendix I), and a further SDR 1.249 billion will become available upon completion of the third and fourth reviews. Outstanding Fund credit at end-May amounted to SDR 7.9 billion, and should fall to around SDR 6.4 billion by the end of the arrangement.
- **Last Board Meeting**: Directors stressed the need for tight fiscal policy and accelerated structural reforms to strengthen the medium-term fiscal position, rein in the current account, and reduce remaining vulnerabilities. Passage of the pension reform law was particularly critical in this respect, as was close monitoring of continued rapid credit growth.
- **Discussions**. During May 8–22 and June 5–9 the staff team met with Deputy Prime Minister Şener, State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Labor Minister Başesgioğlu, Health Minister Akdağ, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Yilmaz, Bank Regulation and Supervision Agency Chairman Bilgin, Savings Deposit Insurance Fund Deputy Chairman Gül, other senior officials, and representatives from the banking and business communities. The staff liaised closely with the World Bank. Ms. Krueger visited Turkey during June 27-29 and met with Prime Minister Erdoğan and the economic team.
- **Staff**. The team comprised Lorenzo Giorgianni (head), Andrei Levchenko, Davide Lombardo, and Donal McGettigan (all EUR), Koshy Mathai (FAD), Mats Josefsson (MFD), Wes McGrew (PDR), Hugh Bredenkamp (senior resident representative) and Christian Keller (resident representative). Levent Veziroglu (OED) accompanied the missions.
- **Letter of Intent** (Attachment I). The authorities propose to tighten fiscal and monetary policies to bring inflation under control and bolster market confidence. They also elaborate on the steps needed to accelerate implementation of delayed tax, social security, and banking reforms (Table 1).
- **Publication**. The staff report for the completion of the first and second program reviews was published (Country Report No. 06/268).

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I. EXECUTIVE SUMMARY

- **While Turkey's economic performance has been strong, growing external imbalances exposed the country to a reversal of sentiment**. The authorities' success in reforming the economy over the past few years has been reflected in record-high capital inflows and a steady lira appreciation. With strong growth and high oil prices, this led to a rapid widening of the current account deficit. More recently, supply shocks contributed to a pick up in inflation. Against this backdrop, a sharp rise in global risk aversion produced larger losses in Turkey than other countries during May-June.

- **In the wake of recent market turbulence, the authorities have recommitted to strong policies and stepped up program implementation**. In their latest Letter of Intent, the authorities reaffirm their commitment to the objectives of the Fund-supported program and propose policy actions to overcome earlier delays in implementing structural reforms.

  - **With the recent tightening of monetary policy having helped to stabilize markets, bringing inflation back on track is now a pressing policy concern**. The CBT's policy rate hikes and the active withdrawal of lira liquidity returned a measure of stability to financial markets. Going forward, monetary policy will aim to restore the disinflationary trend to secure the medium-term targets.

  - **The authorities' commitment to tighter fiscal policy will help preserve market confidence and resume disinflation**. Measures will be taken to rein in spending and save revenue overperformance—making for a tighter fiscal policy in the remainder of 2006. Keeping health spending under control is a key priority.

  - **The recent passage of the pension law is a critical step in safeguarding the medium-term fiscal position**. This should be followed by timely implementation. To guide this process, the authorities have proposed detailed milestones for the final merger of the social security institutions.

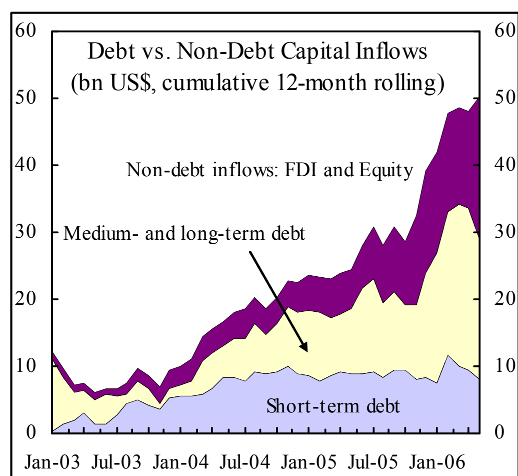
  - **Tax administration reform is being reinvigorated**. A large taxpayer unit under the Revenue Administration will now be set up by end-2006. VAT rebate fraud in the textile sector will also be addressed.

  - **Bank supervision is being strengthened to limit balance sheet risks and safeguard financial stability**. Recent organizational changes at the BRSA and the early adoption of regulations for the banking law are welcome. Bank oversight needs to be intensified, however, in light of heightened financial market volatility.

- **Looking ahead, close adherence to program policies is the best way of sustaining market confidence and underpinning recent economic progress**. This is especially important now given nonresidents' still large exposure to Turkey, and the likelihood that market sentiment will remain sensitive to domestic economic and political developments. With good policies and in light of improved fundamentals, Turkey should be well positioned to cope with future shocks.

II. Recent Developments

1. **Economic performance in Turkey has been strong** (Figures 1–2 and Table 2). Growth last year far exceeded expectations, led by private investment and consumption, fuelled, in turn, by large capital inflows, declining interest rates, and rapid credit growth (Box 1). Growth slowed in the first quarter of 2006, due in part to harsh weather and the avian flu episode, but is expected to have picked up pace in the second quarter. At the same time, the current account deficit continued to widen (with high energy prices and lira strength playing large roles), although the quality of financing improved sharply on the back of record-high FDI flows.



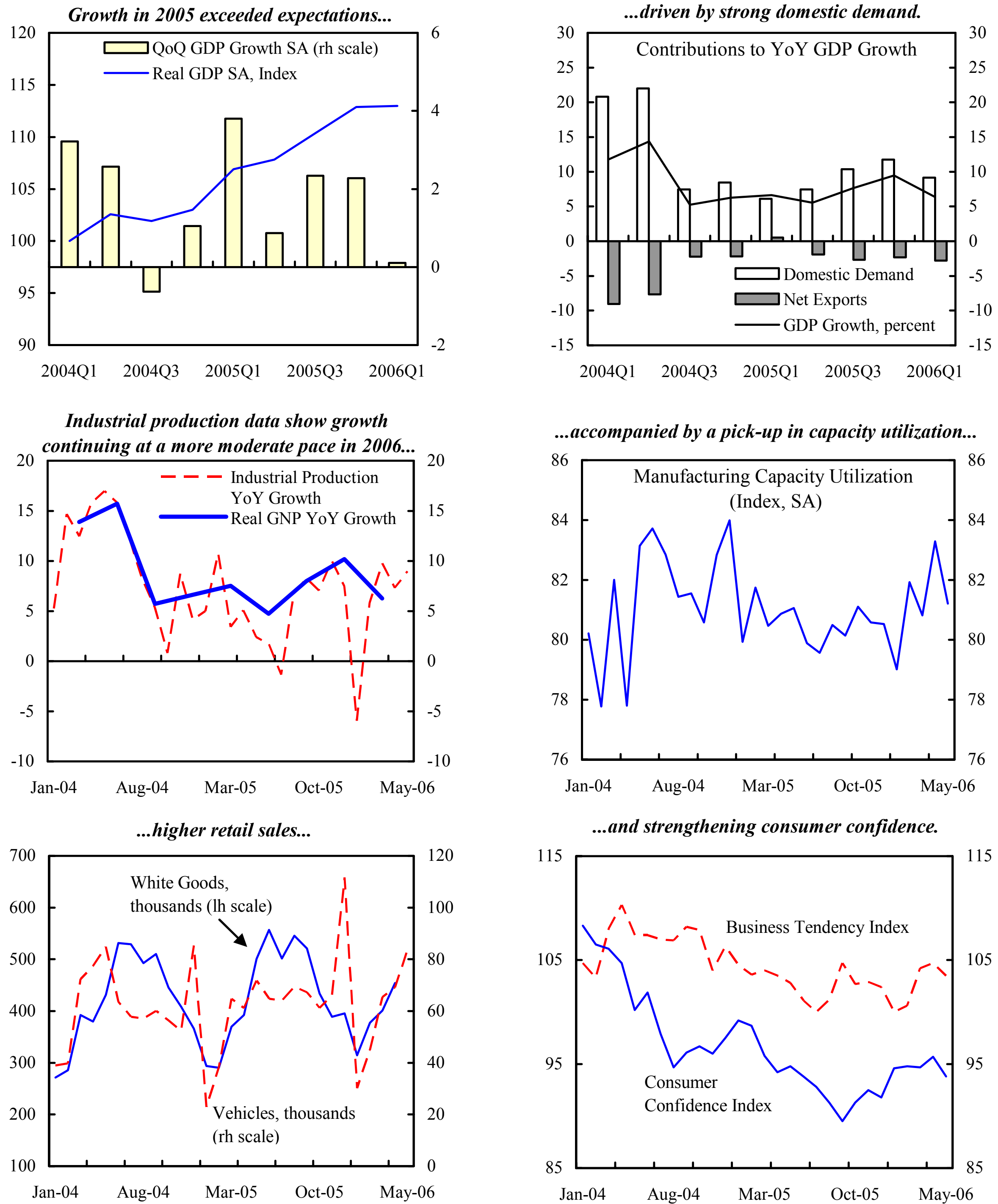
Turkey: Main Macroeconomic Indicators, 2003–06

	2003	2004	2005		2006	
			Country Report 06/268	Estimated		Reference period
	(In percent of period GNP, unless otherwise noted)					
Real GNP y-o-y growth rate, percent	5.9	9.9	5.0	7.6	6.3	Q1
Domestic demand (contribution to GDP growth)	8.9	13.9	5.3	9.1	9.2	Q1
Net exports (contribution to GDP growth)	-3.1	-4.9	-0.3	-1.7	-2.8	Q1
CPI, end of period (12-month percent change)	18.4	9.4	8.0	7.7	10.1	June
Central government primary balance	5.0	5.1	5.0	5.0	4.8 [1/]	Q1
Net public sector debt	70.4	63.5	57.7	55.8	...	
Gross public sector debt	83.4	77.4	70.4	71.6	...	
Current account	-3.4	-5.2	-6.0	-6.4	-8.8	Jan-May, SA
Non oil current account	1.1	-0.9	-0.9	-1.3	-2.4	Jan-May, SA
Exports, y-o-y change in value (percent)	31.0	33.7	14.9	16.2	11.3	Jan-June
Imports, y-o-y change in value (percent)	37.6	39.4	18.9	11.6	18.1	Jan-May
Terms of Trade, y-o-y percent change	2.0	1.0	-2.6	-2.2	-3.4	Jan-May
FDI	0.5	0.7	1.2	2.4	5.4	Jan-May
Gross external debt	56.6	50.5	53.0	47.0	...	

1/ Q1 outturn, annualized and divided by annual projected GNP.

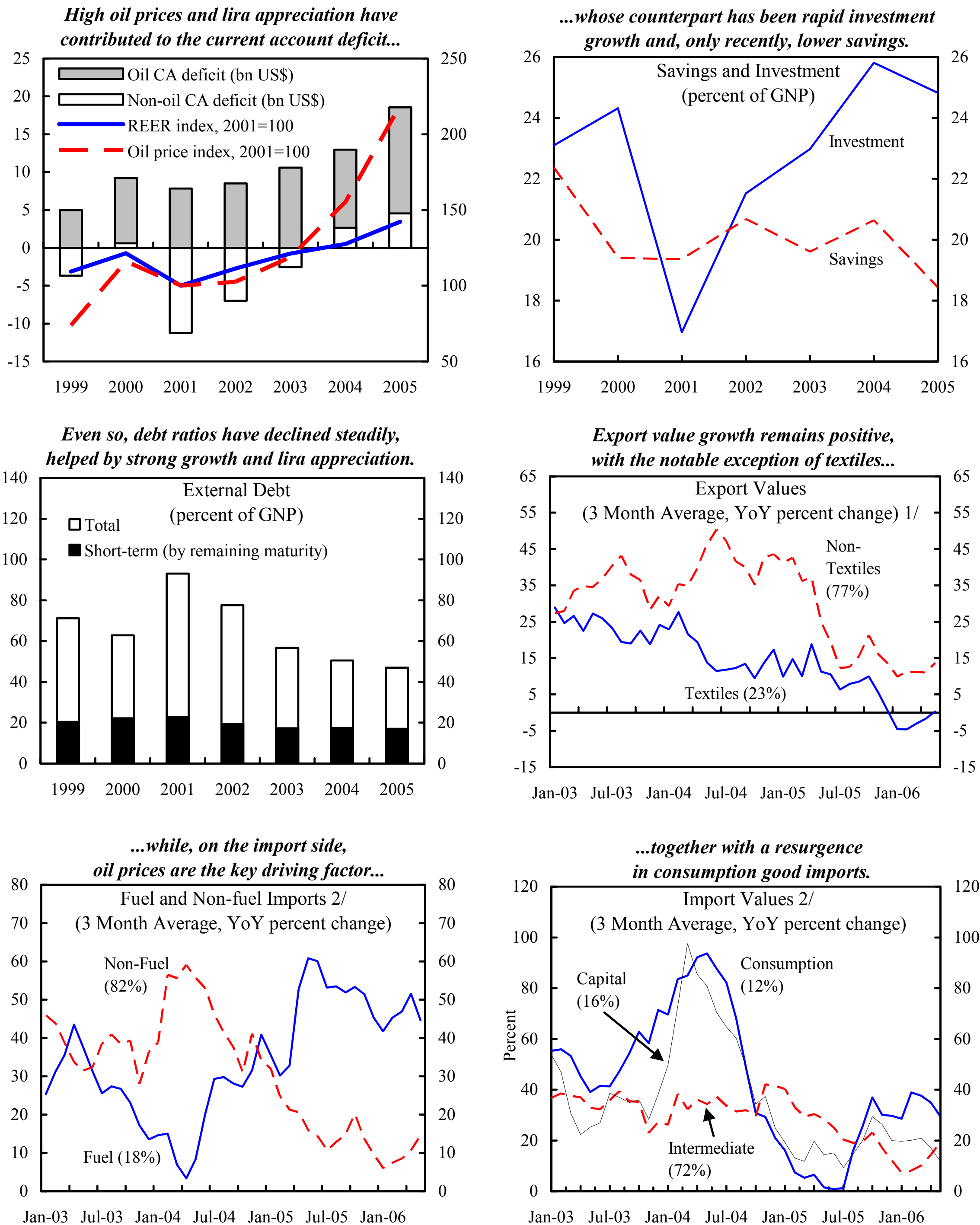
2. **Inflation was below target last year—for the fourth year running—but recently has accelerated, reaching 10 percent on an annual basis in June**. Notwithstanding the sharp appreciation of the lira in 2005, the pace of disinflation had already started to decelerate late last year (Figure 3). This was in part due to oil price effects—which added 1 percentage point to 2005 inflation—but also to domestic demand strength, as evidenced by rising goods inflation and persistently high inflation rates for some demand-sensitive services (such as rents, hospitality and restaurants). In more recent months, inflation has climbed further on the back of adverse supply shocks and, since May, lira weakness. Oil and gold price effects alone are estimated to have contributed, respectively, about 1 and 0.5 percentage

Figure 1. Turkey: Real Sector Indicators, 2004–06
(in percent, unless otherwise indicated)



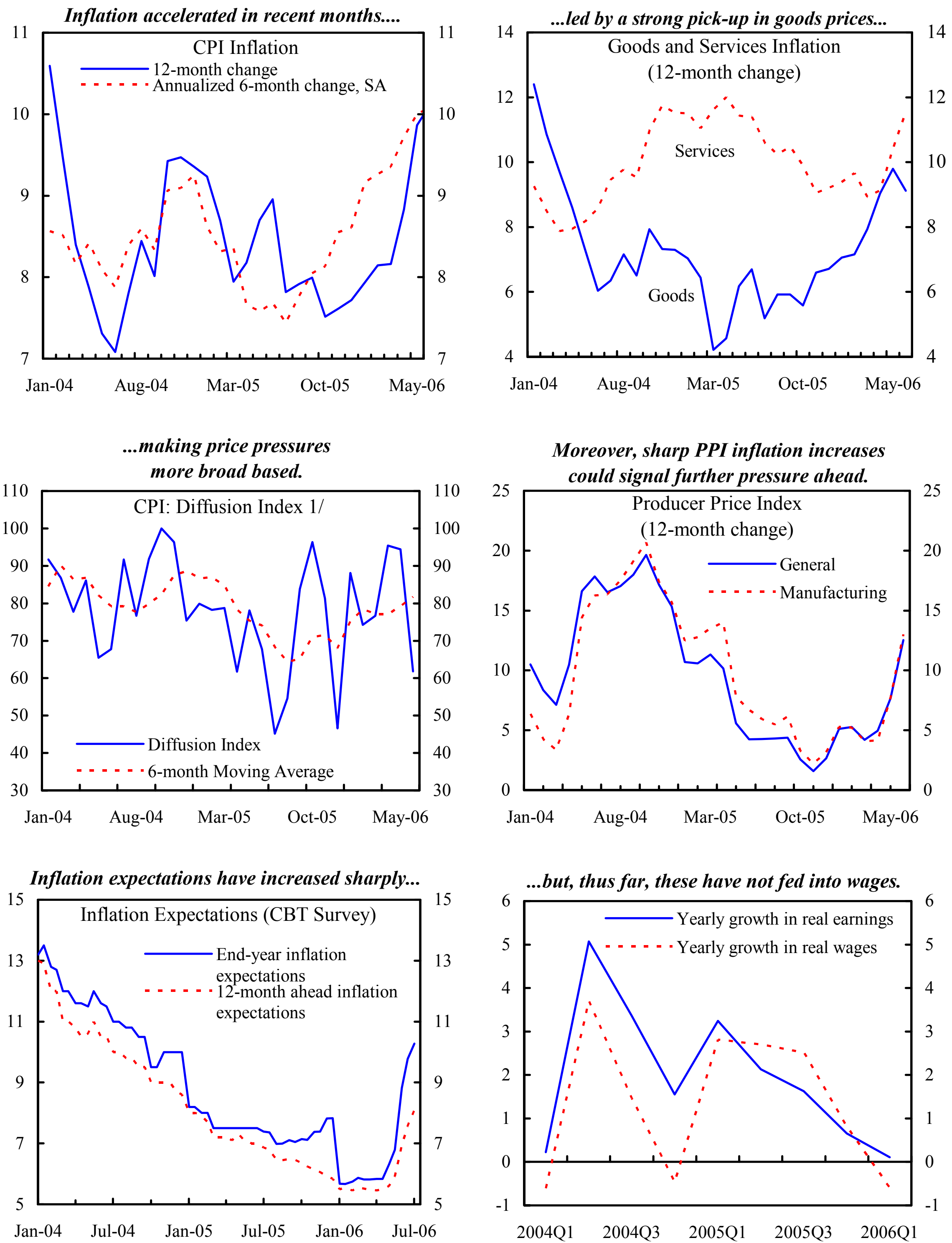
Sources: TurkStat; and IMF Staff Estimates

Figure 2. Turkey: External Sector, 1999–2006



Sources: TurkStat; WEO; and IMF Staff Estimates.
1/ In parentheses, the share of total exports as of April, 2006.
2/ In parentheses, the share of total imports as of April, 2006.

Figure 3. Turkey: Inflation, 2004–06
(In percent, unless otherwise indicated)



Sources: TurkStat; and Central Bank of Turkey.

1/ Percentage of subgroups whose prices increase in a given month.

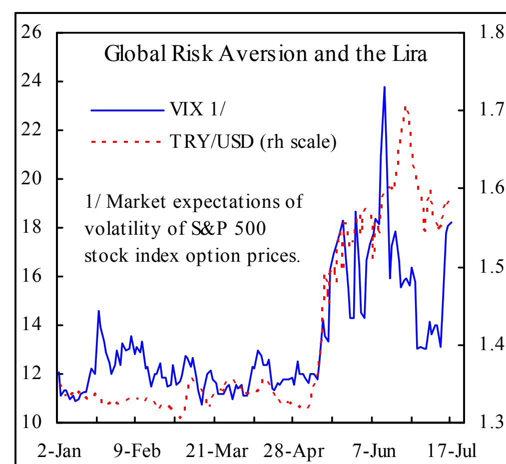
points to 12-month inflation in the first four months of 2006.[1] Sharp increases in unprocessed food prices, possibly related to harsh weather conditions, and other one-off effects were also at play (the alcohol and tobacco tax hikes of August and December of 2005 added some 1.3 percentage points to 12-month inflation in the early months of 2006).

3. **The unexpected resurgence of inflation prompted investors to reassess Turkey's underlying vulnerabilities**. With a large current account deficit (close to 9 percent of GNP on a 12-month rolling basis in May) and a steadily appreciating lira, Turkey was particularly vulnerable to a shift in market sentiment. Thus, the unexpectedly high inflation figures for April and May, averaging 9¼ percent year-on-year, led investors to reexamine the attractiveness of holding large unhedged lira positions.

4. **Program delays also dampened market confidence**. These delays were wide-ranging, including on the landmark pension reform, tax reform, bank supervision, and state bank privatization. Fiscal policies were also allowed to slip towards the end of last year and early in 2006, imparting an unwelcome procyclical fiscal stimulus.

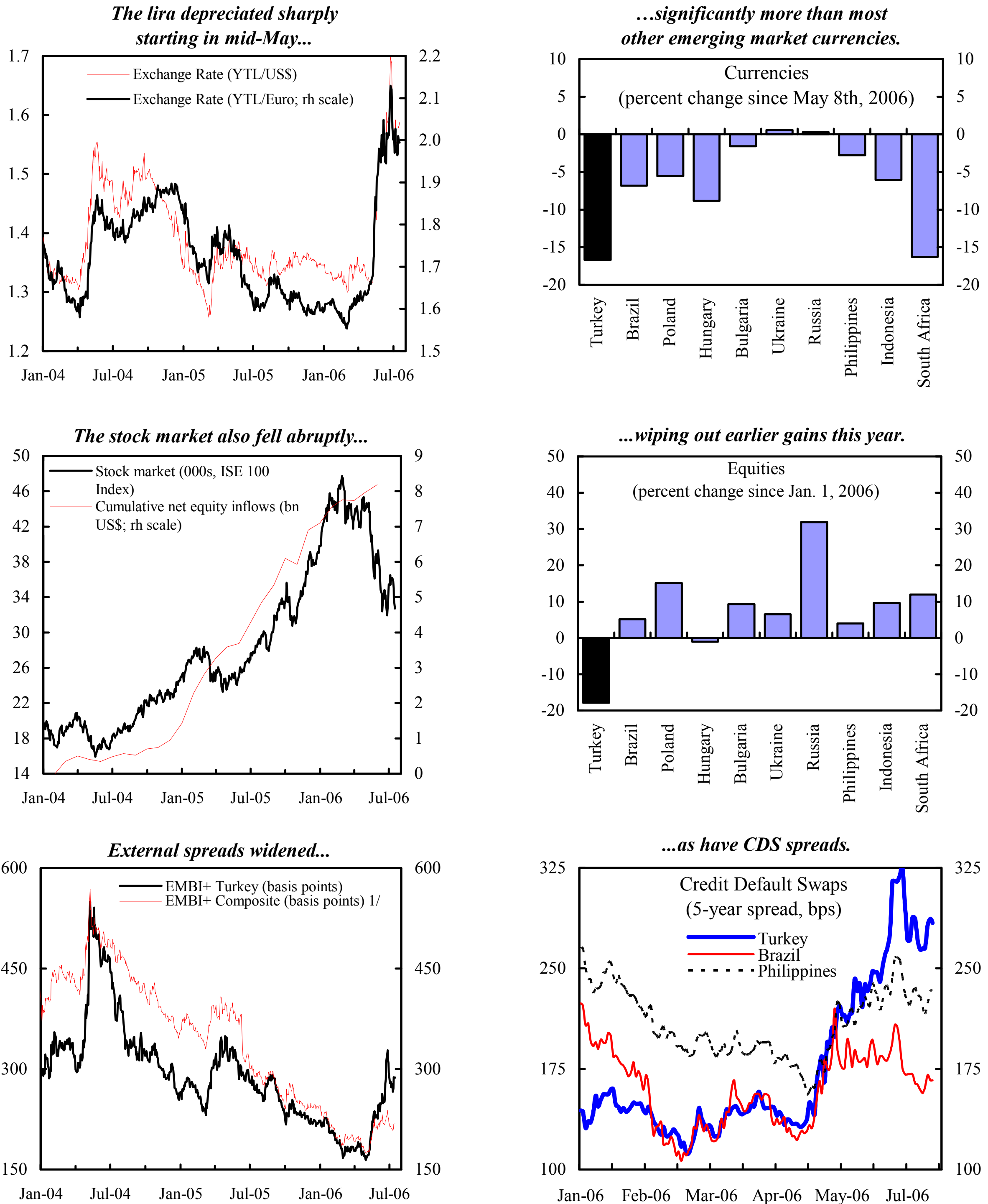
5. **Political developments added to market concern**. The presidential veto of the government-sponsored pension reform law and the assassination of a high court judge in early May weighed heavily on investor sentiment. Prior to that, markets had reacted badly to the prolonged central bank governor appointment process. On the EU front, Turkey's accession process took a historic step forward on June 13 with the successful closure of negotiations on a first chapter of the *acquis* (on science and research). However, an accompanying statement by the EU was critical of the limited progress Turkey had made on a range of political reforms, and laid down markers on Cyprus that many observers interpreted as foreshadowing difficulties in EU relations later in 2006. Taken together, these developments heightened domestic political uncertainties, with market commentators speculating that tensions could mount in the run up to elections for a new president (to be chosen by parliament in April 2007) and a new parliament (scheduled for November 2007). The ruling AK party has retained a commanding lead in opinion polls, though opposition parties have recently gained ground.

6. **With all these factors at play, Turkey's financial markets were harder hit than most during the recent emerging market sell-off triggered by a sharp increase in global risk aversion** (Figure 4 and Box 2). Financial markets posted large losses between early May and end-June, with the lira and equities shedding more than 20 percent, and the local benchmark bond yield widening by over 700 basis points.



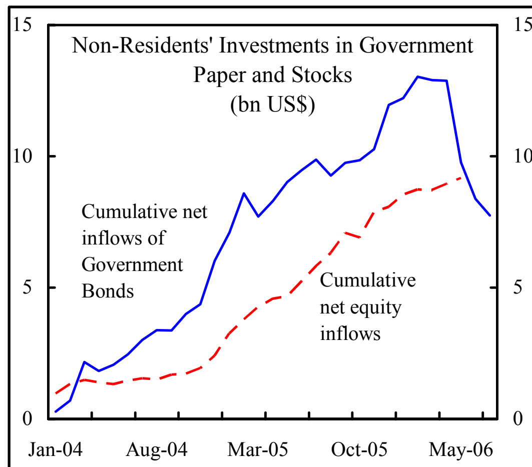
[1] Gold is widely traded in Turkey carrying a 1.2 percent weight in the CPI. Gold prices rose by 40 percent in lira terms during January-April.

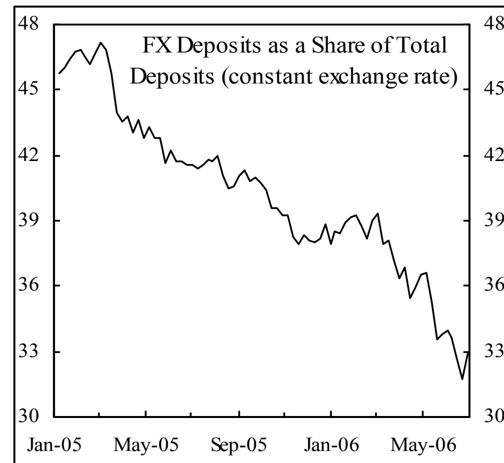
Figure 4. Turkey: Financial Indicators, 2004–06
(In percent, unless otherwise indicated)



Sources: Bloomberg; yield curve data provided by the Turkish authorities.
1/ Decline in composite spreads on June 13, 2005 reflects the switch to swapped Argentina paper.

Nonresident investor exposure to local currency government bonds was scaled back quickly, but this was not accompanied by a reversal of the trend in deposit de-dollarization. Markets have recovered ground in more recent weeks, but have remained volatile.



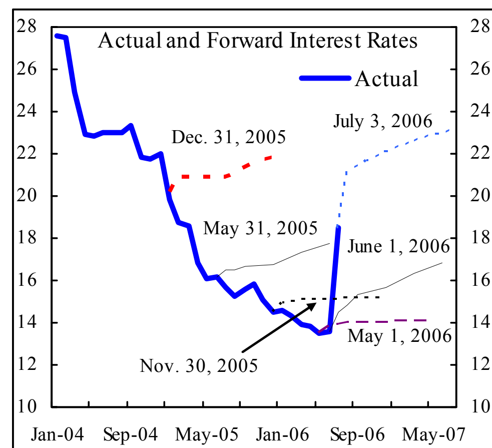


III. Policy Discussions

Given earlier program delays, and in the wake of recent market developments, it was agreed to revise the macroeconomic framework and to strengthen the policy package. To this end, (i) monetary policy would be tightened as needed to stabilize markets and rein in inflation; (ii) corrective measures were taken to secure a primary surplus of at least 6½ percent of GNP (implying a significant tightening in the second half of the year); (iii) efforts were redoubled to put in place reforms of tax administration; and (iv) bank supervision was stepped up further to help safeguard the stability of the financial sector.

A. Revised Macroeconomic Framework

7. **Both sides concluded that recent financial market developments called for revisions to the program's macroeconomic framework** (¶6).[2] For this purpose, the recent exchange rate correction was assumed to be sustained, bringing the lira closer to long-term valuations (Box 3), and interest rates were expected to stay high. The following main changes were agreed:



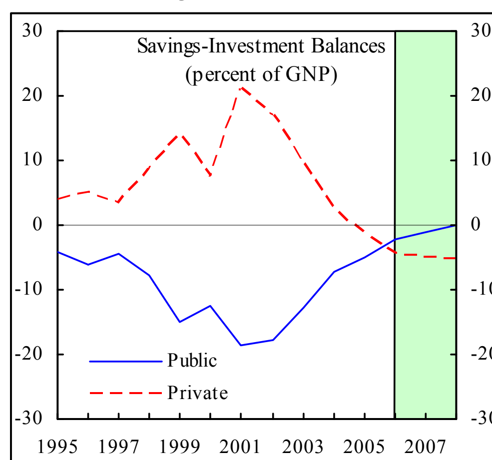
- **Higher inflation**. Given the sizable lira pass-through to consumer prices and despite lower growth and a strong CBT policy response, it was agreed that inflation this

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

year would almost certainly end outside the upper end of the consultation band. Meeting existing 2007 targets could also be challenging.

- **Lower growth**. Before the financial turbulence, growth looked set to comfortably exceed the 5-percent program projection, supported by strong carryover effects from 2005 (about 3 percent). With the sharp deterioration of the financial environment, it was eventually agreed to preserve the original program projection (implying growth of about 2½-3 percent annualized in the second half of 2006). The weaker lira and higher interest rates were expected to feed through to lower domestic demand growth (private consumption and investment). Tighter credit conditions would play a part, with real borrowing costs having already increased sharply. Weaker corporate balance sheets, wealth effects, and dented consumer confidence were also expected to be a factor. While the impact of the depreciated lira would ultimately support exports, this was not likely to outweigh weaker domestic demand in the very near term.

- **Improved current account** (Table 3). The current account deficit was expected to benefit in due course from the weaker lira and the softening domestic demand, as import volumes slowed and exports increased (the latter possibly with a lag). Although the deficit would still be flat as a ratio to GNP in 2006, it was smaller than had been anticipated by staff prior to the recent market turmoil, and was expected to contract in 2007. These improvements in the external balance would continue to be supported by fiscal tightening, while private sector saving-investment imbalances were expected to stabilize. The medium-term outlook is for the current account deficit to narrow gradually to 4 percent of GNP by 2008, with the non-oil current account moving into surplus. As a result, despite the adverse impact of the recent lira depreciation on the external debt burden, gross debt ratios would spike in 2006 and decline over the medium term (Appendix II).



