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# Turkey: Fifth Review and Inflation Consultation Under the Stand-By Arrangement, Request for Waiver of Nonobservance and Applicability of Performance Criteria, Modification of Performance Criteria, and Rephasing of Purchases—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Turkey

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

- the staff report for the fifth review and inflation consultation under the Stand-By Arrangement, the request for waiver of nonobservance and applicability of performance criteria, a modification of performance criteria, and a rephasing of purchases, prepared by a staff team of the IMF, following discussions that ended on October 20, 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 November 27, 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 staff supplement of December 8, 2006, providing an update on developments since the circulation of the staff report to Executive Directors on November 27, 2006.

- a Press Release summarizing the views of the Executive Board as expressed during its December 13, 2006 discussion of the staff report that completed the review.

- a statement by the Executive Director for Turkey.

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

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INTERNATIONAL MONETARY FUND

TURKEY

# Fifth Review and Inflation Consultation Under the Stand-By Arrangement, Request for Waiver of Nonobservance and Applicability of Performance Criteria, Modification of Performance Criteria, and Rephasing of Purchases

Prepared by the European Department in consultation with other departments

Approved by Susan Schadler and Matthew Fisher

November 27, 2006

- **Stand-By Arrangement**. A three-year SDR 6.7 billion (559 percent of new quota) SBA was approved in May 2005. Cumulative purchases amount to SDR 2.9 billion (Appendix I), and a further SDR 750 million will become available upon completion of the fifth review and rephasing of purchases (Table 1). Outstanding Fund credit amounted to SDR 6.5 billion at mid-November.
- **Last Board Meeting**: Directors stressed the need for prudent monetary and fiscal policies and accelerated structural reforms to help disinflation, rein in the current account, and reduce underlying vulnerabilities. They also called for timely execution of structural conditionality.
- **Discussions**. During October 9–20 the staff team met with Deputy Prime Minister Şener, State Minister for Economic Affairs Babacan, Finance Minister Unakitan, Health Minister Akdağ, Treasury Undersecretary Çanakci, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Yilmaz, Bank Regulation and Supervision Agency Chairman Bilgin, other senior officials, and representatives from the banking and business communities. The staff liaised with the World Bank.
- **Staff**. The team comprised Lorenzo Giorgianni (head), Petya Koeva Brooks, Davide Lombardo, Donal McGettigan, and Andre Meier (all EUR), Koshy Mathai (FAD), Mats Josefsson (MCM), Wes McGrew (PDR), Hugh Bredenkamp (senior resident representative) and Christian Keller (resident representative). Levent Veziroglu (OED) accompanied the mission.
- **Conditionality**. End-September performance criteria were met for the primary surplus of the central government, the overall balance of the social security institutions, NIR, and external debt (Table 2). However, the performance criterion on primary spending was not observed, inflation exceeded the upper limit of the consultation band, and the second-stage personal income tax reform was to be submitted to parliament with a small delay resulting in the nonobservance of the associated performance criterion (Table 3).
- **Letter of Intent** (Attachment I). The authorities' main objectives are to bring inflation under control, rein in the current account deficit, and bolster market confidence. They propose to do so by maintaining prudent fiscal policy (6.5 percent of GNP primary surplus in 2007), keeping a tightening bias to monetary policy, and accelerating tax and banking reforms.
- **Publication**. The staff report for the completion of the third and fourth program reviews (Country Report 06/402) was published on November 10, 2006.

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## I. Executive Summary

- **The Turkish economy has weathered well the May–June financial market turbulence**. Despite sharply higher interest rates, a weaker lira and lower asset prices, economic activity has remained robust and FDI inflows buoyant. Balance sheets have also proven resilient (the public debt ratio has continued to decline and bank capitalization remains adequate despite large losses incurred by some banks). These results owe much to the authorities' strong stabilization policies of the past few years.

- **However, economic and political strains are emerging, exposing Turkey to sudden shifts in market sentiment**. The inflation and the current account outlooks have worsened even if both are expected to improve next year. (Spending overruns and a generous civil service wage hike have been unhelpful in this regard.) Together with the high current account deficit, a still high public debt ratio, a large stock of "hot money" investments by nonresidents in the bond and money markets, and a less supportive political environment make Turkey vulnerable to a sudden stop in capital inflows.

- **Against this backdrop, the authorities have renewed their commitment to strong policies**. In the attached Supplementary Letter of Intent, they propose to (i) target a 6½ percent of GNP primary surplus in 2007; (ii) maintain a tightening bias in monetary policy; and (iii) keep up the momentum on structural reform implementation. On reforms, key near-term commitments relate to the implementation of health measures; the enactment of the delayed second-stage personal income tax reform; the establishment of the large taxpayer unit; and the completion of the privatization of Halkbank.

- **To help preserve market confidence and economic progress, it is critical that the authorities stick closely to their ambitious stabilization program**.

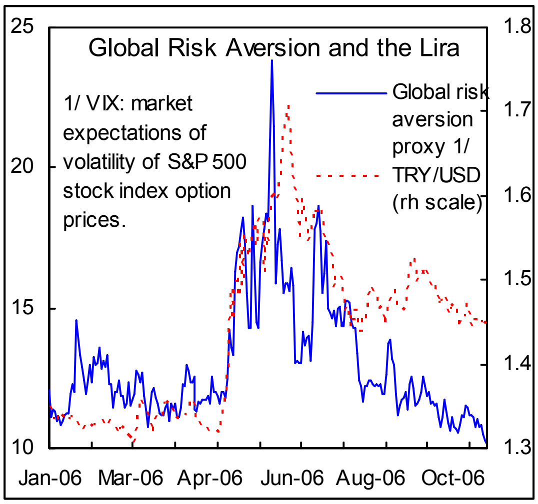
  - **Disciplined implementation of fiscal policy is critical to supporting market confidence in an election year**. It will also help with reducing inflation, real interest rates, and the current account deficit. To this end, it will be important to contain spending and avoid ad hoc tax cuts.

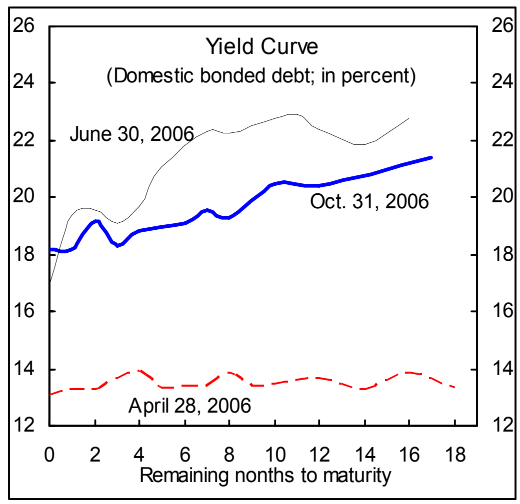
  - **Tight monetary policy and effective communications with markets are crucial to bringing inflation back towards medium-term targets**. In particular, further "bad news" on inflation should prompt interest rate hikes.

  - **Continued progress on structural reforms is needed to complete the policy package**. Achieving efficiency gains in the provision of health services and strengthening tax enforcement are crucial for the sustainability of public finances. In the banking area, further progress in enhancing supervision, early passage of the mortgage law, and a successful privatization of Halkbank would go a long way in improving the resilience of the banking system and deepening financial intermediation.

## II. Recent Developments

1. **Financial market conditions in Turkey have stabilized since the May–June selloff** (Figure 1). Foreign investors cut their exposure to government securities and other lira assets by an estimated US$9 billion during May–June, fuelling sharp asset price declines. This reflected heightened global risk aversion, as well as domestic factors (widening current account deficit, increasing inflation, and political tensions). Buoyed by a strong central bank response and improved global market sentiment, portfolio inflows have since resumed, and lira, bond and equity prices have partially recovered. Domestic interest rates, however, have remained elevated and the yield curve steep, reflecting tighter monetary conditions and an increased risk premium.



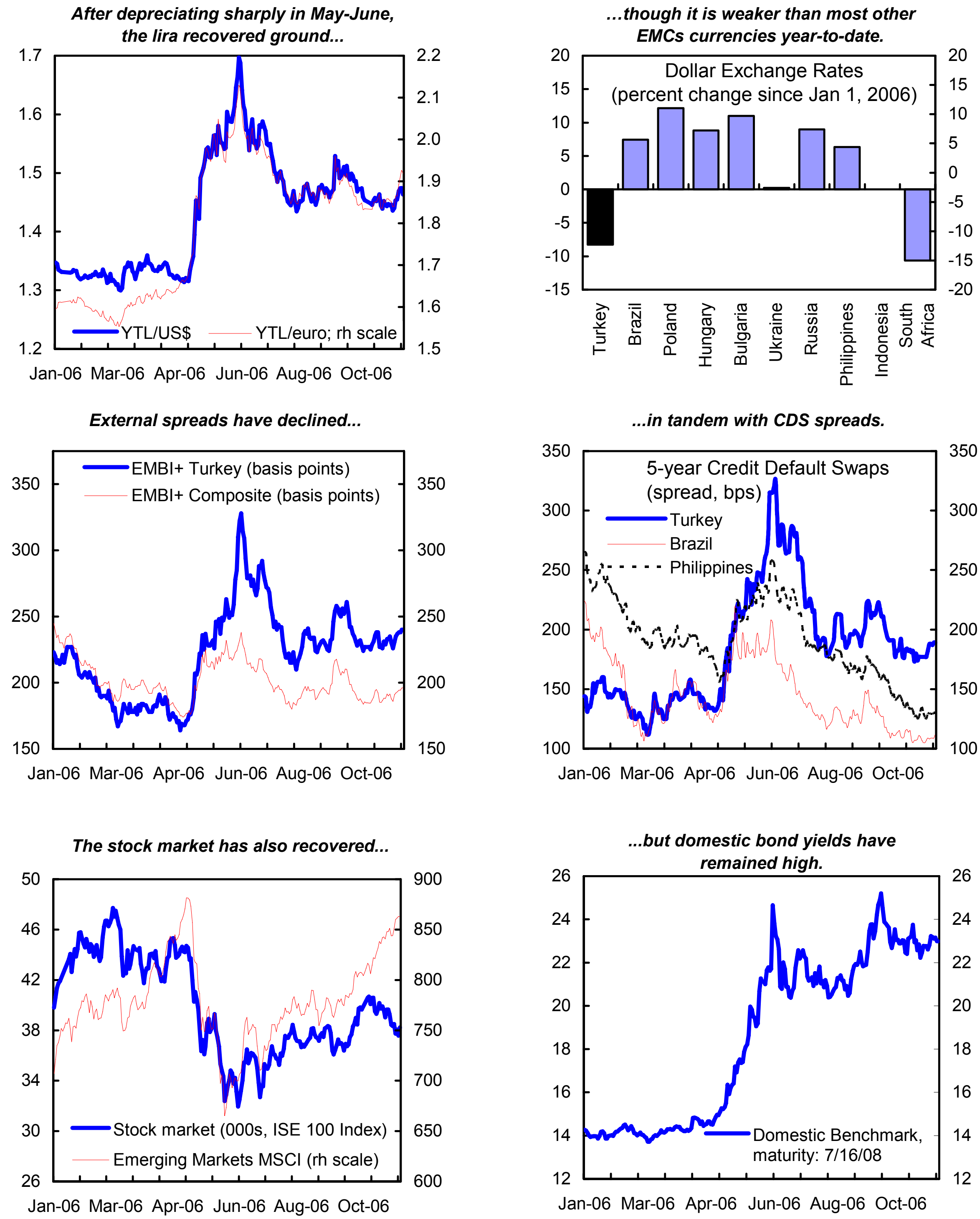




**Market Correction and Recovery in Turkey**

| Change in: | USD/TRY (in percent) | EMBI-Turkey (basis points) | CDS 5yr (basis points) | Lira bond yield (basis points) | Stock market (YTL, in percent) |
|---|---|---|---|---|---|
| May 1 to peak/trough | -22.6 | 164 | 192 | 911 | -27.4 |
| Peak/trough to Nov 21 | 16.4 | -93 | -141 | -131 | 20.0 |
| May 1 to Nov 21 | -9.9 | 71 | 51 | 780 | -12.9 |

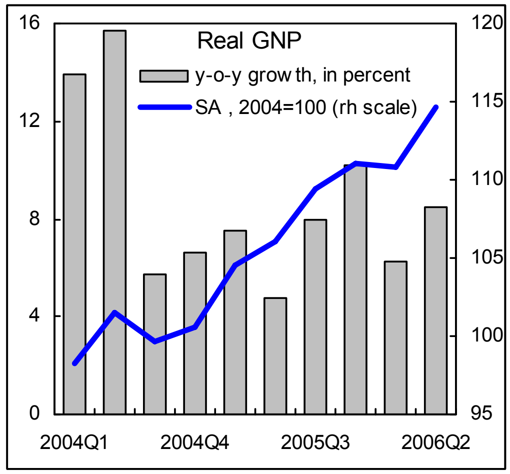
Source: Bloomberg.

Figure 1. Turkey: Financial Indicators, 2006
(In percent, unless otherwise indicated)




Sources: Bloomberg.

2. **Growth has proven resilient, although the current account deficit has widened further and inflation has remained well above target**.




- **Growth was strong** in the first half (7 percent, relative to the same period in 2005, Figure 2), with private consumption and investment expanding sharply. This reflected large capital inflows, declining interest rates, and rapid credit growth through May. Since then, large government spending increases compensated for a slowdown in private domestic demand driven by higher real interest rates and slower credit growth.

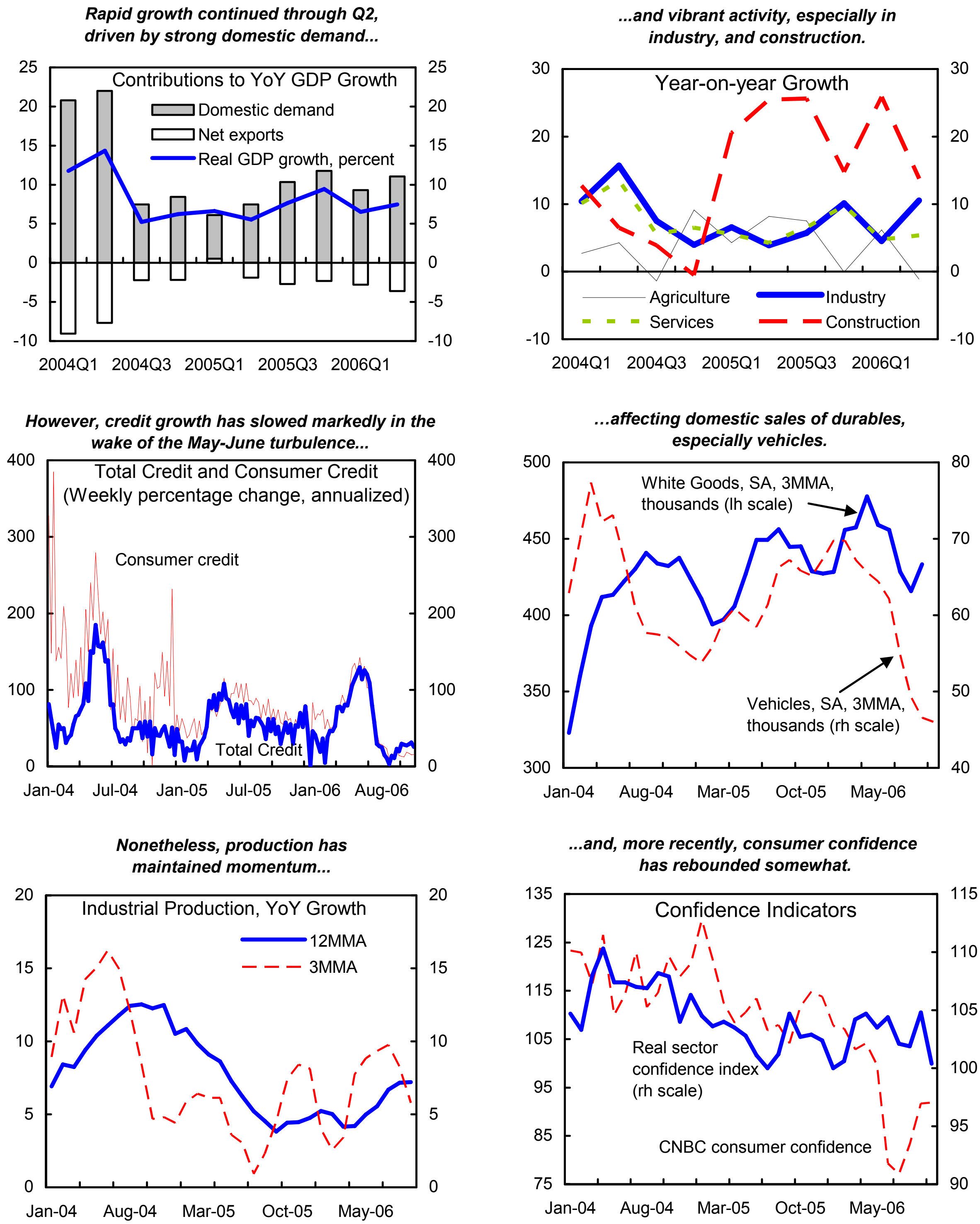
- Higher demand growth, still buoyant capital inflows, and a recent deterioration in the non-energy terms of trade have contributed to an even **wider current account deficit** (6.6 percent of GNP in the year to September, Figure 3). Export performance has been above program projections owing to higher external demand. Imports have also surprised on the upside reflecting resilient domestic activity and the lira's sharp appreciation since June. A key driver for the currency has been the buoyancy of capital inflows, underpinned by large FDI

**Main Macroeconomic Indicators, 2003–06**

| | 2003 | 2004 | 2005 | 2006 | |
|---|---|---|---|---|---|
| | | | | | Reference period |
| | (In percent of GNP, unless otherwise noted) | | | | |
| Real GNP y-o-y growth rate, percent | 5.9 | 9.9 | 7.6 | 7.7 | H1 |
| Domestic demand (contribution to GDP growth) | 8.9 | 13.9 | 9.1 | 11.0 | H1 |
| Net exports (contribution to GDP growth) | -3.1 | -4.9 | -1.7 | -3.6 | H1 |
| CPI, end of period (12-month percent change) | 18.4 | 9.4 | 7.7 | 10.5 | September |
| Central government primary balance | 5.0 | 5.1 | 5.0 | 6.3 | … 1/ |
| Net public sector debt | 70.4 | 63.5 | 55.3 | 46.6 | End-June |
| Gross public sector debt | 83.4 | 77.4 | 71.6 | 65.3 | End-June |
| Current account | -3.4 | -5.2 | -6.4 | -8.4 | 12 mo to Sept-06 |
| Non oil current account | 1.1 | -0.9 | -1.3 | -2.2 | 12 mo to Sept-06 |
| Exports, y-o-y change in value (percent) | 31.0 | 33.7 | 16.2 | 13.4 | Jan-Sept |
| Imports, y-o-y change in value (percent) | 37.6 | 39.4 | 11.6 | 17.8 | Jan-Sept |
| Terms of Trade, y-o-y percent change | 2.0 | 1.0 | -2.2 | -4.9 | Jan-Sept |
| FDI | 0.5 | 0.7 | 2.4 | 4.7 | Jan-Sept |
| Gross external debt | 56.6 | 50.5 | 47.0 | 50.2 | End-June |

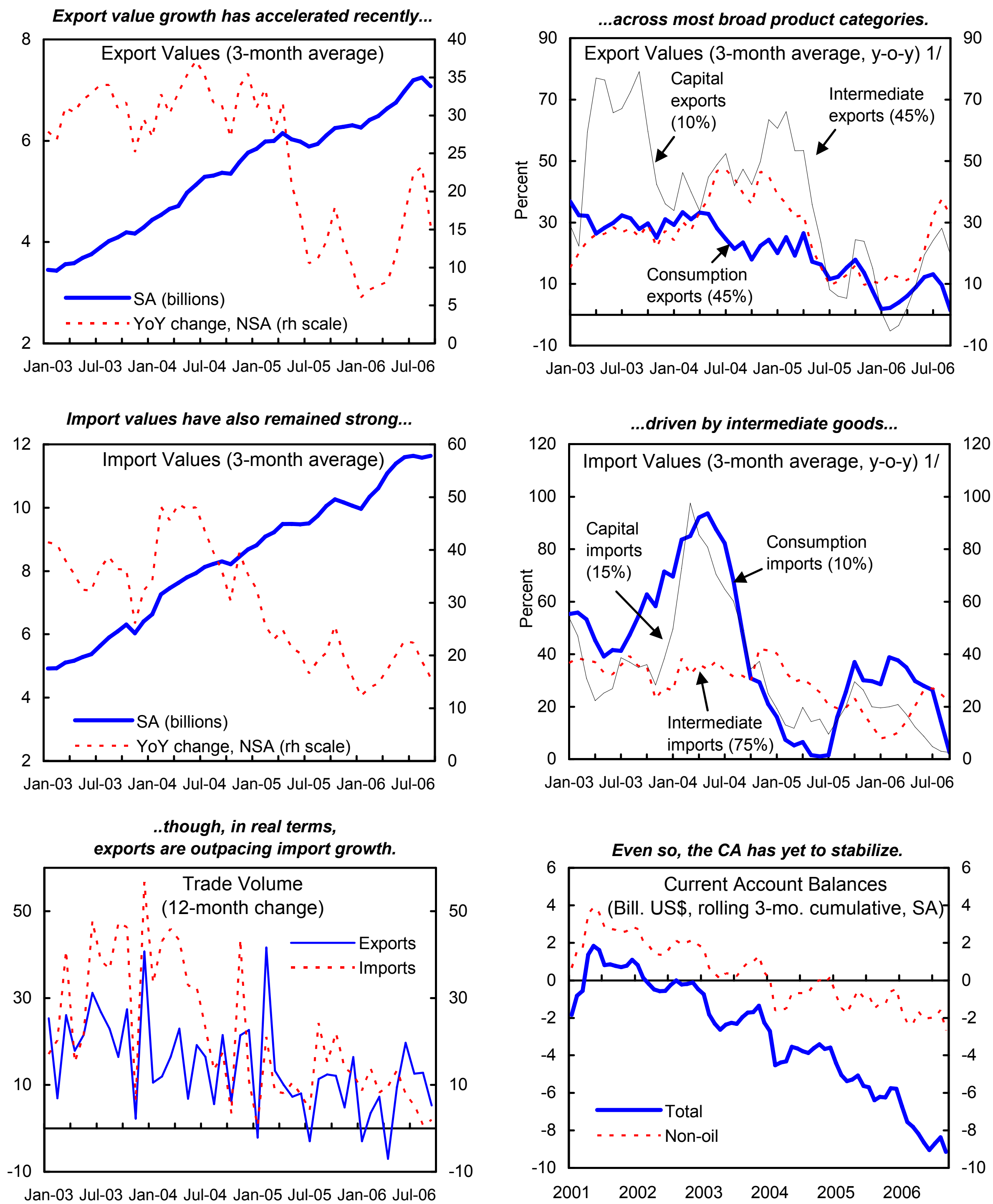
1/ Annual projection agreed with authorities, informed by realizations through August.

Figure 2. Turkey: Real Sector Indicators, 2004−06
(In percent, unless otherwise indicated)



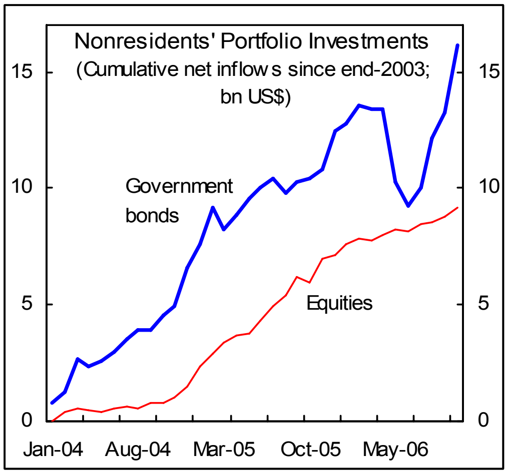

Sources: TurkStat; and Staff Estimates.

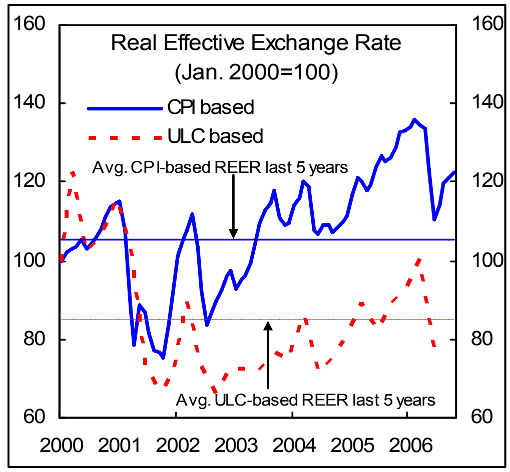
Figure 3. Turkey: External Sector Indicators, 2001−06




Source: TurkStat, WEO, and IMF Staff Estimates.
1/ Values in parentheses denote shares of total as of July, 2006.

and "hot money" investments by nonresidents into government bond and money markets (only temporarily interrupted during the May–June turbulence).




- **Inflation has remained in double digits** (Figure 4). The upper consultation band at end-September was breached by 2¾ percentage points. Helped by the lira rebound since the May-June turbulence, oil price declines, and subdued food prices, annual headline inflation eased somewhat in October (to 10 percent). However, underlying inflation remained elevated (core indicators continued to post increases) owing to robust domestic demand and service inflation inertia.

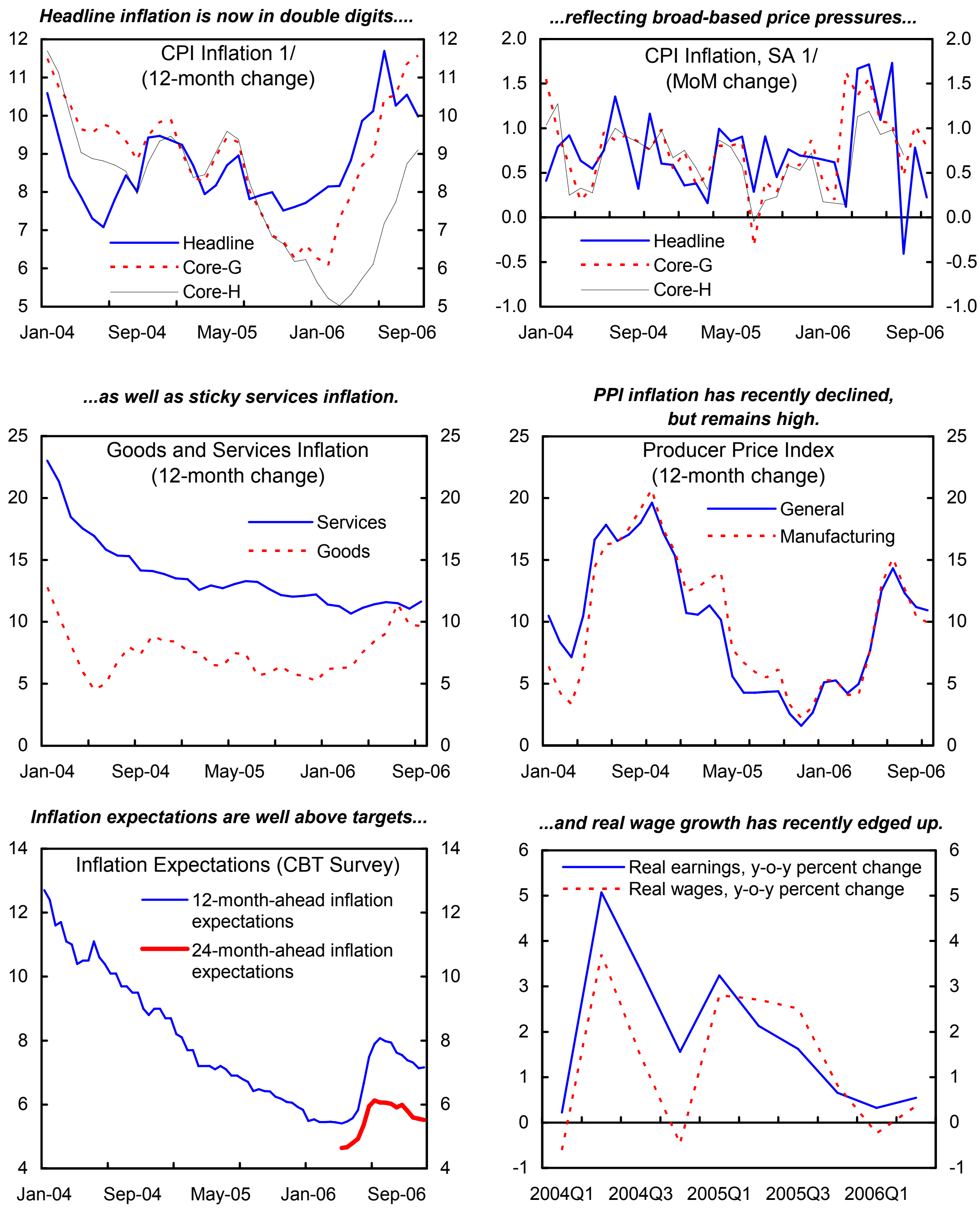
3. **Balance sheets appeared to have weathered well the May–June turbulence**.

➢ The **banking system** has withstood losses from higher interest rates (due to maturity mismatches) and weaker lira (net fx open position, Box 1). However, it was still too early to assess the potential for losses from banks' loan portfolios, with exposures to corporates carrying large fx liabilities being a key risk.

➢ The **public sector net debt** ratio has continued to decline, reflecting the partial recovery in the exchange rate since the May–June turbulence, a high primary fiscal balance, and large privatization proceeds. Nonetheless, higher interest rates have resulted in a heavier public debt service burden, the impact of which will be fully felt in 2007.

4. **The political backdrop is becoming less supportive**. With the nearing of elections—Presidential selection by parliament in May and general elections by next November at the latest—fiscal pressures are emerging. In addition, EU relations have become more tense. The November progress report was critical of reform delays and urged Turkey to comply with the customs union treaty. Without progress in this area, accession negotiations risk losing momentum.

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




Sources: TurkStat; and Central Bank of Turkey.

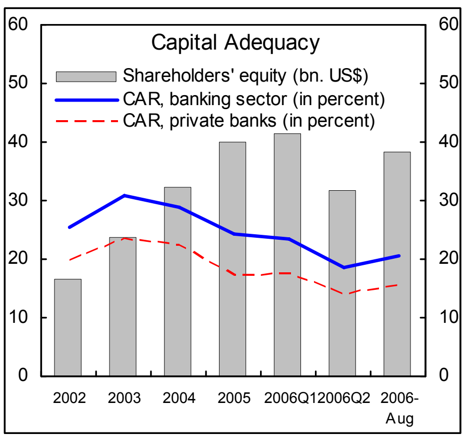
1/ Index "G" excludes energy, alcohol, tobacco, unprocessed foods and other products with administered prices (all indirect taxes on the components of this index are excluded as well). Index "H" is same as "G", apart from excluding gold prices and including products with administered prices.