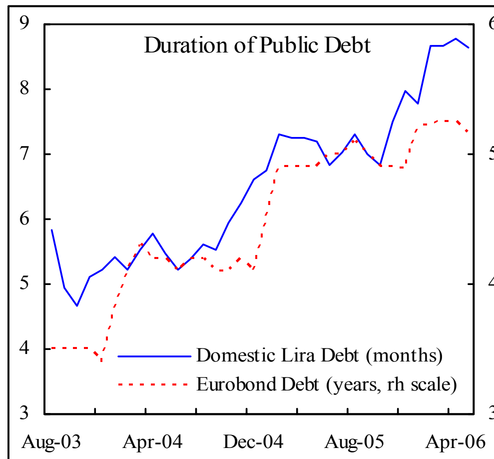
Changes in Key External Program Assumptions, 2005–08

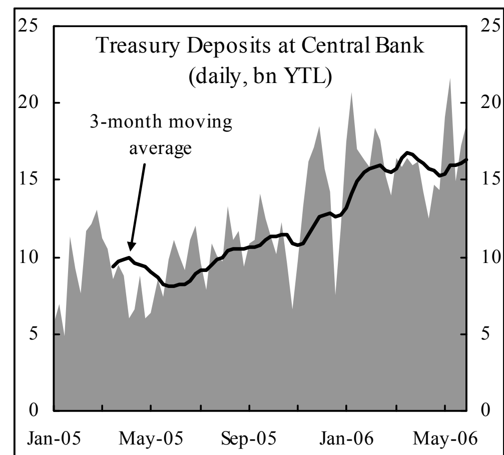
(In billions of U.S. dollars, unless otherwise noted)	2005 Country Report 06/268	2005 Rev.	2006 Country Report 06/268	2006 Rev.	2007 Country Report 06/268	2007 Rev.	2008 Country Report 06/268	2008 Rev.
Current account balance, percent of GNP	-6.0	-6.4	-5.8	-6.5	-5.1	-5.1	-4.6	-4.0
Non-oil current account, percent of GNP	-1.0	-1.3	-0.1	-0.1	0.1	1.8	0.3	2.3
Export volume growth	7.2	11.0	9.1	9.6	10.1	11.2	9.8	11.5
Import volume growth	7.1	11.6	6.6	3.3	6.8	4.4	7.0	6.9
Oil price (APSP)	54.2	53.4	61.8	66.5	60.0	69.8	58.0	68.5
Gross international reserves	53.9	52.2	58.7	57.8	57.8	59.2	56.9	60.1
In percent of short term debt (residual maturity)	85.7	84.2	82.4	79.9	75.2	73.2	69.0	69.7
Gross external debt, as percent of GNP 1/	53.0	47.0	53.0	59.4	51.7	59.3	50.5	58.1
Net external debt, as percent of GNP 1/	31.6	27.4	32.5	35.4	33.3	37.0	33.9	37.2

Source: Data provided by Turkish authorities; and IMF staff estimates.
1/ All debt ratios valued at end-year exchange rates. (Ratios reported in Country Report 06/268 were valued at annual average exchange rates).

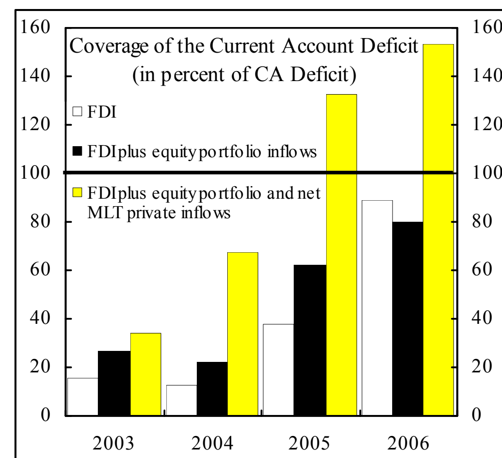
8. **It was also recognized that, although balance sheet effects appeared manageable, these warranted continued close monitoring** (Table 4).

- With good policies, **public finances** should remain resilient to shocks (Appendix III). The public debt ratio had declined far more rapidly than programmed, although it was still high. Its composition had also improved, though the duration of domestic debt was still low. Treasury deposits at the central bank had increased, covering more than a month of redemptions. With this year's net borrowing requirement expected to be negative for the first time in recent history, the public financing situation was less vulnerable to sudden exchange rate and interest rate movements than before.



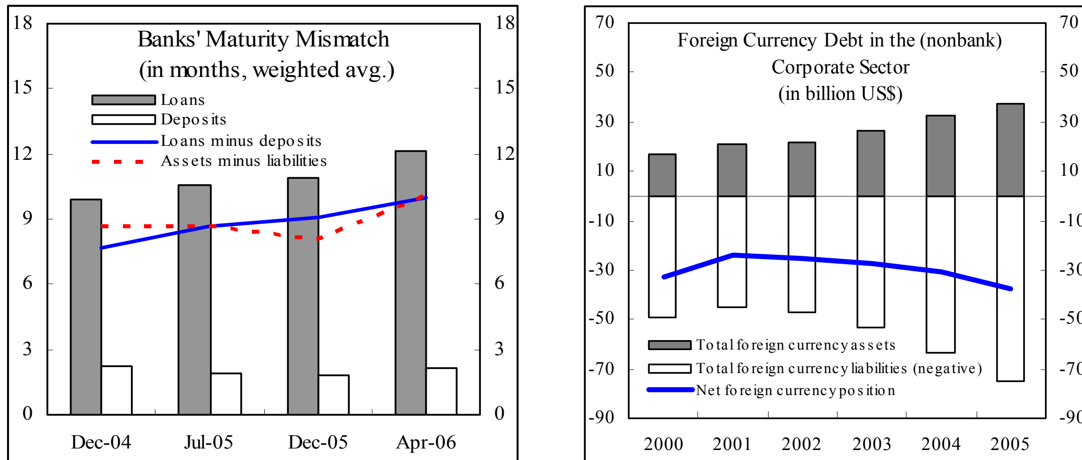


- The quality of **external financing** had also improved, on the back of ongoing privatizations and bank acquisitions and a maturity lengthening of debt-creating flows (Table 5). Thus, this year, FDI was expected to cover more than 80 percent of the current account deficit. Even so, gross financing requirement remained large, with US$14 billion in nonresident holdings of domestic government debt and the rollover of some US$20 billion in short-term interbank credit lines and nonresident deposits at Turkish banks representing key sources of risk.



- While facing a number of risks, the **banking system** appeared able to absorb losses from the recent market volatility. Balance sheets were now much stronger than before, with high capital adequacy ratios and seemingly manageable open foreign exchange positions of banks (Box 4). However, their large holdings of securities and increased interest-rate mismatches (aggravated by aggressive lending strategies over the past couple of years) meant that the latest financial market sell-off would result in some losses. Banks also remained exposed to indirect exchange rate risk on the credit

side. Here, households were long in foreign exchange, but corporates were short, though not to the full extent suggested by headline debt numbers, on account of natural hedges and a buildup of foreign exchange assets (Appendix IV). Nonetheless, the weaker lira and higher interest rates would likely reverse some of the past improvements in corporate balance sheets.



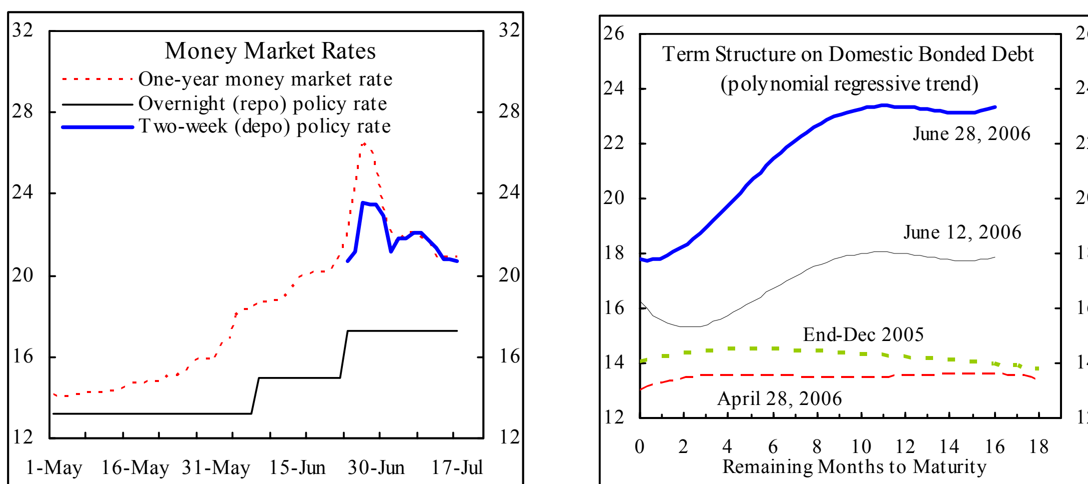
B. Monetary and Exchange Rate Policies

9. **It was agreed that market developments had exacerbated an already challenging inflation outlook**. Even before the turbulence, achieving the end-2006 inflation target of 5 percent would have required a marked deceleration in price dynamics. In the event, a number of known risks (including from continued inertia in services inflation, rising commodity prices, and the possibility of a sudden lira weakening, Country Report No. 06/268) combined to test monetary policy credibility in the first year of implementation of inflation targeting and under a new CBT management team.

10. **Against this backdrop, discussions focused on the appropriate monetary policy response** (¶8−10 and Tables 6–7). The CBT had eased interest rates by 25 basis points in April and left them on hold in May, on the basis that high inflation outturns mainly reflected one-off supply shocks and that medium-term inflation targets remained within reach. The accompanying MPC announcements left markets with the impression that interest rate hikes were less likely than interest rate cuts going forward. Staff argued that domestic demand strength had also played a role and that the CBT's medium-term inflation projections were based on favorable assumptions, especially with regard to assumed lira strength. Accordingly, when it became clear that the financial market turbulence was unlikely to be short lived (rendering earlier CBT assumptions obsolete), staff endorsed a strong preemptive approach to increasing interest rates, backed with effective communications to reinforce central bank credibility.

11. **Despite large interest rate hikes, it had been difficult to convince markets of the central bank's policy resolve**. The initial CBT response—raising interest rates by 175 basis points at the June 7 extraordinary MPC meeting, far in excess of market expectations—was at first well received by markets. The MPC, however, left interest rates unchanged at its

scheduled June 20 meeting, even though financial markets had continued to deteriorate. Following intense pressure on the lira and bond yields that week, and a large one-day fx sale intervention which did not appear to stabilize markets, the CBT called an extraordinary MPC meeting on June 25, at which it increased rates by another 225 basis points. It also announced a more proactive approach to liquidity management and *ad hoc* foreign exchange sale auctions (in the event, only two such auctions were held). These moves, together with the subsequent 200 basis point increase in the CBT's *lending-borrowing* spread (to reduce incentives to short the lira), were eventually successful in stabilizing markets.



12. **While the central bank argued that foreign exchange intervention would help restore calm to the markets, staff saw a more limited role for foreign exchange sales**. The CBT had suspended its daily foreign exchange purchase auctions in mid-May in response to illiquid and volatile foreign exchange markets. It supplemented this in June with more than US$3 billion in foreign exchange sales, using auctions and discretionary sales. While reaffirming their commitment to the floating exchange rate regime, the CBT argued that the use of reserves on a one-off basis would help prevent a disorderly market adjustment (by facilitating the unwinding of speculative trades) and that reserves had been built up during good times for precisely this purpose—with NIR still more than US$6 billion above the program floor on June 30 as a result of large-scale intervention purchases prior to the recent market turbulence. Staff countered that sizeable foreign exchange sales in a one-sided market were largely ineffective and carried costs. Instead the exchange rate should be allowed to adjust—especially given earlier market perceptions that the lira may be overvalued.

13. **It was agreed that expanding the set of instruments for open market operations was key to increase the efficacy of monetary policy**. The CBT had long carried large (mainly overnight) open market operation positions, with banks voluntarily depositing their excess cash holdings at posted CBT borrowing rates. The CBT agreed that the difficult market circumstances called for a more proactive approach in managing this liquidity position, including by borrowing at longer maturities. Options here included deposit auctions (depos), sales of government paper (this would require swapping the CBT's portfolio of government papers into tradable instruments), and the issuance of central bank paper. In the

event the central bank opted for 1- and 2-week daily depo auctions, while leaving the door open to introducing additional instruments as needed.

14. **Looking ahead, both sides agreed on the steps required to rein in medium-term inflation expectations**. The end-June outer consultation band had been exceeded—the inflation outturn was some 1½ percentage points above the agreed 8.5 percent upper bound—calling for remedial measures. It also appeared all but certain that the consultation bands over the remainder of 2006 would not be met. Although domestic demand growth was expected to ease, the impact of the lira depreciation on inflation would likely be felt for some time. This, alongside the many risks to the outlook—energy prices, U.S. rate hikes, elevated inflation expectations, and further lira depreciation—required a particularly cautious conduct of monetary policy in the coming months. The steps agreed included:

- The *inflation targets* would be preserved for now and, to anchor price settings, monetary policy would continue to be guided by the existing medium-term inflation objectives. With market conditions not yet settled, any revision to the targets would be premature at this stage and could undermine the credibility of the framework. The existing program consultation bands would also be retained, even though they were likely to be exceeded, so as to avoid the confusion that could arise if the CBT were to have one set of public bands and another set for IMF program purposes.

- The sharp increase in policy *interest rates* would help stabilize markets and rein in inflation moving forward. The CBT stood ready to supplement this with further interest rate hikes as needed, as well as proactive open market operations. The appropriate interest rate policy stance would be reviewed once markets had stabilized sufficiently to be able to ascertain how to resume the path of disinflation.

- The CBT indicated that it would limit future *foreign exchange intervention* to cases where the currency markets were volatile and illiquid and committed to resuming daily foreign exchange purchase auctions as soon as conditions permitted.

- For its part, the government had also restated publicly the *independence of the central bank*, including in its interest rate decisions.

C. Fiscal Policy and Debt Management

15. **It was agreed that fiscal policy had been adding stimulus to aggregate demand since late last year and that reversing this trend would be beneficial** for the inflation outlook, debt reduction, and investor confidence. While revenues were buoyant—and projected to remain so during the remainder of the year, mainly on account of higher-than-programmed nominal GNP—this was partially offset by spending overruns, particularly on health (Box 5). Possible shortfalls in the state enterprise sector could also weigh on fiscal performance in 2006.

Turkey: Fiscal performance, January-June 2006
(in percent of annual GNP)

	Prog.	Prel.	Variance	Explanation
I. Consolidated budget 1/	**2.66**	**3.56**	**0.89**	**Budget overperforming...**
Revenues, of which:	**11.57**	**12.90**	**1.33**	**...but only on the strength of revenue overperformance...**
Personal Income Tax	2.17	2.27	0.09	Strong wage withholding given increase in formal-sector employment and higher-than-expected minimum wage increase.
Corporate Income Tax	1.12	1.06	-0.06	Advance payments weak in Q1, reflecting tax planning as taxpayers delayed taxable activities to enjoy reduced rate; not fully recovered in Q2.
Value-added Tax	3.54	3.91	0.37	Booming along with the economy and lira depreciation.
Special Consumption Tax	3.06	3.07	0.02	On track on account of unexpected one-off repayment, but petroleum SCT is weak.
Nontax	1.74	2.41	0.67	GSM revenues, SEE dividends, and receipts of new institutions within central government.
Expenditures, of which:	**8.91**	**9.34**	**0.44**	**...some of which has been used to cover spending overruns.**
Personnel, of which:	3.87	3.94	0.08	Overspending on personnel largely health-related.
Health spending for public employees	0.18	0.21	0.03	
Goods and services	0.51	0.69	0.17	Overspending, partly real (on defense) and partly optical (reflecting spending of new institutions within the central government)
SSI / Green Card transfers, of which:	2.26	2.59	0.33	Major overrun in social transfers...
SSI contributions 2/	2.13	2.07	-0.06	
Health spending 2/	0.91	1.26	0.35	...largely on account of overruns on health services, and also medicines.
Agricultural subsidies	0.51	0.45	-0.07	Kept under program targets to date.
Capital expenditures	0.46	0.54	0.09	Overruns reflect carryovers from 2005 and rephasing of spending within 2006.
II. Extrabudgetary funds 2/	**0.00**	**-0.32**	**-0.33**	**EBFs underperform given one-off transfer to TEKEL, delayed from 2005...**
III. SEEs 3/	**0.08**	**0.32**	**0.24**	**...and the SEEs overperform by nearly as much.**
Memorandum item:				
Health spending (SSI, green card, and budget)	1.08	1.46	0.38	Reflect carryovers from 2005 and rephasing of spending within 2006.

1/ Program refers to consolidated budget; outturn essentially refers to new central government classification (but without shared revenues reflected as either revenue or expenditure).
2/ January - April only.
3/ January - March only.

16. **The authorities therefore agreed to implement measures to bring expenditure back within the program envelope and save any revenue overperformance** (¶11–13, Table 8). A package of policy actions—amounting to 0.6 percent of GNP—was agreed in addition to earlier revenue measures taken by the authorities for some 0.2 percent of GNP. The package comprised measures to contain health costs (without sacrificing the quality of services delivered) and cuts in lower-priority capital and other spending. To leave no doubt about their intention to save revenue

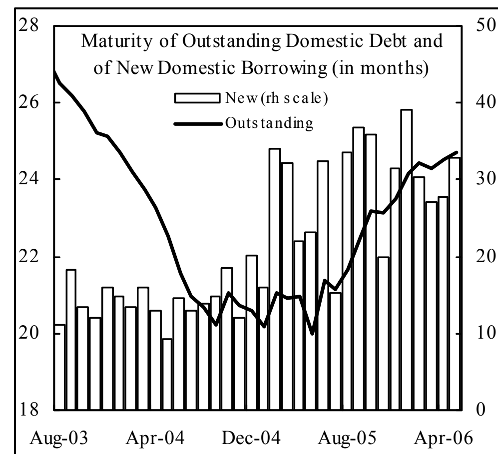
Fiscal Measures, 2006 (percent of GNP)

Description	Yield
I. Health measures	**0.37**
Introduction of global budgeting and capitated payments at MoH hospitals	0.11
Introduction of capitated payments at other hospitals	0.13
Measures to control drug spending	0.13
II. Other expenditure measures	**0.23**
Cuts in lower-priority capital and other expenditures	0.23
TOTAL	**0.59**
Memo item:	
Contingent measures in case of post-reform CIT shortfalls	0.20

overperformance, the authorities proposed a new performance criterion on primary spending, and reaffirmed their commitment to avoid tax concessions. On this basis, the authorities were confident that this year's primary surplus target of 6½ percent of GNP could be exceeded by about ¼ percent of GNP—a welcome development.

17. **The risks of procyclical tightening were discussed, but it was agreed that these were outweighed by the confidence-enhancing effects of prudent fiscal policy**. Containing expenditures to budget levels would imply tighter real spending in the remaining months of the year, given earlier overruns, higher inflation, and a more depreciated lira. In these circumstances, resisting wage and pension pressures would be particularly difficult, although the authorities were confident that existing budgetary allocations would be respected. With growth coming off a high base, it was agreed that the risk that tight policies may set the economy for a hard landing was small. A fiscal tightening, instead, was seen as effective in enhancing policy credibility, reviving confidence in the economic outlook, and limiting downside risks in a context where expectations were unsettled and the current account still large.

18. **Treasury made some temporary adjustments to its debt management strategy in response to the worsened market environment**. The 5-year fixed rate lira bonds were discontinued for now given the lack of appetite in the current environment for longer term, fixed rate issues. Treasury would instead issue one- and two-year discounted lira paper. Although it made one issue of 2-year floating rate notes with quarterly coupons during a week of very high market volatility, Treasury planned to resume issuing 5-year floating rate notes with semiannual coupons in the upcoming auctions. Treasury was successful in reopening a 2014 Eurobond issue and remained hopeful that, with a normalization of market conditions, its international bond issuance target of US$5.5 billion for 2006 could be met.[3] Staff urged Treasury and the CBT to coordinate closely their debt management and open market operation strategies to avoid undue buildup of lira liquidity. Going forward, staff stressed the importance of making efforts to lengthen maturities in good times to further insulate public finances from market risks.



[3] Staff estimates that domestic debt rollover would need to increase to about 85 percent during the second half of 2006 (from 70.7 percent in the first half) should no further international bonds be issued by Treasury.

D. Structural Fiscal Reforms

Social security reforms

19. **Staff strongly welcomed the passage of the administrative and parametric pension reform laws as an essential and politically-difficult first step toward dealing with long-term inefficiencies and vulnerabilities** (¶18). It was agreed that adoption of these reforms would play a key role in underpinning medium-term fiscal sustainability in Turkey. The authorities indicated that they had already made good progress in merging existing social security institutions, which would help ensure that the new social insurance parameters were implemented at the start of 2007, as planned. To underpin this complex process—database amalgamation was especially difficult—detailed milestones were agreed for the merger of the three social security institutions. Staff regretted the weakening of the social security arrears law in Parliament (easier repayment terms than originally agreed), though welcomed the fact that more drastic proposals by parliamentarians were not passed into law.[4] Staff also stressed the importance of strengthening further enforcement capacity and noted that better prioritization of debts for collection and outsourcing of collection activities to the private sector would help in this regard. The authorities were also considering requiring payment of wages through the banking system, but felt that this measure would be more effectively implemented after the merger of the social security institutions.

Tax administration and tax policy reforms

20. **The authorities were reinvigorating tax administration reforms to help pave the way for future tax cuts** (¶16). The authorities ascribed delays to date to the complex administrative challenges at hand rather than any substantive disagreement with staff on the objectives of the reform strategy. Accordingly, they committed to a comprehensive action plan, including completing the functional reorganization of the revenue administration and ensuring that the new tax policy unit at the Ministry of Finance was fully operational by end-July, and completing the establishment of a large taxpayer unit by end-year (structural benchmark). To avoid further slippages in these areas, the authorities had also put in place full-time teams to oversee reform implementation.

21. **VAT rebate fraud in the textiles sector was large and called for remedial steps** (¶17). The authorities had recently cut the VAT rate for textiles from 18 to 8 percent with a view to providing relief to the textile sector (which came under pressure following the elimination of international quotas) and combating tax fraud (estimated at almost ½ percent of GNP last year alone). In staff's view, using tax policy to address a tax administration shortcoming was not sound policy. In fact, targeted tax reductions ran counter to program commitments to simplify the tax structure. They would also invite calls from other sectors for similar treatment. The authorities eventually agreed to complement the rate cut by adopting

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[4] The law allowed restructuring of social security contribution arrears by formula for millions of debtors for whom an investigation of individual capacity to pay would have been administratively infeasible. This led to the nonobservance of the performance criterion against amnesties (see also Country Report 06/268).

remedial measures to address fraud, including by reforming the VAT refund mechanism and tightening tax auditing.

22. **The authorities committed to new tax policy reforms, with the aim of further simplifying the tax code and broadening the tax base** (¶14).

- After some delays, a new *corporate income tax* reform law was passed by Parliament, lowering the headline tax rate from 30 to 20 percent, with the investment tax allowance having been eliminated earlier in the year (contingent compensatory measures of up to 0.2 percent of GNP were also agreed).

- The envisaged second-stage *personal income tax* reform would be delayed by a few months (end-September submission and end-year passage both structural performance criteria). The aim was to broaden the tax base (real estate capital gains), make it simpler and more progressive (replacing consumption with standard credits), and put in place anti-avoidance measures (enabling cross-checking of declared income against assets and other indicators of capacity to pay). Staff regretted delays in this area, which the authorities ascribed to the need for time to forge consensus over this reform. Staff also indicated that a more ambitious reform, including taxing pensions and agricultural incomes, would have made for a simpler and broader tax, but the political difficulty of implementing such moves was also acknowledged.

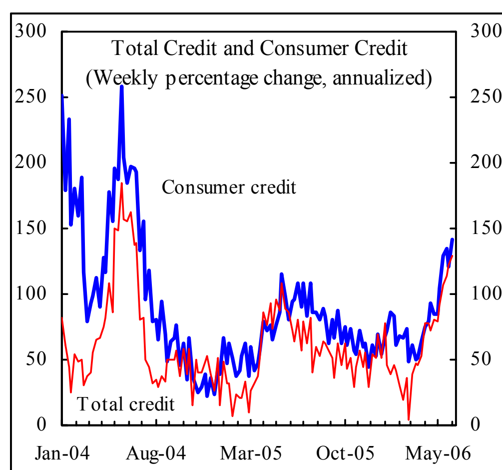
- Finally, the government exempted nonresidents from the recently-introduced *withholding tax* regime for financial income and planned to reduce the tax rate on bonds and equities for residents from 15 to 10 percent. These moves were made in response to the negative impact of this tax on foreign investment in Turkish securities since early this year, which was aggravated by confusion about the applicability of double tax treaties and other administrative issues. The authorities agreed to offset any revenue losses in full.

E. Financial Sector Reforms

23. **The authorities continued to make progress in improving bank supervision** (¶20, Table 9). Recent organizational changes at the BRSA, including the merger of onsite and offsite supervision, should help modernize supervisory practices in Turkey. To ensure early compliance with Basel Core Principles, the BRSA indicated that it would soon complete drafting of supporting regulations for the banking law (end-August benchmark). The authorities welcomed the ongoing FSAP work, which will provide a useful basis for drawing up reform priorities going forward.

24. **To build on progress in bank supervision, the BRSA indicated that bank monitoring would be intensified in light of rapid credit growth and recent financial market volatility** (¶22). Intense competition for market share—in part in a bid to attract foreign investors—had led to a rapid expansion of loan portfolios and a compression in bank lending margins and profits. (The share of Turkish banking assets under foreign control had risen from about 5 percent in 2004 to 13.4 percent as of March 2006). At the same time, banks' growing interest rate mismatches and indirect currency exposure through a less than

fully hedged corporate sector were seen as potential risks. In light of these developments and recent financial market turbulence, the BRSA would intensify its examinations and monitoring of bank lending. Although there was agreement that regulatory changes should not be used to conduct macroeconomic policy, the agency was considering a tightening of prudential regulations to better reflect bank risk exposures. To improve transparency, the BRSA agreed to issue regular reports on banks' off-balance sheet activities and their foreign currency positions.



25. **Staff welcomed progress in the consolidation of supervisory functions** (¶21). On January 1, 2006, supervision of factoring, consumer financing and leasing companies was transferred from the Treasury to the BRSA. Staff noted, however, that Treasury continued to supervise insurance companies and that the Capital Markets Board supervised brokerage and securities firms, many of which were owned by banks. The authorities indicated that the assessment of the merits of further integrating financial sector supervisions would be completed by end-year.

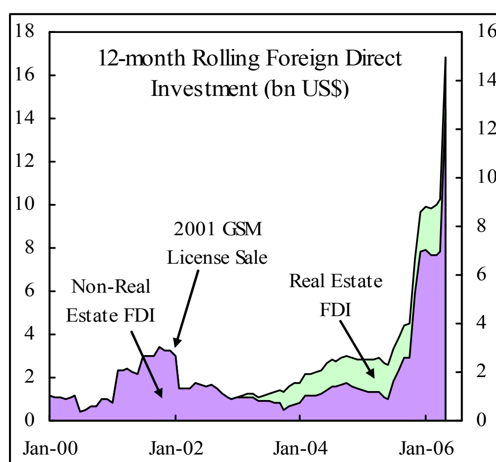
26. **It was agreed that the new draft mortgage law—an important step in further deepening financial intermediation in Turkey—would be implemented gradually** (¶23). This would help prevent mortgage lending from taking off too rapidly. Staff also welcomed the BRSA's sole responsibility for supervising mortgage lending by each institution under its purview, with the Capital Markets Board in charge of remaining mortgage institutions only. This was consistent with the BRSA's responsibility for consolidated supervision. Supporting regulations would be issued shortly after the law's passage (now expected in the fall). It was also agreed that there would be no income tax exemption for mortgage interest payments, as this would only serve to accelerate mortgage activity, while creating undesirable distortions and leading to sizable revenue losses.

27. **The privatization of state banks was progressing as planned** (¶24). The financial advisers for Halkbank recently informed the government of their recommendations on the privatization process. Based on these recommendations, the authorities planned to announce a detailed privatization strategy and timetable by end-July. This would include a timetable to phase out state banks' privileges over public agencies' deposits.

28. **The SDIF was close to resolving all assets in its portfolio and it continued shifting its focus to its role as a deposit insurance agency** (¶25). The SDIF had developed an operational restructuring strategy and, by end-2007, it would have disposed of all of its assets, except for protocols signed with former bank owners. At that point, Treasury would resolve its receivables arising from the restructuring of failed banks. Staff noted that this was an important step in underpinning public confidence in the operation of the deposit insurance agency.

F. Investment Climate

29. **It was agreed that Turkey's investment climate had improved considerably** (¶26-27). The past year had seen significant progress in priority areas, as identified by the Investment Advisory Council (IAC), including: major tax reform; streamlined registration and licensing; a new real estate law (liberalizing non-resident entry); parliamentary submission of a new Commercial Code; energy sector liberalization; and state enterprise privatization. Staff welcomed these achievements, noting that privatization had emerged as a key success area under the program. Over the past two years, some of the largest and most profitable enterprises had been privatized, with headline revenues of more than US$16 billion. With an improved investment climate, in 2005, FDI increased fourfold, to nearly US$10 billion, with a further doubling expected this year. Reflecting the priority attached to further strengthening the investment climate, the Prime Minister had again hosted the IAC in June (the third annual meeting), attended by top level IFI managements and global business leaders.



Privatization and FDI, 2005-06 (US$ billions)

Privatization 1/		FDI in Turkey	
Türk Telekom	6.6	Türk Telekom	6.6
TUPRAŞ refineries	4.1	Telsim cell phone	4.6
ERDEMIR steelworks	2.8	Turkcell	1.6
Other	3.0	Commercial Banks	10.5
TOTAL	**16.5**	Other	8.9
		TOTAL	**32.2**

Sources: data from the authorities and staff estimates
1/ Excludes SDIF asset sales

IV. Program Modalities and Data Issues

A. Program Monitoring

30. **The authorities' supplementary Letter of Intent describes progress in implementing the Fund-supported program and sets out conditionality through end-2006** (Attachment I, ¶1-4):

- **Quantitative conditionality** (Annex A). End-December, end-March and end-June quantitative performance criteria for net international reserves and external debt were met. The floors on primary balances of the consolidated government sector and the consolidated government excluding SEEs were both missed for end-December but met for end-March, while end-June data on those targets are not available. March inflation was within the program consultation bands, but June inflation exceeded the upper limit, and the central bank has sent a letter to the government and the Fund—in accordance with the inflation consultation clause—explaining the reasons for the deviation and the proposed policy response (Attachment II). A proposed new

- performance criterion establishing a ceiling on spending by the central government and social security institutions will underpin the authorities' commitment to save revenue overperformance. Existing performance criteria and indicative targets are proposed to be adjusted to reflect the authorities' broadened coverage of fiscal monitoring (Annex F).

- **Structural conditionality**. Table 1 summarizes progress in implementing structural conditionality. As prior actions, the authorities implemented agreed fiscal measures, the CIT law was passed by parliament, and the financial advisors to Halkbank have issued their recommendation on how to proceed with the bank's privatization. The authorities' Letter of Intent proposes to modify existing structural performance criteria as follows: (i) personal income tax legislation will be submitted to parliament by end-September (reset from end-May), and (ii) it will be passed by end-December (reset from end-September). The following modifications to structural benchmarks are also proposed: (i) a large taxpayer unit will be set up by end-December (previously end-June); and (ii) completion of implementing regulations for the Banking Law will be brought forward from end-September to end-August.

B. Phasing and Program Status

31. **No changes to the existing schedule of reviews and potential purchases are proposed** (Annex C). The merits of treating the program as precautionary were discussed. The authorities noted that, while their economic fundamentals had strengthened in recent years, external financing requirements were still high, suggesting that it was still too early to come to a final view on whether to make the program precautionary.

C. Data Issues

32. **The State Institute of Statistics plans to release revised national account data were ongoing**. This was widely expected to lead to a substantial upward revision in nominal GDP (unrecorded economy and updated surveys). The Fund would provide additional technical assistance in this area as current data weaknesses complicate economic analysis in Turkey (witness the large unexplained growth in inventories in recent years).

V. Staff Appraisal

33. **Turkey's economic performance in recent years has been strong**. The authorities' success in stabilizing and reforming the economy over the past few years has been reflected in high economic growth, rapid disinflation, and declining public and external debt burdens. Yet, even with strengthened fundamentals, the rapid appreciation of the lira and widening current account deficit made the economy vulnerable to a sudden shift in market sentiment. Against this backdrop, a resurgence of inflationary pressures, adverse political developments, and the tentative nature of the initial policy response to the recent emerging market sell-off have produced far larger financial market losses in the past month in Turkey than in other countries.

34. **The authorities' commitment to tighten macroeconomic policies and reinvigorate structural reforms is essential to restore a strong economic performance**. Delays in implementing structural measures under the program, as well as the authorities' failure to tighten fiscal policy as agreed at the time of the first and second reviews, were not helpful in preserving market confidence or containing inflationary pressures. The authorities' commitment to tighten fiscal and monetary policies, as well as reinvigorate structural reforms, is welcome. With these policies in place, the recent lira adjustment holds out the prospect that the economy will move to a more balanced and sustained growth path—after a temporary slowdown in the coming quarters—with more moderate domestic demand and a greater contribution from net exports.

35. **The central bank's commitment to rein in inflation is welcome**. Credibility was strained by a prolonged process of appointing a new governor in March-April, the recent inflation uptick, and the lira decline. After some initial hesitation, the central bank's policy response—the June interest rate hikes and the accompanying active withdrawal of lira liquidity—was appropriate and should, over time, help re-anchor medium-term inflation expectations and restore credibility. This needs to be backed up by clear and consistent communications.

36. **The authorities' commitment to the floating exchange rate regime is also important**. The floating lira has acted as a helpful safety valve in recent years, including during the latest turbulence, and should be left intact. Therefore, in the event of renewed market pressure, the exchange rate should be allowed to adjust and any foreign exchange sales, which may be required to counteract unusual lira volatility in illiquid markets, would need to be accompanied by a tightening of monetary policy.

37. **The authorities' commitment to tighten fiscal policy and rein in health spending is appropriate, given the challenging inflation outlook and unsettled market conditions**. The authorities should be commended for taking measures to reverse spending overruns and saving revenue overperformance to achieve a primary surplus in excess of the 6.5 percent of GNP target. Keeping nominal spending in line with the program and containing health costs will be key in this regard. The introduction of universal health care coverage is highly desirable. But this needs to be managed carefully, so that fiscal savings elsewhere are not undermined. Cost-saving measures that have already been implemented are a step in the right direction, but it is also important that measures are put in place to effectively contain raising demand for health services. Therefore, co-payments should be introduced (at the same time shielding the most needy) at the start of next year at the latest.

38. **Prudent macroeconomic policies need to be underpinned by timely implementation of structural reforms, especially on the fiscal side**. The recent passage of the administrative and pension reform laws was a key step in safeguarding Turkey's fiscal position over the medium term. Timely implementation of these reforms is critical, however. In this regard, the progress that has been made in merging existing social security institutions is welcome. Looking ahead, the authorities should adhere to the detailed milestones that have been agreed for the final merger of these institutions. It is also important that collection capacity of social security contributions be improved, including by better prioritizing debts to be enforced and outsourcing collection activities.

39. **Tax reform should also be reinvigorated to help pave the way for tax cuts in future years**. The envisaged second-stage PIT reform is an important step forward, although it could have been more ambitious, in particular by broadening the tax base to include pension and agricultural income. Further broadening in the future would be welcome. On the tax administration side, where progress has also been lagging, VAT rebate fraud in the textile sector is a major problem and needs to be addressed in a lasting way. The restructuring of social security arrears was regrettable and strengthening enforcement going forward will be crucial to improve tax compliance. The authorities are also urged to complete the transformation of the revenue administration without further delays, especially the setting up of a modern and effective large taxpayer unit by end-year.

40. **Further improvements in bank supervision are key to help safeguard financial stability**. Recent organizational changes at the BRSA, such as the merger of onsite and offsite supervision, should help modernize supervisory practices in Turkey. The BRSA's commitment to complete the drafting of supporting regulations for the banking law ahead of schedule is also welcome, as this will help bring supervisory practices into line with Basel Core Principles. Looking ahead, bank monitoring needs to be intensified in light of recent financial market developments. The BRSA's commitment to issue regular reports on banks' off-balance sheet activities and their foreign currency positions is welcome in this regard. A tightening of prudential regulations might also be required to better reflect banks' risk exposures and avoid excessive foreign exchange indebtedness by households and corporates with no foreign currency earnings.

41. **The improvement of national accounts statistics deserves greater priority**. The pending large upward revisions to national income are long outstanding. In the meantime, existing data inadequacies complicate economic analysis. While it is important that ongoing work in this area not be unduly rushed at the expense of quality, it needs to be completed expeditiously to resolve the current uncertainties surrounding key economic data.

42. **Going forward, the authorities need to adhere closely to their new program commitments if they are to navigate successfully the choppy waters ahead**. Foreign portfolio holdings are large and investors will likely remain sensitive to domestic news, including on inflation and progress elsewhere in the program. This makes it all the more important for the authorities to stay the course of good policies, implement their program commitments in a timely manner, and be ready to respond in a comprehensive way should unexpected financial market pressures reemerge.

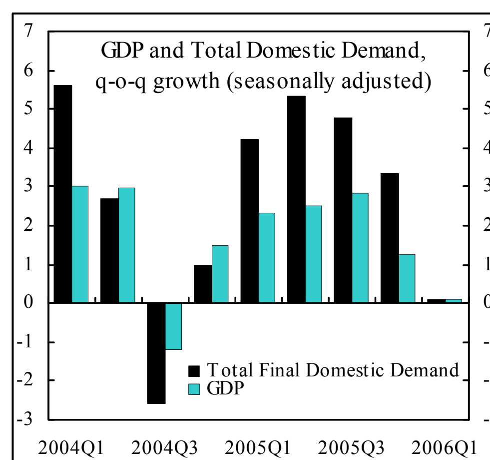
43. **In light of regained momentum in program implementation and the undertakings in the authorities' supplementary Letter of Intent, staff supports the requests for completing the third and fourth reviews**. Staff also supports the requests for waivers of applicability of the end-June quantitative performance criteria on the primary surplus of the consolidated government sector and the government sector excluding SEEs—as the end-March fiscal performance criteria were observed and staff has no clear indication of a worsening during the second quarter—and for the end-June ceiling on the cumulative overall balance of the social security institutions, which was a new performance criterion in June. It also supports the request for waivers of nonobservance of the structural performance criteria on public receivable amnesties (since these were accompanied by corrective efforts to

improve collection capacity), parliamentary approval of the administrative social security reform and pension laws (passed with delay), and the submission of draft legislation for second stage personal income tax reform (now expected by end-September).

Box 1. Turkey: Developments in Supply and Demand

Late revisions to the 2005 national accounts point to much stronger growth in 2005 than earlier projected. Accompanying the release of its fourth quarter national accounts in March 2006, the State Institute of Statistics revised up first half 2005 growth from 4.3 to 6.0 percent, with major upward revisions in private investment and exports on the demand side, and agriculture output on the supply side. As a result, for 2005 as a whole, growth was 2½ percentage points above the program target. Its composition was also more tilted towards domestic demand than had been estimated earlier, with increasing contributions from public spending on investment in the context of a fiscal policy that was more stimulative than programmed.

Growth slowed in the first quarter of 2006. Year-on-year GDP growth was 6.4 percent, down from an average of 9 percent in the previous two quarters. While there is considerable uncertainty about seasonally adjusted quarter-on-quarter growth data, most estimates point to a slowdown compared to 2005Q4, with output possibly having remained flat in the first quarter. With export volumes slowing, the external sector continued to subtract from growth. This was in part offset by higher contribution to growth from public consumption.

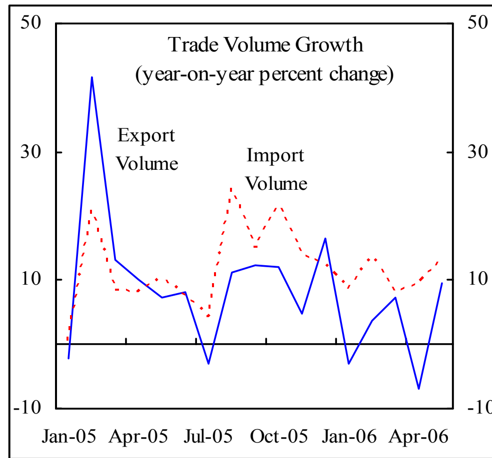


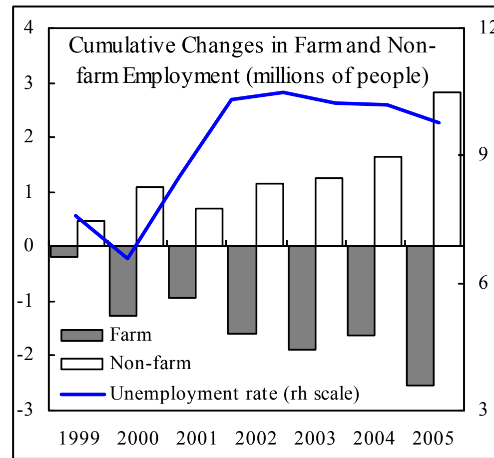
Turkey - Real Output and Expenditure 2005-2006

	Quarterly 2005						2006	Annual 2005		2006
	Q1		Q2		Q3	Q4	Q1			
	Country Report 06/268	Prel.	Country Report 06/268	Prel.	Prel.	Prel.	Prel.	Country Report 06/268	Prel.	Proj.
	(year on year growth rate, in percent)									
Gross National Product	5.3	7.5	3.4	4.7	8.0	10.2	6.3	5.0	7.6	5.0
Gross Domestic Product	4.8	6.6	4.2	5.5	7.7	9.5	6.4	5.0	7.4	5.0
Domestic Demand	4.4	5.6	6.4	6.8	10.9	11.6	8.5	5.1	8.8	5.1
Consumption	4.0	4.1	4.4	3.9	9.8	14.1	8.4	5.2	8.1	4.6
Private	4.0	4.1	4.4	3.9	10.4	16.7	8.4	5.4	8.8	4.9
Public	4.3	4.4	4.0	4.0	3.2	0.0	8.1	3.0	2.4	2.0
Gross Investment	5.2	9.1	9.9	11.9	13.9	6.0	8.7	5.1	10.3	6.3
Gross Fixed Investment	6.9	10.3	17.9	20.0	30.6	33.0	30.5	8.8	24.0	11.4
Private	4.8	8.8	15.8	18.4	29.0	41.6	30.2	9.0	23.6	12.6
Public	36.6	30.7	31.1	30.2	38.2	17.1	34.6	8.0	25.9	6.4
Change in stocks	1.2	6.3	-7.2	-5.5	-77.3	-89.3	-43.9	-6.0	-30.3	-20.0
Exports of g & nfs	11.3	14.0	4.7	6.7	3.9	10.9	3.5	7.3	8.5	2.0
Imports of g & nfs	9.3	10.6	9.2	9.1	11.2	15.3	8.2	7.4	11.5	2.6
	Contribution to GDP growth									
Gross Domestic Product	4.8	6.6	4.2	5.5	7.7	9.5	6.4	5.0	7.4	5.0
Domestic Demand	5.0	6.1	7.1	7.5	10.4	11.8	9.2	5.3	9.1	5.4
Consumption	3.2	3.1	3.1	2.7	6.9	9.8	6.2	3.7	5.8	3.3
Private	2.9	2.8	2.8	2.5	6.8	9.8	5.7	3.5	5.6	3.2
Public	0.3	0.3	0.3	0.3	0.2	0.0	0.5	0.2	0.2	0.1
Gross Investment	1.8	3.0	4.0	4.7	3.4	1.9	2.9	1.6	3.3	2.1
Gross Fixed Investment	1.7	2.4	5.0	5.4	6.4	8.3	7.3	2.1	5.7	3.2
Private	1.1	1.9	3.8	4.3	4.9	6.8	6.7	1.8	4.6	2.8
Public	0.6	0.5	1.2	1.1	1.5	1.5	0.6	0.4	1.2	0.3
Change in stocks	0.1	0.6	-0.9	-0.7	-3.0	-6.3	-4.4	-0.5	-2.5	-1.1
External balance	0.0	0.5	-2.9	-1.9	-2.7	-2.3	-2.8	-0.3	-1.7	-0.4

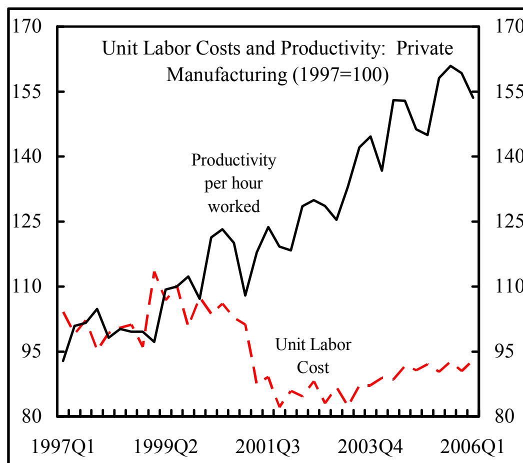
Sources: State Institute of Statistics and CBT.

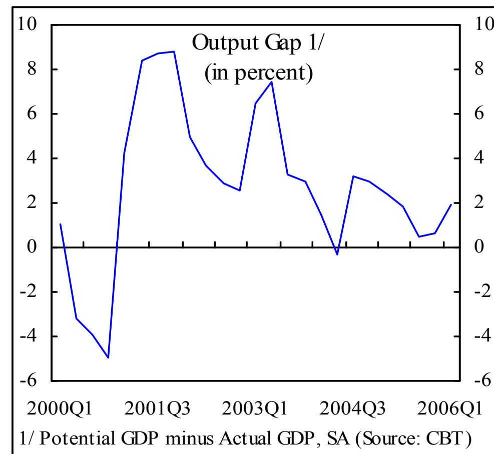
Growth appears to have increased in the second quarter of 2006. From the supply side, in April-May, industrial production growth returned to the pace exhibited in 2005Q4 (8.4 percent, saar). From the demand side, exports regained momentum (especially automotive vehicles and machinery), as did imports and domestic sales of white goods and vehicles.





Available data diminish earlier concerns about possible overheating. Staff and official estimates suggest that, although the carryover for growth into 2006 was strong (3 percent), the pace of activity had slowed in the first half of 2006. Indeed, with the possible exception of the recent pick up in inflation and continued high capacity utilization, there have been few indications of bottlenecks: (i) unemployment has been high, at around 10 percent, despite declining labor force participation, as the flow of workers out of agriculture and into urban service and manufacturing jobs continues; (ii) real wages and unit labor costs have been broadly stable, thanks to strong growth in productivity (especially in larger export establishments); and (iii) while declining last year, the output gap was estimated to remain positive, thanks to strong potential output growth from robust private sector investment. Furthermore, the recent market turbulence is expected to dampen economic activity in the second half of 2006, through tightening credit conditions, weakening corporate balance sheets, wealth and confidence effects.





1/ Potential GDP minus Actual GDP, SA (Source: CBT)

Box 2. Turkey: Recent Market Turbulence in Context

Since early May, the tightening of global liquidity conditions has prompted an increase in risk aversion, triggering a substantial retrenchment by investors from a wide range of risky assets. The realized and prospective withdrawal of liquidity in the US, Japan and Europe, coupled with a renewed market focus on global imbalances, induced a flight to safety and sparked a sell-off of equities, commodities, and emerging markets assets, reversing to varying degrees their respective gains over the previous months.

Amid the global retrenchment from risky assets, Turkey suffered more than other emerging markets. In addition to domestic economic and political circumstances (see paragraphs 2-6), investor behaviors contributed to this outcome. Foreign investor positioning in local equity and bond markets was already very crowded. The Turkish lira (together with the Brazilian real) had also been among the favorite currencies for carry trades, so that the unwinding of these trades following the tightening of global liquidity conditions may have exacerbated financial market losses in Turkey.

Change in financial indicator values (May 8-June 23)

	$/FX (in percent)	Equity index (in percent)	CDS-5yr spread (in b.p.s)	EMBI spread (in b.p.s)	ELMI (in percent)
Turkey	-22.8	-25.1	181	139	-21.9
Brazil	-8.2	-16.1	69	42	-6.0
Hungary	-9.1	-23.7	20	8	-8.0
Poland	-8.4	-17.0	10	6	-7.6
Indonesia	-6.6	-13.0	65	32	-4.7
South Africa	-18.6	-6.1	36	35	...

Source: Bloomberg; staff estimates.

From Turkey's historical perspective, the recent financial market losses were of a smaller order of magnitude than those experienced in previous crises episodes. The recent correction in the exchange rate and domestic bond markets was more pronounced than in previous episodes of market volatility, barring for the 1994 and 2001 crises. However, the widening of credit default swaps and external debt spreads has been generally smaller than in previous market volatility episodes.

Change in financial indicator values during episodes of turbulence (1994-2006)

	$/FX (in percent)	Equity index (in percent)	CDS-5yr spread (in b.p.s)	EMBI spread (in b.p.s)	ELMI (in percent)
2006: May 8 - Jun 23	-22.8	-25.1	181	139	-21.9
2005: Mar 9 - Mar 29	-9.1	-11.6	146	79	-8.2
2004: Apr 12 - May 20	-14.3	-16.2	280	232	-11.8
2003: Mar 3 - Mar 24	-9.7	-23.2	460	396	-6.9
2002: Apr 15 - Jul 11	-22.0	-22.6	713	415	-10.1
2001: Feb 21 - Oct 19	-58.4 1/	0.6	…	29	-30.1
2000: Aug 30 - Dec 4	-3.6 1/	-43.4	…	554	2.9
1994: Jan 26 - Apr 6	-61.6	-17.0	…	…	…

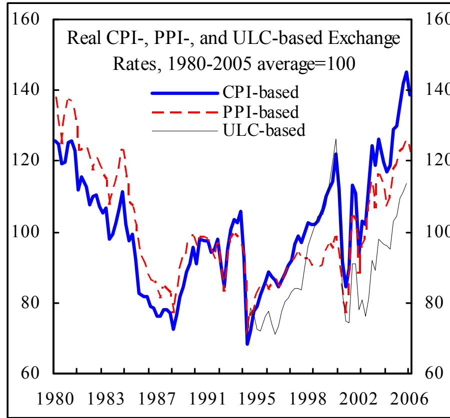
Source: Bloomberg; staff estimates.

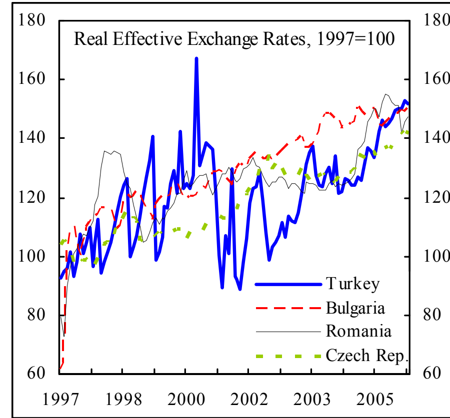
1/ The Turkish lira was floated on Feb 21, 2001.

Investor positioning could expose Turkey to further financial market volatility going forward. Market analysts have noted that despite the reduction in foreign investors' positions over the past weeks, there is still a significant pool of investors who may want to reduce their long Turkish positions in the future, particularly nonresident equity investors, who hold about two-thirds of Turkish equities. Increased liquidity in the currency market, or further negative shocks, could prompt these investors to reduce their positions further. In addition, hedging demand from nonresident equity investors as well as domestic corporates may be another source of pressure on the lira going forward.

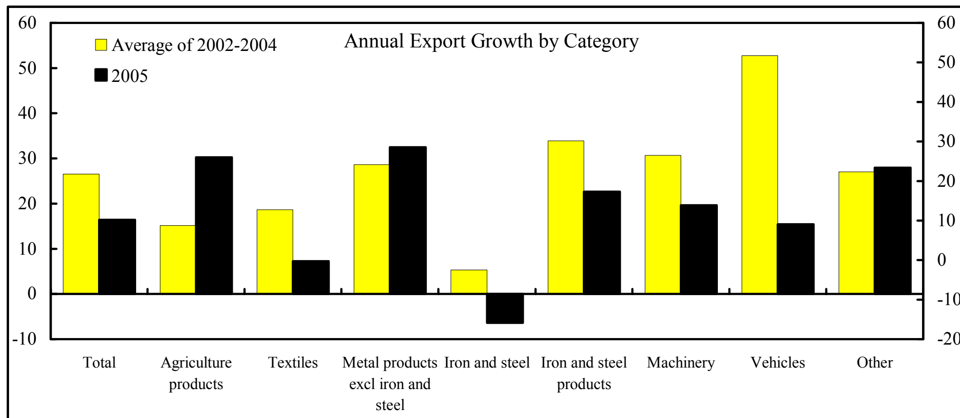
Box 3. Turkey: Competitiveness

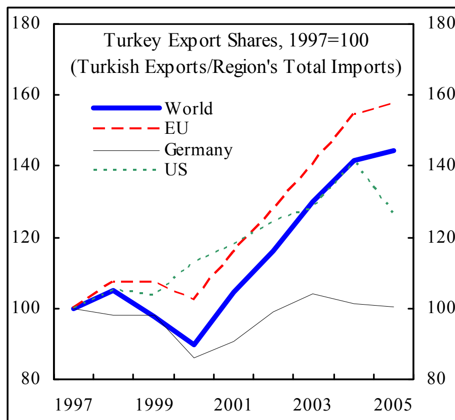
By all measures (see below), the real exchange rate rose sharply in 2005—between 12-20 percent—to levels well above historical averages. This appreciation of the lira was driven by ample global liquidity conditions, and by Turkey's strong economic performance and EU accession prospects, but was by no means unusual by the standards of neighboring emerging market economies.

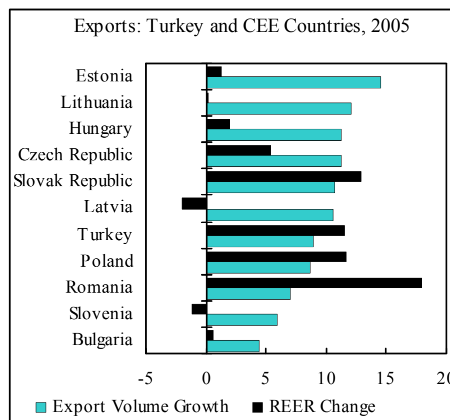




Despite the lira appreciation, export performance has been robust and at par with that of other countries in the region. Export growth has remained strong across most major product categories, although down from immediate post-crisis levels. Moreover, Turkey's market share of world exports continued to rise in 2005 (2 percent), though less than in previous years. This good performance likely reflects high productivity growth, wage restraint, and strong investment.







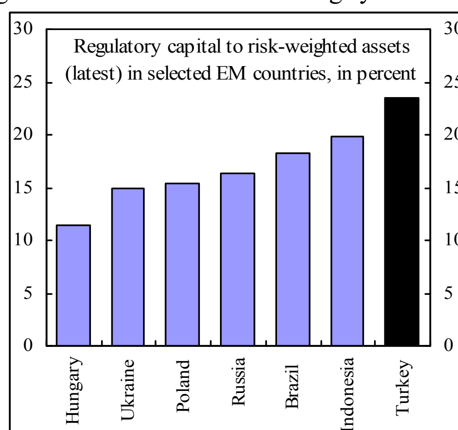
Box 4. Turkey: Banking Sector Vulnerabilities

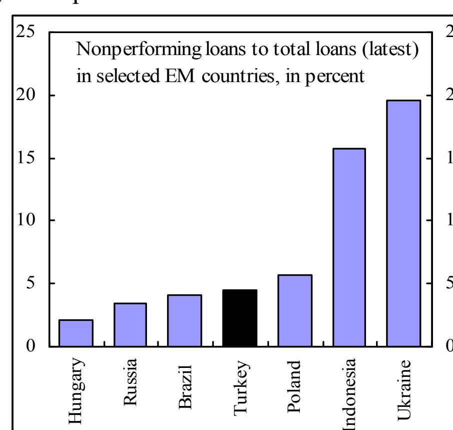
The Turkish banking system has posted a strong recovery since the 2001 financial crisis. Capital adequacy ratios are high and now compare favorably to those of other emerging markets, NPLs are down sharply, and profitability has held up. Taken together with moves towards EU accession and the potential for further rapid growth and deeper financial intermediation, these developments have sparked strong interest in the Turkish banking system from large European banks.

Financial Soundness and Profitability Indicators of Turkish Banks

	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Mar-06
Capital adequacy ratio	15.3	25.3	30.9	28.8	24.2	23.5
NPLs (%) total loans	29.3	17.6	11.5	6.0	4.8	4.5
Return on assets	-5.5	1.1	2.3	2.3	1.7	0.7
Return on equity	-69.4	9.3	16.0	16.4	11.8	5.3

Source: BRSA





Reflecting these developments, rating agency assessments indicate that the risk profile of the Turkish banking sector has improved. For example, Fitch assigns the Turkish banking system a D-2 rating (low quality, moderate vulnerability), putting it alongside Hungary. S&P results are broadly similar.

Fitch Banking System Risk Matrix: Selected EM Countries

Banking System (measure of quality)	*Macro-Prudential Indicator* (measure of vulnerability)		
	1 (low)	2 (moderate)	3 (high)
A ("very high")			
B ("high")	Chile	Estonia	Iceland
C ("adequate")	Czech Rep. Mexico Slovenia	Malta	
D ("low")	Brazil Indonesia Poland	Hungary **Turkey** Ukraine	Russia
E ("very low)	Argentina Equador Uruguay	Vietnam	Azerbaijan

Source: Fitch

S&P Banking Industry Country Risk Assessments: Selected EM Countries

(1 = "strongest"…10 = "weakest")				
Group 1	*Group 2*	*Group 3*	*Group 4*	*Group 5*
		Chile	Czech Rep Iceland	Estonia Malta Mexico Slovenia
Group 6	*Group 7*	*Group 8*	*Group 9*	*Group 10*
Brazil Hungary Poland	**Turkey**	Argentina Indonesia	Russia Uruguay	Ukraine Vietnam

Source: Standard and Poors

Despite these improvements, the Turkish banking system remains vulnerable in key respects. Recently, profit margins have come under pressure, mainly due to intense competition for market share (driven in part by a "beauty contest" for foreign investors). Earnings on government securities have also fallen. In this environment, banks have turned their attention to the household sector—leading to a surge in consumer credit growth (albeit from a low base)—and have used increasingly large-scale foreign borrowings to fund credit expansion. In addition, until the recent market turbulence, banks had

positioned themselves for a continued decline in domestic interest rates by extending large amounts of fixed term lending.

Put together, these trends suggest the following key vulnerabilities:

- *Interest rate risk*. A rise in interest rates would squeeze margins further due to quick re-pricing of liabilities—as rates paid on short-term deposits increase, those on consumer loans remain fixed (in effect, capped by law). This could, in turn, suppress lending growth and profitability.
- *Foreign exchange risk.* Although the reported net foreign exchange position of the banking sector remains manageable, currency exposure may still be an issue. First, hedging costs will likely have risen, dampening profitability going forward. Second, in principle, banks are also exposed to the risk that holders of hedging instruments are unable to honor their commitments—though this risk in the present circumstances is said to be low.

Banking sector FX position (in US$ million, unless noted)

	Dec-03	Dec-04	Dec-05	Mar-06	Jun-06 1/
Net fx position	363	-72	-97	-661	-623
In percent of equity	*1.8*	*-0.2*	*-0.3*	*-1.8*	...
On-balance sheet position	-27	-1,390	-1,880	-5,038	-5,696
In percent of equity	*-0.1*	*-4.3*	*-5.7*	*-13.3*	...
Assets	77,448	89,832	102,549	103,674	106,823
o/w FX-indexed	9,336	7,748	9,809	10,015	8,179
Liabilities	77,516	89,939	104,419	108,712	112,520
Off-balance sheet position	390	1,318	1,784	4,377	5,074

Source: BRSA
1/ As of June 23, 2006.

- *Credit risk*. Even with a closed net fx position, lending in foreign currency may pose a problem if borrowing companies are not naturally or financially hedged. Here, an additional source for concern is that existing regulations restricting the provision of foreign currency loans to firms with export receipts can be circumvented if the loans are channeled through Turkish banks' foreign branches. There are also potential credit risks relating to fx-indexed loans in the event borrowers do not receive fx earnings. Finally, Turkish banks' ability to manage risks associated with large-scale retail lending is yet to be tested.
- *Liquidity risk.* Short-term interbank credit lines and non-resident deposits—both of which contracted sharply in the 2001 crisis—are potential sources of vulnerability in the event that investor confidence deteriorates sharply. As of end-April, banks' borrowings from foreign banks amounted to US$13 billion and non-resident deposits to US$6 billion.

Box 5. Turkey: Health Expenditure Developments

Health expenditures in Turkey have increased markedly over the past few years (from 3.7 percent of GDP in 1999 to 5 percent in 2005) and are now somewhat higher than in comparator countries both relative to GDP and in per capita terms. Despite Turkey's relatively high *public* expenditure on health (both in relation to private-sector health spending and to total government spending), access is highly unequal, both along socio-economic and geographical dimensions (see World Bank's 2005 Country Economic Memorandum for details).

Text Table. Health Systems, Selected Indicators

	Turkey	Average of comparators[b]
Total expenditure on health as percent of GDP[a]	7.6	6.1
Percent of total expenditure on health[a] by general government	71.6	53.9
Percent of total expenditure on health[a] by private sector	28.4	46.1
General government expenditure on health as percent of total government expenditure[a]	13.9	9.5
Per capita total expenditure at average exchange rate[a] (US$)	257	254

a) The World Health Report 2006: working together for health. 2003 data. Geneva, World Health Organization, 2006. (http://www.who.int/whr/2006/annex/en)

b) Comparators include Brazil, Bulgaria, Hungary, Indonesia, Mexico, Philippines, Poland, Russia.

This increase largely reflects a policy decision to expand access and coverage, ahead of the formal inception of the Universal Health Insurance (UHI) scheme, slated for January 2007. Specifically, during 2005: (i) the benefits for Green Card holders were expanded to cover outpatient prescription drugs; (ii) a form of de-facto drug rationing was eliminated when the perpetually-understocked pharmacies owned by SSK, the largest social security institution (SSI), were closed and SSK members allowed to obtain drugs from private pharmacies; (iii) SSK hospitals were transferred to the Ministry of Health (MoH), thus bringing them into the reach of non-SSK members. Moreover, the elimination at MoH hospitals of additional charges to access specialists led to increased demand for specialist care at public expense (and a reduction in out-of-pocket-financed visits to the private clinics of these same specialists). As a result, there have been substantial increases in the numbers of treatments (from 115 million in 2003 to 170 million in 2005) and prescriptions (especially for SSK members, with 11 million in March 2006 from a 2005 monthly average of 8 million).

However, other factors may also have been at play, related to a change in the incentives of health care providers and with SSK's weak financial management system. As SSK hospitals were transferred to the MoH, individual physicians' pay was linked to the revenue they generated for their hospitals and thus, ultimately, to the number of services they perform. (These bonuses can now constitute up to 5 times the basic salary for medical residents, 7 times for mid-level doctors and 8 times for senior doctors). Just as doctors' incentives to order more tests and procedures have increased, the system's capacity to keep them in check has declined, due to SSK lacking a functioning claim processing system (under the previous system, SSK did not have to process any bills, since its members could use only its own hospitals).

A key challenge for Turkey's health system is to complete the transition to a universal access system in a fiscally-neutral manner. Some structural measures to increase efficiency and contain costs have already been taken (e.g., the introduction of a positive list and reference pricing for drug reimbursements), while others (e.g., a 2 YTL co-payment for outpatient treatment) are due to come into effect with the UHI in 2007. Going forward, the World Bank has identified a number of reform priorities, especially to strengthen hospitals' and physicians' incentives to provide quality care at the lowest cost, and tighten financial management and control systems of the paying institutions (the unification of the three SSIs should help here). The delivery of health services needs also to be strengthened, by shifting emphasis from treatment of the sick to health promotion and preventative measures. In this regard, the "family medicine" system, now at the pilot stage under a World Bank program, is very promising. Moreover, having a family doctor, paid based on a capitation fee per enrollee, acting as a mandatory first link in the referral chain should result in a more efficient allocation of cases, with more outpatient treatments performed at less expensive clinics and fewer in hospitals, which could focus to a greater extent on more complex inpatient cases.