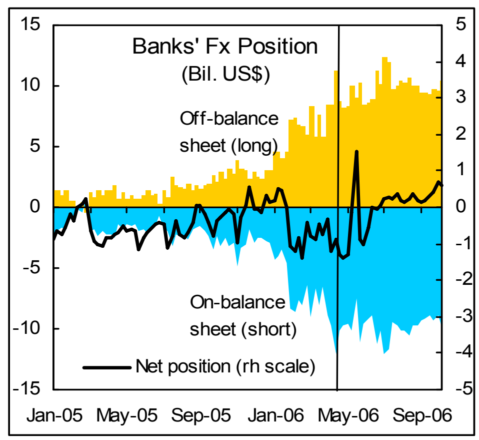
**Box 1. Turkey: Impact of the May−June Turbulence on the Turkish Banking System**

**The May–June market turbulence tested the resilience of the Turkish banking system**. Within a span of seven weeks, the lira depreciated by close to 20 percent and bond yields rose by more than 800 basis points. Although markets subsequently regained ground, these price swings had the potential for seriously damaging balance sheets, given banks' large maturity mismatches, open fx positions, and exposure to credit risk.

**So far, the banking sector has weathered the impact of the turbulence relatively well**:

- ***Capitalization***. In the wake of the market turmoil, banks experienced losses mainly from having to mark to market fixed-rate government securities held in trading portfolios. As a result, the overall capital adequacy ratio fell from 23.1 percent in April to 20.5 percent in August.
- ***Profitability***. With *available for sale* portfolio losses not booked in the banks' profit-and-loss accounts, the market disturbance did not have a discernible adverse impact on standard profitability indicators.
- ***NPLs***. Recent data indicate no evident increase in non-performing loans (in absolute terms, and as a percentage of total loans—3.8 percent in August). These indicators, however, tend to capture problems with credit quality with a significant lag.
- ***Loans***. Lending growth slowed sharply (particularly for housing), mainly reflecting lower demand due to higher interest rates. As a result, banking sector assets remained flat between May and August.
- ***Deposits***. The turbulence halted the de-dollarization trend, with the share fx deposits increasing slightly to 37 percent in August, from 35 percent in April.



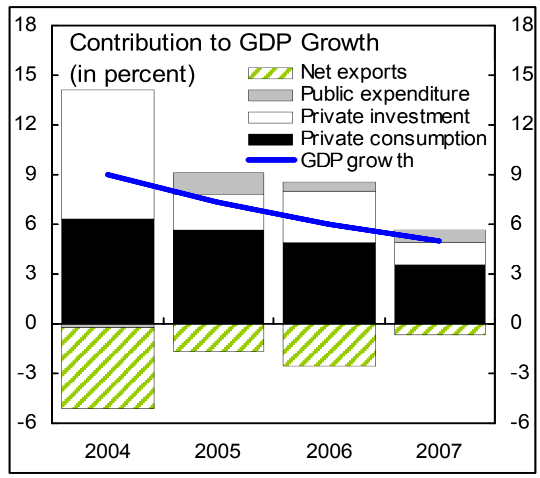

**Several factors have helped mitigate the negative effect of the turbulence on Turkish banks**. First, the starting balance sheet position of the sector was strong, with capital adequacy and provisioning well above regulatory minima, and non-performing loans down to very low levels. Second, losses from the lira depreciation were not as large as in the past, given that the large on-balance sheet short fx position was almost fully hedged off-balance sheet, leaving the net open fx position comparatively small. (As a group, private banks suffered more, reflecting their larger currency exposure before the turbulence.) Third, some banks were shielded from the increase in interest rates by holding fixed rate securities in the held-to-maturity portfolio (which did not need to be marked to market) and carrying floating rate notes.

**The full effect of the turbulence, however, may take longer to materialize**. The deterioration in credit quality over time will depend on the resilience of borrowers' balance sheets, especially of corporates with large fx liabilities. Moreover, higher interest rates may keep lending (and balance sheet) growth subdued in the coming quarters, thereby putting pressure on profitability.

# III. Policy Discussions

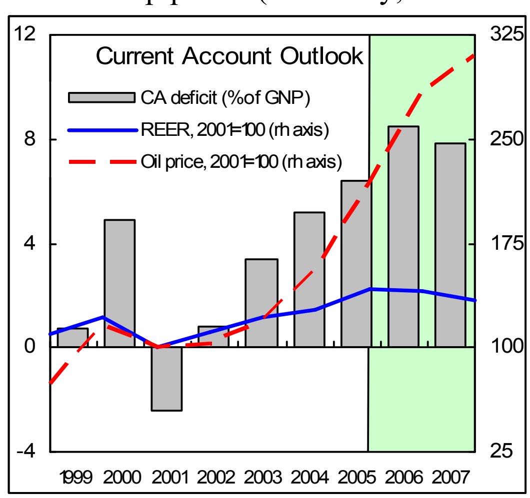
## A. Revised Macroeconomic Framework

5. **It was agreed that recent developments warranted revisions to the program's macroeconomic framework** (¶6−8, Table 4).[1] In particular, improvements in market sentiment and buoyant capital inflows had led to a more appreciated lira (some 13 percent in nominal terms) relative to the third- and fourth-review baseline projections (IMF Country Report No. 06/402):




- **Stronger growth**. Given the scale of the earlier financial market turbulence, growth had surprised on the upside. Available coincident indicators, while suggesting a slowdown, indicated that overall growth could well reach 6 percent this year. With higher interest rates and slower credit, next year's growth was projected to decelerate to 5 percent (broadly in line with potential). Private investment was expected to slow, and growth to become more reliant on external demand and public spending.

- **Higher inflation**. With the effects of the stronger-than-envisaged lira and domestic demand broadly offsetting each other, it was agreed to leave this year's inflation projection unchanged at 10 percent—well above the upper end of the consultation band. Next year's inflation outlook remained challenging, with growth expected to be close to trend, strong evidence of inflation inertia (especially in services), elevated inflation expectations, and one-off price increases in the pipeline (electricity, natural gas, tobacco). Thus, staff cautioned that, under unchanged policies, inflation would converge only gradually to the 4 percent target, ending 2007 just below the 6 percent upper consultation band.



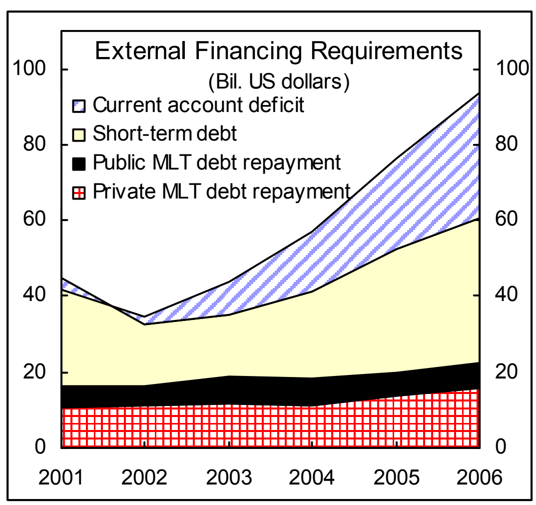

- **Wider current account deficit** (Table 5). Lower tourism revenues and the stronger-than-envisaged lira and domestic demand, together with some recent deterioration in the non-energy terms of trade, were expected to more than offset recent oil price weakness. The current account deficit would therefore likely widen to

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

8½ percent of GNP in 2006 (historical data revisions also added to the deficit). For 2007, the current account was expected to benefit from the full effects of the year-to-date weaker lira and the softening of private domestic demand (though the deficit would still be above earlier program projections). In the medium term, staff continued to expect the deficit to decline gradually, as the non-oil current account moved into balance. As a result, despite the adverse impact of the year-to-date lira depreciation on the external debt burden, gross external debt ratios would remain flat over the medium term, after a small jump in 2006 (Appendix II). International reserve coverage of short-term debt would stay below 80 percent.

6. **The 2007 outlook remained highly uncertain**. The risks to growth (and, hence, the current account deficit) were seen as evenly balanced: slowing global growth and renewed financial market volatility were the key downside risks, and larger-than-assumed capital inflows leading to stronger domestic demand was the main upside potential. Prospects for the current account would also depend crucially on an uncertain oil price outlook (every US$1 increase in oil prices would add almost 0.1 percent of GNP to the deficit). At the same time, there was broad consensus that the risks to the inflation outlook remained tilted to the upside. In particular, the potential for a lower-than-projected inflation outturn from a weakening in global growth, an appreciation of the lira, or an easing of oil prices was seen to be outweighed by a number of upside risks to inflation. These included (i) a less pronounced slowdown in domestic demand due to government spending increases or a weaker-than-expected monetary transmission mechanism; (ii) shifts in appetite for global risk leading to a weaker lira; (iii) continued inertia in services inflation (one-third of the CPI basket); (iv) civil service-led wage pressures; and (v) cost-push inflation from hikes in energy prices.

7. **Turkey's large financing requirements made it particularly vulnerable to a sudden stop in capital inflows** (Box 2 and Table 6). Weaker fundamentals than in other emerging market countries (a large and widening current account deficit; a still high gross public debt ratio tilted towards instruments with adjustable rates or short maturities; and an uncertain inflation outlook) exposed Turkey to a sudden reversal of capital inflows. These vulnerabilities were amplified by Turkey's hefty near-term public and external financing requirements (respectively, 30 and 27 percent of GNP) and still high degree of liability dollarization (especially, corporates' large net open foreign exchange position, estimated at 10 percent of GNP—see Appendix IV of IMF Country Report No.06/402). Moreover, large foreign investor positions ("hot money") in the government bond and money markets (estimated at around 9 percent of GNP), amid less supportive political and global economic environments, made Turkey very sensitive to shifts in market sentiment.

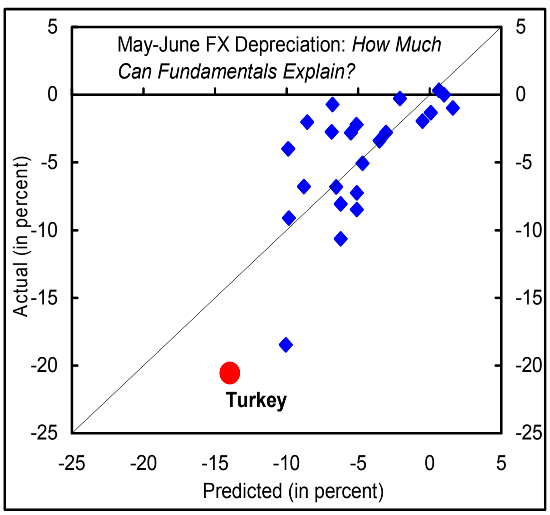


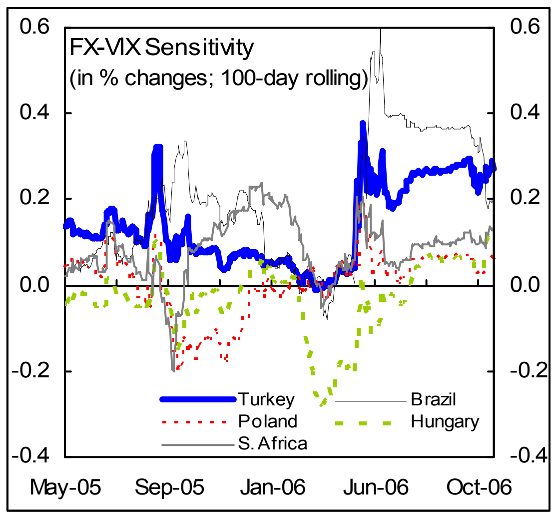
**Box 2. Turkey: Vulnerabilities**

**Turkey's vulnerabilities reflect the country's comparatively weak fundamentals, unfavorable investor base and positioning, and high sensitivity to shifts in global market sentiment**:

***Fundamentals***. Based on fundamentals, Turkey is more vulnerable than most emerging markets. Staff analysis suggests that three factors—current account deficit, real currency overvaluation (as measured by deviations of the REER from long-run trend), and past credit growth—can largely explain why financial markets in some countries were more affected than others during the May-June market turbulence. (About half of the variation in currency responses across 23 emerging markets could be attributed to these variables). From this perspective, it is hardly surprising that the lira came under heavy pressure, as Turkey's current account deficit, real overvaluation, and credit growth were among the highest in large emerging markets. Other less favorable fundamentals (low reserve cover, high public debt, uncertain inflation outlook, high degree of dollarization) and political risks also leave Turkey susceptible to abrupt changes in investor sentiment (Figure 5).

***Investor base and positioning***. With the resumption of "carry" trades, foreign investors have rebuilt positions in the domestic bond and money markets that are reportedly among the most popular in the region. Moreover, anecdotal evidence suggests that recent inflows have been mostly due to "hot" money (volatile, leveraged, with short-term focus) rather than "real" money (more stable, with medium-term focus). Therefore, even a temporary deterioration in domestic or external conditions could lead to a quick liquidation of long lira positions, with deleterious effects on Turkey's overall financial market performance.

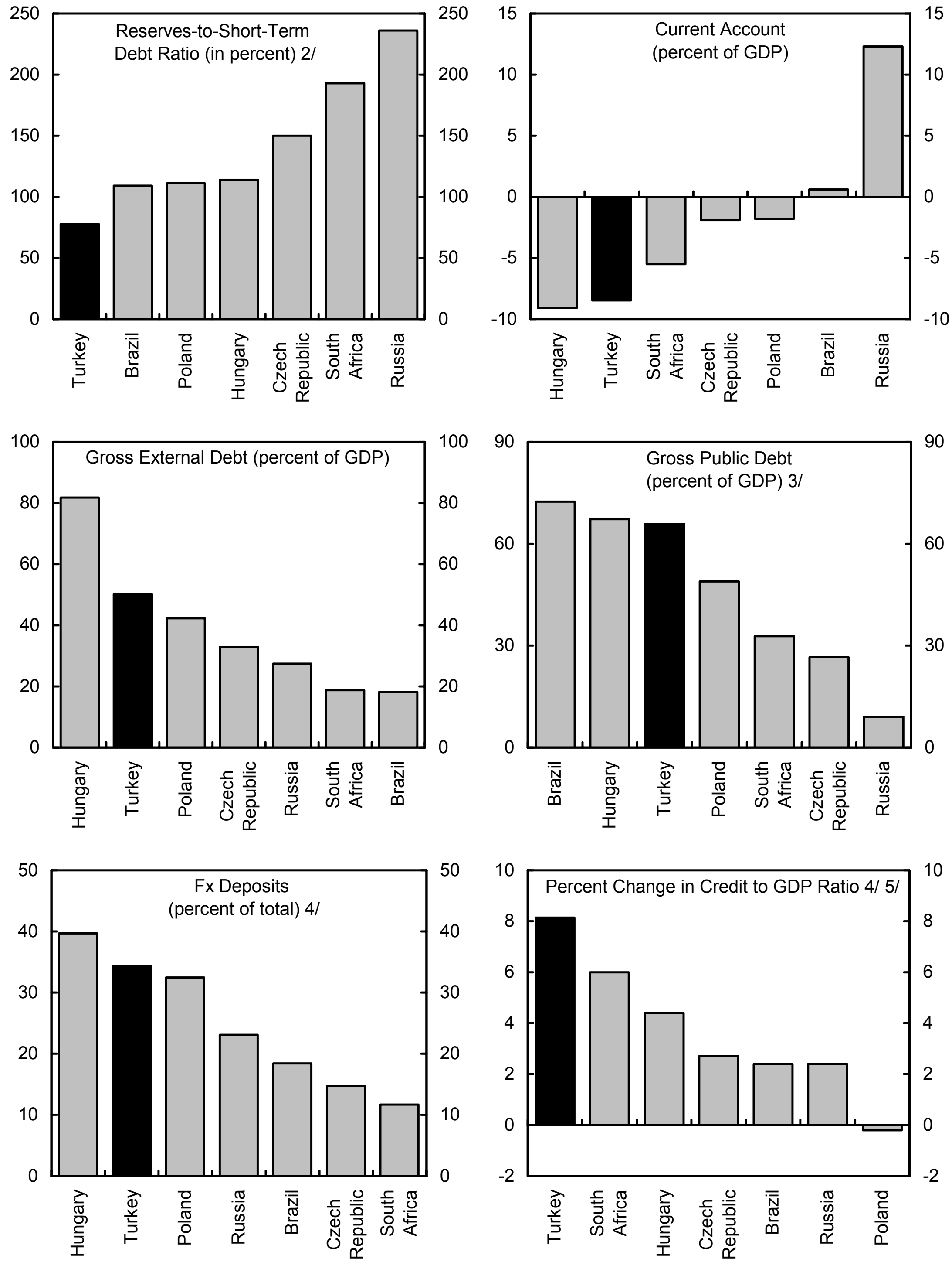



***Market sentiment***. Turkey's financial markets are highly susceptible to changes in global market sentiment. For example, staff analysis (based on daily rolling regressions) shows that the lira has become more sensitive than other EM currencies to changes in global risk aversion, as proxied by the VIX. Hence, a sharp change in foreign investor risk appetite is more likely to affect Turkey than most EM countries.