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	Not observed. Waiver requested
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	Observed. New hires by the SEE sector as a whole were well below 10 percent, although two enterprises exceeded individual limits to address critical shortages of specialized, technical staff
3. Complete comprehensive review of civil service wage and employment structure (¶17)	SB. End-December 2005	Observed
4. Put in place secondary legislation required under the Public Financial Management and Control Law (¶20)	SB. End-December 2005	Observed
5. Establish Tax Policy Unit at Ministry of Finance (¶15)	SB. End-December 2005	Not observed. While the establishing law was passed in January 2006, the unit was expected to be made fully functional by end-July 2006
6. 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	Met with delay. Legislation passed in March 2006.
7. Parliamentary approval of administrative social security reform (¶14)	PC. End-January 2006	Met with delay. Waiver requested
8. Parliamentary approval of pension reform legislation (¶15)	PC. Mid-February 2006	Met with delay, Waiver requested
9. Complete functional restructuring of Revenue Administration, including reorganization of local tax offices (¶15)	SB. End-April 2006	Not observed. Expected to be implemented by end-July 2006
10. Submission of draft legislation for second stage of personal income tax reform (¶18)	PC. End-May 2006	Not observed. Waiver requested. Reset to end-September 2006 (PC) to permit broader consultation with stakeholders
11. Approval of second stage of personal income tax reform (¶18)	PC. End-September 2006	Reset to end-December 2006 (PC)
12. Establish a large-taxpayers unit within the Revenue Administration (¶19)	SB. End-June 2006	Not observed. Reset to end-Dec 2006 because of ongoing administrative delays
Financial Sector Measures		
13. SDIF to sell all remaining non-related-party loans by auction (¶31)	SB. End-December 2005	Observed. Loans that received no bids will be re-auctioned this year
14. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶29)	SB. End-March 2006	Not observed. Expected to be met by end-July 2006
15. Set up a committee to assess whether integrated financial sector supervision is warranted, with findings to be presented (¶28)	SB. End-March 2006	Met with delay
16. Announcement of detailed state bank privatization strategies and timetables (¶22)	SB. End-June 2006	Not observed. Expected to be met by end-July 2006
17. Completion of implementing regulations for the Banking Law (¶26)	SB. End-September 2006	Pending. Brought forward to end-August 2006

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the April 26, 2005 Memorandum of Economic Policies, except for actions 5, 6, 9 and 16, where references are to the supplementary Letter of Intent dated November 24, 2005.

Table 2. Turkey: Selected Economic Indicators, 2001–06

	2001	2002	2003	2004	2005	2006 Proj.
			(In percent change)			
Real sector						
Real GNP growth rate	-9.5	7.9	5.9	9.9	7.6	5.0
GNP deflator	55.3	44.4	22.5	9.5	5.3	9.6
Nominal GNP growth rate	40.5	55.8	29.7	20.3	13.4	15.1
CPI Inflation (12-month, end-of period)	68.5	29.7	18.4	9.4	7.7	10.0
WPI Inflation (12-month, end-of-period)	88.6	30.8	13.9	15.3	2.7	8.7
Unemployment rate	10.4	11.0	10.3	10.3	10.2	..
Average nominal treasury bill interest rate	99.1	63.5	45.4	24.9	16.4	16.6
Average ex-ante real interest rate	35.5	30.5	33.9	15.4	6.3	9.5
			(In percent of GNP, unless otherwise indicated)			
Central government budget						
Primary balance	4.8	2.4	5.0	5.1	5.0	5.5
Net interest payments	22.2	17.3	16.1	12.3	9.0	8.0
Overall balance	-17.4	-14.9	-11.0	-7.2	-4.0	-2.5
Consolidated public sector						
Primary balance	5.5	4.1	6.4	7.0	6.2	6.7
Net interest payments	22.6	17.6	15.4	11.7	8.4	7.6
Overall balance	-17.1	-13.6	-9.0	-4.7	-2.2	-0.9
Net debt of public sector	90.5	78.5	70.4	63.5	55.8	55.5
Net external	37.8	32.3	22.1	17.5	8.5	8.4
Net domestic	52.8	46.2	48.3	45.9	47.3	47.1
Share of FX debt (percent total public debt)	57.8	58.1	46.3	41.5	37.6	..
External sector						
Current account balance	2.4	-0.8	-3.4	-5.2	-6.4	-6.5
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.1	31.6
Volume growth (goods only, in percent)	15.7	17.2	19.1	15.0	11.0	9.6
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	33.9	36.3
Volume growth (goods only, in percent)	-23.8	26.1	24.6	22.2	11.6	3.3
Trade Balance	-2.6	-4.0	-5.9	-7.9	-9.1	-9.7
of which : oil (in billions of US dollars)	-7.8	-8.5	-10.6	-13.0	-18.6	-23.1
Gross external debt 1/	93.1	77.6	56.6	50.5	47.0	59.4
Net external debt 1/	64.1	52.8	37.7	32.2	27.4	35.4
Foreign Direct Investment (net)	1.9	0.5	0.5	0.7	2.4	5.8
Short-term external debt (by remaining maturity)	22.6	19.3	17.3	17.4	17.0	20.1
Monetary aggregates						
Seignorage	1.1	1.0	1.2	1.2	1.7	1.0
Nominal growth of M2Y broad money (in percent)	87.5	25.4	13.0	22.1	24.5	21.8
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds 2/	2.8	0.5	0.2	1.3	3.8	9.6
Net external financing of central government	8.4	6.7	-0.7	-2.7	-4.1	-0.6
Amortization	-6.7	-11.4	-8.7	-11.7	-14.1	-13.5
Gross borrowing	15.0	18.1	8.0	8.9	10.0	13.0
of which : Eurobond issues	2.2	3.3	5.3	5.8	6.5	5.5
GNP	144.0	182.7	238.5	301.5	361.9	359.7
GNP (in billions of Turkish lira)	176.5	275.0	356.7	428.9	486.4	559.8

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

1/ Debt ratios valued at end-year exchange rates (in Country Report No. 06/268 valued at annual average exchange rates).

2/ Privatization revenue received by fiscal authorities.

Table 3. Turkey: Balance of Payments, 2001–08
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005		2006		2007	2008
					Prel.	Country Report 06/268	Proj.	Country Report 06/268		
Current account balance	3.4	-1.5	-8.0	-15.6	-23.1	-21.3	-23.5	-22.0	-18.2	-15.5
Trade balance	-3.7	-7.3	-14.0	-23.9	-32.8	-32.0	-34.9	-34.3	-32.1	-29.9
Exports (f.o.b.)	34.4	40.1	51.2	67.0	76.9	76.1	84.2	82.7	93.2	102.4
Of which:										
Exports (f.o.b.) in trade returns	31.3	36.1	47.3	63.2	73.4	72.5	80.4	79.1	89.4	98.7
Shuttle trade	3.0	4.1	4.0	3.9	3.5	3.6	3.8	3.6	3.8	3.8
Imports (f.o.b.)	-38.1	-47.4	-65.2	-90.9	-109.6	-108.1	-119.1	-117.0	-125.3	-132.4
Of which:										
Imports (c.i.f.), incl. non-monetary gold	-41.4	-51.6	-69.3	-97.5	-116.5	-115.0	-126.6	-124.4	-133.3	-140.8
Energy imports (c.i.f.)	-8.3	-9.2	-11.6	-14.4	-21.2	-20.3	-26.4	-23.8	-27.9	-27.7
Services and Income (net)	4.1	3.3	4.9	7.1	8.2	9.3	9.7	10.7	12.3	12.8
Services and Income (credit)	18.8	17.3	21.3	25.6	29.5	31.7	30.3	35.0	34.9	36.8
Of which:										
Tourism receipts	8.1	8.5	13.2	15.9	18.2	18.5	19.0	20.4	20.3	21.2
Services and Income (debit)	-14.7	-13.9	-16.3	-18.4	-21.3	-22.3	-20.5	-24.3	-22.6	-23.9
Of which:										
Interest	-7.1	-6.4	-6.9	-7.2	-8.3	-8.1	-9.0	-9.3	-9.9	-10.5
Private transfers (net) 1/	2.8	1.9	0.7	0.8	0.9	0.8	0.9	0.8	1.0	1.0
Official transfers (net)	0.2	0.5	0.3	0.3	0.6	0.6	0.8	0.8	0.6	0.6
Capital account balance	-14.6	1.2	7.1	17.7	43.8	38.9	32.4	30.7	22.2	18.2
(including errors and omissions)	-16.3	1.3	12.1	19.9	46.3	42.9	32.8	30.7	22.2	18.2
Direct investment 2/	2.8	0.9	1.2	2.0	8.6	4.2	20.8	4.3	7.1	7.3
Portfolio investment in securities	-4.6	-1.2	1.1	6.1	10.4	8.7	-7.8	5.6	-2.8	-0.7
Public sector (central & local governments & EBFs)	-1.9	0.4	-0.7	0.8	1.3	1.7	2.4	3.2	1.3	0.9
Bonds (net)	0.1	1.0	1.5	2.0	3.4	2.8	2.9	2.7	1.8	2.1
Eurobond drawings	2.1	3.3	5.3	5.8	6.5	6.0	5.5	5.5	5.5	5.8
Eurobond repayments	-2.0	-2.3	-3.8	-3.8	-3.1	-3.2	-2.6	-2.8	-3.7	-3.7
Loans (net)	-2.0	-0.7	-2.2	-1.2	-2.2	-1.0	-0.5	0.5	-0.5	-1.2
Loan disbursements	1.6	2.3	1.0	2.0	1.1	2.5	2.6	3.9	3.0	2.0
Loan repayments	-3.6	-3.0	-3.2	-3.2	-3.3	-3.6	-3.1	-3.4	-3.4	-3.3
CBT, (Excl. reserve assets, liabilties)	0.8	1.4	0.6	-0.1	-0.5	-0.2	-0.6	0.0	0.1	0.1
Domestic money banks (net)	-9.4	-1.8	3.0	1.2	9.8	13.2	4.0	8.4	4.9	3.5
Domestic money banks (FX deposits abroad, -: accumulation)	0.9	0.6	0.7	-6.0	-0.4	0.0	0.0	2.2	0.0	0.0
Domestic money banks (other, net)	-10.3	-2.4	2.3	7.2	10.2	13.2	4.0	6.1	4.9	3.5
Domestic money banks (MLT, net)	-1.0	-0.7	-0.2	2.4	6.1	6.7	5.0	4.1	4.5	2.4
Domestic money banks (short-term, net)	-9.3	-1.7	2.5	4.8	4.2	6.5	-1.0	2.0	0.4	1.1
Interbank credit lines from foreign commercial banks	-7.1	-0.7	2.0	3.3	2.7	2.7	2.0	2.0	1.9	1.1
Other private sector (net)	-2.3	1.5	1.8	7.7	14.2	11.3	13.6	9.3	11.7	7.2
Other private sector (medium and long term, net)	0.3	2.5	1.6	5.2	9.9	7.7	12.2	6.8	11.3	6.7
Other private sector (short term, net)	-2.6	-1.0	0.2	2.4	4.3	3.5	1.4	2.5	0.4	0.5
Errors and omissions	-1.7	0.1	5.0	2.3	2.4	4.0	0.4	0.0	0.0	0.0
Overall balance	-12.9	-0.2	4.1	4.3	23.2	21.5	9.4	8.7	3.9	2.8
Overall financing (NIR change excl. ST liabilities, +: decline)	12.9	0.2	-4.1	-4.3	-23.2	-21.5	-9.4	-8.7	-3.9	-2.8
Change in net international reserves (+ denotes decline)	12.9	0.2	-4.1	-4.3	-23.2	-21.5	-9.4	-8.7	-3.9	-2.8
Change in gross official reserve assets (+ denotes decline)	2.7	-6.2	-4.0	-0.8	-17.8	-16.3	-5.6	-4.8	-1.4	-0.9
Change in reserve liabilities (IMF)	10.2	6.4	-0.1	-3.5	-5.4	-5.2	-3.8	-3.9	-2.5	-1.8
Purchases	11.3	12.5	1.7	1.2	2.4	2.5	3.7	3.7	2.8	0.9
Repurchases	-1.1	-6.1	-1.7	-4.7	-7.8	-7.7	-7.4	-7.6	-5.3	-2.8

Table 3 (concluded) Balance of Payments, 2001–08
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005		2006		2007	2008
					Prel.	Country Report 06/268	Proj.	Country Report 06/268		
Memorandum items:										
Trade in goods and services										
As percent of GNP										
Current account balance, incl. shuttle trade	2.4	-0.8	-3.4	-5.2	-6.4	-6.0	-6.5	-5.8	-5.1	-4.0
Non-oil current account balance	7.8	3.8	1.1	-0.9	-1.3	-0.9	-0.1	-0.1	1.8	2.3
Trade account balance, incl. shuttle trade	-2.6	-4.0	-5.9	-7.9	-9.1	-8.9	-9.7	-9.0	-9.0	-7.8
Exports of goods and non-factor services	36.1	31.0	30.1	30.5	29.1	29.9	31.6	30.6	35.6	36.0
Imports of goods and non-factor services	31.7	30.1	31.3	33.8	33.9	34.2	36.3	34.7	38.8	38.1
Percent change										
Value growth in exports of goods (incl. shuttle trade)	11.9	16.7	27.6	30.9	14.6	13.6	9.6	8.7	10.6	9.9
Value growth in exports of goods (excl. shuttle trade)	12.8	15.1	31.0	33.7	16.2	14.9	9.6	9.1	11.1	10.4
Value growth in imports of goods	-27.7	24.4	37.6	39.4	20.6	18.9	8.6	8.2	5.2	5.6
Volume growth in exports of goods	15.7	17.2	19.1	15.0	11.0	7.2	9.6	9.1	11.2	11.5
Volume growth in imports of goods	-23.8	26.1	24.6	22.2	11.6	7.1	3.3	6.6	4.4	6.9
Volume growth in imports of goods exluding fuel	-22.9	25.2	19.8	28.0	15.3	9.4	5.1	6.5	5.7	8.2
Terms of trade	-2.2	-0.6	2.0	1.0	-2.2	-2.6	-4.9	-1.5	-0.9	0.3
Reserve and debt indicators										
Gross foreign reserves (Central Bank of Turkey)										
In billions of U.S. dollars	19.8	28.1	35.2	37.6	52.2	53.9	57.8	58.7	59.2	60.1
Months of goods & NFS imports	4.5	5.5	3.9	3.4	4.5	4.6	4.7	4.7	4.5	4.3
External debt (end-of-period)										
In billions of U.S. dollars	113.6	130.2	145.0	162.2	170.1	181.9	189.9	197.5	207.6	219.8
Percent of GNP 3/	93.2	77.6	56.6	50.5	47.0	53.0	59.4	53.0	59.3	58.1
Percent of exports of goods & NFS	218.4	230.0	201.9	176.5	161.4	170.1	167.2	169.5	164.3	159.9
Net external debt (end-of-period) 4/										
In billions of U.S. dollars	78.0	89.0	96.7	102.5	96.2	108.4	113.3	121.3	129.6	140.8
Percent of GNP 3/	63.9	53.1	37.8	31.9	26.6	31.6	35.4	32.5	37.0	37.2
Short-term debt (end-of-period)										
In billions of U.S. dollars	16.4	16.4	23.0	32.6	38.2	41.6	40.3	47.1	43.4	47.5
Reserves to short-term debt ratio	120.7	170.9	152.8	115.6	136.5	129.7	143.4	124.7	136.2	126.5
Short-term debt plus MLT repayments										
In billions of U.S. dollars	32.6	35.2	41.1	52.5	61.6	62.9	72.3	71.3	80.8	86.2
Reserves to short-term debt ratio	60.7	79.7	85.5	71.7	84.7	85.7	79.9	82.4	73.2	69.7
Debt service ratio 5/	41.9	38.1	35.1	27.2	26.4	27.1	28.1	28.3	32.5	34.1

Sources: Data provided by the Turkish authorities; and Fund staff estimates and projections.
1/ Until 2003, remittances include tourism receipts from foreign citizens. These are now classified under the services account. Also, the "imports with waiver item" was reclassified in November 2004, leading to a revision of the current account balance for 2003 as well as 2004.
2/ Including privatization receipts.
3/ All debt ratios valued at end-year exchange rates. (Ratios reported in Country Report No. 06/268 were valued at annual average exchange rates).
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: Indicators of External Vulnerability, 2000–06

	2000	2001	2002	2003	2004	2005	2006 Proj.
	(In percent, unless otherwise noted)						
CPI inflation (end year)	39.0	68.5	29.7	18.4	9.4	7.7	10.0
Overall Balance Public Sector (percent of GNP)	-13.0	-17.1	-13.6	-9.0	-4.7	-2.2	-0.9
Gross public sector borrowing requirement (percent of GNP)	12.0	26.5	75.4	40.9	36.8	30.5	27.7
Net debt of the public sector (percent of GNP)	57.1	90.5	78.5	70.4	63.5	55.8	55.5
Export volume (percent change)	9.2	15.7	17.2	19.1	15.0	11.0	9.6
Import volume (percent change)	28.2	-23.8	26.1	24.6	22.2	11.6	3.3
Current account balance, in percent of GNP	-4.9	2.4	-0.8	-3.4	-5.2	-6.4	-6.5
Capital account balance (in billions of U.S. dollars)	9.6	-14.6	1.2	7.1	17.7	43.8	32.4
Of which : Foreign direct investment	0.1	2.8	0.9	1.2	2.0	8.6	20.8
Foreign portfolio investment	-5.2	-4.6	-1.2	1.1	6.1	10.4	-7.8
Gross official reserves, in billions of U.S. dollars	23.2	19.8	28.1	35.2	37.6	52.2	57.8
In months of imports of goods and NFS	4.1	4.5	5.5	3.9	3.4	4.5	4.7
In percent of broad money	27.4	26.7	34.3	32.5	27.4	34.4	35.1
Gross total external debt, in billions U.S. dollars	117.5	113.6	130.2	145.0	162.2	170.1	189.9
In percent of GNP 2/	62.9	93.1	77.6	56.6	50.5	47.0	59.4
In percent of exports of goods and NFS	222.8	218.4	230.0	201.9	176.5	161.4	167.2
Gross short-term external debt, in billions of U.S. dollars 3/	28.3	16.4	16.4	23.0	32.6	38.2	40.3
In percent of gross total external debt	24.1	14.4	12.6	15.9	20.1	22.5	21.2
In percent of gross official reserves	192.6	164.7	125.4	117.0	139.5	118.0	125.2
Debt service 4/	37.2	41.9	38.1	35.1	27.2	26.4	28.1
REER appreciation (CPI based, period average)	10.9	-17.6	11.4	8.9	5.1	11.5	3.3
REER appreciation (CPI based, end of period)	15.9	-21.2	7.8	12.1	1.8	19.6	-17.0
Capital adequacy ratio 5/	17.3	15.3	25.3	30.9	28.8	24.2	…
State banks	7.9	34.0	50.2	56.3	41.5	40.9	…
SDIF banks	..	-17.8	-7.6	-21.6	-42.0	...	…
Private banks	18.3	9.0	19.6	23.5	22.3	17.2	…
Foreign banks	29.4	41.0	48.4	60.8	56.0	40.2	…
Nonperforming loans (in percent of total)	11.1	25.2	17.6	11.5	6.0	4.8	…
Real broad money, percentage change 6/	0.8	11.2	-3.3	-4.6	11.7	15.6	-4.2
Real credit to the private sector, percentage change 6/	24.5	-27.5	-16.5	20.1	38.5	21.3	…
Banks' net foreign asset position, in billions of U.S. dollars	-5.4	-0.1	-0.4	0.3	-0.1	-0.1	…
Banks' net open exchange position, in billions of U.S. dollars	-5.4	-0.1	-0.4	0.3	-0.1	-0.1	…
EMBI Global bonds spread (in basis points)	800	707	693	309	265	223	…

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 debt, plus short-term debt at end of previous period, minus privatization receipts.
2/ Debt ratios valued at end-year exchange rates (in Country Report No. 06/268 valued at annual average exchange rates).
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 5. Turkey: External Financing Requirements and Sources, 2001–08
(In billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
Gross financing requirements	41.5	34.7	43.6	57.2	76.4	86.0	91.3	97.1
Current account deficit (excluding official transfers)	-3.2	2.0	8.3	15.9	23.7	24.2	18.9	16.1
Amortization on debt securities	2.1	2.7	3.9	3.8	3.4	2.6	3.7	3.7
Of which:								
Public sector	2.0	2.3	3.8	3.8	3.1	2.6	3.7	3.7
Deposit money banks	0.0	0.4	0.2	0.0	0.4	0.0	0.0	0.0
Medium and long-term debt amortization	14.3	13.6	14.9	14.5	16.7	20.9	28.5	33.9
Of which:								
Public sector 1/	3.6	3.0	3.2	3.2	3.3	3.1	3.4	3.3
Private sector	8.9	9.0	10.3	10.1	11.1	14.8	19.1	23.0
Deposit money banks	1.9	1.6	1.4	1.2	2.4	3.0	6.0	7.6
Short-term debt amortization	28.3	16.4	16.4	23.0	32.6	38.2	40.3	43.4
Public sector (net)1/	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade credits 2/	16.9	8.0	6.3	9.7	14.5	17.8	16.8	17.2
Banks and other private (net)	11.4	8.4	10.1	13.3	18.0	20.4	23.5	26.3
Available financing	41.5	34.7	43.6	57.2	76.4	86.0	91.3	97.1
Foreign direct investment (net)	2.8	0.9	1.2	2.0	8.6	20.8	7.1	7.3
Portfolio flows	-1.7	4.2	7.8	13.2	18.1	-1.0	3.5	5.8
Public sector	2.1	3.3	5.3	5.8	6.5	5.5	5.5	5.8
Deposit money banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector (net)	-3.8	0.9	2.5	7.5	11.6	-6.5	-2.0	0.0
Medium and long-term debt financing	13.2	15.8	14.1	20.6	30.2	37.0	43.8	41.7
Of which:								
Public sector 1/	3.2	2.9	0.7	1.7	0.5	2.0	3.0	2.0
Private sector	9.2	11.5	11.9	15.4	21.0	27.0	30.3	29.7
Deposit money banks	0.9	1.3	1.4	3.5	8.8	8.0	10.5	9.9
Short-term trade credits, banks, currency and deposits	15.7	13.0	19.3	23.2	39.6	37.3	40.3	44.4
Official transfers	0.2	0.5	0.3	0.3	0.6	0.8	0.6	0.6
Other 3/	-1.7	0.1	5.0	2.3	2.4	0.4	0.0	0.0
Net reserves (+/- = decrease/increase)	12.9	0.2	-4.1	-4.3	-23.2	-9.4	-3.9	-2.8
Accumulation of gross reserves	2.7	-6.2	-4.0	-0.8	-17.8	-5.6	-1.4	-0.9
IMF (net)	10.2	6.4	-0.1	-3.5	-5.4	-3.8	-2.5	-1.8
Purchases	11.3	12.5	1.7	1.2	2.4	3.7	2.8	0.9
Repurchases	-1.1	-6.1	-1.7	-4.7	-7.8	-7.4	-5.3	-2.8
Memorandum item:								
Net public sector financing (incl. IMF, excl. reserves)	10.2	7.8	-0.7	-2.7	-4.1	-1.2	-0.6	-0.3

1/ General government and Central Bank of Turkey (excludes IMF).
2/ Series reflects net stock of short term trade credits at end of previous year.
3/ Errors and omissions.

Table 6. Turkey: Monetary Aggregates, 2001–06
(In billions of Turkish Lira) 1/

	2001	2002	2003	2004	2005				2006			
					Mar.	Jun.	Sep.	Dec.	Mar.	Jun. Est.	Sep. Proj.	Dec. Proj.
Broad money (M2Y)	106.6	133.7	151.0	184.4	185.3	197.5	214.5	229.5	237.4	253.9	265.8	279.6
Lira broad money (M2)	47.2	61.9	82.7	108.5	113.7	126.4	138.5	153.5	162.1	173.8	182.1	191.6
Foreign exchange deposits 2/	59.3	71.8	68.3	75.9	71.6	71.1	76.0	76.1	75.4	80.1	83.7	88.0
Repos	2.8	2.8	3.1	1.7	1.7	1.7	1.5	2.2	2.0	2.1	2.2	2.4
Broad liquidity	109.4	136.4	154.1	186.1	187.0	199.2	216.0	231.7	239.4	256.0	268.0	281.9
Base money	7.8	10.4	14.9	20.2	23.0	24.6	27.7	32.5	32.6	33.9	36.0	37.9
Net foreign assets 2/	-1.9	-6.3	-6.8	-0.1	0.1	5.4	10.8	18.0	24.7	24.8	30.1	31.3
(in billions of U.S. dollars)	-1.3	-3.9	-4.8	-0.1	0.1	4.0	8.0	13.4	18.4	14.9	17.7	17.9
Net domestic assets	108.5	140.0	157.8	184.5	185.2	192.2	203.7	211.5	212.7	229.1	235.7	248.3
Net claims on government	89.7	122.8	139.1	151.4	151.0	148.7	153.7	152.2	151.1	153.7	154.7	160.4
Claims on business sector 3/	38.7	42.0	59.6	90.3	98.1	109.4	117.8	129.9	141.0	149.7	156.3	164.3
Turkish lira claims	23.1	24.5	40.7	71.2	77.6	88.2	98.0	108.2	117.4	124.6	130.1	136.7
Foreign exchange claims (est.) 2/	15.6	17.5	18.9	19.1	20.5	21.2	19.7	21.7	23.6	25.1	26.2	27.6
Other items (net)	-20.0	-24.8	-40.9	-57.2	-63.9	-66.0	-67.7	-70.6	-79.3	-74.3	-75.3	-76.3
Memorandum items:												
Broad money (M2Y)	87.5	25.4	13.0	22.1	20.5	19.7	21.4	24.5	28.1	28.5	23.9	21.8
Lira broad money (M2)	48.0	31.0	33.7	31.2	22.9	29.8	34.6	41.4	42.5	37.5	31.5	24.8
Foreign exchange deposits 2/	137.9	21.0	-4.9	11.1	16.9	5.1	2.9	0.3	5.3	12.6	10.1	15.7
Claims on business sector 3/	22.3	8.4	42.1	51.4	49.4	39.6	39.4	43.9	43.8	36.9	32.7	26.4
Broad money (M2Y)	74.0	81.8	108.2	137.4	135.2	147.3	159.4	170.7	176.5	152.7	156.3	159.7
Lira broad money (M2)	32.8	37.9	59.3	80.9	83.0	94.2	103.0	114.1	120.5	104.5	107.1	109.5
Foreign exchange deposits	41.2	43.9	48.9	56.5	52.2	53.0	56.5	56.6	56.0	48.2	49.2	50.3
Net claims on government	62.3	75.1	99.6	112.8	110.2	110.9	114.2	113.1	112.3	92.4	91.0	91.6
Credit to the private sector	26.9	25.7	42.7	67.3	71.6	81.6	87.5	96.6	104.9	90.1	91.9	93.8
Base money/GNP 4/	4.4	3.8	4.2	4.7	5.2	5.4	5.9	6.7	6.5	6.5	6.6	6.7
Broad money (M2Y)/GNP 4/	60.4	48.6	42.3	43.0	41.8	43.2	45.4	47.2	47.4	48.7	48.8	49.5
Lira broad money (M2)/GNP 4/	26.8	22.5	23.2	25.3	25.7	27.7	29.3	31.5	32.4	33.4	33.4	33.9
Private credit/GNP	21.9	15.3	16.7	21.0	22.1	23.9	24.9	26.7	28.2	28.7	28.7	29.1
Foreign currency deposits/M2Y	55.7	53.7	45.2	41.1	38.6	36.0	35.4	33.1	31.7	31.6	31.5	31.5
Money multiplier												
Broad money (M2Y)	13.7	12.8	10.2	9.1	8.1	8.0	7.7	7.1	7.3	7.5	7.4	7.4
Lira broad money (M2)	6.1	5.9	5.6	5.4	4.9	5.1	5.0	4.7	5.0	5.1	5.1	5.1

Sources: CBT; and Fund staff estimates.
1/ In quadrillions of old Turkish lira before 2005.
2/ Evaluated at current exchange rates, monetary authorities and deposit money banks.
3/ Includes credit to local governments and state economic enterprises.
4/ Evaluated as percent of nominal GNP over previous four quarters.

Table 7. Turkey: Central Bank Balance Sheet, 2001–06 1/

	2001	2002	2003	2004	2005				2006			
					Mar	Jun	Sep	Dec	Mar	Jun Est.	Sep Proj.	Dec Proj.
1. Central Bank Balance Sheet	(in billions of Turkish lira) 1/											
Net foreign assets	-12.7	3.9	8.8	11.0	18.5	24.2	26.2	39.1	51.3	49.5	53.4	53.5
Gross foreign assets	28.6	37.7	42.5	53.0	57.5	63.0	65.8	80.0	90.9	85.3	87.6	87.0
Gross foreign liabilities	41.2	33.8	33.6	42.0	39.0	38.8	39.6	40.9	39.6	35.8	34.2	33.4
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	22.3	22.0	21.2	19.4	18.5
Banks' FX deposits with CBT	10.4	9.1	9.3	14.0	12.6	14.0	16.1	17.0	16.0	13.0	13.2	13.4
Net domestic assets	20.6	6.5	6.0	9.2	4.4	0.4	1.5	-6.2	-18.5	-15.6	-17.4	-15.6
Base money	7.8	10.4	14.9	20.2	23.0	24.6	27.7	32.5	32.6	33.9	36.0	37.9
Currency issued	5.3	7.6	10.7	13.5	14.6	16.3	18.6	19.6	20.2	23.1	24.8	26.1
Banks' lira deposits at the CBT	2.5	2.8	4.2	6.7	8.4	8.3	9.1	12.9	12.4	10.8	11.3	11.8
	(in billions of U.S. dollars)											
CBT gross international reserves	19.8	26.2	29.5	35.4	38.4	42.0	44.0	53.4	60.7	56.9	58.5	58.1
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	27.3	26.4	23.9	22.8	22.3
CBT net foreign assets	-8.8	2.7	6.1	7.4	12.4	16.1	17.5	26.1	34.3	33.0	35.7	35.7
plus CBT forward position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
plus other reserve liabilities	7.1	9.2	10.1	14.9	14.8	14.7	14.3	14.7	14.5	14.2	13.0	12.3
minus Dresdner one year deposits	0.7	1.4	2.1	3.0	3.0	3.0	2.9	2.9	2.8	2.7	2.7	2.6
minus defence 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	39.4	46.8	44.2	45.7	45.1
Treasury net international reserves 3/	-1.3	-14.7	-14.2	-17.6	-17.6	-17.1	-15.4	-15.2	-13.3	-11.5	-12.5	-12.4
Net international reserves (Treasury plus CBT)	-4.2	-4.6	-0.5	1.3	6.3	10.5	13.2	24.2	33.5	32.6	33.2	32.7
	(in billions of Turkish Lira, program exchange rate) 1/											
Net foreign assets (Treasury)	-1.8	-21.1	-20.4	-26.3	-26.3	-25.5	-23.0	-22.8	-19.9	-17.3	-18.7	-18.6
Net foreign assets (Treasury plus CBT)	-14.5	-17.2	-11.6	-15.3	-7.8	-1.4	3.2	16.3	31.4	32.2	34.7	34.9
Net domestic assets (Treasury) 4/	1.8	21.1	20.4	26.3	26.3	25.5	23.0	22.8	19.9	17.3	18.7	18.6
Net domestic assets (Treasury plus CBT)	22.4	27.6	26.4	35.5	30.8	26.0	24.6	16.6	1.5	1.7	1.3	3.0
Base money (Treasury plus CBT)	7.9	10.4	14.9	20.2	23.0	24.6	27.7	32.9	32.8	33.9	36.0	37.9
Exchange rate (TL per US dollar, in millions)	1.44	1.63	1.40	1.34	1.37	1.34	1.35	...	...	...	...	...

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

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

2/ Mainly Dresdner deposit liabilities.

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

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

Table 8. Turkey: Public Sector Finances, 2002−06

	2002	2003	2004	2005		2006		
				Proj. 1/	Prel.	Prog.	Rev prog.	Rev prog. 2/
	(In millions of New Turkish Lira)							
Public sector primary balance	**11,246**	**22,682**	**29,982**	**31,553**	**30,117**	**35,517**	**37,273**	**37,352**
Central government 3/	**6,644**	**17,954**	**21,876**	**24,412**	**24,094**	**27,542**	**30,727**	**30,807**
Primary revenue	63,369	90,445	105,049	122,654	122,845	137,403	140,083	156,191
Tax revenue	59,634	84,335	101,058	119,651	119,254	132,570	133,722	133,722
Direct taxes, *of which* :	20,077	27,800	31,146	36,138	36,591	39,920	40,317	40,317
Personal income taxes	13,724	17,062	19,689	22,736	22,817	24,720	25,720	25,720
Corporate income taxes	5,578	8,646	9,619	11,002	11,402	12,420	11,817	11,817
Indirect taxes, *of which* :	39,557	56,535	69,912	83,513	82,663	92,649	93,405	93,405
VAT	20,401	27,028	34,324	38,300	38,280	43,450	44,050	44,050
SCT	13,651	22,299	26,288	33,723	32,753	36,419	36,576	36,576
Nontax revenue 3/	9,402	14,446	15,147	15,694	16,005	19,233	20,073	21,868
Revenue shares 4/	...	...	...	...	...	...	...	14,313
Tax rebates 5/	-5,666	-8,335	-11,156	-12,724	-12,447	-14,400	-13,712	-13,712
Primary expenditure	56,726	72,492	83,173	98,242	98,752	109,861	109,355	125,384
Personnel	23,160	30,200	35,433	38,232	38,585	42,887	42,708	43,987
Goods and services, of which:	6,995	8,216	9,486	10,254	10,286	11,420	11,120	12,816
Defense and security	4,485	5,668	5,479	6,304	5,896	6,745	6,445	6,445
Transfers, of which: 5/	19,289	26,911	30,282	40,344	40,192	44,325	44,967	56,311
Social security institutions	9,684	15,883	18,830	23,446	23,322	23,285	23,172	23,172
Agricultural subsidies	1,868	2,805	3,079	3,813	3,707	4,000	4,000	4,000
Transfers of revenue shares 4/	...	...	...	...	...	...	...	13,145
Capital transfers	1,423	917	437	1,514	1,546	2,184	2,064	1,714
Capital expenditure	7,282	7,165	7,972	9,407	9,684	11,230	10,560	12,270
Rest of the public sector	**4,603**	**4,728**	**8,106**	**7,141**	**6,023**	**7,976**	**6,545**	**6,545**
Extrabudgetary funds	-358	594	551	-4	917	1,251	-665	-665
Revolving funds 6/ 7/	407	933	976	809	809	840	1,287	1,287
Social security institutions	-85	53	-293	186	-78	0	0	0
Unemployment insurance fund	962	1,228	1,557	1,710	1,681	2,088	2,127	2,127
Local governments 7/	538	-567	766	702	702	761	761	761
State economic enterprises 8/	3,139	2,487	4,548	3,738	1,992	3,036	3,036	3,036
Public sector overall balance	**-37,270**	**-32,089**	**-20,357**	**-9,367**	**-4,300**	**-7,095**	**-5,340**	**-4,943**
Interest expenditure (net)	48,516	54,771	50,339	40,920	34,417	42,613	42,613	42,296
Domestic	48,358	50,547	44,283	33,852	28,472	33,012	33,012	32,695
External	159	4,224	6,056	7,068	5,945	9,600	9,600	9,600
Public sector financing	**37,270**	**32,089**	**20,357**	**9,367**	**4,300**	**7,095**	**5,340**	**4,943**
Amortization	170,216	113,949	137,486	144,042	144,042	150,145	150,145	150,145
External	19,438	11,519	12,655	15,257	15,257	20,980	20,980	20,980
Domestic	150,779	102,430	124,830	128,785	128,785	129,165	129,165	129,165
Borrowing	206,798	146,268	159,421	151,945	151,945	146,360	146,360	146,360
External	30,917	11,706	11,293	13,655	13,655	16,306	16,306	16,306
Domestic	175,881	134,562	148,127	138,290	138,290	130,054	130,054	130,054
Deposits decrease 9/	-120	-529	-3,427	-3,704	-8,771	-3,304	-5,059	-5,456
Privatization	808	299	1,848	5,168	5,168	14,184	14,184	14,184

Sources: Data provided by the Turkish authorities; and Fund staff estimates.
1/ Consistent with Country Report No. 06/268, with expenditure measures distributed across economic categories.
2/ Revised program figures adjusted for broadened scope of fiscal monitoring.
3/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).
4/ Revenues shared with local governments and extrabudgetary funds (shown as gross revenues and expenditures for the first time in 2006).
5/ Tax rebates to pensioners classified as transfers starting in 2004.
6/ Added to the public sector balance for 2002. Not included in the 2001 primary surplus calculation.
7/ Excluded from consolidated government sector subject to quantitative conditionality.
8/ 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).
9/ Including statistical discrepancy.

Table 8. Turkey: Public Sector Finances, 2002−06 (Concl.)

	2002	2003	2004	2005				2006		
				Prog.	Country Report 06/268	Proj. 1/	Prel.	Prog.	Rev prog.	Rev prog. 2/
	(In percent of GNP; unless otherwise indicated)									
Public sector primary balance	**4.1**	**6.4**	**7.0**	**6.5**	**6.5**	**6.5**	**6.2**	**6.6**	**6.7**	**6.7**
Central government 3/	**2.4**	**5.0**	**5.1**	**5.1**	**5.0**	**5.0**	**5.0**	**5.1**	**5.5**	**5.5**
Primary revenue	23.0	25.4	24.5	25.2	25.3	25.3	25.3	25.4	25.0	27.9
Tax revenue	21.7	23.6	23.6	24.7	24.7	24.7	24.5	24.6	23.9	23.9
Direct taxes, *of which* :	7.3	7.8	7.3	6.7	7.4	7.4	7.5	7.4	7.2	7.2
Personal income taxes	5.0	4.8	4.6	4.4	4.7	4.7	4.7	4.6	4.6	4.6
Corporate income taxes	2.0	2.4	2.2	1.8	2.3	2.3	2.3	2.3	2.1	2.1
Indirect taxes, *of which* :	14.4	15.9	16.3	18.0	17.2	17.2	17.0	17.2	16.7	16.7
VAT	7.4	7.6	8.0	8.4	7.9	7.9	7.9	8.0	7.9	7.9
SCT	5.0	6.3	6.1	7.3	7.0	7.0	6.7	6.7	6.5	6.5
Nontax revenue 3/	3.4	4.1	3.5	3.2	3.2	3.2	3.3	3.6	3.6	3.9
Revenue shares 4/	...	...	...			...	...	...	...	2.6
Tax rebates 5/	-2.1	-2.3	-2.6	-2.6	-2.6	-2.6	-2.6	-2.7	-2.4	-2.4
Primary expenditure	20.6	20.3	19.4	20.2	20.3	20.3	20.3	20.3	19.5	22.4
Personnel	8.4	8.5	8.3	8.1	7.9	7.9	7.9	7.9	7.6	7.9
Goods and services, of which:	2.5	2.3	2.2	2.2	2.1	2.1	2.1	2.1	2.0	2.3
Defense and security	1.6	1.6	1.3	1.4	1.3	1.3	1.2	1.2	1.2	1.2
Transfers, of which: 5/	7.0	7.5	7.1	7.6	8.4	8.3	8.3	8.2	8.0	10.1
Social security institutions	3.5	4.5	4.4	4.3	4.8	4.8	4.8	4.3	4.1	4.1
Agricultural subsidies	0.7	0.8	0.7	0.7	0.8	0.8	0.8	0.7	0.7	0.7
Transfers of revenue shares 4/	...	...	...			...	...	...	...	2.3
Capital transfers	0.5	0.3	0.1	0.2	0.3	0.3	0.3	0.4	0.4	0.3
Capital expenditure	2.6	2.0	1.9	2.2	2.0	1.9	2.0	2.1	1.9	2.2
Rest of the public sector	**1.7**	**1.3**	**1.9**	**1.4**	**1.5**	**1.5**	**1.2**	**1.5**	**1.2**	**1.2**
Extrabudgetary funds	-0.1	0.2	0.1	0.1	0.0	0.0	0.2	0.2	-0.1	-0.1
Revolving funds 6/ 7/	0.1	0.3	0.2	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Social security institutions	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.4	0.4	0.4	0.4	0.3	0.4	0.4	0.4
Local governments 7/	0.2	-0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
State economic enterprises 8/	1.1	0.7	1.1	0.8	0.8	0.8	0.4	0.6	0.5	0.5
Public sector overall balance	**-13.6**	**-9.0**	**-4.7**	**-4.6**	**-1.9**	**-1.9**	**-0.9**	**-1.3**	**-1.0**	**-0.9**
Interest expenditure (net)	17.6	15.4	11.7	11.1	8.4	8.4	7.1	7.9	7.6	7.6
Domestic	17.6	14.2	10.3	9.0	7.0	7.0	5.9	6.1	5.9	5.8
External	0.1	1.2	1.4	2.1	1.5	1.5	1.2	1.8	1.7	1.7
Public sector financing	**13.6**	**9.0**	**4.7**	**4.6**	**1.9**	**1.9**	0.9	**1.3**	**1.0**	**0.9**
Amortization	61.9	31.9	32.1	32.3	29.7	29.7	29.6	27.8	26.8	26.8
External	7.1	3.2	3.0	3.6	3.1	3.1	3.1	3.9	3.7	3.7
Domestic	54.8	28.7	29.1	28.8	26.5	26.5	26.5	23.9	23.1	23.1
Borrowing	75.2	41.0	37.2	37.1	31.7	31.3	31.2	27.1	26.1	26.1
External	11.2	3.3	2.6	3.5	2.8	2.8	2.8	3.0	2.9	2.9
Domestic	63.9	37.7	34.5	33.6	28.5	28.5	28.4	24.1	23.2	23.2
Deposits decrease 9/	0.0	-0.1	-0.8	-0.6	-0.8	-0.8	-1.8	-0.6	-0.9	-1.0
Privatization	0.3	0.1	0.4	0.4	1.1	1.1	1.1	2.6	2.5	2.5
Memorandum item:										
GNP (in millions of YTL)	275,032	356,681	428,932	480,963	485,145	485,145	486,401	539,966	559,850	559,850

Sources: Data provided by the Turkish authorities; and Fund staff estimates.
1/ Consistent with Country Report No. 06/268, with expenditure measures distributed across economic categories.
2/ Revised program figures adjusted for broadened scope of fiscal monitoring.
3/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figure for 2006 excludes two SEEs undergoing privatization (TÜPRAŞ and Türk Telekom).
4/ Revenues shared with local governments and extrabudgetary funds (shown as gross revenues and expenditures for the first time in 2006).
5/ Tax rebates to pensioners classified as transfers starting in 2004.
6/ Added to the public sector balance for 2002. Not included in the 2001 primary surplus calculation.
7/ Excluded from consolidated government sector subject to quantitative conditionality.
8/ 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).
9/ Including statistical discrepancy.

Table 9. Turkey: Banking System—Selected Indicators, 2001-06 1/
(in million of Turkish Liras)

	2001	2002	2003	2004	2005				2006
	Dec. 1/	Dec.	Dec.	Dec.	March	June	Sept.	Dec.	March
Banking System									
Total assets	**179,675**	**212,681**	**249,693**	**306,448**	**313,722**	**337,267**	**364,241**	**396,963**	**412,466**
Cash and claims on CBT	12,558	13,872	14,962	20,819	20,988	21,559	24,338	29,498	28,672
Claims on other banks	19,871	15,401	15,141	21,044	15,130	20,769	25,006	25,842	20,343
Securities portfolio	70,026	86,105	106,844	123,681	129,196	131,394	142,016	143,016	148,348
Loans, net	41,058	52,932	67,210	100,101	108,529	122,505	133,987	150,701	165,099
Other assets	36,162	44,371	45,536	40,803	39,879	41,038	38,894	47,906	50,004
Total liabilities	**179,675**	**212,680**	**249,693**	**306,448**	**313,722**	**337,267**	**364,241**	**396,963**	**412,466**
Deposits	110,298	137,973	155,312	191,065	192,552	204,607	221,195	243,121	254,734
Borrowing from banks	23,798	21,967	25,918	33,765	34,757	42,890	48,408	54,310	58,832
Repos	10,776	6,161	11,241	10,596	12,836	14,996	15,015	17,414	12,363
Other liabilities	20,527	21,351	21,683	25,055	26,255	27,873	32,202	28,383	30,864
Shareholders' equity (incl. profits)	14,276	25,228	35,539	45,966	47,322	46,900	47,421	53,736	55,673
Memorandum items:									
Capital adequacy ratio (%)	15.3	25.3	30.9	28.8	28.4	25.6	23.3	24.2	23.5
NPLs (%) total loans	29.3	17.6	11.5	6.0	5.8	5.4	5.2	4.8	4.5
Provisions (%) NPLs	47.1	64.2	88.5	88.1	89.2	88.4	89.6	89.8	89.6
Net profit (loss) after tax	-9,910	2,336	5,678	6,451.1	2,181.8	4,212.4	4,070.0	5,714.7	2,688.6
ROA (%)	-5.5	1.1	2.3	2.3	0.7	1.4	1.3	1.7	0.7
ROE (%)	-69.4	9.3	16.0	16.4	5.2	9.5	8.7	11.8	5.3
Share in assets (%)	100	100	100	100.0	100.0	100.0	100.0	100.0	100.0
Share in deposits and repos (%)	100	100	100	100.0	100.0	100.0	100.0	100.0	100.0
Private Banks									
Total assets	**97,930**	**119,471**	**142,270**	**175,924**	**182,743**	**202,506**	**215,006**	**237,043**	**243,670**
Cash and claims on CBT	8,434	9,356	9,868	14,149	13,856	14,945	15,966	20,760	17,773
Claims on other banks	10,494	7,623	6,369	9,483	6,244	9,861	11,385	13,425	9,392
Securities portfolio	27,146	39,819	51,485	56,445	60,039	63,695	69,728	71,013	71,688
Loans, net	26,506	35,752	46,402	69,011	75,330	86,367	91,145	102,916	114,352
Other assets	25,350	26,921	28,146	26,836	27,274	27,636	26,782	28,928	30,465
Total liabilities	**97,930**	**119,471**	**142,270**	**175,924**	**182,743**	**202,506**	**215,006**	**237,043**	**243,670**
Deposits	67,223	80,629	88,180	105,195	106,422	115,906	125,451	138,669	144,192
Borrowing from banks	15,585	13,703	18,158	23,920	25,672	31,882	34,578	40,243	42,420
Repos	1,803	4,074	8,103	8,954	11,077	13,698	13,255	15,692	10,498
Other liabilities	5,779	5,871	6,872	10,455	11,749	12,995	15,561	13,043	15,768
Shareholders' equity (incl. profits)	7,540	15,194	20,958	27,399	27,823	28,023	26,161	29,396	30,792
Memorandum items:									
Capital adequacy ratio (%)	9.0	19.64	23.5	22.3	21.3	19.5	16.8	17.2	17.3
NPLs (%) total loans	27.6	8.9	6.5	4.9	4.9	4.5	4.4	4.1	3.9
Provisions (%) NPLs	31.0	53.0	80.0	83.5	85.3	84.0	86.1	86.1	86.3
Net profit (loss) after tax	-7,382.6	2409.6	2917.0	2825.4	1113.3	2,148.2	882.0	1,391.0	1,566.4
ROA (%)	-7.5	2.0	2.1	1.8	0.7	1.2	0.5	0.7	0.7
ROE (%)	-97.9	15.9	13.9	11.8	4.4	8.0	3.2	5.0	5.5
Share in assets (%)	54.5	56.2	57.0	57.4	58.2	60.0	59.0	59.7	59.1
Share in deposits and repos (%)	57.0	58.8	57.8	56.6	57.2	59.0	58.7	59.2	57.9

Table 9 (Continued). Turkey: Banking System—Selected Indicators, 2001-06 1/
(in million of Turkish Liras)

	2001	2002	2003	2004	2005				2006
	Dec. 1/	Dec.	Dec.	Dec.	March	June	Sept.	Dec.	March
				State Banks /2					
Total assets	**57,583**	**67,831**	**83,134**	**108,841**	**108,496**	**111,318**	**116,426**	**126,344**	**132,185**
Cash and claims on CBT	3,544	4,000	4,589	6,000	6,477	5,855	7,094	7,351	9,028
Claims on other banks	5,096	3,996	5,365	6,689	4,821	6,263	7,497	5,995	6,039
Securities portfolio	32,756	39,245	47,716	63,333	64,781	63,482	65,486	65,444	69,474
Loans, net	9,177	8,804	12,202	21,057	22,711	24,642	27,125	31,518	32,660
Other assets	7,011	11,786	13,263	11,763	9,706	11,074	9,224	16,037	14,984
Total liabilities	**57,583**	**67,831**	**83,134**	**108,841**	**108,496**	**111,318**	**116,426**	**126,344**	**132,185**
Deposits	37,258	48,489	59,862	81,156	81,265	83,426	85,948	94,472	99,539
Borrowing from banks	2,381	2,230	2,338	4,249	2,676	4,142	5,145	5,357	5,531
Repos	3,844	1,022	1,018	1,231	1,085	999	762	653	1,530
Other liabilities	9,707	9,343	10,342	10,865	11,277	11,435	12,350	11,077	10,477
Shareholders' equity (incl. profits)	4,393	6,747	9,574	11,340	12,193	11,314	12,221	14,786	15,108
Memorandum items:									
Capital adequacy ratio (%)	34.0	50.2	56.3	41.5	45.2	39.1	38.2	40.9	38.2
NPLs (%) total loans	37.3	37.4	26.2	10.7	10.0	9.5	8.8	7.7	7.2
Provisions (%) NPLs	63	74	98	95.2	96.1	96.4	96.4	96.7	96.5
Net profit (loss) after tax	-681	1,056	1,790	3,068.7	808.2	1,521.4	2,264.0	3,128.5	770.2
ROA (%)	-1.2	1.6	2.2	3.2	0.8	1.4	2.1	2.8	0.6
ROE (%)	-15.5	15.7	18.7	31.9	8.0	14.3	19.7	25.5	5.9
Share in assets (%)	32.0	31.9	33.3	35.5	34.6	33.0	32.0	31.8	32.0
Share in deposits and repos (%)	33.9	34.4	36.6	40.9	40.1	38.4	36.7	36.5	37.8
				SDIF Banks /2					
Total assets	**11,035**	**9,310**	**7,075**	-	-	-	-	-	-
Cash and claims on CBT	45	62	52	-	-	-	-	-	-
Claims on other banks	874	619	456	-	-	-	-	-	-
Securities portfolio	8,451	4,655	4,964	-	-	-	-	-	-
Loans, net	602	1,889	910	-	-	-	-	-	-
Other assets	1,064	2,085	693	-	-	-	-	-	-
Total liabilities	**11,035**	**9,310**	**7,075**	-	-	-	-	-	-
Deposits	3,566	5,770	4,133	-	-	-	-	-	-
Borrowing from banks	2,020	1,274	837	-	-	-	-	-	-
Repos	5,023	1,024	2,025	-	-	-	-	-	-
Other liabilities	814	2,338	927	-	-	-	-	-	-
Shareholders' equity (incl. profits)	-388	-1,096	-847	-	-	-	-	-	-
Memorandum items:									
Capital adequacy ratio (%)	-17.8	-7.6	-21.6	-	-	-	-	-	-
NPLs (%) total loans	67.3	69.4	53.8	-	-	-	-	-	-
Provisions (%) NPLs	89.1	60.5	75.4	-	-	-	-	-	-
Net profit (loss) after tax	-2,344	-1,677	272	-	-	-	-	-	-
ROA (%)	-21.2	-18.0	3.8	-	-	-	-	-	-
ROE (%)	…	-153.0	-32.1	-	-	-	-	-	-
Share in assets (%)	6.1	4.4	2.8	-	-	-	-	-	-
Share in deposits and repos (%)	7.1	4.7	3.7	-	-	-	-	-	-

Table 9 (Concluded). Turkey: Banking System—Selected Indicators, 2001-06 1/
(in million of Turkish Liras)

	2001	2002	2003	2004	2005				2006
	Dec. 1/	Dec.	Dec.	Dec.	March	June	Sept.	Dec.	March
Foreign and Investment Banks									
Total assets	**13,126**	**16,068**	**17,213**	**21,683**	**22,483**	**23,442**	**32,809**	**33,576**	**36,611**
Cash and claims on CBT	535	454	454	629	594	696	1,159	1,236	1,191
Claims on other banks	3,408	3,164	2,951	4,871	4,064	4,645	6,124	6,422	4,913
Securities portfolio	1,673	2,386	2,680	3,903	4,376	4,215	6,803	6,559	7,186
Loans, net	4,773	6,487	7,695	10,034	10,489	11,495	15,717	16,267	18,087
Other assets	2,738	3,577	3,434	2,246	2,960	2,389	3,007	3,092	5,234
Total liabilities	**13,126**	**16,068**	**17,213**	**21,683**	**22,483**	**23,442**	**32,809**	**33,576**	**36,611**
Deposits	2,252	3,086	3,137	4,714	4,866	5,275	9,796	9,980	11,004
Borrowing from banks	3,812	4,761	4,585	5,596	6,409	6,864	8,685	8,710	10,881
Repos	105	40	95	411	674	298	998	1,069	335
Other liabilities	4,227	3,798	3,542	3,735	3,229	3,442	4,290	4,263	4,619
Shareholders' equity (incl. profits)	2,730	4,383	5,854	7,226	7,306	7,561	9,039	9,554	9,772
Memorandum items:									
Capital adequacy ratio (%)	41.0	48.37	60.8	56.0	54.3	49.4	40.3	40.25	37.90
NPLs (%) total loans	9.3	4.3	3.8	3.2	3.2	3.1	3.5	3.37	3.26
Provisions (%) NPLs	81.2	69.3	85.5	81.5	83.1	80.7	84.9	86.07	85.57
Net profit (loss) after tax	498	548	698	557	260	543	924	1,196	352
ROA (%)	3.8	3.4	4.1	2.9	1.2	2.4	3.7	4.28	1.13
ROE (%)	18.2	12.5	11.9	8.6	3.8	7.6	12.0	14.44	3.96
Share in assets (%)	7.3	7.6	6.9	7.1	7.2	7.0	9.0	8.5	8.9
Share in deposits and repos (%)	1.9	2.2	1.9	2.5	2.7	2.5	4.6	4.2	4.2

Sources: Data provided by Turkish authorities; and Fund staff estimates
1/ Data for December 2001 onward reflect the results of the audits conducted during the first half of 2002.
2/ SDIF banks group consist of only one bank and Bayındırbank is added to the State Banks group due to Banks Act.

Table 10. Turkey: Indicators of Fund Credit, 2003–11 1/

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Outstanding Fund credit (end of period)									
In billions of SDRs	16.2	13.8	10.2	7.6	5.9	4.7	2.3	0.3	-1
In percent of quota	1,682	1,436	1,058	790	616	491	234	32	-66
In percent of exports of G&NFS	32	22	14	10	7	5	2	0	-1
In percent of GNP	9	6	4	4	3	2	1	0	0
In percent of public sector external debt	24	22	18	14	11	9	4	1	-1
In percent of overall external debt	16	13	9	6	4	3	1	0	0
In percent of end-period foreign reserves	65	54	29	19	15	12	6	1	-1
Repurchases of Fund Credit									
In billions of SDRs	1.2	3.2	5.3	5.1	3.6	1.8	2.5	2.0	0.9
In percent of quota	127	328	550	528	368	190	256	202	97
In percent of exports of G&NFS	2	5	7	7	4	2	3	2	1
In percent of GNP	1	1	2	2	2	1	1	1	0
In percent of public sector external debt service	11	27	39	40	30	18	26	21	13
In percent of overall MLT external debt service	6	16	22	19	11	6	7	5	3
In percent of start period foreign reserves	6	13	21	14	9	5	6	5	2
In percent gross public sector ext. financing 2/	7	16	11	16	16	11	13	9	5
Net Fund Resource Flows 3/									
In billions of SDRs	-0.7	-3.0	-4.3	-3.0	-2.0	-1.4	-2.6	-2.0	-0.9
In percent of quota	-72	-312	-443	-314	-205	-150	-271	-207	-97
In percent of exports of G&NFS	-1	-5	-6	-4	-2	-2	-3	-2	-1
In percent of GNP	0	-1	-2	-1	-1	-1	-1	-1	0
In percent of public sector external debt service	-6	-26	-31	-24	-17	-14	-28	-22	-12
In percent of overall MLT external debt service	-4	-15	-18	-11	-6	-4	-7	-5	-3
In percent start period foreign reserves	-3	-13	-17	-9	-5	-4	-7	-5	-2
In percent gross public sector ext. financing 2/	-4	-15	-9	-10	-9	-8	-13	-10	-4

1/ Projected on an expectations basis, except repurchase expectations on purchases made between February 2002 and July 2003 falling due in 2004-2005, as well as all 2006 repurchase expectations, which are projected on an obligations basis. Assumes purchase of SDR 1.25 billion in July 2006 and remaining purchases according to Proposed Schedule of purchases.
2/ Consolidated govt. and CBT. Includes reserve accumulation before repurchases.
3/ Net purchases less repurchases and charges.

APPENDIX I: FUND RELATIONS

(As of May 31, 2006)

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	8,724.71	905.05
Reserve position in Fund	112.78	11.70

III. **SDR Department:**	**Millions of SDRs**	**Percent of Allocation**
Net cumulative allocation	112.31	100.00
Holdings	12.17	10.84

IV. **Outstanding Purchases and Loans**:	**Millions of SDRs**	**Percent of Quota**
Stand-By Arrangements	7,873.49	816.75

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	1,665.51
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)**[5]

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	2,609.95	3,481.67	1,087.91	693.96	
Charges/Interest	228.68	201.53	72.47	26.67	4.43
Total	2,838.63	3,683.19	1,160.38	720.63	4.43

[5]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)[6]
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	2,609.95	2,520.65	961.02	1,087.91	693.96
Charges/Interest	228.68	224.88	125.94	72.12	26.76
Total	2,838.63	2,745.53	1,086.96	1,160.02	720.72

VII. **Safeguard Assessments**:

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

VIII. **Exchange Rate Arrangement**:

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

IX. **Article IV Consultations**:

The 2004 Article IV staff report (Country Report No. 05/163) was published on May 19, 2005, and the accompanying Selected Issues paper was issued as an Occasional Paper No. 242 in 2005. Board discussion took place on July 30, 2004.

X. **ROSCs**

Standard or Code Assessed	**Date of Issuance**	**Document Number**
Fiscal Transparency	June 26, 2000	
Corporate Governance (prepared by the World Bank)	December 11, 2000	

[6]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.

Data ROSC	March 14, 2002	Country Report No. 02/55
Fiscal ROSC	March 24, 2006	Country Report No. 06/126

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

Dept.	**Timing**	**Purpose**
FAD		Assistance to IBRD Public Financial Managing Project; 8 FAD missions since 1994, assignment of 5 resident experts, mainly focused on customs modernization
MAE	Jul. 94	Banking sector reform
MAE	Jul. 95	Inflation accounting
FAD	Sep. 95	Taxation of petroleum products
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
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	Apr. 02	National accounts statistics
MAE/RES	Apr.-May. 02	Inflation targeting
STA	Jul. 02	Public finance statistics

Dept.	Timing	Purpose
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	Income tax reform
FAD	Aug. 05	Social security contribution collections
FAD	Sep. 05	Tax and social security administration reforms
FAD	Apr. 06	Tax and social security administration reforms

Appendix II: External Debt Sustainability

The external debt ratio will increase in 2006 due to the recent lira depreciation, but is projected to decline over the medium-term, supported by narrowing current account deficits.

1. **Gross external debt is expected to jump more than 12 percentage points of GNP in 2006 as a result of the recent lira depreciation and debt financing of the current account**.[7] The depreciation raises the lira value of external debt, adding nearly 10 percentage points to the end-2006 debt ratio.[8] Debt inflows are expected to be close to $20 billion in 2006, driven by long-term bank (US$5 billion) and corporate (US$12 billion) borrowing. Non-debt financing from higher FDI is largely offset by lower non-debt portfolio inflows, reflecting the recent decline in investor appetite for Turkish risk.

2. **The gross debt ratio is projected to peak in 2006, as assumed earlier in the program**. Under the revised projections, gross debt peaks at a higher ratio and then settles into a downward trajectory that leaves it 6.6 percentage points above the program levels in 2010. That difference is due entirely to valuation effects of the recent lira depreciation, which is assumed to be permanent, with projected 2010 debt unchanged from the program in dollar terms. The downward trajectory of the debt ratio is supported by a gradually narrowing current account deficit, which reflects the assumptions that recent competitiveness gains are permanent and that these outweigh the adverse impact of higher projected oil prices. The medium-term debt stabilizing current account deficit (excluding interest) rises from 2.2 percent to 3.4 percent (Table II.1).

3. **External debt remains vulnerable to standardized shocks** (Figure II.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 (in addition to the lira depreciation to date) would cause the gross external debt ratio to jump by 15 percentage points to almost 75 percent, before declining gradually over the medium term. While the sensitivity of the external debt ratio to exchange rate shocks is large, this would likely lead to a significant reversal of the current account deficit and improved medium-term ratios—a dynamic not captured in this debt sustainability exercise.

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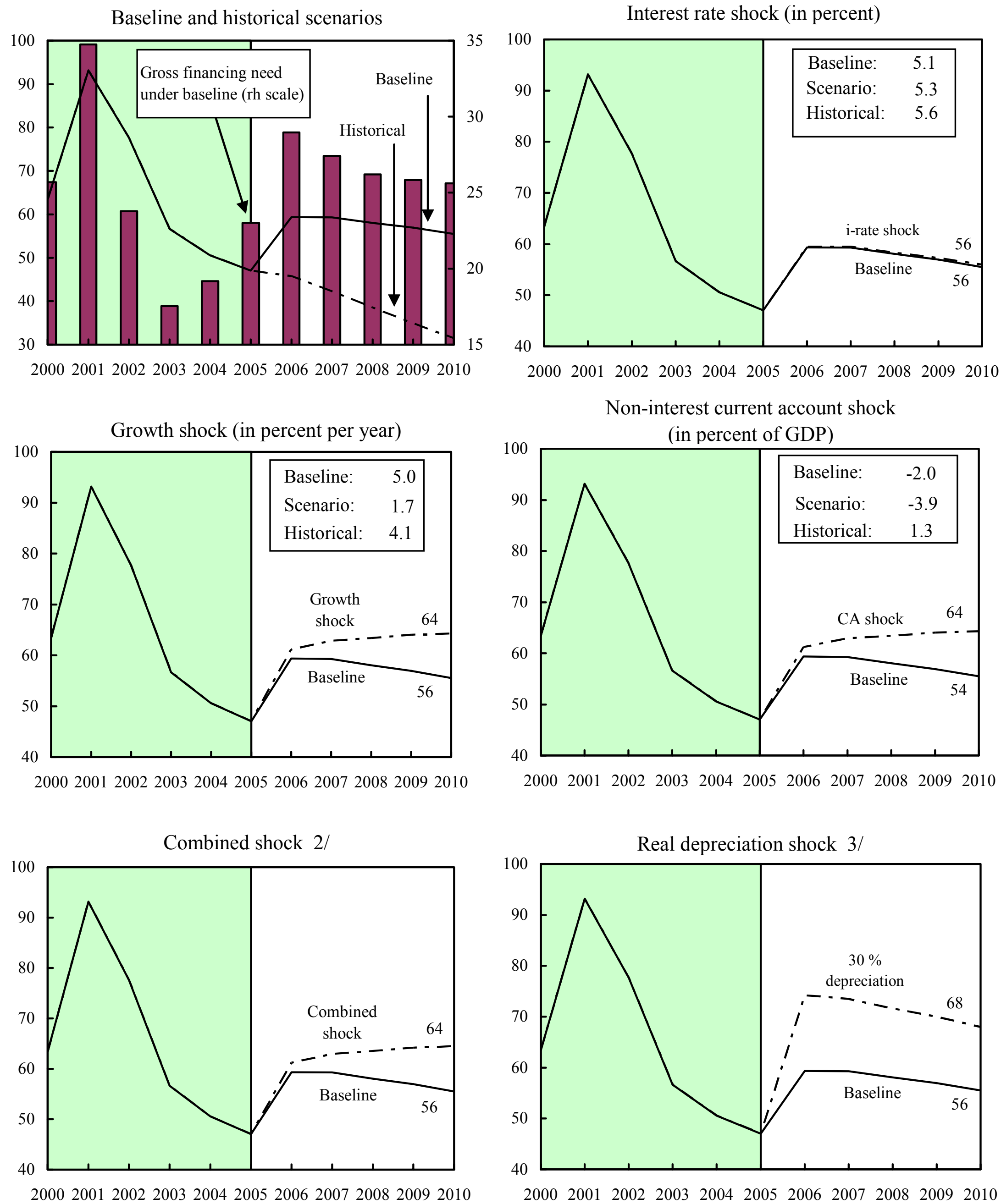
[7] External debt in general refers to current, non-contingent claims by nonresidents on residents usually in the form of loans, bonds, leases, etc. For the purpose of this analysis, it is assumed that: (i) securities issued abroad, e.g., Eurobonds, are held by nonresidents; (ii) domestically issued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

[8] Each 10 percent of lira depreciation adds approximately 6 percentage points to the gross external debt ratio.