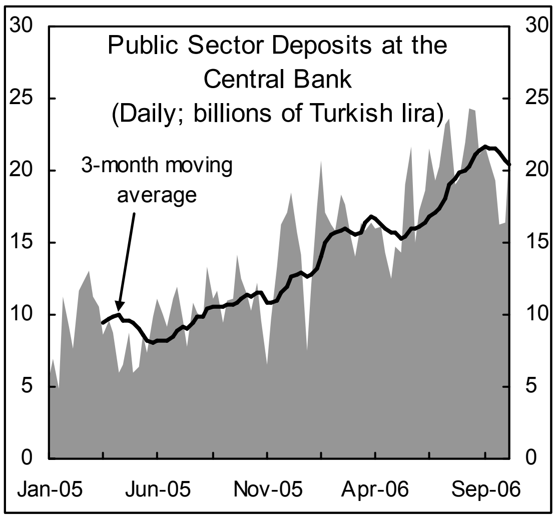
**A potential investor exit could be triggered by various events**. On the external side, the turning point could be a pickup in risk aversion (due to a further tightening of global liquidity conditions or concerns about global growth) or market jitters in another emerging market (similar to the lira contagion from last September's political tensions in Thailand, Hungary, and Poland). On the domestic side, the trigger could be tensions related to next year's elections or EU accession, or policy missteps.

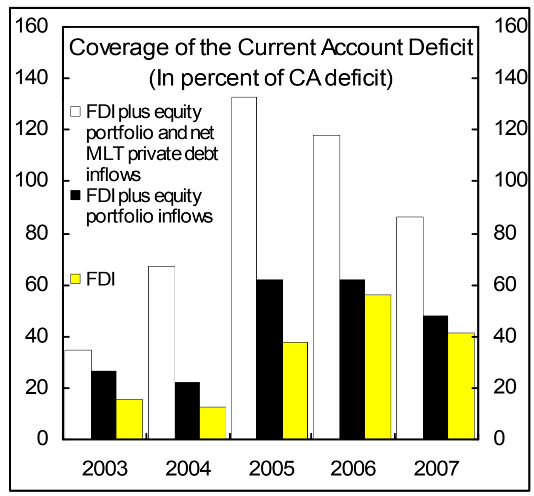
Figure 5. Cross-Country Vulnerability Indicators, 2006 1/




Source: IMF staff estimates.
1/ Projections for 2006.
2/ External Debt on remaining maturity basis. Gross international reserves are end of previous year stocks.
3/ Consolidated public sector for Turkey and Brazil.
4/ Data as of 2005.
5/ Credit to the private sector.

8. **Stronger balance sheets and a robust policy framework were mitigating factors**. The public debt ratio had continued to decline and was resilient to most shocks (Annex III). And, although its short-maturity composition exacerbated rollover risks, the much-increased Treasury deposits at the CBT provided a useful liquidity buffer.[2] The quality of external financing had also improved on the back of record FDI (privatization and acquisition activity) and the maturity lengthening of debt flows—however, reserve coverage remained low (Table 7). Bank balance sheets appeared resilient, though cushions had been partly eroded by the May-June turbulence. Importantly, the authorities' commitment to preserving the flexible exchange rate regime, enhancing international reserve buffers, and pre-financing the government's external requirements were crucial in alleviating financing pressures. Their perseverance with prudent fiscal policies and continued enhancements in the bank supervisory framework were also key in containing vulnerabilities.




## B. Fiscal Policy and Debt Management

9. **Comforted by large unexpected one-off revenues, the authorities had allowed substantial overspending relative to program understandings** (¶11, Tables 8−9). Exceptional arrears collections—including from former bank owners and social security participants—would reach 1¼ percent of GNP. Underlying revenues were also generally strong. This overperformance was only in part being saved—contrary to program commitments—with spending overruns (0.8 percent of GNP, absent corrective measures) concentrating not only on health, but also on agricultural subsidies, personnel, and defense. Despite overspending, the primary surplus was likely to exceed 7 percent of GNP in 2006.

[2] Even with external financing plans (Eurobond issues, Fund program purchases) on track, meeting next year's gross financing requirements of the public sector meant targeting a domestic debt rollover rate of about 75 percent.

10. **Pointing to the large overperformance on the primary surplus target, the authorities would commit to reversing only part of the projected spending overruns** (¶11–12). Noting that it was too late in the year to do any more, the authorities agreed to block 0.2 percent of GNP in appropriations. As a safeguard, any overruns relative to the revised end-2006 spending ceiling would be offset fully during 2007. Recognizing that much of the overspending was on health (and that the earlier administrative measures had failed to deliver the desired savings), the authorities also committed themselves to taking fundamental actions to minimize the risk of future overruns in this area. These actions included (i) passing legislation to facilitate adjustment of copayments; (ii) changing the structure of compensation in state hospitals to generate efficiency gains in the production, provision, and utilization of health care services; and (iii) increasing capacity at primary health care centers (which provided health services at lower costs than hospitals).

11. **For 2007, the authorities reaffirmed their commitment to target a headline primary surplus of 6.5 percent of GNP** (¶13–14). Preserving this target was made difficult by next year's projected losses from accounting changes and a generous civil service wage award (which would increase 2007 personnel costs by 0.3 percent of GNP), as well as limited political support for containing the growth in current spending.[3] Thus, securing the primary surplus target required difficult measures, including (i) scaling down the desired increase in the investment envelope; (ii) slowing down the pace of hiring in the civil service (structural benchmark); (iii) limiting the increase in nominal tax brackets to the mandatory minimum; and (iv) substantially raising electricity and natural gas retail prices to improve the financial performance of state enterprises and achieve the programmed adjustment outside of the central government. The authorities renewed their general commitment to save revenue overperformance. However, there was agreement that consideration could be given during future reviews to using some revenue overperformance to cut financial transaction or labor taxes, or finance high-priority investment spending, conditional on improved outlooks for the current account and inflation.

**Consolidated Fiscal Accounts: Public Sector, 2005-07**

(In percent of GNP)

| | 2005 Est. | 2006 Proj. | 2007 Prog. |
|---|---|---|---|
| *Headline primary surplus* | *6.2* | *7.5* | *6.5* |
| **On a comparable basis** | **6.1** | **7.2** | **6.5** |
| **I. Central government and social security** | **4.8** | **6.3** | **5.0** |
| **Revenue** | **34.3** | **36.4** | **35.8** |
| Central government revenue | 28.1 | 29.2 | 28.9 |
| Tax revenue | 24.5 | 24.5 | 25.0 |
| Nontax revenue | 3.6 | 4.7 | 3.8 |
| Social security revenue | 6.2 | 7.2 | 6.9 |
| **Expenditures** | **29.5** | **30.1** | **30.7** |
| Central government expenditure | 16.5 | 16.8 | 17.3 |
| Personnel | 7.1 | 6.7 | 7.0 |
| Goods and services | 2.3 | 2.3 | 2.4 |
| Transfers (excludes those going to SSI) | 5.1 | 5.9 | 5.9 |
| Capital expenditure | 2.1 | 1.9 | 2.0 |
| Social security expenditure | 13.0 | 13.3 | 13.4 |
| *Of which:* pension | 8.0 | 7.9 | 8.0 |
| *Of which:* health | 3.5 | 4.0 | 4.0 |
| **II. Rest of public sector (state enterprises, etc.)** | **1.3** | **1.0** | **1.5** |

[3] The accounting of shared revenues transferred to local governments would change in 2007 so that the measured public sector surplus would fall by 0.2 percent of GNP, without any real change in fiscal stance. The public sector would also lose more than 0.2 percent of GNP in dividend revenue from privatized enterprises.

12. **Even with a headline primary surplus of 6.5 percent of GNP, next year's fiscal stance would be somewhat expansionary**.[4] While a tighter overall stance would have been desirable to contain macroeconomic risks (high inflation and current account deficits), its credibility would have been doubtful, as this would have required increasing an already high tax burden or executing politically sensitive and difficult-to-sustain cuts in current spending.

**Fiscal Policy Stance: Public Sector**
(In percent of GNP)

| | | 2005 | 2006 Proj. | 2007 Proj. |
|---|---|---|---|---|
| A. | Headline Consolidated Primary Surplus | 6.2 | 7.5 | 6.5 |
| B. | Adjusted Consolidated Primary Surplus 1/ | 6.0 | 6.6 | 6.5 |
| C. | Interest Bill | 7.0 | 7.2 | 7.5 |
| D. | Overall balance (=B-C) | -1.0 | -0.6 | -1.0 |
| E. | Fiscal stimulus (adjusted for cycle) from: | | | |
| | Primary balance (line B) | 0.7 | -0.5 | 0.2 |
| | Overall balance (line D) | -4.0 | -0.3 | 0.5 |
| **Memo item:** | | | | |
| Output gap ("+"=actual below potential) | | 0.3 | 0.0 | 0.0 |

1/ On a comparable central government basis. For 2005, mapping from consolidated budget to central government approximated. 2006 adjusted down for extraordinary collection of tax arrears from former bank owners (0.8 percent of GNP).

13. **The pressures on current spending were again pre-empting desirable cuts in tax rates**. With buoyant underlying revenues (next year's consolidated revenues were projected to rise by more than ½ percent of GNP after adjusting for one-off effects), current spending was allowed to continue to increase in 2007 (by some ½ percent of GNP). The effect of large civil service wage hikes had been compounded by commitments, under the new pension law, to pay substantially larger social security premiums on behalf of civil servants.[5] Agricultural subsidies, while declining as a share to GNP relative to the revised 2006 projection, would be 0.1 percentage point higher than programmed for 2006. Finally, even with agreed measures, health spending pressures would likely remain an issue over the medium term, given Turkey's still comparatively low access to health services. Therefore, cuts in distortionary financial transactions taxes or in the high labor tax wedge, needed to make the economy more competitive, had to be postponed. Staff warned that Turkey's impressive fiscal performance was unlikely to be sustainable without a marked improvement in budget quality.

14. **From this perspective, the authorities' commitment to set in train a long-overdue civil service reform package was welcomed by staff** (¶14). Though action here would likely not be possible until early 2008, it was envisaged that, inter alia, the reform would (i) synchronize wage decisions more closely with budget preparations; (ii) preventing further compression of the pay scale (which had significantly distorted work incentives); and (iii) simplify the pay structure and bring almost all components of the wage into the tax base. While such a reform could entail short-term costs, it would, over time, help improve the efficiency of the civil service and, together with efforts to slow the pace of hiring civil servants, bring the wage bill under control.

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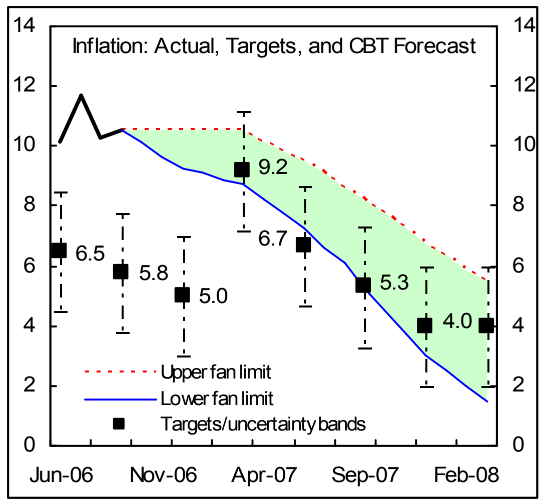
[4] Measurement of the fiscal impulse was complicated by accounting changes and large one-off tax arrear collections, the bulk of which were not contractionary as they were financed by selling seized assets to foreign investors.

[5] The law commits the government to pay additional premiums in its capacity as employer and, for two years, to compensate civil servants for the increase in their employee premiums on account of the base broadening.

15. **On debt management, Treasury continued to adjust its debt issuance strategy as market developments improved**. Fixed-rate lira bonds had been reintroduced in tandem with renewed inflows by foreign investors. The authorities had also carried out their first Eurobond swap—extending the maturity of the outstanding portfolio and raising additional cash—and had surpassed their annual Eurobond issuance target of US$5.5 billion. Going forward, the authorities intended to pre-finance 2007 external requirements and lengthen further debt maturities. Staff welcomed these steps, as well as the renewed close cooperation between Treasury and the CBT in managing lira liquidity.

## C. Monetary and Exchange Rate Policies

16. **Despite the challenging inflation outlook, understandings were reached on keeping the inflation targets for 2007 and beyond at 4 percent**. Existing program consultation bands of 2 percentage points on either side of the central target would also be retained. Even though the 4 percent target would likely be exceeded in 2007, inflation was expected to converge to target during 2008. Barring major new shocks, the central bank projected with 70 percent probability headline inflation to be in a range of 1.7–5.2 percent by the first quarter of 2008. (This was based on the assumption of constant interest rates until the last quarter of 2007 and a gradual easing thereafter.) Thus, staff and the CBT thought the credibility and anchoring of expectations would be better served by leaving the targets unchanged than by a change. This view was unanimously shared by market analysts. (The experience of other inflation targeters that had undergone inflation overshooting was varied in terms of changing targets, leaving little clear guidance for Turkey.)