Figure II.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 II.1. Turkey: External Debt Sustainability Framework, 2000–10
(In percent of GNP, unless otherwise indicated)

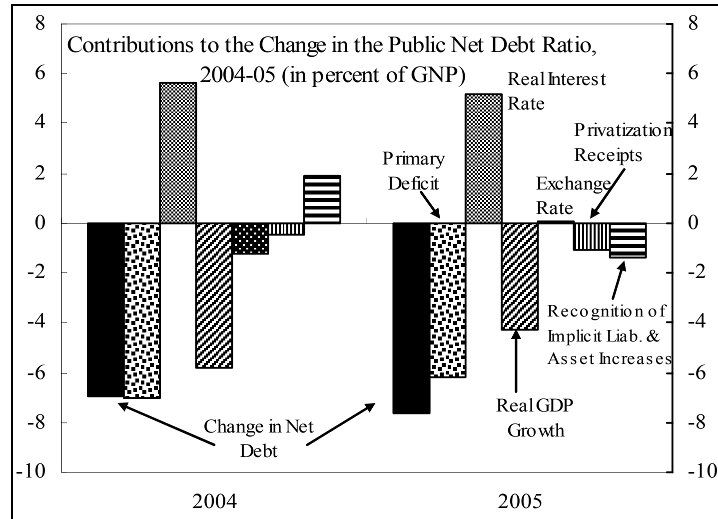
	Actual								Projections					
	2000	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	**Debt-stabilizing non-interest current account 7/**
1 **Baseline: External debt 1/**	63.4	93.2	77.6	56.6	50.5	47.0			**59.4**	**59.3**	**58.1**	**56.9**	**55.5**	**-3.4**
2 Change in external debt	-7.6	29.7	-15.5	-21.0	-6.1	-3.5			12.3	-0.1	-1.2	-1.1	-1.4	
3 Identified external debt-creating flows (4+8+9)	-10.7	28.8	-24.7	-24.0	-7.7	-1.0			-1.2	0.5	-0.9	-0.9	-1.2	
4 Current account deficit, excluding interest payments	1.9	-8.6	-2.9	0.4	2.6	4.1			4.5	2.4	1.3	1.1	0.9	
5 Deficit in balance of goods and services	7.8	-0.3	2.4	3.5	5.2	6.8			7.9	5.7	4.5	4.1	3.8	
6 Exports	28.8	43.6	34.2	28.3	28.9	29.4			35.8	36.6	36.8	36.7	36.6	
7 Imports	36.6	43.2	36.6	31.9	34.1	36.2			43.7	42.2	41.3	40.8	40.4	
8 Net non-debt creating capital inflows (negative)	-0.3	-2.2	-0.2	-0.4	-1.1	-4.0			-5.9	-2.0	-2.2	-2.0	-2.0	
9 Automatic debt dynamics 2/	-12.2	39.6	-21.6	-24.1	-9.2	-1.1			0.2	0.1	0.0	0.0	-0.1	
10 Contribution from nominal interest rate	3.4	5.8	3.8	2.7	2.3	2.3			2.8	2.8	2.8	2.7	2.6	
11 Contribution from real GNP growth	-3.5	9.3	-5.4	-3.0	-4.5	-3.4			-2.7	-2.7	-2.7	-2.7	-2.6	
12 Contribution from price and exchange rate changes 3/	-12.1	24.5	-20.0	-23.8	-7.0	...			...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 4/	3.0	1.0	9.2	3.1	1.6	-2.5			13.5	-0.6	-0.4	-0.2	-0.2	
External debt-to-exports ratio (in percent)	219.9	213.8	226.9	200.1	175.2	159.8			165.9	162.1	157.9	155.2	151.8	
Gross external financing need (in billions of US dollars) 5/	48.0	42.4	39.9	44.9	61.6	83.2			92.6	96.0	99.2	105.3	112.3	
in percent of GNP	25.7	34.8	23.8	17.5	19.2	23.0			29.0	27.4	26.2	25.8	25.6	
Scenario with key variables at their historical averages 6/									**45.7**	**42.3**	**38.5**	**34.9**	**31.4**	**-2.8**
Key Macroeconomic Assumptions Underlying Baseline							10-Year Historical Average	10-Year Standard Deviation						Projected Average
Real GNP growth (in percent)	6.3	-9.5	7.9	5.9	9.9	7.6	4.1	6.5	5.0	5.0	5.0	5.0	5.0	5.0
GNP deflator in US dollars (change in percent)	20.5	-27.9	27.4	44.2	14.1	4.7	8.2	20.5	-15.8	4.3	3.0	2.5	2.5	-0.7
Nominal external interest rate (in percent)	6.1	6.0	5.6	5.3	5.0	5.1	5.6	0.4	5.3	5.2	5.1	5.0	4.9	5.1
Growth of exports (US dollar terms, in percent)	12.4	-1.4	8.0	26.3	27.8	14.9	11.1	12.8	7.6	11.9	8.7	7.4	7.3	8.6
Growth of imports (US dollar terms, in percent)	26.3	-23.0	16.3	32.9	34.1	19.7	12.9	18.7	6.6	5.9	5.7	6.4	6.5	6.2
Current account balance, excluding interest payments	-1.9	8.6	2.9	-0.4	-2.6	-4.1	1.3	3.7	-4.5	-2.4	-1.3	-1.1	-0.9	-2.0
Net non-debt creating capital inflows	0.3	2.2	0.2	0.4	1.1	4.0	0.8	1.6	5.9	2.0	2.2	2.0	2.0	2.8

1/ Debt ratios valued at end-year exchange rates (in Contry Report No. 06/268 valued at annual average exchange rates).
2/ 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 GNP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
3/ 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).
4/ For projection, line includes the impact of price and exchange rate changes.
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
6/ The key variables include real GNP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GNP.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GNP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GNP) remain at their levels of the last projection year.

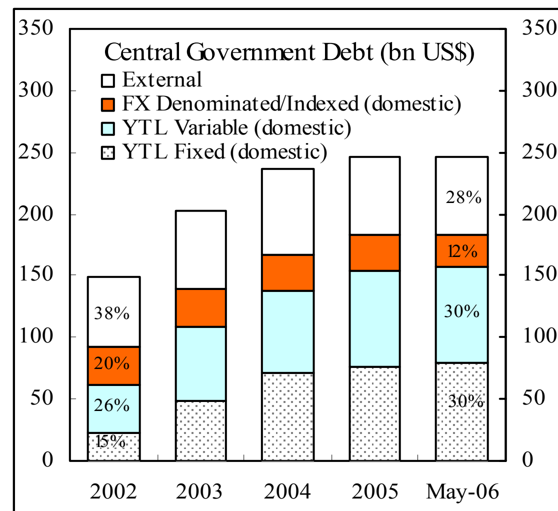
APPENDIX III: PUBLIC DEBT SUSTAINABILITY

The recent lira depreciation and higher interest rates will slowdown debt reduction. Provided fiscal discipline is maintained, debt dynamics remain sustainable under most plausible shocks.

The public sector *net* debt ratio has been declining faster than programmed. On the back of good fiscal performance, higher-than-expected privatization receipts, stronger-than-projected economic growth, an appreciating lira, and a further decline in domestic interest rates, the net public debt ratio fell by about 8 percentage points in 2005 (to less than 56 percent, Table III.1), against a program expectation that the debt ratio would be reduced by 10 percentage points during the entire life of the SBA. However, gross debt is still high at close to 72 percent of GNP.



The financing structure of public debt has also improved in recent years. The share of foreign currency debt has been reduced, maturities lengthened, and the share of fixed rate debt increased. And, although floating-rate lira notes still account for a significant portion of debt, last year's switch to semi-annual coupons made interest payments less sensitive to short-term fluctuations in domestic interest rates.



Notwithstanding these improvements, the recent lira depreciation and widening of bond yields would slowdown the debt reduction trend of the past years. The recent lira depreciation is estimated to add some 6 percentage points to this year's net debt ratio, while the impact of higher interest rates should be felt only gradually. These effects are expected to be offset by strong economic growth, an expected primary surplus of 6.7 percent of GNP, and privatization receipts of over to 2½ percent of GNP. Thus this year's net debt ratio should remain at around last year's level of 56 percent of GNP.

The public sector debt burden is projected to continue declining over the medium term. With higher than previously assumed real interest rates, this is predicated on continued

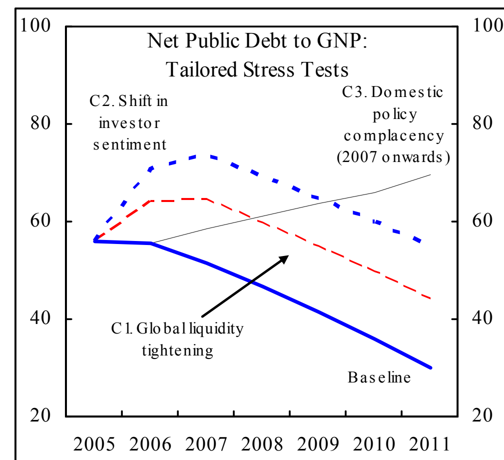
annual growth of 5 percent and a primary fiscal surplus of 6.5 percent throughout the projection period. Under these assumptions, and baring further exchange rate or interest rate shocks, Turkey's net public debt would fall to 30 percent of GNP by 2011.

Debt dynamics remain sustainable under most standard *alternative scenarios,* but become unsustainable when all key variables are set at their historical averages (Table III.1, panel A). The *no policy change* (A.2) scenario is even somewhat better that the baseline, because it perpetuates the strong 6.7 percent primary surplus assumed in 2006 throughout the projection period. Under the *reduced growth* scenario (A.3) the net debt ratio would still fall to about one third of GNP by 2011. The *market forecast* scenario (A.4) assuming a slightly lower primary surplus in the outer years of the projection period yields a similar result. In sharp contrast, were key variables to return to *historical averages* (A.1), the net debt ratio would increase back to over 80 percent of GNP by 2011.

The standardized *bound tests* show that Turkey could cope with most isolated shocks, but a combination of large shocks could undermine sustainability (Table III.1, panel B). Temporary shocks on the exchange rate (B.5) and contingent liabilities (B.6) would create one-time increases in the debt ratio followed by a decline back to below the initial ratio after two years. With a temporary shock on real growth (B.2) or the primary balance (B.3), the net debt ratio rises rapidly over the first two years, peaking at around 68 percent, before returning on a declining path. While the interest rate shock (B.1) and the combination shock (B.4) result in a similar path, net debt under these scenarios would peak at much higher ratios (85 and 86 percent, respectively), and the subsequent decline would be much slower, putting debt sustainability be at risk.

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

- **Further weakening of financial markets in 2006 (C.1)**. This test assumes that the lira weakens further to a cumulative 30 percent in 2006 and that interest rates rise significantly above 2006 and 2007 baseline assumptions, driven by large capital outflows. As a result, growth in 2006-07 is assumed to fall to roughly half the baseline rate. This would raise the net debt ratio to about 62 percent of GNP (6 percentage points above the 2005 ratio) by end-2006. The net debt ratio would stay flat in 2007, but then steadily decline in the following years, as parameters return to baseline assumptions. In this scenario, fiscal primary surplus is as in the baseline.



- **Heightened exchange rate pressure (C.2)**. This assumes that the lira loses further ground through 2006 (a cumulative 40 percent depreciation), which requires very sharp interest rate increases in order to stabilize market expectations. For purpose of

this scenario, it is assumed that economic activity contracts significantly in the second half of 2006, leading to zero growth for the year as a whole. As a result, the net debt ratio would jump by 13 percentage points to 69 percent of GNP by the end of 2006 and rise further in 2007, before returning on a declining path by 2008. The fiscal primary surplus is assumed at the baseline level throughout the projection period.

- **Domestic policy complacency (C.3)**. This assumes that, starting in 2007, the primary surplus is lowered, while structural reforms are no longer pursued, including an immediate halt of the privatization program. This lead to a permanent increase in the real interest rate; and, while the initial fiscal stimulus helps to maintain output in the first year, growth then falls to a lower trend rate in the following period. Taken together, this places the net debt ratio on a steadily increasing path, reaching almost 70 percent of GNP by end 2011.

While these tests highlight Turkey's vulnerability to further market turmoil, they also show the key role of fiscal policy to preserve debt sustainability. In particular, the first two tests illustrate how maintaining fiscal discipline can help prevent a lasting deterioration of debt dynamics even under severe financial market pressures.

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

(In percent of GDP, unless otherwise indicated)

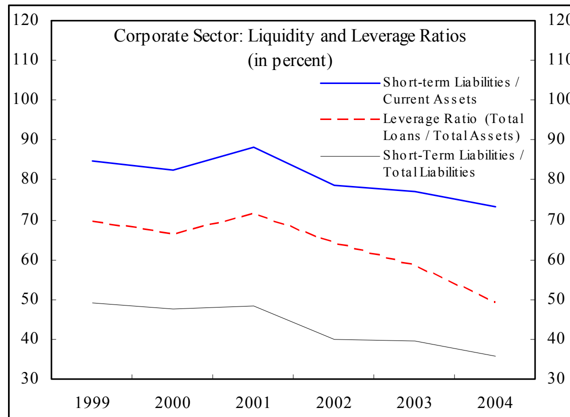
	Actual							Projections					
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011
										I. Baseline Projections			
Public sector gross debt	107.5	93.5	83.4	77.4	71.6			71.2	66.3	59.8	53.0	45.9	38.5
Public sector debt 1/	90.5	78.5	70.4	63.5	55.8			**55.5**	**51.6**	**46.6**	**41.3**	**35.8**	**30.0**
Of which: foreign-currency denominated	60.0	48.6	33.2	25.7	21.4			20.0	18.6	16.8	14.9	12.9	10.8
Change in public sector debt	33.5	-12.0	-8.2	-6.9	-7.7			-0.3	-3.9	-5.0	-5.3	-5.5	-5.8
Identified debt-creating flows (4+7+12)	26.3	-12.5	-15.3	-8.8	-6.2			-7.2	-4.1	-5.1	-5.4	-5.6	-5.8
Primary deficit	-5.5	-4.1	-6.4	-7.0	-6.2			-6.7	-6.5	-6.5	-6.5	-6.5	-6.5
Revenue and grants	26.1	24.8	26.7	26.9	27.9			26.5	26.2	26.2	26.2	26.2	24.3
Primary (noninterest) expenditure	20.6	20.6	20.3	19.9	21.7			19.8	19.7	19.7	19.7	19.7	17.8
Automatic debt dynamics 2/	31.8	-8.1	-8.9	-1.4	1.0			2.2	2.9	1.9	1.3	1.1	0.9
Contribution from interest rate/growth differential 3/	6.1	-14.8	-2.6	-0.1	0.9			2.2	2.9	1.9	1.3	1.1	0.9
Of which: contribution from real interest rate	2.3	-10.2	0.9	5.7	5.2			4.7	5.4	4.3	3.5	3.1	2.5
Of which: contribution from real GDP growth	3.9	-4.6	-3.6	-5.8	-4.3			-2.4	-2.5	-2.4	-2.2	-1.9	-1.7
Contribution from exchange rate depreciation 4/	25.6	6.7	-6.3	-1.2	0.1			...	...	...	...	...	...
Other identified debt-creating flows	0.0	-0.3	-0.1	-0.4	-1.1			-2.7	-0.6	-0.5	-0.2	-0.2	-0.2
Privatization receipts (negative)	0.0	-0.3	-0.1	-0.4	-1.1			-2.7	-0.6	-0.5	-0.2	-0.2	-0.2
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	0.0
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	0.0
Residual, including asset changes (2-3) 5/	7.2	0.5	7.2	1.9	-1.4			6.9	0.3	0.1	0.1	0.1	0.1
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	7.6	4.1	6.5	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	20.1	15.0	59.1	35.1	19.1	16.1	12.7	11.2	11.1	10.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	11.2	7.9	15.9	10.6	9.7	18.1	12.3	10.0	11.1	9.2	8.2	8.1	7.8
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-53.6	-11.8	17.7	4.3	-0.4	-23.2	24.8	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	55.3	44.4	22.5	9.5	5.3	47.8	27.6	9.1	5.0	3.5	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-15.3	8.1	4.3	7.3	17.4	5.2	8.1	-3.5	5.0	5.0	5.0	5.0	-4.9
Primary deficit	-5.5	-4.1	-6.4	-7.0	-6.2	-3.0	3.4	-6.7	-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 2007-11								**55.5**	**59.2**	**63.3**	**68.3**	**74.0**	**80.4**
A2. No policy change (constant primary balance) in 2007-11								**55.5**	**50.0**	**44.8**	**39.2**	**33.5**	**27.4**
A3. 2007 GDP growth is reduced (relative to baseline) by one standard deviation								**55.5**	**55.8**	**50.3**	**44.6**	**38.6**	**32.4**
A4. Selected variables are consistent with market forecast in 2007-11								**55.5**	**51.6**	**47.1**	**42.8**	**38.8**	**34.6**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2007 and 2008								**55.5**	**67.9**	**84.8**	**80.9**	**76.7**	**72.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2007 and 2008								**55.5**	**60.5**	**65.3**	**60.5**	**55.4**	**50.1**
B3. Primary balance is at historical average minus two standard deviations in 2007 and 2008								**55.5**	**61.9**	**67.5**	**63.1**	**58.5**	**53.5**
B4. Combination of B1-B3 using one standard deviation shocks								**55.5**	**64.5**	**85.5**	**81.3**	**76.9**	**72.2**
B5. One time 30 percent real depreciation in 2007 8/								**55.5**	**62.0**	**57.6**	**52.8**	**47.9**	**42.7**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**55.5**	**61.6**	**57.0**	**52.0**	**46.8**	**41.3**
C. Tailored Tests													
C1. No market stabilization in second half of 2006 9/								**62.2**	**62.3**	**57.7**	**52.7**	**47.5**	**42.0**
C2. Heightened exchange rate pressure 10/								**69.0**	**71.5**	**67.3**	**62.6**	**57.7**	**52.5**
C3. Domestic policy complacency starting in 2007 11/								**55.5**	**58.7**	**61.3**	**63.7**	**66.2**	**69.7**

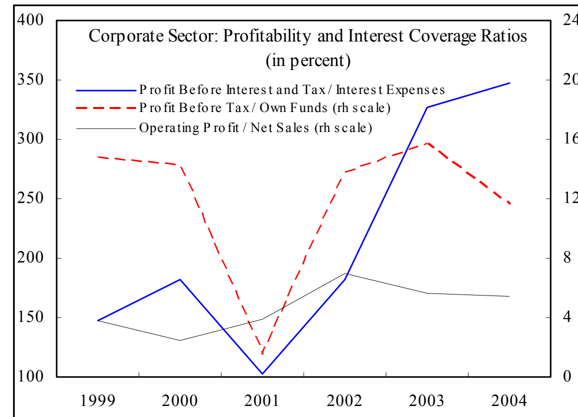
1/ Consolidated nonfinancial public sector, net debt. Calculation of FX assets uses pre-May 2006 methodology.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; 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 30 percent depreciation and 500 additional bps to baseline in 2006-7; reduced annual GNP growth of 3 percent in 2006−7. Baseline assumptions for 2008−11.
10/ Assumes a 40 percent depreciation in 2006, interest rates 1000 bps and 500bps above baseline in 2006 and 2007, res[ectively. Zero growth in 2006. Baseline assumptions for 2008−11.
11/ Assumes that starting in 2007 the primary fiscal balance is permanently reduced to 4 percent, privatizations are cancelled (zero receipts) and real interest rates permanently rise by 4 percentage points. As a result, annual growth drops permanently to 2.5 percent (beginning in 2008) and the annual lira depreciation is faster than under baseline.

APPENDIX IV: CORPORATE SECTOR VULNERABILITY

In recent years, corporations have increased their reliance on external borrowings, making the sector more vulnerable to a sudden exchange rate correction. A mitigating factor has been a rise in foreign currency assets, as well as higher foreign exchange earnings (exports). While data limitations impede a comprehensive and timely assessment of vulnerabilities, a number of key ratios do not paint an alarming picture, either by historical or cross-country standards. Yet, many corporations are likely to experience a worsening in their financial conditions as a result of the recent lira depreciation, calling for close monitoring of developments in this sector.

On the back of the strong economic recovery, corporate balance sheets strengthened in recent years. Sector-wide data through 2004 show an overall improvement of financial indicators in the corporate sector since the 2001 crisis.[9] Short-term liabilities decreased both as a share of liquid assets and total liabilities and the average leverage ratio fell. Thus, both liquidity and solvency risk should have declined on average. In addition, corporations' interest coverage ratio improved sharply, reflecting not only better profits but also a large decline in the cost of capital. However, 2003–04 data also indicate that, while profit margins surged in the immediate aftermath of the 2001-crisis, they have tightened since. This development probably continued in 2005, as the strong lira weighed on many industries' competitiveness.





However, corporations increased their reliance on foreign currency debt. While the lira strengthened—making foreign currency borrowing appear cheap—the corporate sector increased its foreign currency borrowing to finance its strong investment activity. Most of this came as external loans, but part of it was also in the form of foreign currency lending from domestic banks, which started to rebuild their corporate loan portfolios. Total foreign

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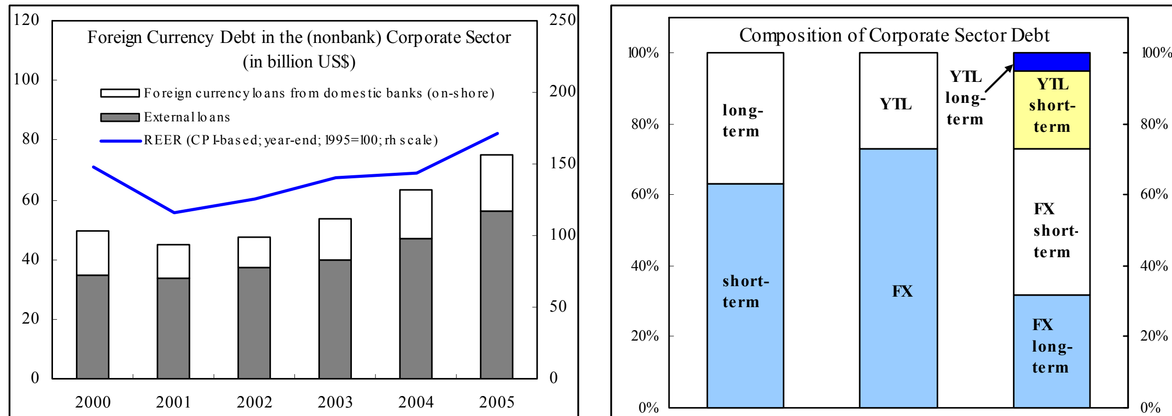
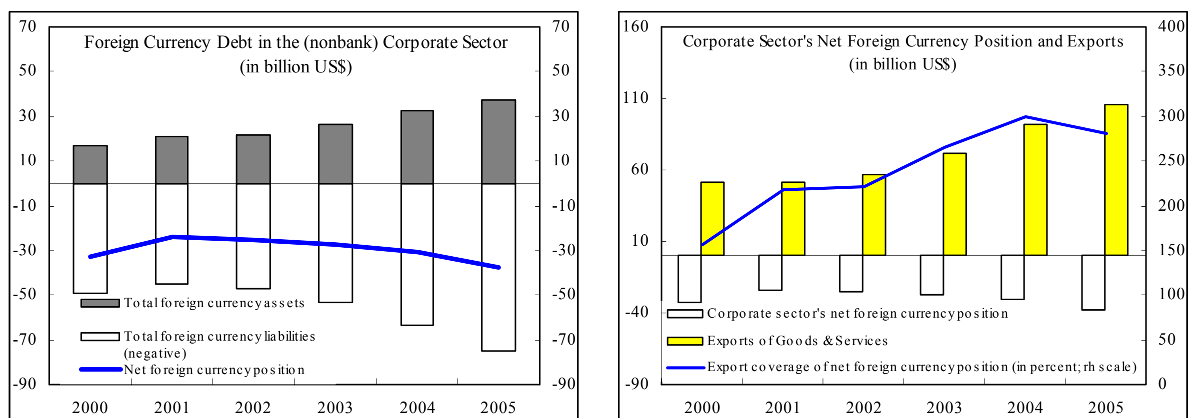
[9] CBT's Company Accounts database. 2005 data will become available in Q3 2006.

currency debt in the corporate sector reached US$75 billion by end-2005, over 20 percent of GNP, and almost three-quarters of the sectors' total debt (Table IV.1).



The widening of the negative net foreign currency position of the corporate sector was in part mitigated by the sector's accumulation of foreign currency assets. As of the end of 2005, the corporate sector's foreign currency assets added up to US$37 billion, with one third of this in the form of foreign currency deposits with domestic banks. About half of the sector's foreign currency liabilities were therefore covered by foreign currency assets, reducing the net foreign currency position on the sector's balance sheet to US$38 billion by end-2005. Yet, while this net position had changed little in the years 2001–03, it widened by US$11 billion in the last two years. Corporations may have been using off-balance sheet transaction to hedge this mismatch. However, there is only anecdotal, and at times conflicting, evidence on the extent to which firms use derivatives to reduce foreign currency exposure. Indeed, indications are that some firms may even have used such instruments to further increase their exposure, in the expectation that continued lira appreciation would boost their financial income.



At the same time, however, the sector's exports rose rapidly, providing some natural hedge against currency risk. Exports of good and non-factor services more than doubled since the 2001 crisis, outpacing the rise in the negative foreign currency position. As a result, the net foreign currency position's coverage by exports roughly doubled since 2000 to

300 percent in 2004 (though falling somewhat in 2005). This implies an increased capacity to service foreign currency debt and thus to manage the risk associated with the negative foreign currency position. As export competitiveness improves with a weaker lira, export activity provides an important natural hedge for non-financial corporations.

Overall, the corporate sector foreign currency exposure today remains below the levels associated with crises situations in Turkey's past and in other emerging markets. Although Turkey's corporate foreign currency indebtedness is quite high as a share of GDP, it is comparatively low when measured against exports. For example, Turkey's corporate sector foreign currency debt is around the same level as Brazil's in 2001 when measured as a share of GDP—but it is only about half when measured as a share of exports. A similar pattern emerges when comparing Turkey today with Turkey at end-2000 (when the corporate sector's foreign currency debt was much lower in absolute terms). Compared to Thailand, Argentina and Uruguay in their pre-crisis years, Turkey's ratios today look even less alarming. Only Korea in 1996 seemed to have had lower debt ratios, although there the problem was the concentration in short-term debt, which exposed Korean firms to serious rollover risk.

Corporate Sector Foreign-Currency Debt in Selected Countries and Periods

	Thailand 1996	Korea 1996	Argentina 2000	Uruguay 2001	Brazil 2001	Turkey 2000	Turkey 2005
	(In billions of U.S. dollars, unless otherwise indicated)						
Foreign currency debt to domestic banks	32	32	30	5	21	15	19
Foreign currency debt to external creditors	62	28	37	1	70	35	56
Total foreign currency debt	94	60	67	7	91	49	75
Exports (goods and services)	71	153	31	3	68	51	105
GDP	180	496	284	19	517	200	362
Foreign currency debt to exports (in percent)	132	39	213	199	135	97	71
Foreign currency debt to GDP (in percent)	52	12	24	35	18	25	21

Sources: For Turkey, CBT and BRSA. For other countries see IMF Occasional Paper No. 240 (2005), Table 4.1.

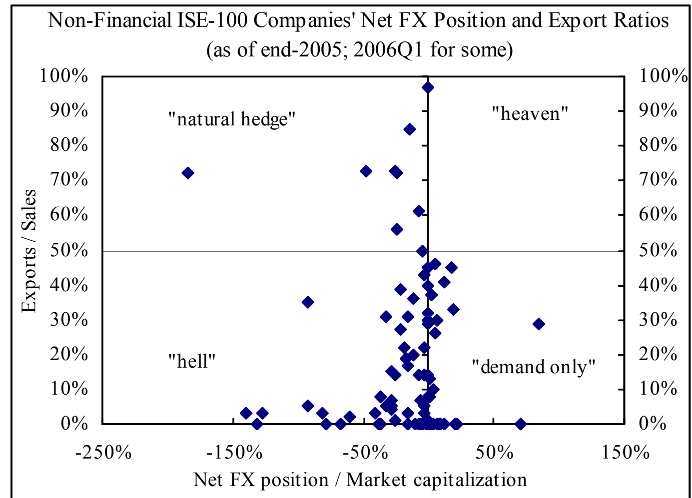
Nevertheless, individual corporations are still likely to be negatively affected by the recent lira depreciation. Based on combinations of two financial ratios, (i) net foreign currency position over market capitalization and (ii) exports over sales, Turkey's corporations can be divided in four different groups in terms of their ability to withstand currency depreciation:[10]

- *Hell*—a large negative foreign currency position and a low export ratio;
- *Heaven*—a positive foreign currency position and a high export ratio;
- *Hedge*—a negative foreign currency position and a high export ratio; and,

[10] This follows Echeverry, J.C., Fergusson, L. Steiner, R. and C. Aguilar (2003a), "Hell, Heaven or Hedged: Debt, Devaluation and Firm Investment in Colombia," *Mimeo*, Inter-American Development Bank; and Echeverry, J.C., Fergusson, L. Steiner, R. and C. Aguilar (2003b), "Dollar Debt in Colombian Firms: Are Sinners Punished During Devaluations?" *Emerging Markets Review*, 4 (4) 417-449..

- *Demand only*—a positive or balanced foreign currency position and a low export ratio.

For companies in *hell* the debt burden increases, while they experience no positive effect on their sales. Companies in *heaven* see their debt burden decrease while also becoming more competitive in their (export) sales. *Hedge* companies have a higher debt burden, but can compensate for it through improved export performance. *Demand only* companies are neither exposed through their foreign currency position nor do they have significant exports. They feel the depreciation effect indirectly through the economy's demand channel. The scatter chart for Turkey nonfinancial ISE-100below shows that a large share of the ISE companies fall in the *hell* category and (to a lesser extent) in the *hedge* territory.



Therefore, the weaker lira and higher interest rates will likely reverse some of the past improvements in corporate balance sheet ratios. For example, given that on average close to three-quarters of debt is in foreign currency, corporations' leverage ratios (loans over assets)—reportedly at around 50 percent at end-2004—would rise by about 8 (11) percentage points as a result of a 20 (30) percent lira depreciation.[11] In addition, given that roughly two thirds of corporations' debt still has maturities shorter or equal to one year, the higher interest rates will quickly translate into higher interest payments for firms, cutting into their profits and weakening their ability to stay current on debt obligations.

Looking forward, close monitoring of corporate sector risks is warranted. Given the size and the heterogeneous nature of the corporate sector, lenders are better placed to assess risks, including with regard to individual firm's foreign currency exposures. The banking supervisor must ensure, however, that banks thoroughly analyze their corporate clients' on- and off-balance sheet risks when extending loans. Regulations on foreign currency lending may also have to be reconsidered: for instance, while existing rules restrict banks' domestic foreign currency lending to trade-related activities, this restriction can be circumvented by providing loans through foreign branches of domestic banks. Moreover, no limits apply to fx-*indexed* lending, which also creates room to channel exchange rate sensitive loans to debtors who are not hedged through any foreign currency earnings.

[11] By the same token, this also shows that the leverage ratio's rapid decline in recent years (from 70 percent in end-2001) has been largely due to the exchange rate effect.

Table IV.1. Turkey: Corporate sector foreign currency position 1/

	2000	2001	2002	2003	2004	2005
	(in billions US$)					
1. Foreign financial assets	11	13	14	17	21	25
Deposits with BIS reporting banks	9	9	10	11	14	18
External trade credit extended	3	3	4	5	7	7
2. Foreign debt /2	35	34	37	40	47	56
Long-term	25	26	29	29	32	39
Short-term	10	8	8	10	15	18
Trade credit received	8	6	7	9	13	16
Other	2	2	1	2	1	2
3. Foreign balance (1-2)	-23	-21	-23	-23	-26	-31
4. Domestic fx assets (deposits with onshore banks)	5	8	8	10	12	12
5. Domestic fx liabilities (loans from onshore banks) 3/	15	11	10	14	16	19
6. Domestic balance (4-5)	-9	-3	-2	-4	-5	-6
7. Total fx assets (1+4)	17	21	22	26	33	37
8. Total fx liabilities (2+5)	49	45	47	53	63	75
9. Total net foreign currency position (7-8)	**-33**	**-24**	**-26**	**-27**	**-31**	**-38**
Memo items						
Exports of Goods & Non-factor services (GNFS)	51	52	57	72	92	105
GNP (in US$ billion)	200	144	183	239	302	362
Total fx liabilities in percent of GNFS exports	97	86	84	74	69	71
Total fx liabilities in percent of GNP	25	31	26	22	21	21
Net foreign currency position's coverage by GNFS exports	**156**	**219**	**221**	**265**	**300**	**281**
Net foreign currency position in percent of GNP	16	17	14	11	10	10

Sources: CBT; BRSA; Staff calculations.