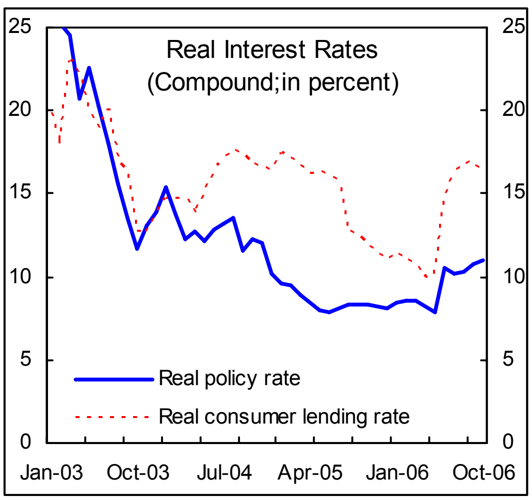


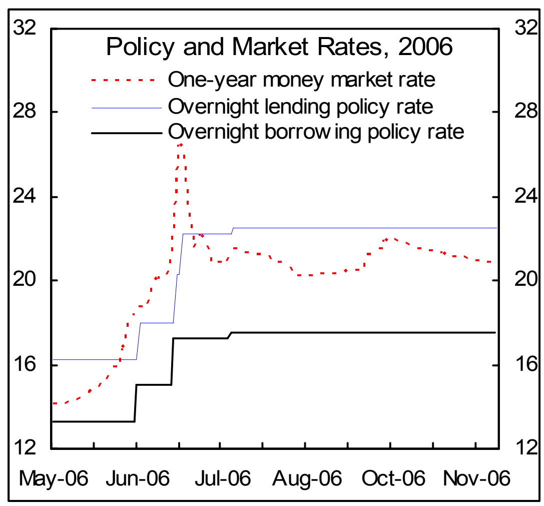

**Inflation Overshooting Episodes in Selected Inflation Targeting Countries**

| Country | Overshooting | Target adjusted? | Note |
|---|---|---|---|
| Brazil | 2001-03 | Yes | Target and band width adjusted slightly twice |
| Colombia | 2002-04 | No | |
| Hungary | 2003-04 | No | |
| Iceland | 2001-02 | No | An inflation target of 2.5% was adopted in 2001 with tolerance limits of +/-1.5%. The upper tolerance was asymmetrical for the first two years at 6% in 2001 and 4.5% in 2002. |
| Iceland | 2006 | No | |
| Israel | 2002-03 | No | |
| Israel | 2006 | No | |
| Mexico | 2004-06 | No | |
| New Zealand | 1991 | No | |
| New Zealand | 1994-96 | Yes | Target range widened to 0-3 percent (from 0-2 percent) at end-1996 |
| New Zealand | 2000-01 | No | |
| New Zealand | 2005-06 | No | |
| Peru | 2004 | No | |
| Philippines | 2004-06 | Yes | 2005 target adjusted up from 4-5 to 5-6 percent |
| Poland | 2000 | Yes | 2001 target shifted up from 5.4-6.8 to 6.0-8.0 percent |
| Poland | 2004-05 | No | |
| South Africa | 2002-03 | Yes | Targets for 2004 and 2005 adjusted up from 3-5 to 3-6 percent |

Sources: Central bank websites and IMF staff reports.

17. **Given the challenging inflation outlook and significant upside risks, a tight monetary policy stance was required** (¶9, Tables 10–11). Staff noted that, with inflation risks tilted to the upside, little evidence that underlying inflation was receding, and a subdued response of medium-term inflation expectations to earlier policy rate hikes, a case could have been made for raising policy rates further in September and October. The CBT, however, argued that real interest rates were already very high and expected the impact of this tight monetary stance on economic activity and, hence, on inflation to become more evident over the coming quarters. Moreover, immediate rate hikes could be counterproductive after the pause, as the policy shift could confuse markets. In the event, both sides agreed that, in the current circumstances, the central bank should adopt an explicit tightening bias. Specifically, while the central bank would remain focused on incoming data, future policy responses would be asymmetric, with less attention given to favorable developments in the inflation outlook and greater attention given to adverse developments, such as evidence that domestic demand was stronger than expected (due, for example, to increased government spending or credit growth).




18. **Understandings were reached on ways to raise the effectiveness of the communications policy**. This was crucial, given the overshooting of inflation targets in coming months. The CBT pledged to explain in a timely and clear manner the reasons for deviations from the inflation targets and any corrective actions (analysts had praised the CBT's recent open letters on inflation). To enhance two-way communications with markets and to facilitate a more timely release of key documents in English, the central bank was considering setting up a professional public relations team and hiring additional translators.

19. **On intervention, foreign exchange reserve purchase auctions were restarted in November** (¶10). There was agreement that prudential considerations called for the resumption of foreign exchange auctions (they had been suspended during last May's market turbulence). In particular, the ratio of reserves to short-term debt was well below unity and expected to worsen, and, without the early resumption of auctions, NIR would have shown a declining trend, adding to vulnerabilities. As for discretionary intervention, the CBT restated its commitment to limit such intervention to cases where the currency markets were volatile and illiquid.

## D. Structural Fiscal Reforms

20. **Implementing the new pension parameters in a timely way and controlling health spending pressures were essential to securing Turkey's medium-term public finances** (¶15). The authorities had made progress toward unifying the three social security institutions—common databases and management were being developed. It was recognized, however, that work needed to accelerate to ensure that the new pension parameters could be implemented by the start of 2007, as planned. Staff also underscored the importance of ensuring the fiscal sustainability of the Universal Health Insurance framework. In this regard, it welcomed the deployment by the start of 2007 of the efficiency savings measures embedded in the new framework, including the introduction of copayments on hospital treatments, family medicine, and referral systems. The authorities agreed to monitor health spending developments closely, and take remedial actions (including a further increase in copayments) if spending pressures increased.

21. **Good progress had also been made on tax administration—this now needed to be accompanied by greater efforts to strengthen social security contribution collection** (¶16). Tax policy was increasingly being carried out by the new Tax Policy Unit. The functional restructuring of the Revenue Administration had been completed and good progress was being made towards starting operations of the Large Taxpayers' Unit by January 1, 2007. Further work was needed, however, including on staffing, training, and other operational issues. While social security contributions had picked up following the launch of the arrears restructuring framework and the outsourcing of collections, enforcement capacity needed to be strengthened. The authorities, therefore, pledged to introduce a new system for paying salaries through bank accounts and to take other steps in line with previous technical assistance recommendations (including, expanding the employer audit program, developing risk assessment techniques, and prioritizing arrears based on ability to collect).

22. **Second-stage personal income tax reforms—aimed at further simplifying the tax code and broadening the tax base—had suffered further delays** (¶17). New legislation will be submitted to Parliament soon (prior action), and approval was now expected to follow in early 2007 (structural performance criterion). The authorities ascribed the latest holdup to the need for more time to work with key stakeholders and forge consensus. The legislation would introduce a standard tax credit in lieu of consumption credits, broaden real estate capital gains taxation, and give the Revenue Administration more audit powers. Also on tax reform, it was agreed that the planned mortgage law would not provide tax deductibility of interest payments and that the authorities would continue to refrain from introducing ad hoc initiatives and sectoral tax cuts.

## E. Financial Sector Reforms

23. **The authorities planned to step up bank oversight** (¶20, Table 12). The BRSA had taken some comfort from the resilience of the banking system in the wake of the May–June turbulence. Nonetheless, in light of continued interest rate and credit risks (rapid expansion of retail lending and corporates' large foreign currency exposures), bank monitoring would intensify, with emphasis placed on building up prudential buffers. Consistent with this approach, general provisioning requirements had been doubled to 1 percent on new loans,

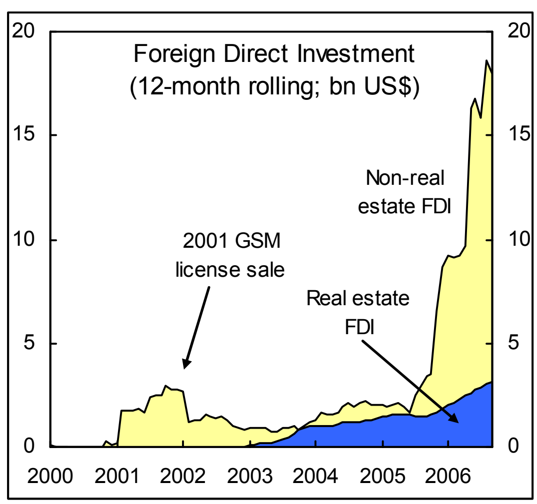
even though for existing loans they remained low compared with other emerging market countries. The BRSA was also considering tightening capital adequacy requirements (by setting a target CAR of 12 percent), with a decision expected soon. With supporting regulations for the banking law having been issued, the main challenge was to ensure the early adaptation of supervisory practices in line with the new law, particularly for credit risk management and consolidated supervision. As the FSAP work was nearing completion, the authorities planned to use its findings to draw up reform priorities in these areas.

24. **It was acknowledged that the envisaged mortgage law could have large beneficial effects, though risks needed to be monitored carefully** (¶22). By allowing variable interest rate loans, the new mortgage framework would enhance the pool of long-term loanable funds, thereby deepening financial intermediation and supporting growth. It would also allow banks to control more effectively their liquidity and maturity risks by promoting a secondary market for asset-backed securities. Staff therefore urged the authorities to proceed with this important legislation as soon as practicable and to avoid delays in issuing implementing regulations. Given the potential for the new framework to accelerate credit, staff also welcomed the decision to restrict mortgage lending initially to banks and to the financing of purchases of dwellings.

25. **The privatization of state banks was entering a decisive phase** (¶21). The Privatization Agency will soon announce the timetable for the block sale of Halkbank, the seventh-largest bank in Turkey (prior action). The sale process was expected to be relatively short—about a month to prequalify potential investors, with two additional months for due diligence, before the submission of bids (by auction). With legal and other work required to complete the sale expected to take an additional three months, the privatization could be concluded by mid-2007. The authorities indicated that they remained committed to preparing a strategy for Ziraat (the largest bank in Turkey), drawing on the experience of Halkbank.

## F. Investment Climate

26. **Turkey's investment climate had continued to improve** (¶24-25). Economic stabilization, a liberal investment regime, prospects for EU accession, and privatization of the largest state economic enterprises had set the stage for record FDI inflows in 2006 (US$18 billion, or more than double the previous year's total). Staff welcomed these achievements and the ambitious privatization agenda for 2007, which included electricity distribution (followed by generation) companies, Halkbank, Tekel tobacco, and petrochemicals, and sales of government shares in partly privatized firms. Together with private merger and acquisition



activity and real estate investment, this was expected to lead to some US$13 billion in net FDI in 2007, covering close to half the projected current account deficit. However, greenfield-type investments had remained low, pointing to the need for further improvements in the investment environment, including by cutting red tape and increasing labor market flexibility.

**Privatization and FDI, 2005–06**

(In billions of U.S. dollars)

| Privatization 1/ | | Inward FDI | |
|---|---|---|---|
| Türk Telekom | 2.7 | Türk Telekom | 2.7 |
| TUPRAŞ refineries | 4.1 | Telsim cell phone | 4.6 |
| ERDEMIR steelworks | 3.0 | Turkcell | 1.6 |
| Other | 3.3 | Commercial banks | 10.5 |
| | | Other | 9.6 |
| **TOTAL** | **13.1** | **TOTAL** | **29.0** |

Sources: data from the authorities and staff estimates

1/ Excludes SDIF asset sales.

## IV. PROGRAM MODALITIES AND DATA ISSUES

### A. Program Monitoring

27. **The authorities' supplementary Letter of Intent describes progress in implementing the Fund-supported program and sets out conditionality through end-2007** (Attachment I, ¶1-5):

- **Quantitative conditionality** (Annex A). End-September performance criteria were met for the consolidated government primary surplus (excluding SEEs), the floor on overall balance of the social security institutions, the NIR floor, and ceilings on short-term and medium- and long-term external debt. The performance criterion on the primary surplus of the consolidated government sector including SEEs was also expected to have been met (SEE data were not yet available). However, the cap on primary spending was not observed. September inflation exceeded the upper limit of the consultation band, and the central bank had sent a letter to the government and the Fund—in accordance with the inflation consultation clause—to explain the reason for the deviation and the proposed policy response (Attachment II). The authorities' Letter of Intent proposes raising the existing end-December 2006 performance criterion on primary spending.

- **Structural conditionality** (Annex B). As prior actions, the authorities submitted a 2007 central government budget consistent with achieving a public sector primary surplus of 6.5 percent of GNP, and will announce a detailed timetable for the privatization of Halkbank, and submit to parliament legislation on second-stage personal income tax reform. The authorities' Letter of Intent proposes to modify existing structural performance criteria as follows: (i) personal income tax legislation will be submitted to parliament as a prior action (previously a PC for end-September); (ii) personal income tax legislation will be passed by end-February 2007 (reset from end-December 2006). It also proposes that parliamentary passage of legislation to authorize the social security institution to alter copayments by end-December 2006 be a new structural performance criterion. New structural benchmarks are also proposed as follows: (i) no more than 50 percent of civil servants leaving through attrition will be replaced; (ii) key parameters—including pricing assumptions—underlying the 2007 program for state economic enterprises will be observed; (iii) the tender process for Halkbank privatization will be completed by end-May 2007; and (iv) a report on quantification of existing tax expenditures will be published by end-June 2007.

### B. Phasing and Program Status

28. **In view of program review delays, understandings were reached with the authorities on rephasing purchases**. Specifically, the purchase associated with the sixth review was requested to be rephased evenly over the five remaining purchases under the arrangement, including that associated with the fifth review (Annex C). The outlook for Turkey's capacity to repay the Fund remained broadly unchanged (Table 13).

### C. Data Issues

29. **Work by the Statistic Institute (TURKSTAT) on revisions to the national accounts continued to meet with delays**. Despite staffing constraints, the authorities remained, however, confident that the work could be completed in the coming months. More generally, staff encouraged TURKSTAT to make their data more easily accessible, including through upgrading the website and adopting a more open approach on data provision.

## V. Staff Appraisal

30. **In the wake of the May–June financial market turbulence, economic performance has, in many ways, been better than expected**. Markets stabilized quite quickly in response to the tightening of policy. Economic activity has remained robust and FDI inflows buoyant. Balance sheets have also proved to be resilient, with the public debt ratio continuing to decline and overall bank capitalization remaining adequate.

31. **This good performance owes much to the sound policy framework embraced by the authorities**. Namely, (i) the establishment of a credible fiscal framework—the product of several consecutive years of budgetary discipline, producing a significant reduction in the public debt burden, with a gradual lengthening of maturities and a declining foreign exchange component; (ii) the adoption of a floating exchange rate regime, with a rising stock of official reserves as a backstop; (iii) the granting of independence to the central bank, giving it a free hand to adjust policy interest rates in pursuit of its inflation targets; and (iv) the fostering of a well-regulated and adequately-capitalized banking system, whose open foreign exchange positions are strictly contained.

32. **Turkey is, however, still vulnerable to renewed financial market pressure**. Higher-than-expected growth and buoyant capital inflows (interrupted only temporarily during the May-June turbulence) have contributed to a further widening of the current account deficit. The inflation outlook has also deteriorated, including due to higher-than-programmed government spending and an overly generous civil service wage hike. Moreover, the gross public debt ratio, while declining, is still high by emerging market standards. These vulnerabilities, together with the large stock of "hot money" investments by nonresidents, and Turkey's sensitivity to shifts in global market sentiment, expose the country to a sudden stop in capital inflows. Reflecting these pressures, as well as rising political uncertainties related to the forthcoming elections and the EU-entry process, interest rate risk premia have remained elevated.

33. **It is, therefore, critical for Turkey to persevere with good policies and keep the Fund-supported program anchor firmly in place**. From this perspective, it is unfortunate

that spending could not be kept in line with program objectives this year. On the other hand, the authorities' decision to target a primary surplus of 6½ percent of GNP in 2007 is the right one. Tight monetary policy will also be required in view of the predominantly upside inflation risks. With heightened vulnerabilities, it will be important to enhance buffers to cushion the effect of unforeseen shocks on balance sheets and step up bank oversight. The authorities should also stand ready to adjust the overall policy stance as needed. Disciplined macroeconomic policies will need to be underpinned by timely implementation of structural reforms—including tax, social security, privatization, and banking reforms. These steps should help preserve confidence, while steering Turkey towards a more balanced and sustained growth path.