1/ Incl. nonfinancial SEEs.

2/ Foreign debt includes loans received from Turkish banks' off shore branches.

3/ Incl. fx-indexed loans.

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

Ankara, July 7, 2006

Dear Mr. de Rato,

1. Economic performance under our program has been strong. In 2005, growth significantly exceeded expectations, while the inflation target was undershot for the fourth year in a row. The wider-than-projected current account deficit mainly reflected rising oil prices, and it was amply financed by record-high capital inflows, including sharply increased FDI. The overall fiscal deficit dropped to below 2½ percent of GNP and net public debt fell sharply.

2. In recent weeks, liquidity in global financial markets has tightened significantly, prompting turbulence in emerging market currencies and asset prices. Turkey has been among the most affected, reflecting our comparatively large current account deficit as well as adverse inflation outcomes in April and May. We prudently assume that the shift in global liquidity is sustained, rather than transitory, and are prepared to adapt our policies as needed. Already, we have reinforced our fiscal stance with measures to rein in government spending, while the central bank has acted to tighten monetary conditions substantially. We are determined to respond actively and flexibly to any future market turbulence, including by tightening policies further as needed to safeguard our program objectives.

3. As a result of sustained policy implementation, we met most program targets.

- With regard to the *quantitative performance criteria*, the end-2005 and end-March targets for external debt and net international reserves were met, and while annual inflation remained within the inner consultation band at end-March, it exceeded the outer band at end-June. The end-2005 primary surplus realizations for the consolidated government sector and the consolidated government sector excluding state economic enterprises (SEEs) fell short of targets, mainly on account of weak performance in the social security institutions—which we have since taken steps to address—and one-off factors that worsened SEE performance. The deviation from the target excluding SEEs was very small, and, although expenditures during the first few months of 2006 were above budget, revenues have been strong.

- Key *fiscal reforms* envisaged under the program have been implemented. On April 13, Parliament approved social security legislation that unifies the three existing social security institutions. This was followed on April 19 by parliamentary approval of a law that (i) introduces parametric changes to pension formulas to make the system financially sustainable; and (ii) establishes universal health insurance. These laws were enacted on May 20 and June 16, respectively. We also completed the first

phase of personal income tax (PIT) reform and passed into law the corporate income tax (CIT) reform (prior action). Furthermore, we (i) addressed social security contribution arrears and strengthened future collection capacity; (ii) created a tax policy unit at the Ministry of Finance that, once fully operational, will permit the Revenue Administration to focus entirely on tax collection; (iii) conducted a review of wage and employment conditions in the civil service; and (iv) established regulations required under the Public Financial Management and Control Law.

- Progress was also made in the area of *financial sector reforms*. We submitted legislation to Parliament that will launch a mortgage system in Turkey. We also hired financial advisors for the privatization of Halkbank and established a committee to assess the merits of further integrating financial sector supervision. Separately, the Savings Deposit Insurance Fund auctioned off all remaining non-related-party loans, with the exception of about US$100 million of loans (accounting for 10 percent of total non-related-party loans), which were not purchased because the supporting documentation was incomplete.

4. In light of this performance, our unabated commitment to the objectives of our program, and our resolve to adhere to strong policies, as further elaborated in this Letter, we request the completion of the Third and Fourth Reviews under the Stand-By Arrangement. We also request waivers of applicability for the end-June performance criteria on the primary surplus of the consolidated government sector, the primary surplus of the consolidated government sector excluding SEEs, and the balance of the social security institutions, as the relevant data are not yet available and we expect these targets to be met. End-June inflation exceeded the upper program band, and the central bank will shortly send a letter to the government explaining the reasons for the deviation and the policy response. This letter will be forwarded to the Fund, in accordance with the inflation consultation clause. We also request waivers for the end-January and mid-February performance criteria on Parliamentary approval of the administrative and parametric social security laws, which were both passed with delay. Moreover, given that it would be impractical to assess the capacity-to-pay of millions of social security debtors, our recently-introduced installment payment facility allows clearing of existing arrears for small debtors according to simple rules. This requires a waiver for the nonobservance of the continuous performance criterion on amnesties. Finally, we request a waiver of nonobservance for the end-May performance criterion on submission to Parliament of the second stage of personal income tax reform. We are actively discussing alternatives with stakeholders and propose that the performance criterion be reset as an end-September performance criterion.

5. We are confident that the policies set out in the April 26, 2005 Memorandum of Economic and Financial Policy and supplementary Letters 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 2006

6. Growth was stronger than expected in 2005, and this trend continued into early 2006, driven by continued robust private investment and consumption demand. With the recent tightening of policies and credit conditions, domestic demand is expected to slow in the second half of this year. Nevertheless, our program objective of 5 percent GNP growth for 2006 remains achievable. The pass-through from a weaker lira, however, coupled with pressure from high commodity prices, has rendered the inflation outlook considerably more challenging (see below).

7. The slowdown in domestic demand and the recent changes in the exchange rate are expected to stabilize the current account deficit this year and help reduce it in the medium term, despite adverse energy price developments. At the same time, the composition of foreign capital inflows is expected to improve further. Privatization receipts and foreign investments, especially in Turkey's banking sector, should further raise the current account's coverage by non-debt creating flows, in particular FDI. The floating exchange rate will continue to serve as an important safety valve. We will allow automatic stabilizers to work, continue to review current account developments during the year, and, if necessary, adjust our policies.

Monetary policy

8. We moved to formal inflation targeting at the beginning of the year. As outlined in our December announcement, under the new framework, we set CPI inflation targets of 5 percent for this year (with a 2 percentage point uncertainty band) and targets of 4 percent for 2007–08. Under the program, progress is being monitored using a standard inflation consultation clause (Annex I).

9. Inflation moved sharply upward in April and May, driven by unexpectedly high unprocessed food prices, rising oil and gold prices, and sticky services prices. Together with the recent depreciation of the lira, this makes it likely that end-year inflation will exceed the 5 percent point target. In fact, annual inflation in June was 1½ percentage points above the 8½ percent upper limit of the inflation consultation band. To stabilize market expectations and safeguard our medium-term inflation targets, we have moved forcefully to tighten monetary conditions. Policy interest rates were increased by a cumulative 400 basis points at extraordinary sessions of the Monetary Policy Committee on June 7 and 25, and these moves were supported by open market operations to drain excess lira liquidity from the system. We stand ready to tighten monetary policy further as necessary to ensure that inflation converges back to our medium-term target path. To this end, we will use all instruments at our disposal, and indeed plan to develop additional instruments that will enhance the effectiveness of our sterilization operations.

10. Building international reserves for prudential reasons is an important objective of the central bank. Although we recently paused the daily reserve purchase auctions temporarily, we expect to reinstate these when market conditions allow. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

Fiscal policy

11. Fiscal discipline remains the cornerstone of our program, both for the purposes of reducing further the public debt burden and for reining in the current account deficit. The end-2005 targets were missed mainly on account of weakness in the social security system and state enterprise sector. The former we are addressing with measures to control spending and boost revenue collection, while the latter was caused mostly by one-off factors, including larger-than-expected grain purchases by the Soil Products Office (TMO). In the first five months of 2006, the central government primary surplus was higher than programmed, but with spending well ahead of plans, particularly on health and investment, most of the substantial revenue overperformance could not be saved. Although the spending overruns partly reflected spending brought-forward from later in the year, they were also driven by carryovers from 2005. As prior action for the completion of the reviews, we have adjusted our spending plans to bring back expenditures in line with the program. Specifically, we have:

- Taken further measures to bring health spending under control, including by (i) reducing the reimbursable margin on top of the cheapest generic drug in a bioequivalence group from 30 to 22 percent; (ii) merging across institutions and further rationalizing the positive list for pharmaceuticals; (iii) improving medical audit of pharmaceuticals to reduce error and fraud in prescriptions; (iv) signing a global budget protocol with the Ministry of Health, consistent with achieving the programmed health spending envelope and underpinned by payment-per-case system for Ministry of Health hospitals; and (v) introducing the payment-per-case system also for private and university hospitals (with tariffs in line with the new ones in force for Ministry of Health hospitals, except for outpatient care provided by university hospitals, for which premia are capped at 50 percent). These measures are expected to achieve YTL 2.1 billion in savings.

- Blocked YTL 1.3 billion in budget appropriations and issued an instruction to the TMO to ensure that its operations are consistent with budget allocations and programmed financing.

12. In light of Turkey's current account deficit and the less accommodating external financing situation, we have strengthened our commitment to lock in revenue overperformance so as to allow automatic stabilizers to work unimpeded. This will be achieved by introducing a ceiling on expenditures of the central government, excluding SSI transfers, but including expenditures of the SSIs (performance criterion, Annex F). If corporate income tax collection falls short of its expected post-reform levels, we have also identified offsetting expenditure measures that will be put in place by end-August. We expect that this combination of policies would enable achieving a primary surplus above the 6.5 percent of GNP target for the year as a whole. This will result in a tightening of the fiscal stance during the second half of 2006, which will help support the central bank's disinflation efforts.

13. Our efforts to improve fiscal transparency continue. As set out in the Public Financial Management and Control Law, we expanded the scope of our 2006 budget from the "consolidated budget" to the "central government budget" in accordance with international standards (We request that the fiscal performance criteria under the program be reset to be consistent with this new concept, Annex F). The new concept includes the revenues and expenditures of some regulatory, supervisory, and other institutions that were previously reflected only in terms of budgetary transfers received. We are working on presenting previous years' fiscal figures in the new format for comparability purposes.

Structural fiscal reforms

14. Tax reform is of key importance to the government. Its overarching objectives are to simplify the tax structure, broaden the tax base, and strengthen enforcement to reduce fraud and evasion. In this context, our plans in these areas are as follows:

- Following the completion of a first stage of the *personal income tax* (PIT) reform, which streamlined the tax structure, we plan to prepare a draft of a second stage of reform by mid-July, and submit this to Parliament by end-September (structural performance criterion). The reform will aim to broaden the base of the tax, including by: (i) lengthening the holding periods on real estate capital gains; (ii) curtailing the exemptions for professional income earners; and (iii) introducing anti-avoidance provisions. The reform will also make the tax simpler to administer and more progressive, including by reforming the existing system of consumption credits. The changes will be designed to enhance the overall revenue yield. Parliamentary approval of the law is expected by end-December (structural performance criterion).

- The *corporate income tax* (CIT) reform law was enacted on June 21. Effective for the fiscal year 2006, the reform reduces the headline tax rate from 30 to 20 percent, while maintaining a simple single-rate structure. At the same time, the reform strengthens anti-avoidance provisions, by tightening transfer pricing and thin capitalization rules and introducing a controlled foreign company regime. The scheme of investment tax allowances had been approved by Parliament earlier.

15. To support the overall objective of broadening tax bases and reducing distortions, we will refrain from introducing new ad-hoc incentives and sectoral tax cuts. The recent decision to lower the VAT rate on textiles was driven by our desire to provide some immediate relief for a sector under particular stress. Going forward we will avoid introducing any further rate reductions or any exemptions that undermine the structure of the VAT. To preserve the base of the income tax, we expect that mortgage interest deductibility will not be introduced.

16. We will reinforce our efforts to strengthen tax administration. To this end, we will take the necessary steps to (i) complete the functional restructuring of the Revenue Administration (RA) by end-July (an end-April 2006 structural benchmark) and (ii) make the newly established tax policy unit at the Ministry of Finance fully operational by end-July—including by assigning sufficient technical staff to undertake daily responsibility for tax analysis.

17. As regards our detailed plans for the RA, we have already established a full-time Reform Project team to oversee its organizational transformation. Going forward, our plans in this area will focus on: (i) unifying all enforcement activities (audit and collection of arrears) under one Vice Presidency, excluding those activities carried out within the large taxpayer office; (ii) realigning responsibilities to separate operational and support activities; and (iii) increasing the grade levels of vice presidents. We also plan to have a fully-operational large taxpayer unit by end-2006 (structural benchmark). To this end, we have (i) established a full-time project team, as a sub-group of the Reform Project team itself; (ii) developed detailed milestones and target dates for the units' organizational structure; and (iii) obtained approval of legislation establishing one additional Vice President position responsible for the large taxpayer unit. Finally, we are committed to tackle in a comprehensive way the significant revenue losses associated with fraudulent VAT refunds. To this end, we will step up tax audits of firms receiving VAT refunds and review the appropriateness of the current VAT rebate system, drawing on IMF technical assistance.

18. Social security reform is of critical importance to help rein in social security deficits and keep fiscal policy on a sustainable path.

- To ensure the administrative infrastructure is in place to implement the new social insurance parameters in a timely manner, we have developed milestones for the merger of the three social security institutions. Key steps include: (i) preparing necessary regulations; (ii) designing premium collection processes for the new institution; (iii) specifying the entitlement system for social insurance; and (iv) preparing the IT platform and testing its application.

- We will accelerate progress on other reforms to make health care more cost efficient, and to ensure that the social security deficit does not exceed 4.5 percent of GNP, including by introducing family medicine and a referral system, and ensuring that a contribution-free provision of health care services will be restricted to those who have no financial means to contribute. All these steps will be taken before introduction of universal health care at the start of 2007.

- To bolster social security revenues, we will closely monitor the implementation of the social security arrears restructuring law and the related measures to strengthen the premium collection capacity of the new social security institution. In this regard, we will outsource collection of premium arrears on a commission basis to contracted lawyers starting no later than end-September. We are also considering modalities for requiring employers to pay employee salaries over a reasonable threshold through the banking system and expect to make a decision on this by end-September.

Financial sector reforms

19. We have invited the IMF and the World Bank to jointly carry out a Financial Sector Assessment Program (FSAP) for Turkey. The FSAP findings are expected to provide a useful guide for reform measures going forward.

20. The BRSA continues to bring its supervision closer to best international practice. To this end, it has implemented the organizational changes envisaged in the banking law, including the merger of onsite and offsite supervision. The BRSA has also adopted the other remaining measures set out in its October action plan, including new audit teams and further improvements in transparency and accountability. To come into line with Basle Core Principles, the BRSA will complete the drafting of supporting regulations for the banking law by end-August 2006 (the associated structural benchmark is proposed to be brought forward from end-September).

21. The consolidation of supervisory activities is also proceeding well, with the BRSA recently acquiring supervisory responsibility of non-bank financial institutions. For the next phase, we have established a committee to assess the merits of further integrating financial sector supervision, with work expected to be completed before end-2006.

22. To preserve financial stability in the face of rapid credit growth and higher financial market volatility, the BRSA has intensified its examinations and monitoring of banks, and is considering options to tighten prudential regulations. The BRSA has made public a report on banks' foreign currency positions, including off-balance sheet transactions, trends in the derivative market and banks' on- and off-shore lending in foreign currency. It is the BRSA's intention to publish such reports on a regular basis.

23. The mortgage law is an important step to further deepen financial intermediation in Turkey. To guide its successful implementation and give sufficient time to strengthen administrative systems and loan approval procedures, the following steps are enshrined in the law: (i) for the first six months following its enactment, only banks will be allowed to lend under the new law; and (ii) lending will be restricted to purchases of dwellings. Consistent with BRSA's responsibility in implementing consolidated supervision, the law will give the BRSA sole supervisory responsibility for mortgage lending by all institutions it supervises. The Capital Markets Board will be in charge of supervising Housing Finance Companies and Mortgage Finance Companies owned by non-financial companies. Supporting regulations on mortgage lending will be issued shortly after the law's passage. These regulations will set tight norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value.

24. We are moving ahead with our preparations for the privatization of state banks. We recently hired financial advisors for Halkbank, and their recommendations on how to proceed with the bank's privatization have been received on June 27 (prior action). Based on this recommendation, the government will announce a detailed privatization strategy and timetable by end-July (an end-June 2006 structural benchmark), including a timetable to phase out state banks' privileges over public agencies' deposits (an end-March 2006 structural benchmark). We plan to prepare a strategy for Ziraat drawing on the experience from Halkbank.

25. The SDIF made good progress in asset resolution and its focus continues to shift towards its role as a deposit insurance agency. By end-2006, the SDIF will have developed a strategy for its operational restructuring. By end-2007, the SDIF will have disposed of all its

holdings of shares in companies and other assets, including the non-related-party loans that were not sold yet. At that point, the Treasury will resolve its receivables arising from earlier bank restructurings.

Investment Climate

26. Our efforts to improve the investment climate and to expand foreign direct investment are paying off. FDI reached US$9.7 billion in 2005--an amount several times higher than historical averages—driven by significant mergers and acquisition activity, successful implementation of our privatization program, and improvements in the investment environment. To provide easy access to information to potential investors, we launched a dedicated investment portal InvestinTurkey-www.investinturkey.gov.tr. Underscoring our commitment to further improve the investment environment, and building on the recommendations of the Investment Advisory Council, we have submitted legislation for a new Turkish Commercial Code that will strengthen corporate governance, and we intend to press forward with initiatives to further streamline registration and licensing requirements, and remove other obstacles to investment.

27. 2005 was a very successful year regarding our privatization program, with US$8.2 billion in privatization revenues generated. The privatizations of Türk Telekom (telecommunications), TÜPRAŞ (refineries) and Erdemir (steel) have been concluded, and the remaining state-owned companies under the portfolio of the Privatization Administration will be disposed of in the coming period. In this regard, we have recently passed legislation that will pave the way for the privatization of electricity distribution companies, which we expect to commence later this year.

Very truly yours,

/s/	/s/
Ali Babacan	Durmuş Yılmaz
Minister of State for Economic Affairs	Governor of the Central Bank of Turkey

Attachments

Annex A: Quantitative Performance Criteria and Indicative Targets for 2005–06

	May 31, 2005 2/ Ceiling/ Floor	May 31, 2005 2/ Outcome	June 30, 2005 Ceiling/ Floor	June 30, 2005 Outcome	Sept. 30, 2005 Ceiling/ Floor	Sept. 30, 2005 Outcome	Dec. 31, 2005 Ceiling/ Floor	Dec. 31, 2005 Outcome	Mar. 31, 2006 Ceiling/ Floor	Mar. 31, 2006 Outcome	June 30, 2006 Ceiling/ Floor	June 30, 2006 Outcome	Sept. 30, 2006 Ceiling/ Floor	Dec. 31, 2006 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	12,366	15,745	17,360	25,995	24,157	30,363	28,254	7,771	10,376	17,320	24,761	29,250	34,050
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 3/	8,079	9,910	14,145	16,063	23,295	23,428	26,660	26,615	7,471	8,176	16,420	21,738	27,550	31,350
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 3/													123,350	168,650
4. Ceiling on contracting or guaranteeing of new external pubic debt with original maturities of more than one year (in millions of US$)	7,000	4,527	10,000	5,795	13,000	6,855	16,000	10,570	8,500	4,196	14,000	4,806	18,000	21,500
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0	1,000	1,000
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	2.0	5.8	2.0	10.5	2.8	13.2	15.9	22.4	19.7	32.4	24.3	31.0	20.3	22.6
7. Ceiling on base money (in billions of YTL)	23.6	23.0	23.6	22.6	24.7	27.7	29.2	28.8	...		...		...	...
8. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 4/	-7,200	-7,274	-10,500	-11,196	-16,500	-17,720	-21,500	-23,398	-6,100	-6,820	-12,000	-11,002	-18,400	-24,300
II. Inflation Consultation Bands														
Outer Band (upper limit)	...	...	...	...	...	...	...	...	9.4		8.5		7.8	7.0
Inner Band (upper limit)	...	...	...	...	...	...	...	...	8.4		7.5		6.8	6.0
Central Point	...	...	...	...	...	...	...	...	7.4	8.2	6.5	10.1	5.8	5.0
Inner Band (lower limit)	...	...	...	...	...	...	...	...	6.4		5.5		4.8	4.0
Outer Band (lower limit)	...	...	...	...	...	...	...	...	5.4		4.5		3.8	3.0
III. Indicative Targets														
1. Floor on the cumulative overall balance of the consolidated government sector 3/	-8,121	-787	-8,755	602	-10,205	-2,831	-19,687	-4,222	-3,429	976	-3,980	6,856	-5,900	-6,900
2. Ceiling on the stock of net domestic assets of the CBT and Treasury combined	37.7	31.3	37.7	24.0	37.8	23.7	25.5	12.6	...	...	...	...	...	...
3. Privatization Proceeds (in millions of US$)	...	...	300	886	1,250	1,200	1,900	n.a.	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.

2/ End-April 2005 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. Coverage from June 2006 onwards expanded, to account for new institutions now covered under the Central Government Budget.

4/ Indicative target for March 2006, performance criteria from June 2006 onwards.

ANNEX B: Turkey: Structural Conditionality 2006 1/

Action	PC/SB
Prior Actions	
Adopt fiscal measures to bring back expenditures in line with the program (¶11)	Five days before Board meeting
Parliamentary approval of corporate income tax legislation (¶14)	Five days before Board meeting
Financial advisors to finalize recommendations on how to proceed with the privatization of Halkbank (¶24)	Five days before Board meeting
Fiscal Measures	
1. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19, LOI April 26, 2005)	Continuous PC
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 LOI April 26, 2005)	Continuous SB
3. Maintain excise taxes and SEE prices in line with 2006 program assumptions (¶11 LOI April 26, 2005)	Continuous SB
4. Complete functional restructuring of Revenue Administration, including reorganization of local tax offices (¶16)	This end-April 2006 SB is expected to be completed by end-July 2006
5. Establish tax policy unit at the Ministry of Finance (¶16)	SB for end-December 2005. With the establishing law passed in January 2006, the unit is expected to be made fully functional by end-July 2006
6. Submission to Parliament of second stage of personal income tax reform (¶14)	PC. End-September 2006
7. Establish a large-taxpayers unit within the Revenue Administration (¶17)	SB. End-December 2006
8. Parliamentary approval of second stage of personal income tax reform (¶14)	PC. End-December 2006
Financial Sector Measures	
9. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶24)	This end-March 2006 SB is expected to be met by end-July 2006.
10. Announcement of detailed state bank privatization strategies and timetables (¶24)	This end-June 2006 SB is expected to be met by end-July 2006
11. Completion of implementing regulations for the Banking Law (¶20)	SB. End-August 2006

1/ PC=structural performance criterion, SB=structural benchmark. **¶s** refer to the July 7, 2006 Supplementary Letter of Intent.

Annex C: Table. Turkey: Proposed Schedule of Purchases, 2005-08

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

ANNEX D: 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	28.8

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	12.6

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.

ANNEX E: 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	Floor Adjusted for Privatization Outcome	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	15.9	22.4	37.5
March 31, 2006 (performance criterion)	17.2	19.7	32.4	45.7
June 30, 2006 (performance criterion)	19.9	24.3	30.7	42.4
September 30, 2006 (performance criterion)	20.3			
December 31, 2006 (performance criterion)	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$0.31 billion on March 31, 2006). Reserve assets as of March 31, 2006 amounted to US$60.33 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 March 31, 2006 reserve liabilities thus defined amounted to US$14.66 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 March 31, 2006 these amounts were zero.

6. As of March 31, 2006 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$13.29 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
2006 Q1	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.

Annex F: 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, 2006, to:	
March 31, 2006 (performance criterion)	7,550
June 30, 2006 (performance criterion)	17,250
September 30, 2006 (performance criterion)	29,250
December 31, 2006 (performance criterion)	34,050
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 (performance criterion)	27,550
December 31, 2006 (performance criterion)	31,350

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of: the consolidated budget or central government;[1], the 3 extra budgetary funds (EBFs) identified below; the three social security institutions (SSIs) identified below; the unemployment insurance fund; and the 23 state economic enterprises (SEEs) identified below. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

a) For the consolidated budget/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.

[1] In table 1, the targets for March and June 2006 are set for the consolidated budget, while those for September and December 2006 are set for the central government. All realization data however will be on the latter 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 central government (including on tax arrears, although combined penalty/interest charges associated with tax payments will be counted as primary revenues), 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 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. 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.

The targets for September and December have been altered to account for the broadened coverage of fiscal monitoring implicit in the government's move from "consolidated budget" to "central government." The latter aggregate includes on a gross basis the revenues and expenditures of 25 formerly autonomous institutions and 8 regulatory bodies that were formerly captured only via transfers to/from the consolidated budget.

The 25 formerly autonomous institutions that received transfers from the consolidated budget are:

1. Student Selection and Placement Center,
2. Ataturk Institute of Culture, Language and History
3. Turkey and Middle-East Public Administration Institute -TODAİE
4. The Scientific and Technological Research Council of Turkey
5. The Turkish Academy of Sciences
6. Turkish Justice Academy
7. General Directorate of Mineral Research and Exploration
8. Agency for Workshops in Penalty and Correction Institutions and Prisons
9. General Directorate of Higher Education Credit and Hostels Institution
10. General Directorate of State Theaters,

11. General Directorate of State Opera and Ballet,
12. Turkish Accreditation Agency,
13. Turkish Standards Institute,
14. National Productivity Center,
15. Turkish Patent Institute,
16. National Boron Research Institute
17. Turkish Atomic Energy Agency
18. Undersecretariat for Defense Industries
19. Small and Medium Industry Development Organization
20. Export Promotion Center
21. Turkish Cooperation and Development Agency
22. Authority for Protection of Special Environmental Areas
23. Southeastern Anatolia Project Regional Development Administration
24. Privatization Administration
25. General Directorate of Electrical Power Resources Reconnaissance and Development Administration

The 8 regulatory bodies that made transfers to the consolidated budget are:

1. Radio and Television High Council,
2. Telecommunications Authority
3. Capital Markets Board,
4. Banking Regulation and Supervision Agency,
5. Energy Market Regulatory Authority
6. Public Procurement Agency,
7. Turkish Competition Authority,
8. Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Agency.

5. These institutions were collectively in deficit, and their inclusion in the CGS thus implies a reduction in the annual primary surplus of YTL 1.091 billion, and a reduction in the overall balance of YTL 0.774 billion (the difference relating to YTL 317 million in interest revenues of the 33 new agencies). In addition, the revenues and expenditures (YTL 690 million) of university-affiliated health, social and cultural centers, which were not included in the consolidated budget, are included in the central government budget.

6. Finally, the central government reflects on a gross basis both the tax revenues to be shared with local governments and funds and the transfers of these monies. Transfers are effected one month after collection, and in the transitional year of 2006, central government statistics cover 12 months of shared revenues on the revenue side, but only 11 months of these monies on the expenditure side. This then raises primary surplus targets by YTL 1.168 billion (the amount of December 2005 shared revenues).

Table. Mapping "Consolidated budget" to "central government," 2006 revised program.
(in billions of YTL)

		Primary Revenues 1/	Primary Expenditures	Primary bal.
1.	**Consolidated budget**	**140.083**	**109.355**	**30.728**
+ a	Operations of new institutions being brought into the fiscal monitoring aggregate (which formerly appeared only indirectly in the budget, in that their operations were partially financed by budget transfers).	2.164	5.157	-2.993
+ b	Operations of the university sport, health, and cultural centers (which charge fees and pay teacher bonuses out of these monies, none of which were previously recorded in the consolidated budget)	0.690	0.690	0.000
- c	Transfers to / from consolidated budget	1.200	3.185	-1.985
+ d	Revenue sharing with local governments (formerly omitted from both revenues and expenditures)	14.313	13.145	1.168
= 2.	Subtotal	156.050	125.162	30.888
3.	**Central government**	**156.191**	**125.386**	**30.805**
4. = 3.-2.	Residual (may reflect institutions which were excluded from the consolidated budget but will be included in the central government as departments of other budget agencies (rather than as independent agencies))	0.141	0.224	-0.083
Memo items:				
5.=a+b-c+4.	**"Real" increase (excludes revenue sharing)**	**1.795**	**2.886**	**-1.091**
6.	Interest revenues and expenditures of the new institutions	0.317	0.000	0.317
7.	Effect on overall revenues, expenditures, and balance (excludes revenue sharing)	2.112	2.886	-0.774

1/ Program definition.

Extrabudgetary funds

7. 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

8. The 23 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), 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, TİGEM, KIYEM, TDİ, and DMO.

9. 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.

10. 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, 2005 the stock of net banking claims on SEEs as defined above stood at YTL 1612 million, valued at the exchange rates on that day.

11. 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, 2005 the stock of external loans stood at YTL 8155 million, valued at the exchange rates on that day.

Social security institutions

12. 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

13. 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 Emekli Sandığı stood at YTL 0 million on December 31, 2005. These stocks of arrears will be used for the purpose of calculating the adjustor.

14. 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.

15. 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, 2006.

16. 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. Primary Spending of the Central Government and the Social Security Institutions

Table 1. Turkey: Performance Criteria on the sum of the Cumulative Primary Spending of the Central Government (excluding transfers to Social Security Institutions) and the Social Security Institutions

	Ceiling (In millions of YTL)
Cumulative primary spending from January 1, 2006 to:	
September 31, 2006	123,350
December 31, 2006	168,650

17. The ceilings in Table 1 are established on the sum of (i) the primary spending of the central government, excluding transfers to social security institutions, measured as in paragraph 1.a of Section A above; and (ii) the primary spending of the social security institutions, measured as in paragraph 1.c of Section A above.

Adjusters

18. The ceiling on primary spending will be adjusted symmetrically to compensate for any over- or underperformance in collections of the revenue bases subject to sharing with local governments and extrabudetary funds.

C. 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, 2006 to:	
March 31, 2006	-3,650
June 30, 2006	-4,050
September 30, 2006	-5,900
December 31, 2006	-6,900

19. 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; (v) state bank dividends payments; and (vi) expenditures under the risk account (net lending).

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

21. 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, 2006.

D. 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, 2006 to:	
March 31, 2006 (indicative target)	-6,100
June 30, 2006 (performance criterion)	-12,000
September 30, 2006 (performance criterion)	-18,400
December 31, 2006 (performance criterion)	-24,300

22. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı. It excludes additional payments made to pensioners in lieu of phased-out tax rebates (up to YTL 1.772 billion).

E. Amnesties and Public Sector Receivables

23. 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.

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

ANNEX G: 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.

ANNEX H: 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 (performance criterion)	1,000
December 31, 2006 (performance criterion)	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).

ANNEX I: MEDIUM- AND LONG-TERM DEBT CEILINGS

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

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

ANNEX J: 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.

TÜRKİYE CUMHURİYET MERKEZ BANKASI

ANONİM ŞİRKETİ
SERMAYESİ : YTL 25.000
İDARE MERKEZİ : **ANKARA**
(THE CENTRAL BANK OF THE REPUBLIC OF TURKEY)

HEAD OFFICE
Please refer to :

ANKARA, July, 14 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington D.C.

Dear Mr. de Rato,

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

Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Durmuş Yılmaz
Governor

Erdem Başçı
Vice Governor

İSTİKLAL CAD. 10 06100 ULUS - ANKARA
TEL: (90 - 312) 310 36 46 FAX: (90 - 312) 310 74 34 E-MAIL: iletisimbilgi@tcmb.gov.tr SWIFT: tcmbtr2a
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July 14, 2006, Ankara

Ali Babacan
Minister of State
Ankara

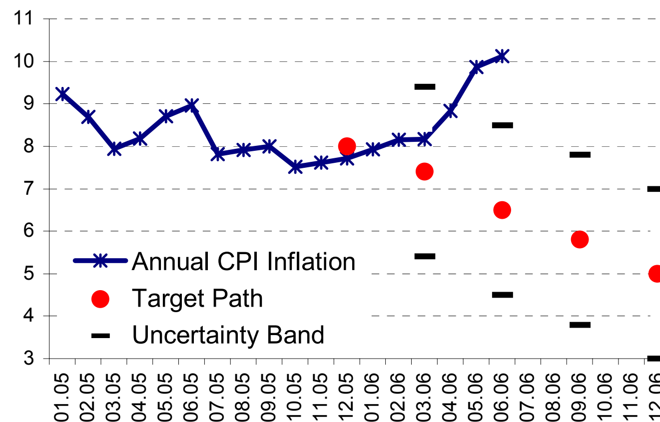
Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. The general framework of monetary policy was explained in the policy statement dated December 5th 2005. Accordingly, the end-year annual inflation target for 2006 was set as 5 percent. The CBT has also disclosed a quarterly path of inflation for 2006 consistent with the end-year target with an uncertainty band of 2 percentage points on both sides (Table 1).

Table 1: Inflation Path Consistent with the End-Year Target and the Uncertainty Band

	March 2006	June 2006	Septembe 2006	Decembe 2006
Uncertainty Band (upper limit)	9.4	8.5	7.8	7
Path Consistent with the Target	**7.4**	**6.5**	**5.8**	**5**
Uncertainty Band (lower limit)	5.4	4.5	3.8	3

Figure 1 shows the target path and the actual inflation outcomes. The target for 12-month CPI inflation in June 2006 was set at 6.5 percent, with an upper limit of 8.5 percent. The actual outcome for 12-month inflation in June 2006 is 10.12 percent. As stipulated in Article 42 of the Central Bank law, the CBT will provide the Government with a written statement explaining the reasons for inflation exceeding the upper limit of the uncertainty band and the measures to be taken to ensure that inflation rate will return to levels within pre-established limits. This open letter serves this purpose. As mentioned in our policy statement titled “General Framework of Inflation Targeting and Monetary and Exchange Rate Policy for 2006” published on December 5, 2005, the public announcement to be made in such a case will also be presented to the IMF as part of the program conditionality.

Figure 1: Annual CPI Inflation and Target Path



Source: CBT, TURKSTAT

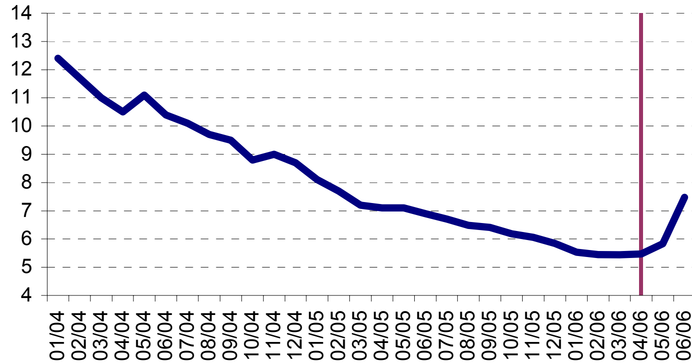
Under the inflation targeting regime, monetary policy is based on a medium term perspective in which the main goal is to ensure the consistency of medium term inflation forecasts-and expectations- with the multi year targets. The main communication device is the quarterly Inflation Report. We have published our first inflation report in January 2006 along with quantitative inflation forecasts. Following the most recent literature on inflation targeting, we based our forecasts on an endogenous policy path in which the CBT reacts to the deviations of projected inflation from the targeted path. Consistent with this approach, we have made it explicit that underlying our January forecast was a policy rate path that would be constant in the first couple of months of 2006 and gradually ease thereafter. Under this scenario, our end-year 2006 inflation forecasts pointed to a range between 4.7 percent and 6.3 percent, which was inside the uncertainty band of 3-7 percent with a safe margin.

The forecasts in the Inflation Report suggested that annual inflation would start to decline gradually in the second quarter of 2006 after exhibiting a slight increase in the first quarter due to some base effect. In the Inflation Report of January 2006, the CBT had identified two major risks to the forecast: First, it was argued that the forecasts were based on a constant oil price path and thus further increases in the oil prices might lead to higher inflation than projected. Second, we mentioned the possibility of a reversal in global liquidity conditions and a decline in global risk appetite, both of which had been favorable for emerging markets in the last couple of years.

Reasons for Breaching the Target

The main reasons for inflation exceeding the upper limit of the uncertainty band in June 2006 can be attributed to a combination of several supply shocks. The first four months were dominated by rising oil prices, increases in the tobacco product prices, high unprocessed food price inflation and the continued increases in the gold prices. It is important to note that, despite these adverse supply factors, inflation expectations were well behaved in the first 4 months of 2006 (Figure 2).

Figure 2: Inflation Expectations for the Next 12 Months

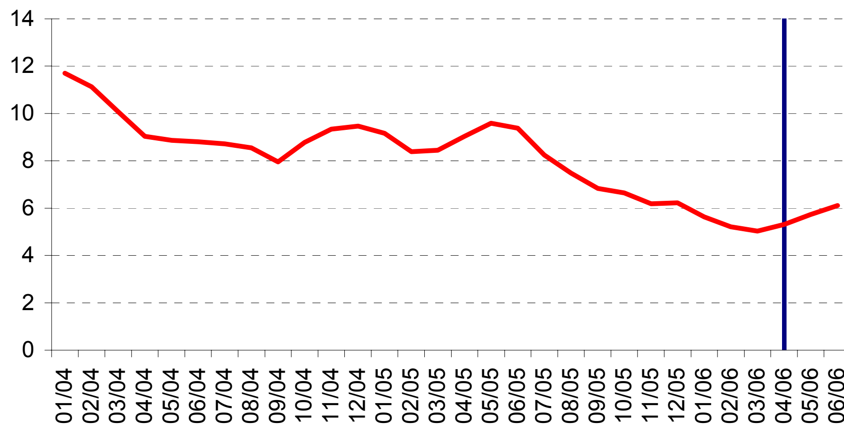


Source: CBT

12-month ahead inflation expectation in April was around 5.4 percent, close to our medium term targets. Annual change in the CPI excluding the most volatile items such as unprocessed food, tobacco-alcohol, energy and gold was on a declining trend (Figure 3); with an annual change of 5 percent by the end of March, suggesting that the rise in headline inflation was likely to be temporary and that underlying inflation trend was much lower than the actual headline inflation. Moreover, the sustained decrease in the risk premium in the first quarter supported the policy action of further monetary easing. Although the domestic demand indicators were pointing to a robust recovery, there were no signs of overheating in the overall economic activity. Various indicators, such as capacity utilization rates, working hours in the manufacturing industry and the output gap estimates pointed the absence of capacity pressures in the economy. All these observations suggest that supply factors played a dominant role in rising inflation.

Figure 3: CPI Excluding Energy, Unprocessed Food, Alcoholic Beverages, Tobacco Products and Gold

(Annual percent Change)



Source: CBT

This outlook has allowed the Monetary Policy Committee (MPC) to stick to the policy path underlying the January forecast and the policy rates were cut by 0.25 percentage points in the April meeting. April inflation figures, which came out a couple of days after the policy rate cut, turned out to be much higher than market expectations. However, as mentioned above, a closer look at the April figures revealed that inflation was mostly due to supply-side factors such as unprocessed food, gold and energy prices.

Nonetheless, the overall market sentiment began to shift in May, as global liquidity conditions started changing in favor of developed countries. Higher global risk aversion has triggered capital outflows in many emerging markets such as Turkey, Hungary and South Africa. In other words, one of the major risk factors we have mentioned in our Inflation Report was realized. Turkey has witnessed a sudden deterioration in the credit risk premium (measured by the EMBI spread) by around 150 basis points during May and June and the New Turkish Lira depreciated more than 20 percent against the US$ in the meantime.

The direct impact of the exchange rate pass-through was visible through items such as gold, petroleum products and electrical appliances etc. in May. Moreover, the unfavorable course of unprocessed food and international gold prices continued in May. As a consequence annual inflation rose to 9.86 percent. Our computations point to a direct pass-through impact of around 0.6 percentage points in May and another 0.9 points in June. In other words, had the exchange rate not moved in the last two months, annual inflation in June would have been around 8.6 percent—not 10.12 percent. Therefore, the outer band would have been most likely breached with a small margin even in the absence of the recent exchange rate movements.

How did the Monetary Policy Respond?

Coupled with the aforementioned supply shocks, depreciation of the domestic currency has led to deterioration in inflation expectations (Figure 2). 12-month ahead inflation expectations increased by almost 2 percentage points in two months. What is more, the 24-month ahead expectations worsened by about 1 percentage point. These developments have indicated that the impact of depreciation on prices might go way beyond a relative price adjustment, calling an immediate policy response. CBT reacted decisively by holding an extraordinary MPC meeting on the 7th of June in which the policy rates were hiked by 175 basis points. The decision was well received and helped the markets to calm down.

In the ordinary meeting of the MPC dated June 20, the Committee assessed that the information flow between 7th and 20th of June did not justify a change in the policy stance and decided to keep the policy rates on hold. Nevertheless, markets turned more unstable and inflation expectations deteriorated sharply in the following days, calling for immediate action. As a response, the MPC held another extraordinary meeting on the 25th of June 2006 to assess the developments and to discuss the measures to be taken. Members of the Committee have reached a consensus on the view that; although the extent of the market instability did not reflect the true economic fundamentals, it had the potential to further worsen the expectations and thus threaten the medium term inflation

targets. The response of the MPC was a rate hike of 225 basis points, reaching a total of 400 basis points tightening in June.

The CBT not only tightened by increasing the policy rate but also by withdrawing the excess YTL liquidity in the financial markets through a combination of one and two week deposit purchase auctions and FX sales in order to reduce the excess New Turkish Lira liquidity in the overnight money market, while raising the lending rate up by a total of 600 basis points. By doing so, the CBT has also aimed at easing the excess volatility in the financial markets originating from factors that are independent from economic fundamentals. Hence, the CBT has explicitly demonstrated its commitment to the medium term inflation targets.

Markets reacted positively to this package, with lower bond yields possibly reflecting a reduction in inflation uncertainty. Table 2 shows the CBT overnight borrowing rates set at each of the 2006 meetings of the MPC.

Table 2: MPC Decisions in 2006

Dates for MPC Meeting	**Decision on Interest Rate**	**Interest Rate**
January 23rd, 2006	No Change	13.50
February 23rd, 2006	No Change	13.50
March 23rd, 2006	No Change	13.50
April 27th, 2006	-0.25	13.25
May 25th, 2006	No Change	13.25
June 7th, 2006(1)	+1.75	15.00
June 20th, 2006	No Change	15.00
June 25th, 2006(1)	+2.25	17.25

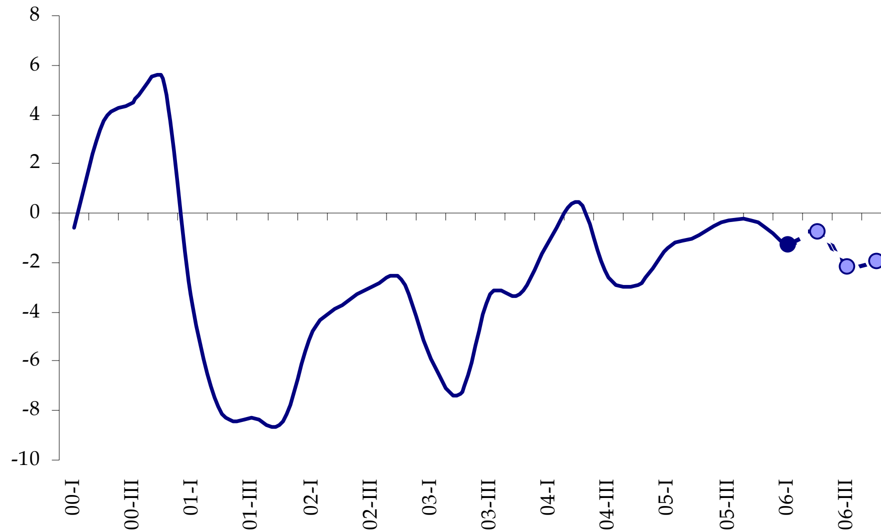
(1) extraordinary

Medium Term Inflation Outlook

The CBT conducts monetary policy based on the evaluation of the future trend of inflation. In assessing future inflation, the CBT uses the best available information, both quantitative, using structural models, simulations and other statistical measures, and qualitative which demands a more subjective analysis. Taking the monetary policy measures in June into account and assuming that the monetary policy will preserve its prudent stance, this section of the letter evaluates the medium term outlook of inflation.

While the recent volatility in the financial markets is expected to slow down the domestic demand growth, the depreciation of the domestic currency is likely to have a favorable impact on net exports. However, it is expected that the slowdown in domestic demand will surpass the rise in net foreign demand, leading to an overall decline in the aggregate demand for home goods. In other words, the net effect of the recent volatility on the aggregate demand is expected to support the disinflation in the second half of the year 2006. In light of these assessments, the output gap is expected to widen for the remainder of the year (Figure 4). The economic activity is projected to pick up gradually in the medium term.

Figure 4: Output Gap

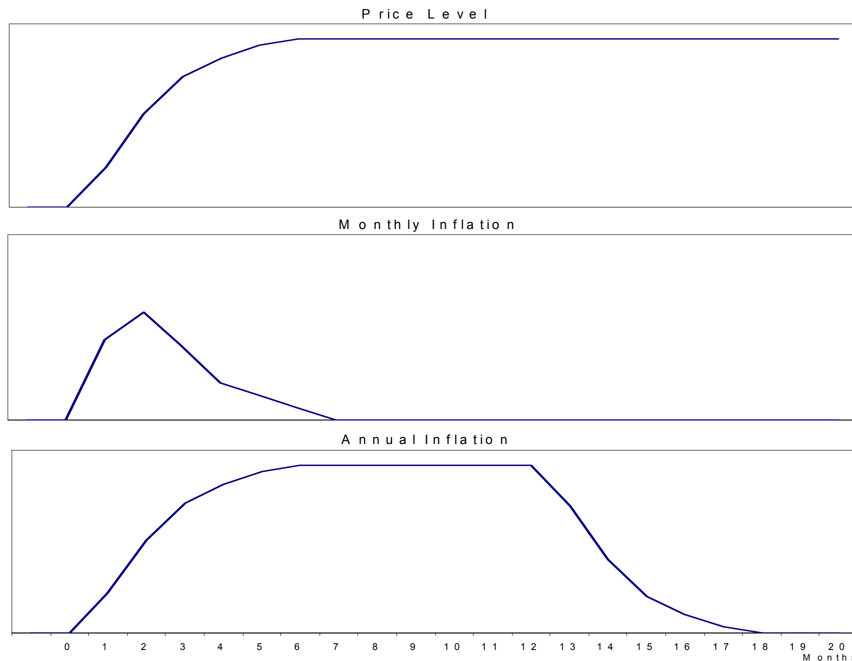


Forecasting the course of inflation in the near term requires an assessment of the pass-through impact of recent movements in exchange rates. Although empirical evidence shows that exchange rate pass-through has been significantly reduced after the adoption of floating exchange rates, our studies suggest that the impact on the price of tradable goods may still be sizeable. Using the techniques developed by our staff, our computations point roughly to a cumulative of 3.5 percentage points of pass-through impact on headline CPI inflation throughout 2006. It is noteworthy to emphasize that, we contemplate the impact of exchange rate on inflation to take the form of a change in relative prices between tradable and non-tradable goods rather than price readjustments. In such a case, overall impact on inflation will be temporary so long as the medium to long-term expectations are under control.

At this point, it will be helpful, using a hypothetical case, to illustrate the typical behavior of the price level, monthly inflation and the annual inflation upon an exchange rate shock in the absence of second round effects. Assuming that exchange rate exhibits a one-time shift at period zero, Figure 5 depicts the price level and inflation paths induced by the direct pass-through effect. Note that even if there are no second round effects, the change in headline index induced by the relative price adjustments (first order effects) may take several months. Our example assumes a 6 months adjustment period (possibly due to staggered price setting in the economy). This lagged pass-through dynamics is also consistent with the Turkish case in which most of the direct impact is completed in 6 months.[1]

[1] Although empirical evidence shows that the pass-through impact may last more than 6 months, one should note that this finding involves *both* the first round and second round effects throughout the sample period.

Figure 5: Behavior of price level and inflation after a one-time jump in the exchange rate



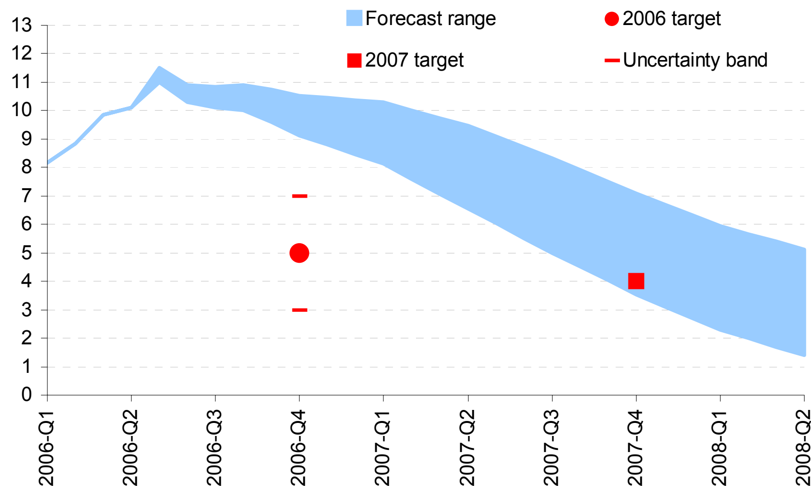
Two main results can be deduced from this exercise: (i) As long as the second round effects are negligible, the impact of a one time jump in exchange rates on inflation is bound to be temporary. (ii) Provided that the impact on the price level dies out in T months (6 months in our example), monthly inflation is affected for T months while annual inflation stays above the steady state for T+12 months (18 months in our case); therefore, *ceteris paribus*, it will take 18 months for the annual inflation rate to return to the target. This simple observation explains why it may take more than a year to bring *annual* inflation down after a significant exchange rate shock.

Our recent policy responses should be interpreted as an intention to realign inflation expectations, to avoid the propagation of supply shocks, and to inhibit a generalized increase in prices. Accordingly, we expect the monetary tightening to contain the second-round impact of the recent exchange rate movements on 2007 inflation, partly due to the slowdown in the overall economic activity. Although the implied inflationary inertia may still add another 1 percentage point to the headline CPI inflation in 2007, our aim is to keep this effect at a minimum level.

Against this background, our latest forecast constructed using a constant policy rate suggest that inflation will be between 9.1 and 10.5 percent at the end of 2006 with 70 percent probability (Figure 6). Besides the slowdown in domestic demand, we expect that unprocessed food prices will normalize (which already showed signs of normalization in June), the one-off increases in tobacco prices will disappear and the impact of exchange rate pass-through will gradually fade out in the medium term. We project the annual

inflation to come down after the first quarter of 2007, the downward trend becoming more significant in the second half of the year. Inflation is expected to converge to the target around one and a half to two years time. The forecast indicate a range between 3.5 and 7 percent for end-2007. Given that this forecast is created under the constant rates assumption, adherence to the 4 percent target may require some further policy tightening.

Figure 6: Inflation Projections for 2006 and 2007 (Preliminary)*



*** Current forecasts are based on information as of July 10th, and thus, may differ from the forecasts in the July Inflation Report, which will be published on the 28th of July. The shaded region indicates the 70 percent confidence interval for the forecast.**

Note that, that the chance of inflation staying within the shaded region is 70 percent, i.e. there may be breaches around the baseline projections, especially in the presence of large shocks. One such risk is the possibility of a sustained rise in oil prices. The CBT will accommodate the first order effect of oil shocks, which mainly works through energy and transportation prices. However, the CBT will monitor the pricing behavior closely and will not hesitate to react to any deterioration in medium term inflation expectations.

Latest developments have signaled that, a shift in investor confidence originating from changes in expectations or swings in the global risk appetite are among major risk factors for the medium term forecasts. Should such a risk realize and the exchange rate exhibit significant fluctuations, the CBT will act in line with its medium-term approach: It will not react to changes in relative prices, but stand ready to respond to any deterioration in medium term inflation expectations. Also, in such a case the excess liquidity in the market will be managed carefully to dampen the potential volatility in the financial markets.

Conclusion

In sum, breaching the upper bound of the uncertainty band of inflation target in June 2006 can be attributed to two major developments. First, one of the risk factors we have set out in our inflation reports, namely the change in the global liquidity conditions, has been realized. Second, there have been unexpected increases in the volatile prices such as unprocessed food, gold and energy prices. Although, the relatively strong course of the domestic demand might have been one of the factors affecting inflation, a careful analysis of the price data and capacity indicators suggests that the role of the supply factors in breaching the target, by and large, was dominant. The CBT has already responded vigorously to bring inflation back to the targets. Our recent forecasts suggest that medium term targets are attainable under a cautious monetary policy stance. However, it should be carefully noted that, these assessments are made within a context where the fiscal discipline is not relaxed, the income policy is in line with the inflation targets and that expectations are managed properly.

The current macroeconomic framework in Turkey is built on three fundamental pillars: inflation targeting, floating exchange rate regime and prudent fiscal policy. This framework has proven to be effective in dealing with the sequence of shocks to the Turkish economy, keeping inflation - and inflation expectations - under control. The Central Bank of Turkey remains attentive to developments in the economy in both domestic and external fronts. Our end year 2007 and 2008 targets remain as 4 percent. As in the recent past, the CBT will react promptly to events that would endanger the achievement of the policy targets.

/s/

INTERNATIONAL MONETARY FUND

TURKEY

Third and Fourth Reviews Under the Stand-By Arrangement, and Requests for Waiver of Nonobservance and Applicability of Performance Criteria and Modification of Performance Criteria

Supplementary Information

Prepared by the European Department in consultation with other departments

Approved by Susan Schadler and Matthew Fisher

July 27, 2006

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

1. **The central bank raised the overnight policy rate by a further 25 basis points—to 17.5 percent—on July 20**. The accompanying statement maintained the hawkish tone of last week's letter to the IMF (Staff Report, Appendix II), noting that some further tightening may be needed to rein in inflation expectations and secure the medium-term inflation targets. Analysts welcomed the move as a signal of the CBT's resolve.

2. **The authorities have reallocated spending in favor of higher farmer subsidies**. Income support was increased by just under 0.2 percent of GNP, with offsetting cuts targeting capital spending. This shift is undesirable from a structural perspective, but the fact that the authorities took steps to keep spending within programmed levels is welcome.

3. **With all prior actions already completed, progress has also been made on meeting pending end-July benchmarks** (Staff Report, Annex B).

- The **tax policy unit** at the Ministry of Finance was made operational by assigning staff and drawing up work programs. The associated benchmark was therefore met.
- The functional reorganization of the **Revenue Administration** has been completed at the headquarters level, but restructuring of local offices will take more time. As a result, the associated benchmark will not be fully met by end-July. The authorities viewed this as a temporary delay and reiterated their commitment to the tax administration reform goals. FAD technical assistance scheduled for early August will assess prospects in this and other reform areas.
- On **state bank reform**, the authorities have adopted a timetable for phasing out special privileges and obligations, thus meeting the associated benchmark.
- The authorities have informed staff that they plan to announce a detailed **privatization strategy for Halkbank** on July 31, in line with the letter of intent.

INTERNATIONAL MONETARY FUND

EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/167
FOR IMMEDIATE RELEASE
July 28, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third and Fourth Reviews Under the Stand-By Arrangement for Turkey and Approves US$1.85 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third and fourth reviews under the three-year SDR 6.66 billion (about US$9.87 billion) Stand-By Arrangement with Turkey approved on May 11, 2005 (see Press Release No. 05/104). The Board also approved Turkey's request for the waiver of the nonobservance of performance criteria pertaining to the parliamentary approval of administrative and social security reforms, the parliamentary approval of the pension reform legislation, the submission to parliament of the legislation to reform personal income tax as well as the continuous performance criterion on grants of amnesties of arrears on public sector receivables.

The completion of the reviews will enable Turkey to draw immediately an amount equivalent to SDR 1.25 billion (about US$1.85 billion).

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

"Turkey's economic performance has been strong. Rapid growth was accompanied until recently by record-high capital inflows, declining debt ratios, and lira strength. In tandem with a number of adverse supply shocks, these outcomes also led to a widening of the current account deficit and a pick up in inflation. Against this backdrop, the rise in global risk aversion since last May had a larger impact on Turkey than on many other emerging market countries. The authorities have responded appropriately to these challenges by tightening macroeconomic policies and reinvigorating structural reforms. The recent lira adjustment should help reduce the current account deficit, but it also makes for a more challenging inflation outlook.

"The central bank's commitment to rein in inflation is welcome. The recent interest rate hikes and the accompanying active withdrawal of lira liquidity have helped restore stability to financial markets and should re-anchor inflation expectations. The authorities' continued adherence to the floating exchange rate regime is also appropriate, as this has acted as a helpful safety valve, including during the latest episode of market turbulence. Looking ahead, the central bank stands ready to adjust its policy stance, should this be needed, to keep the medium-term inflation targets within reach.

"The authorities have risen to the challenge of tightening fiscal policy so as to reduce debt ratios, resume disinflation, and rein in the current account deficit. They have taken measures to reverse spending overruns and have committed to save revenue overperformance so as to achieve a primary surplus in excess of the 6.5 percent of GNP target. To achieve these objectives it will be essential that the authorities maintain their resolve to keep nominal spending in line with the program and preserve the tax base. Continued efforts to improve the composition of the public debt will also be important.

"Prompt actions on the authorities' structural reform agenda will help sustain growth, maintain market confidence, and reduce vulnerabilities. Timely implementation of the recently passed administrative and pension reform laws will be key to safeguard the medium-term fiscal position. The commitment to improve the personal and corporate tax regime is welcome, but more efforts are needed to strengthen tax administration, including through the establishment of a large taxpayer unit by end-2006. On the financial sector side, the authorities' emphasis on accelerating reforms of the bank supervisory framework is appropriate in light of rapid credit growth. This should be accompanied by progress in privatizing state banks to help enhance the efficiency of the financial system and strengthen the investment climate.

"Close adherence to these policies will be key to ensuring high growth with low inflation, and reducing the vulnerability of the economy to any shift in market sentiment. The authorities' efforts to regain investor confidence by tightening monetary and fiscal policies and renewing their commitment to structural reform deserve the support of the international community," Mr. de Rato said.

Statement by Willy Kiekens, Executive Director for Turkey and Levent Veziroglu, Senior Advisor to Executive Director July 28, 2006

The staff appraisal is fair and balanced. Turkey's economic policies under its Fund-supported program have considerably strengthened the fundamentals of the economy and its resilience to shocks. High growth, rapid disinflation, declining public and external debt burdens, and a significant increase in foreign direct investment, all are proof of and reward for a track record of good policies. Yet, the widening current account deficit, some delays in implementing structural reforms and political developments, both in Turkey and abroad, explain why the economy has been hit harder than the economies of other emerging market countries during the recent episode of tightening global liquidity conditions.

Turkey is well on its way to overcome the consequences of the recent excessive market volatility, thanks to the enhanced resilience of the economy, adequate policy responses, and the country's firm adherence to the Fund-supported program.

The floating exchange rate regime, the much higher level of external reserves, the improved debt situation and the soundness of the banking sector, are the foundation for maintaining market confidence. To bolster this confidence, restore strong economic performance and return to the path of disinflation, monetary and fiscal policies have been tightened and structural reforms reinvigorated.

Market reactions to these policy actions have been favorable. The current account deficit, a significant source of vulnerability, is expected to shrink in the medium term as domestic demand slows, and in response to the recent exchange rate adjustment. Moreover, not least because of much larger FDI inflows – USD 8.1 billion so far this year, and expected to reach at least twice that amount next year – the financing of the current account deficit is now on a sounder footing than it was before.

It is encouraging that the recent Investment Advisory Council, which took place after the recent market fluctuations, confirmed that major global investors continue to see Turkey as a profitable investment location. It is clear to all that Turkey's economic prospects would remain bright, if appropriate policies are maintained. With this goal in mind, the Turkish authorities request the continued support of the Fund for their policies as outlined in their Letter of Intent of July 7, 2006. We would like to summarize these policies and expand on a few topics.

Fiscal policy

The authorities regret that – contrary to projections - the end-2005 fiscal targets were missed because of unexpected deficits in the social security system and state enterprises.

The root cause of the weakness of the social security system has now been addressed with the implementation of the recently enacted social security reform. Moreover, in Turkey, as in

many other countries, health spending is a source of cost overruns that the country is now addressing with a wide spectrum of measures to rein in spending at hospitals and on pharmaceuticals. The Universal Health Insurance scheme, to be introduced in 2007, will also help to make the system more cost efficient and sustainable.

The government is committed to save any revenue overperformance during the remainder of 2006. A firm ceiling on the central government's primary spending will be respected. To bolster market confidence further, the government proposes that adherence to the latter fiscal policy intention be a performance criterion under the SBA. The government is confident that under its strengthened fiscal policy the primary surplus at the end of this year will be more than the original target of 6.5 percent of GNP.

Fiscal Structural Reforms

The new social security law is a milestone designed to ensure lasting fiscal discipline in an area plagued with inefficiencies. Both the parametric pension reform and the administrative overhaul of the social security address the financial sustainability problems of the system.

This major reform will be complemented by smaller administrative measures such as paying wages through the banking system in order to enhance efficiency and reducing the unrecorded portion of the economy.

Making the tax system more efficient is a major goal of the government. In order to be efficient, the tax system must yield the desired level of revenues with minimal or no economic distortions. As part of this strategy, the corporate income tax rate has been reduced from 30 percent to 20 percent while total revenues have been preserved by broadening the tax base, inter alia, by eliminating the investment tax allowance.

In tandem with the corporate tax reform, the forthcoming reform of the personal income tax aims at introducing a simpler system by reducing tax brackets and replacing consumption credits with a standard credit.

A functional reorganization of the Tax Administration will enhance flexibility and efficiency and should contribute to better tax compliance.

Monetary Policy

Recent price developments suggest that the end-year inflation target will be missed. However, the medium-term inflation targets remain realistic. High international oil and gold prices and the stickiness in the services sector have increased inflationary pressures. The pass through of the recent correction in the exchange rate will also have its impact.

The Central Bank's response to recent market developments has proved effective. After increasing its policy interest rates by a cumulative 400 basis points, another 25 basis points increase was announced after the Monetary Policy Committee meeting of July 20, 2006. The interest rate hikes were accompanied by open market operations to mop up excess liquidity.

In its communications, the Central Bank of Turkey (CBT) continues to emphasize its commitment to both inflation targeting and the floating exchange rate regime, as well as its readiness to tighten monetary policy as necessary to ensure that inflation converges back to the medium-term target.

The policy actions of the CBT are expected to ease inflationary pressures. However, the CBT remains cautious because of rising oil and other commodity prices. Developments in international liquidity conditions and domestic demand, as well as the pricing behavior of businesses and public sector wage developments will all be considered when shaping the CBT's monetary policy.

Financial Sector

After five years of comprehensive reforms, the financial sector is now on a broadly sound footing. The new Banking Law ensures more efficient supervision, inter alia, by allowing on-site and off-site supervision to be merged, and by a reorganization of monitoring activities. Even so, the recent market turbulence is a reminder that prudent bank management and close and effective supervision are needed at all times.

The Turkish banking system is now much more resilient to external shocks because of stronger balance sheets, higher capital adequacy ratios, limited open foreign currency positions that respect prudential limits, low levels of non-performing loans and supervision on a consolidated basis. The authorities are well aware of the sources of vulnerabilities in the banking sector. They include the recent rapid credit expansion, maturity mismatches and, to a lesser extent, the potential impact of currency risk on the corporate sector. The Banking Regulation and Supervision Agency (BRSA) increased its supervision activities in the wake of recent market developments. Strict monitoring, close dialogue with the banks and improved transparency are key factors to keep the sector under control.

Debt Sustainability

Monetary tightening in advanced economies has led to a reassessment of emerging market country risk and a reallocation of portfolio investments. It resulted in capital outflows from emerging market countries. Shifting portfolios from equities to fixed income and money market instruments triggered a sharp fall in emerging market asset prices. Fortunately, Turkey's debt indicators had improved more than envisaged in the program and the debt to GNP ratio has declined significantly over the last 5 years. Reduced and better structured public debt and a comfortable financing position, thanks to the Treasury's cash account at the CBT, are safeguards for debt sustainability. Nonetheless, recent developments may temporarily halt the downward trajectory of debt. Privatization proceeds and asset recovery revenues of the Saving Deposits Insurance Fund (SDIF) exceed 3 percent of GNP which help mitigate the effects of the recent market volatility. The authorities remain convinced that achieving high primary fiscal surpluses during the last 4 years was the most important factor that reduced the debt-to-GDP ratio. Fiscal prudence will, therefore, continue to be the main policy tool to improve the debt dynamics further.