34. **Next year's 6.5 percent of GNP primary surplus target is the linchpin of the authorities' policy package and it needs to be observed**. This will help keep the public debt ratio on a declining path and contain the current account deficit and inflation. Achieving the target will not be easy in an election year, however, especially given the limited room for maneuver. It will be crucial, in this respect, to contain spending pressures, achieve efficiency savings in the provision of health services, and adjust energy prices so that state enterprises contribute to the primary surplus target. Pressures for ad hoc tax concessions should also be resisted.

35. **Regrettably, there is no improvement in the quality of next year's budget**. Wage and other current spending is set to increase rapidly, constraining room for reducing Turkey's high tax rates and increasing investment spending. Without an improvement in budget composition, Turkey's fiscal adjustment of recent years will prove increasingly difficult to sustain over time. From this perspective, the authorities' plans for civil service reforms are welcome, although, to be effective in controlling the wage bill, the pace of hiring civil servants will have to slow.

36. **Maintaining a tight monetary stance is essential to bringing inflation back on track**. Retaining existing inflation targets (4 percent for 2007–08) should help prevent an upfront loss of central bank credibility, presuming an effective communications strategy is in place. Achieving the inflation targets will, however, likely prove challenging, given elevated underlying inflation and many upside risks (demand strength, global liquidity, inflation inertia, wage pressures, and administered price increases). Despite already-tight monetary policy, this calls for a strict tightening bias. The resumption of foreign exchange auctions is welcome, given Turkey's low reserves in relation to short-term external debt.

37. **Fiscal structural reforms are crucial to underpin good fiscal performance**. Good results are expected from the ongoing tax administration reforms, with the Revenue Administration up and running and preparations for the new Large Taxpayers Unit on track. While work proceeds on the unification of the three social security institutions, enforcement of social security contributions needs further strengthening. At the same time, it will be crucial to ensure that the planned broadening of health coverage be done without compromising medium-term fiscal sustainability.

38. **Further progress in banking reforms and privatization would help preserve market confidence**. Good progress is being made on upgrading the bank regulatory

framework. This includes adopting supporting regulations for the new Banking Law and stricter provisioning requirements. These steps are expected to be accompanied by efforts to enhance supervisory practices, particularly with regard to the consolidation of all banking activities and the management of credit risks. Since the new mortgage framework could bring considerable benefits, the law should be passed without further delay. The authorities are to be commended for their achievements on privatization and for their continued commitment to an ambitious privatization agenda. In this regard, completing the sale of Halkbank by mid-2007 will be a signal achievement.

39. **Staff supports the request for completing the fifth review, modifying performance criteria, and rephasing purchases**. Despite risks ahead, the authorities' progress in implementing the Fund-supported program and their forward-looking reform plans deserve the support of the international community. Staff also supports the requests for waivers of nonobservance of the end-September performance criterion on primary spending (in light of the commitment to implement cuts to contain the overrun and measures to rein in health spending in 2007) and the structural performance criterion on submission to parliament of legislation to reform the personal income tax (for which the deviation is expected to be temporary), as well as for a waiver of applicability of the end-September performance criterion on the primary surplus of the consolidated government sector including SEEs (which is likely to have been met).

**Table 1. Turkey: Purchases and Proposed Schedule of Purchases, 2005-08**

| | SDR millions | Percent of quota | Test date 1/ | Earliest possible purchase date | Date of Board Approval |
|---|---|---|---|---|---|
| **Approval** | 555.2 | 57.6 | | | 11-May-05 |
| **2005** | | | | | |
| 1st & 2nd Reviews | 1,110.3 | 115.2 | 30-Sep-05 | | 9-Dec-05 |
| **2006** | | | | | |
| 3rd Review 2/ | 624.6 | 64.8 | 31-Dec-05 | 1-Mar-06 | 28-Jul-06 |
| 4th Review 2/ | 624.6 | 64.8 | 31-Mar-06 | 1-Jun-06 | 28-Jul-06 |
| 5th Review | 749.5 | 62.9 | 30-Sep-06 | 1-Dec-06 | |
| **2007** | | | | | |
| 6th Review | 749.5 | 62.9 | 31-Dec-06 | 1-Mar-07 | |
| 7th Review | 749.5 | 62.9 | 30-Apr-07 | 1-Jul-07 | |
| 8th Review | 749.5 | 62.9 | 31-Aug-07 | 1-Dec-07 | |
| **2008** | | | | | |
| 9th Review | 749.5 | 62.9 | 31-Dec-07 | 1-Mar-08 | |
| Total 3/ | 6,662.0 | 559.2 | | | |

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

**Table 2. Turkey: Quantitative Performance Criteria and Indicative Targets for 2006−07**

| | Ceiling/ Floor | Outcome | Ceiling/ Floor | Outcome | Ceiling/ Floor | Outcome | Ceiling/ Floor | Ceiling/ Floor | Ceiling/ Floor | Ceiling/ Floor |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar. 31, 2006 | | June 30, 2006 | | Sept. 30, 2006 | | Dec. 31, 2006 | April 30, 2007 | August 31, 2007 | Dec. 31, 2007 |
| | (in millions of new Turkish liras, unless otherwise specified) | | | | | | | | | |
| I. Quantitative Performance Criteria 1/ | | | | | | | | | | |
| 1. Floor on the cumulative primary balance of the consolidated government sector 2/ | 7,771 | 10,562 | 17,366 | 25,038 | 29,705 | | 34,050 | 10,450 | 30,450 | 37,850 |
| 2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/ | 7,471 | 8,362 | 16,414 | 22,091 | 28,072 | 31,396 | 31,350 | 9,850 | 29,250 | 35,350 |
| 3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/ | | | | | 124,046 | 124,874 | 174,000 | 58,250 | 122,000 | 194,200 |
| 4. Ceiling on contracting or guaranteeing of new external pubic debt with original maturities of more than one year (in millions of US$) | 8,500 | 4,196 | 14,000 | 4,806 | 18,000 | 6,829 | 21,500 | 9,000 | 15,000 | 22,000 |
| 5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$) | 1,000 | 0 | 1,000 | 0 | 1,000 | 0 | 1,000 | 1,000 | 1,000 | 1,000 |
| 6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$) | 19.7 | 32.4 | 24.3 | 31.0 | 25.7 | 31.0 | 22.6 | 28.0 | 28.0 | 29.0 |
| 7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/ | -6,100 | -6,634 | -12,000 | -10,554 | -18,400 | -16,486 | -24,300 | -5,000 | -8,850 | -12,850 |
| II. Inflation Consultation Bands (12-month change, in percent) 4/ | | | | | | | | | | |
| Outer Band (upper limit) | 9.4 | | 8.5 | | 7.8 | | 7.0 | | | |
| Inner Band (upper limit) | 8.4 | | 7.5 | | 6.8 | | 6.0 | | | |
| *Central Point* | 7.4 | 8.2 | 6.5 | 10.1 | 5.8 | 10.5 | 5.0 | N/A | N/A | N/A |
| Inner Band (lower limit) | 6.4 | | 5.5 | | 4.8 | | 4.0 | | | |
| Outer Band (lower limit) | 5.4 | | 4.5 | | 3.8 | | 3.0 | | | |
| III. Indicative Targets | | | | | | | | | | |
| 1. Floor on the cumulative overall balance of the consolidated government sector 2/ | -3,429 | 1,162 | -3,934 | 7,129 | -5,445 | | -6,900 | -8,500 | -5,500 | -8,400 |
| 2. Privatization Proceeds (in millions of US$) | 1,900 | 4,579 | 2,800 | 7,970 | 3,200 | 8,008 | 4,200 | N/A | N/A | N/A |

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

## Table 3. Turkey: Structural Conditionality 2006 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 | Observed |
| 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 |
| 3. Maintain excise taxes and SEE prices in line with 2006 program assumptions (¶10) | Continuous SB | Observed |
| 4. Establish Tax Policy Unit at Ministry of Finance (¶16) | SB. End-December 2005 | Observed with delay. Unit made fully functional in July 2006 |
| 5. Complete functional restructuring of Revenue Administration, including reorganization of local tax offices (¶16) | SB. End-April 2006 | Observed with delay. Functional restructuring completed in August 2006 |
| 6. Submission of draft legislation for second stage of personal income tax reform (¶14) | PC. End-September 2006 | Not observed. Waiver needed. Will be submitted as a prior action |
| 7. Approval of second stage of personal income tax reform (¶14) | PC. End-December 2006 | Delay expected. PC proposed to be reset to end-February 2007 |
| 8. Establish a large-taxpayers unit within the Revenue Administration (¶17) | SB. End-December 2006 | Pending |
| **Financial Sector Measures** | | |
| 9. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶24) | SB. End-March 2006 | Observed with delay. Timetable announced in July 2006 |
| 10. Announcement of detailed state bank privatization strategies and timetables (¶24) | SB. End-June 2006 | Observed with delay. Timetable will be announced as a prior action |
| 11. Completion of implementing regulations for the Banking Law (¶20) | SB. End-August 2006 | Observed with delay. Regulations issued in November 2006 |

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the April 26, 2005 Memorandum of Economic Policies, except for actions 4-11, where references are to the supplementary Letter of Intent dated July 7, 2006.

**Table 4. Turkey: Selected Economic Indicators, 2001−07**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | | 2007 |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Prog. (7/06) | Proj. | Proj. |
| | | | | | (In percent) | | | |
| Real sector | | | | | | | | |
| Real GNP growth rate | -9.5 | 7.9 | 5.9 | 9.9 | 7.6 | 5.0 | 6.0 | 5.0 |
| Private consumption growth rate | -9.3 | 2.2 | 6.7 | 9.9 | 8.8 | 4.1 | 7.5 | 5.3 |
| Private gross fixed investment growth rate | -34.9 | -5.3 | 20.3 | 45.5 | 23.6 | 12.6 | 14.6 | 5.0 |
| Final domestic demand growth rate | -9.2 | 2.1 | 6.6 | 10.1 | 8.8 | 6.5 | 7.5 | 5.3 |
| GNP deflator growth rate | 55.3 | 44.4 | 22.5 | 9.5 | 5.3 | 9.6 | 9.0 | 7.0 |
| Nominal GNP growth rate | 40.5 | 55.8 | 29.7 | 20.3 | 13.4 | 15.1 | 15.5 | 12.4 |
| CPI inflation (12-month, end-of period) | 68.5 | 29.7 | 18.4 | 9.4 | 7.7 | 10.0 | 10.0 | 5.5 |
| PPI inflation (12-month, end-of-period) | 88.6 | 30.8 | 13.9 | 15.3 | 2.7 | 8.7 | 13.1 | 6.0 |
| 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 | 16.4 | 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 | 6.3 | 5.0 |
| Net interest payments | 22.2 | 17.3 | 16.1 | 12.3 | 7.7 | 8.0 | 7.7 | 8.0 |
| Overall balance | -17.4 | -14.9 | -11.0 | -7.2 | -2.7 | -2.5 | -1.4 | -3.0 |
| Consolidated public sector | | | | | | | | |
| Primary balance | 5.5 | 4.1 | 6.4 | 7.0 | 6.2 | 6.7 | 7.5 | 6.5 |
| Net interest payments | 22.6 | 17.6 | 15.4 | 11.7 | 7.0 | 7.6 | 7.2 | 7.5 |
| Overall balance | -17.1 | -13.6 | -9.0 | -4.7 | -0.8 | -0.9 | 0.3 | -1.0 |
| Net debt of public sector | 90.4 | 78.4 | 70.3 | 63.4 | 55.3 | 55.5 | 49.6 | 45.6 |
| Net external | 37.5 | 32.1 | 21.9 | 17.4 | 8.5 | 8.4 | 8.0 | 7.8 |
| Net domestic | 52.9 | 46.3 | 48.4 | 45.9 | 46.8 | 47.1 | 41.6 | 37.7 |
| Share of FX debt (percent total public debt) | 57.8 | 58.1 | 46.3 | 41.5 | 37.6 | .. | 26.0 | 23.0 |
| External sector | | | | | | | | |
| Current account balance | 2.4 | -0.8 | -3.4 | -5.2 | -6.4 | -6.5 | -8.5 | -7.9 |
| Exports of goods and non-factor services | 36.1 | 31.0 | 30.1 | 30.5 | 29.1 | 31.6 | 29.8 | 32.1 |
| Volume growth (goods only, in percent) | 15.7 | 17.2 | 19.1 | 15.0 | 9.9 | 9.6 | 9.1 | 13.1 |
| Imports of goods and non-factor services | 31.7 | 30.1 | 31.3 | 33.8 | 33.9 | 36.3 | 36.4 | 38.0 |
| Volume growth (goods only, in percent) | -23.8 | 26.1 | 24.6 | 22.2 | 11.6 | 3.3 | 10.8 | 8.0 |
| Trade balance | -2.6 | -4.0 | -5.9 | -7.9 | -9.1 | -9.7 | -10.5 | -10.1 |
| *Of which* : oil (in billions of U.S. dollars) | -7.8 | -8.5 | -10.6 | -13.0 | -18.6 | -23.1 | -23.9 | -24.9 |
| Gross external debt 1/ | 93.1 | 77.6 | 56.6 | 50.5 | 47.0 | 59.4 | 53.2 | 53.2 |
| Net external debt 1/ | 64.1 | 52.8 | 37.7 | 32.2 | 27.4 | 35.4 | 31.0 | 32.0 |
| Foreign direct investment (net) | 1.9 | 0.5 | 0.5 | 0.7 | 2.4 | 5.8 | 4.7 | 3.3 |
| Short-term external debt (by remaining maturity) | 22.6 | 19.3 | 17.3 | 17.4 | 16.7 | 20.1 | 18.1 | 19.2 |
| Monetary aggregates | | | | | | | | |
| Nominal growth of M2Y broad money (in percent) | 87.5 | 25.4 | 13.0 | 22.1 | 24.5 | 21.8 | 25.7 | 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 | 9.6 | 2.2 |
| Net external financing of central government | 8.4 | 6.7 | -0.7 | -2.7 | -4.1 | -0.6 | -0.6 | 0.1 |
| Amortization | -6.7 | -11.4 | -8.7 | -11.7 | -14.1 | -13.5 | -13.5 | -12.0 |
| Gross borrowing | 15.0 | 18.1 | 8.0 | 8.9 | 10.0 | 13.0 | 13.0 | 12.1 |
| *Of which* : Eurobond issues | 2.2 | 3.3 | 5.3 | 5.8 | 6.5 | 5.5 | 5.8 | 5.5 |
| GNP | 144.0 | 182.7 | 238.5 | 301.5 | 361.9 | 359.7 | 385.8 | 404.7 |
| GNP (in billions of Turkish lira) | 176.5 | 275.0 | 356.7 | 428.9 | 486.4 | 559.8 | 562.0 | 631.4 |

**Social Indicators:**

**Per Capita GDP (2005): $5,062** **Poverty Rate (2003): 26 percent (WB poverty line estimate)**

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

1/ Debt ratios valued at end-year exchange rates (in IMF Country Report 06/268, valued at annual average exchange rates).
2/ Privatization revenue received by fiscal authorities.

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

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | | 2007 | | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Prog. July 06 | Proj. | Prog. July 06 | Proj. | Proj. |
| Current account balance | 3.4 | -1.5 | -8.0 | -15.6 | -23.1 | -23.5 | -32.7 | -18.2 | -31.8 | -29.4 |
| Trade balance | -3.7 | -7.3 | -14.0 | -23.9 | -32.8 | -34.9 | -40.4 | -32.1 | -40.8 | -40.7 |
| Exports (f.o.b.) | 34.4 | 40.1 | 51.2 | 67.0 | 76.9 | 84.2 | 87.8 | 93.2 | 99.9 | 108.9 |
| *Of which:* | | | | | | | | | | |
| Exports (f.o.b.) in trade returns | 31.3 | 36.1 | 47.3 | 63.2 | 73.4 | 80.4 | 83.3 | 89.4 | 95.0 | 104.1 |
| Shuttle trade | 3.0 | 4.1 | 4.0 | 3.9 | 3.5 | 3.8 | 4.5 | 3.8 | 4.9 | 4.8 |
| Imports (f.o.b.) | -38.1 | -47.4 | -65.2 | -90.9 | -109.6 | -119.1 | -128.2 | -125.3 | -140.7 | -149.6 |
| *Of which:* | | | | | | | | | | |
| Imports (c.i.f.), incl. non-monetary gold | -41.4 | -51.6 | -69.3 | -97.5 | -116.5 | -126.6 | -135.7 | -133.3 | -149.7 | -159.1 |
| Energy imports (c.i.f.) | -8.3 | -9.2 | -11.6 | -14.4 | -21.2 | -26.4 | -27.5 | -27.9 | -28.3 | -30.2 |
| Services and Income (net) | 4.1 | 3.3 | 4.9 | 7.1 | 8.2 | 9.7 | 6.2 | 12.3 | 7.2 | 9.7 |
| Services and Income (credit) | 18.8 | 17.3 | 21.3 | 25.6 | 29.5 | 30.3 | 28.3 | 34.9 | 31.4 | 34.4 |
| *Of which:* | | | | | | | | | | |
| Tourism receipts | 8.1 | 8.5 | 13.2 | 15.9 | 18.2 | 19.0 | 17.2 | 20.3 | 18.5 | 19.3 |
| Services and Income (debit) | -14.7 | -13.9 | -16.3 | -18.4 | -21.3 | -20.5 | -22.2 | -22.6 | -24.3 | -24.7 |
| *Of which:* | | | | | | | | | | |
| Interest | -7.1 | -6.4 | -6.9 | -7.2 | -8.3 | -9.0 | -9.9 | -9.9 | -11.1 | -10.8 |
| Private transfers (net) 1/ | 2.8 | 1.9 | 0.7 | 0.8 | 0.9 | 0.9 | 1.0 | 1.0 | 1.2 | 1.0 |
| Official transfers (net) | 0.2 | 0.5 | 0.3 | 0.3 | 0.6 | 0.8 | 0.5 | 0.6 | 0.6 | 0.6 |
| Capital account balance | -14.6 | 1.2 | 7.1 | 17.7 | 43.8 | 32.4 | 40.2 | 22.2 | 37.2 | 32.3 |
| (including errors and omissions) | -16.3 | 1.3 | 12.1 | 19.9 | 46.3 | 32.8 | 39.5 | 22.2 | 37.2 | 32.3 |
| Direct investment 2/ | 2.8 | 0.9 | 1.2 | 2.0 | 8.6 | 20.8 | 18.3 | 7.1 | 13.2 | 8.0 |
| Portfolio investment in securities | -4.6 | -1.2 | 1.1 | 6.1 | 10.4 | -7.8 | 3.6 | -2.8 | 3.6 | 3.8 |
| Public sector (central & local governments & EBFs) | -1.9 | 0.4 | -0.7 | 0.8 | 1.3 | 2.4 | 2.3 | 1.3 | 2.8 | 1.1 |
| Bonds (net) | 0.1 | 1.0 | 1.5 | 2.0 | 3.4 | 2.9 | 2.0 | 1.8 | 2.1 | 2.1 |
| Eurobond drawings | 2.1 | 3.3 | 5.3 | 5.8 | 6.5 | 5.5 | 5.5 | 5.5 | 5.5 | 5.8 |
| Eurobond repayments | -2.0 | -2.3 | -3.8 | -3.8 | -3.1 | -2.6 | -3.5 | -3.7 | -3.4 | -3.7 |
| Loans (net) | -2.0 | -0.7 | -2.2 | -1.2 | -2.2 | -0.5 | 0.4 | -0.5 | 0.7 | -1.0 |
| Loan disbursements | 1.6 | 2.3 | 1.0 | 2.0 | 1.1 | 2.6 | 3.6 | 3.0 | 3.8 | 2.0 |
| Loan repayments | -3.6 | -3.0 | -3.2 | -3.2 | -3.3 | -3.1 | -3.2 | -3.4 | -3.2 | -3.0 |
| Central Bank of Turkey (excl. reserve assets, liabilties) | 0.8 | 1.4 | 0.6 | -0.1 | -0.5 | -0.6 | -0.8 | 0.1 | -1.1 | -1.1 |
| Deposit money banks (net) | -9.4 | -1.8 | 3.0 | 1.2 | 9.8 | 4.0 | -1.0 | 4.9 | 7.4 | 7.5 |
| FX deposits abroad (- denotes accumulation) | 0.9 | 0.6 | 0.7 | -6.0 | -0.4 | 0.0 | -7.4 | 0.0 | 0.0 | 0.0 |
| Other, net | -10.3 | -2.4 | 2.3 | 7.2 | 10.2 | 4.0 | 6.4 | 4.9 | 7.4 | 7.5 |
| Medium and long-term (net) | -1.0 | -0.7 | -0.2 | 2.4 | 6.1 | 5.0 | 5.1 | 4.5 | 5.8 | 4.5 |
| Short-term (net) | -9.3 | -1.7 | 2.5 | 4.8 | 4.2 | -1.0 | 1.3 | 0.4 | 1.6 | 3.0 |
| Interbank credit lines from foreign commercial banks | -7.1 | -0.7 | 2.0 | 3.3 | 2.7 | 2.0 | -0.4 | 1.9 | 0.0 | 1.0 |
| Other private sector (net) | -2.3 | 1.5 | 1.8 | 7.7 | 14.2 | 13.6 | 17.8 | 11.7 | 11.4 | 13.1 |
| Medium and long term (net) | 0.3 | 2.5 | 1.6 | 5.2 | 9.9 | 12.2 | 13.1 | 11.3 | 6.6 | 8.0 |
| Short term (net) | -2.6 | -1.0 | 0.2 | 2.4 | 4.3 | 1.4 | 4.7 | 0.4 | 4.7 | 5.0 |
| Errors and omissions | -1.7 | 0.1 | 5.0 | 2.3 | 2.4 | 0.4 | -0.7 | 0.0 | 0.0 | 0.0 |
| Overall balance | -12.9 | -0.2 | 4.1 | 4.3 | 23.2 | 9.4 | 6.8 | 3.9 | 5.3 | 3.0 |
| Overall financing (NIR change excl. ST liabilities, + denotes decline) | 12.9 | 0.2 | -4.1 | -4.3 | -23.2 | -9.4 | -6.8 | -3.9 | -5.3 | -3.0 |
| Change in net international reserves (+ denotes decline) | 12.9 | 0.2 | -4.1 | -4.3 | -23.2 | -9.4 | -6.8 | -3.9 | -5.3 | -3.0 |
| Change in gross official reserve assets (+ denotes decline) 3/ | 2.7 | -6.2 | -4.0 | -0.8 | -17.8 | -5.6 | -2.4 | -1.4 | -3.5 | -2.2 |
| Change in reserve liabilities (IMF) | 10.2 | 6.4 | -0.1 | -3.5 | -5.4 | -3.8 | -4.4 | -2.5 | -1.8 | -0.7 |
| Purchases | 11.3 | 12.5 | 1.7 | 1.2 | 2.4 | 3.7 | 3.0 | 2.8 | 3.3 | 1.1 |
| Repurchases 4/ | -1.1 | -6.1 | -1.7 | -4.7 | -7.8 | -7.4 | -7.4 | -5.3 | -5.2 | -1.8 |

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

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | | 2007 | | 2008 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Prog. July 06 | Proj. | Prog. July 06 | Proj. | Proj. |
| **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 | -6.5 | -8.5 | -5.1 | -7.9 | -6.7 |
| Non-oil current account balance | 7.8 | 3.8 | 1.1 | -0.9 | -1.3 | -0.1 | -2.3 | 1.8 | -1.7 | -0.6 |
| Trade account balance, incl. shuttle trade | -2.6 | -4.0 | -5.9 | -7.9 | -9.1 | -9.7 | -10.5 | -9.0 | -10.1 | -9.3 |
| Exports of goods and non-factor services | 36.1 | 31.0 | 30.1 | 30.5 | 29.1 | 31.6 | 29.8 | 35.6 | 32.1 | 32.4 |
| Imports of goods and non-factor services | 31.7 | 30.1 | 31.3 | 33.8 | 33.9 | 36.3 | 36.4 | 38.8 | 38.0 | 37.4 |
| Percent change | | | | | | | | | | |
| Value growth in exports of goods (incl. shuttle trade) | 11.9 | 16.7 | 27.6 | 30.9 | 14.6 | 9.6 | 14.2 | 10.6 | 13.8 | 9.0 |
| Value growth in exports of goods (excl. shuttle trade) | 12.8 | 15.1 | 31.0 | 33.7 | 16.2 | 9.6 | 13.5 | 11.1 | 14.0 | 9.6 |
| Value growth in imports of goods | -27.7 | 24.4 | 37.6 | 39.4 | 20.6 | 8.6 | 16.9 | 5.2 | 9.7 | 6.3 |
| Volume growth in exports of goods | 15.7 | 17.2 | 19.1 | 15.0 | 9.9 | 9.6 | 9.1 | 11.2 | 13.1 | 11.2 |
| Volume growth in imports of goods | -23.8 | 26.1 | 24.6 | 22.2 | 11.6 | 3.3 | 10.8 | 4.4 | 8.0 | 8.2 |
| Volume growth in imports of goods exluding fuel | -22.9 | 25.2 | 19.8 | 28.0 | 15.3 | 5.1 | 12.2 | 5.7 | 8.6 | 9.1 |
| Terms of trade | -2.2 | -0.6 | 2.0 | 1.0 | -2.2 | -4.9 | -1.0 | -0.9 | -1.4 | 0.3 |
| Reserve and debt indicators | | | | | | | | | | |
| Gross foreign reserves (Central Bank of Turkey) | | | | | | | | | | |
| In billions of U.S. dollars | 19.8 | 28.1 | 35.2 | 37.6 | 52.2 | 57.8 | 54.5 | 59.2 | 58.0 | 60.3 |
| Months of goods & NFS imports | 4.5 | 5.5 | 3.9 | 3.4 | 4.2 | 4.7 | 4.0 | 4.5 | 4.0 | 3.9 |
| External debt (end-of-period) | | | | | | | | | | |
| In billions of U.S. dollars | 113.6 | 130.2 | 145.0 | 162.2 | 170.1 | 189.9 | 193.9 | 207.6 | 212.2 | 231.9 |
| Percent of GNP | 93.1 | 77.6 | 56.6 | 50.5 | 47.0 | 59.4 | 53.2 | 59.3 | 53.2 | 53.7 |
| Percent of exports of goods & NFS | 218.4 | 230.0 | 201.9 | 176.5 | 161.4 | 167.2 | 168.9 | 164.3 | 163.6 | 163.7 |
| Net external debt (end-of-period) 5/ | | | | | | | | | | |
| In billions of U.S. dollars | 78.2 | 88.6 | 96.5 | 103.4 | 99.1 | 113.3 | 113.0 | 129.6 | 127.8 | 145.2 |
| Percent of GNP | 64.1 | 52.8 | 37.7 | 32.2 | 27.4 | 35.4 | 31.0 | 37.0 | 32.0 | 33.7 |
| Short-term debt (end-of-period) | | | | | | | | | | |
| In billions of U.S. dollars | 16.4 | 16.4 | 23.0 | 32.6 | 38.2 | 40.3 | 44.1 | 43.4 | 50.0 | 57.8 |
| Reserves to short-term debt ratio | 120.7 | 170.9 | 152.8 | 115.6 | 136.5 | 143.4 | 123.8 | 136.3 | 116.0 | 104.3 |
| Short-term debt plus MLT repayments | | | | | | | | | | |
| In billions of U.S. dollars | 32.6 | 35.2 | 41.1 | 52.5 | 60.5 | 72.3 | 69.8 | 80.8 | 77.8 | 87.7 |
| Reserves to short-term debt ratio | 60.7 | 79.7 | 85.5 | 71.7 | 86.2 | 79.9 | 78.1 | 73.2 | 74.6 | 68.7 |
| Debt service ratio 6/ | 41.9 | 38.1 | 35.1 | 27.2 | 26.4 | 28.1 | 27.5 | 32.5 | 27.9 | 26.7 |

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.
2/ Including privatization receipts.
3/ Projections exclude year-to-date valuation changes in 2006 (approximately US$3 billion).
4/ 2007 repurchases on an expectations basis.
5/ Non-bank external debt minus the net foreign assets of the banking sector and the central bank.
6/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excluding official transfers).

**Table 6. Turkey: Indicators of External Vulnerability, 2000–06 1/**

| | 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 | -0.8 | 0.3 |
| Net debt of the public sector (percent of GNP) | 57.1 | 90.4 | 78.4 | 70.3 | 63.4 | 55.3 | 49.3 |
| Export volume (percent change) | 9.2 | 15.7 | 17.2 | 19.1 | 15.0 | 9.9 | 9.1 |
| Import volume (percent change) | 28.2 | -23.8 | 26.1 | 24.6 | 22.2 | 11.6 | 10.8 |
| Current account balance, in percent of GNP | -4.9 | 2.4 | -0.8 | -3.4 | -5.2 | -6.4 | -8.5 |
| Capital account balance (in billions of U.S. dollars) | 9.6 | -14.6 | 1.2 | 7.1 | 17.7 | 43.8 | 40.2 |
| *Of which*: Foreign direct investment | 0.1 | 2.8 | 0.9 | 1.2 | 2.0 | 8.6 | 18.3 |
| Foreign portfolio investment | -5.2 | -4.6 | -1.2 | 1.1 | 6.1 | 10.4 | 3.6 |
| Gross official reserves, in billions of U.S. dollars 2/ | 23.2 | 19.8 | 28.1 | 35.2 | 37.6 | 52.2 | 54.4 |
| In months of imports of goods and NFS | 4.1 | 4.5 | 5.5 | 3.9 | 3.4 | 4.2 | 4.0 |
| In percent of broad money | 27.4 | 26.7 | 34.3 | 32.5 | 27.4 | 30.5 | 29.1 |
| Gross total external debt, in billions U.S. dollars | 117.5 | 113.6 | 130.2 | 145.0 | 162.2 | 170.1 | 193.8 |
| In percent of GNP | 62.9 | 93.1 | 77.6 | 56.6 | 50.5 | 47.0 | 53.2 |
| In percent of exports of goods and NFS | 222.8 | 218.4 | 230.0 | 201.9 | 176.5 | 161.4 | 168.8 |
| Gross short-term external debt, in billions of U.S. dollars 3/ | 44.6 | 32.6 | 35.2 | 41.1 | 52.5 | 60.5 | 69.8 |
| In percent of gross total external debt | 38.0 | 28.7 | 27.0 | 28.4 | 32.4 | 35.6 | 36.0 |
| In percent of gross official reserves | 192.6 | 164.7 | 125.4 | 117.0 | 139.5 | 116.0 | 128.3 |
| Debt service ratio 4/ | 37.2 | 41.9 | 38.1 | 35.1 | 27.2 | 26.4 | 27.5 |
| REER appreciation (CPI based, period average) | 10.9 | -17.6 | 11.4 | 8.9 | 5.1 | 11.5 | ... |
| REER appreciation (CPI based, end of period) | 15.9 | -21.2 | 7.8 | 12.1 | 1.8 | 19.7 | ... |
| 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 | 40.8 | … |
| 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 | 48.0 | 60.7 | 56.0 | 40.3 | … |
| 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 | … |
| Real credit to the private sector, percentage change 6/ | 24.5 | -27.5 | -16.5 | 20.1 | 38.5 | 33.6 | … |
| Banks' net foreign asset 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 public sector debt, plus short-term debt at end of previous period.
2/ Projection excludes year-to-date valuation changes in 2006 (approximately US$3 billion).
3/ By residual maturity.
4/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excluding official transfers).
5/ For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank. 2004 data for SDIF banks are as of end-September.
6/ Deflated by the CPI.

**Table 7. 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 | 93.9 | 102.4 | 107.9 |
| Current account deficit (excluding official transfers) | -3.2 | 2.0 | 8.3 | 15.9 | 23.7 | 33.3 | 32.5 | 30.0 |
| Amortization on debt securities | 2.1 | 2.7 | 3.9 | 3.8 | 3.4 | 3.5 | 3.4 | 3.7 |
| Government Eurobonds | 2.0 | 2.3 | 3.8 | 3.8 | 3.1 | 3.5 | 3.4 | 3.7 |
| Medium- and long-term debt amortization | 14.3 | 13.6 | 14.9 | 14.5 | 16.7 | 18.9 | 22.5 | 24.2 |
| Public sector 1/ | 3.6 | 3.0 | 3.2 | 3.2 | 3.3 | 3.2 | 3.2 | 3.0 |
| Private non-bank sector | 8.9 | 9.0 | 10.3 | 10.1 | 11.1 | 14.5 | 16.6 | 16.9 |
| Banks | 1.9 | 1.6 | 1.4 | 1.2 | 2.4 | 1.2 | 2.7 | 4.3 |
| Short-term debt amortization | 28.3 | 16.4 | 16.4 | 23.0 | 32.6 | 38.2 | 44.1 | 50.0 |
| Public sector (net) 1/ | 1.7 | 0.8 | 1.7 | 2.9 | 3.3 | 2.8 | 2.6 | 2.2 |
| Trade credits 2/ | 7.9 | 5.7 | 7.1 | 8.9 | 13.3 | 16.1 | 20.7 | 25.6 |
| Banks | 16.9 | 8.0 | 6.3 | 9.7 | 14.5 | 17.7 | 19.2 | 20.8 |
| Other private | 1.9 | 2.0 | 1.3 | 1.6 | 1.5 | 1.6 | 1.5 | 1.5 |
| Increase in portfolio and other investment assets | 1.4 | 2.9 | 2.4 | 8.3 | 1.0 | 8.4 | 1.1 | 0.8 |
| Available financing | 41.5 | 34.7 | 43.6 | 57.2 | 76.4 | 93.9 | 102.4 | 107.9 |
| Foreign direct investment (net) | 2.8 | 0.9 | 1.2 | 2.0 | 8.6 | 18.3 | 13.2 | 8.0 |
| *Of which:* privatization inflows (estimated) | | | | | 1.7 | 10.8 | 1.5 | |
| Portfolio flows | -1.7 | 4.2 | 7.8 | 13.2 | 18.1 | 10.0 | 10.0 | 10.3 |
| Government Eurobonds | 2.1 | 3.3 | 5.3 | 5.8 | 6.5 | 5.5 | 5.5 | 5.8 |
| Private non-bank sector (net) 3/ | -3.8 | 0.9 | 2.5 | 7.5 | 11.6 | 4.5 | 4.5 | 4.5 |
| Medium and long-term debt financing | 13.2 | 15.8 | 14.1 | 20.6 | 30.2 | 36.8 | 34.6 | 34.7 |
| Public sector 1/ | 3.2 | 2.9 | 0.7 | 1.7 | 0.5 | 2.9 | 2.8 | 1.0 |
| Private non-bank sector | 9.2 | 11.5 | 11.9 | 15.4 | 21.0 | 27.7 | 23.2 | 25.0 |
| Banks | 0.9 | 1.3 | 1.4 | 3.5 | 8.8 | 6.3 | 8.5 | 8.7 |
| Short-term financing | 15.7 | 13.0 | 19.3 | 23.2 | 39.6 | 35.7 | 49.3 | 57.3 |
| Public sector 1/ | 0.7 | 1.6 | 2.8 | 3.3 | 2.8 | 2.6 | 2.2 | 1.8 |
| Trade credits | 5.7 | 7.1 | 8.9 | 13.3 | 16.1 | 20.7 | 25.6 | 30.7 |
| Banks | 9.3 | 4.2 | 7.6 | 6.6 | 20.7 | 12.4 | 21.6 | 24.8 |
| Other private | 2.0 | 1.3 | 1.6 | 1.5 | 1.6 | 1.5 | 1.5 | 1.5 |
| Official transfers | 0.2 | 0.5 | 0.3 | 0.3 | 0.6 | 0.5 | 0.6 | 0.6 |
| Other 4/ | -1.7 | 0.1 | 5.0 | 2.3 | 2.4 | -0.7 | 0.0 | 0.0 |
| Net reserves (- denotes increase) | 12.9 | 0.2 | -4.1 | -4.3 | -23.2 | -6.8 | -5.3 | -3.0 |
| Accumulation of gross reserves /5 | 2.7 | -6.2 | -4.0 | -0.8 | -17.8 | -2.4 | -3.5 | -2.2 |
| IMF (net) | 10.2 | 6.4 | -0.1 | -3.5 | -5.4 | -4.4 | -1.8 | -0.7 |
| Purchases | 11.3 | 12.5 | 1.7 | 1.2 | 2.4 | 3.0 | 3.3 | 1.1 |
| Repurchases 6/ | -1.1 | -6.1 | -1.7 | -4.7 | -7.8 | -7.4 | -5.2 | -1.8 |
| **Memorandum item:** | | | | | | | | |
| Net public sector financing (incl. IMF, excl. reserves) | 10.9 | 9.5 | 2.1 | 0.6 | -1.4 | 0.3 | 2.7 | 1.8 |

Sources: Data provided by the Turkish authorities; and Fund staff estimates and projections.
1/ General government and Central Bank of Turkey (excludes IMF purchases and repurchases).
2/ Series reflects stock of short term trade credits at end of previous year.
3/ Portfolio equity and domestic government debt (net).
4/ Errors and omissions.
5/ Projections exclude year-to-date valuation changes in 2006 (approximately US$3 billion).
6/ 2007 repurchase are on an expectations basis.

**Table 8. Turkey: Consolidated Fiscal Presentation, 2005-07**

| | 2005 | | 2006 | | | 2007 |
|---|---|---|---|---|---|---|
| | Est. | Est. 1/ | Prog. | Proj. | Proj. 1/ | Prog. |
| | (In percent of GNP; unless otherwise indicated) | | | | | |
| **PUBLIC SECTOR** | **6.2** | **6.1** | **6.7** | **7.5** | **7.2** | **6.5** |
| **I. Central government and social security** | **4.9** | **4.8** | **5.5** | **6.5** | **6.3** | **5.0** |
| **Revenue** | **31.6** | **34.3** | **34.7** | **36.6** | **36.4** | **35.8** |
| Central government revenue | **25.3** | **28.1** | **27.9** | **29.2** | **29.2** | **28.9** |
| Tax revenue | 24.5 | 24.5 | 24.0 | 24.5 | 24.5 | 25.0 |
| Nontax revenue | 3.3 | 3.6 | 3.9 | 4.7 | 4.7 | 3.8 |
| Tax rebates | -2.6 | ... | ... | ... | ... | ... |
| Social security revenue | **6.3** | **6.2** | **6.8** | **7.4** | **7.2** | **6.9** |
| Total SSI revenue | 7.3 | 10.3 | 7.7 | 8.2 | 11.0 | 11.4 |
| Portion coming from central government | 0.9 | 4.1 | 0.9 | 0.9 | 3.8 | 4.5 |
| Other | 6.3 | 6.2 | 6.8 | 7.4 | 7.2 | 6.9 |
| **Expenditures** | **26.6** | **29.5** | **29.2** | **30.1** | **30.1** | **30.7** |
| Central government expenditure | 14.6 | 16.5 | 17.4 | 17.9 | 16.8 | 17.3 |
| Personnel | 7.0 | 7.1 | 7.0 | 7.2 | 6.7 | 7.0 |
| Total personnel costs | 7.9 | 8.1 | 7.9 | 8.1 | 7.6 | 8.6 |
| Portion paid to SSI | 0.9 | 1.0 | 0.9 | 0.9 | 0.9 | 1.6 |
| Other | 7.0 | 7.1 | 7.0 | 7.2 | 6.7 | 7.0 |
| Goods and services | 2.1 | 2.3 | 2.3 | 2.3 | 2.3 | 2.4 |
| Transfers (excludes those going to SSI) | 3.5 | 5.1 | 5.9 | 6.5 | 5.9 | 5.9 |
| Total transfers | 8.3 | 10.9 | 10.1 | 10.6 | 11.3 | 10.9 |
| Portion going to SSI | 4.8 | 5.9 | 4.1 | 4.1 | 5.3 | 4.9 |
| Regular | 4.8 | 5.6 | 4.1 | 4.1 | 5.0 | 4.6 |
| * State Contribution to the Social Security System | ... | 2.2 | ... | ... | 2.0 | 1.7 |
| * Health Premiums for Poor People not Having Health Insurance | ... | 0.0 | ... | ... | 0.0 | 0.4 |
| * Duty Losses of the Social Security System | ... | 0.7 | ... | ... | 0.6 | 0.5 |
| * Financing of the Social Security System | ... | 2.7 | ... | ... | 2.4 | 2.0 |
| "Tax rebates" to pensioners | 0.0 | 0.3 | 0.0 | 0.0 | 0.3 | 0.4 |
| Non-SSI transfers | 3.5 | 5.1 | 5.9 | 6.5 | 5.9 | 5.9 |
| Capital expenditure | 2.0 | 2.1 | 2.2 | 1.9 | 1.9 | 2.0 |
| Social security expenditure | 12.1 | 13.0 | 11.9 | 12.2 | 13.3 | 13.4 |
| Of which: pension | 8.4 | 8.0 | 8.2 | 8.2 | 7.9 | 8.0 |
| Of which: "tax rebates" to pensioners | ... | 0.3 | ... | ... | 0.3 | 0.4 |
| Of which: health | 2.8 | 3.5 | 2.9 | 3.2 | 4.0 | 4.0 |
| **II. Rest of public sector** | **1.3** | **1.3** | **1.2** | **1.0** | **1.0** | **1.5** |
| **EBFs and SEEs** | 0.6 | 0.6 | 0.4 | 0.2 | 0.2 | 0.7 |
| EBFs | 0.2 | 0.2 | -0.1 | -0.2 | -0.2 | 0.2 |
| SEEs | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.5 |
| **UIF** | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| **RFs** | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| **LGs** | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 |
| **Memorandum items:** | | | | | | |
| **Central government primary surplus (unconsolidated)** | **5.0** | **4.8** | **5.5** | **6.3** | **6.1** | **5.0** |
| Revenue | 25.3 | 28.1 | 27.9 | 29.2 | 29.2 | 28.9 |
| Expenditure | 20.3 | 23.4 | 22.4 | 22.9 | 23.1 | 23.9 |
| **Social security balance (unconsolidated) after transfers** | **0.0** | **0.0** | **0.0** | **0.1** | **0.1** | **0.0** |
| Social security balance (unconsolidated) before transfers | -4.8 | -2.7 | -4.1 | -4.0 | -2.3 | -2.0 |
| Revenue | 7.3 | 10.3 | 7.7 | 8.2 | 11.0 | 11.4 |
| Expenditure | 12.1 | 13.0 | 11.9 | 12.2 | 13.3 | 13.4 |
| **Transfers** | **4.8** | **2.7** | **4.1** | **4.1** | **2.4** | **2.0** |
| **Monitored spending 2/** | **27.6** | **30.5** | **30.1** | **31.0** | **31.0** | **32.3** |
| GNP (millions of YTL) | 486,401 | 486,401 | 559,850 | 562,000 | 562,000 | 631,410 |

1/ On a 2007-comparable basis. Health spending on public employees, green card, and tax rebates for pensioners all reclassified. For 2005, mapping from consolidated budget to central government approximated. For 2006, one-off revenue share effect removed.

2/ Overrun in 2006 monitored spending after adjujsting for shared revenue is 0.6 percent of GNP.

## Table 9. Turkey: Public Sector Finances, 2002−07

| | 2002 | 2003 | 2004 | 2005 | 2006 Prog. | 2006 Adj. Prog. 1/ | 2006 Proj | 2007 Proj |
|---|---|---|---|---|---|---|---|---|
| | (In millions of new Turkish liras) | | | | | | | |
| **Public sector primary balance** | **11,246** | **22,682** | **29,982** | **30,383** | **37,352** | **37,352** | **41,885** | **41,003** |
| **Central government** | **6,644** | **17,954** | **21,876** | **24,092** | **30,807** | **30,807** | **35,685** | **31,660** |
| Primary revenue | 63,369 | 90,445 | 105,049 | 122,846 | 156,191 | 156,191 | 164,133 | 182,441 |
| Tax revenue | 59,634 | 84,335 | 101,058 | 119,254 | 133,722 | 134,235 | 137,643 | 158,153 |
| Direct taxes, *of which*: | 20,077 | 27,800 | 31,146 | 36,591 | 40,317 | 42,460 | 41,818 | 49,882 |
| Personal income taxes | 13,724 | 17,062 | 19,689 | 22,817 | 25,720 | 27,259 | 28,156 | 34,318 |
| Corporate income taxes | 5,578 | 8,646 | 9,619 | 11,402 | 11,817 | 12,061 | 10,500 | 11,925 |
| Indirect taxes, *of which*: | 39,557 | 56,535 | 69,912 | 82,663 | 93,405 | 91,773 | 95,827 | 108,271 |
| VAT | 20,401 | 27,028 | 34,324 | 38,280 | 44,050 | 40,234 | 42,832 | 49,783 |
| SCT | 13,651 | 22,299 | 26,288 | 32,753 | 36,576 | 37,474 | 37,016 | 40,170 |
| Nontax revenue 2/ | 9,402 | 14,446 | 15,147 | 16,005 | 21,868 | 21,957 | 26,490 | 24,288 |
| Revenue shares 3/ | ... | ... | ... | ... | 14,313 | ... | ... | ... |
| Tax rebates 4/ | -5,666 | -8,335 | -11,156 | -12,447 | -13,712 | ... | ... | ... |
| Primary expenditure | 56,726 | 72,492 | 83,173 | 98,752 | 125,384 | 125,384 | 128,448 | 150,781 |
| Personnel | 23,160 | 30,200 | 35,433 | 38,585 | 43,987 | 43,987 | 45,260 | 54,489 |
| Goods and services, of which: | 6,995 | 8,216 | 9,486 | 10,286 | 12,816 | 12,816 | 12,868 | 14,844 |
| Defense and security | 4,485 | 5,668 | 5,479 | 5,896 | 6,445 | 6,445 | 6,640 | 7,015 |
| Transfers, of which: 4/ | 19,289 | 26,911 | 30,282 | 40,192 | 56,311 | 56,311 | 59,680 | 68,782 |
| Social security institutions | 9,684 | 15,883 | 18,830 | 23,322 | 23,172 | 23,171 | 23,004 | 29,021 |
| Agricultural subsidies | 1,868 | 2,805 | 3,079 | 3,707 | 4,000 | 4,000 | 4,910 | 5,250 |
| Transfers of revenue shares 3/ | ... | ... | ... | ... | 13,145 | 13,145 | 14,860 | 16,963 |
| Capital transfers | 1,423 | 917 | 437 | 1,546 | 1,714 | 1,714 | 2,564 | 3,647 |
| Capital expenditure | 7,282 | 7,165 | 7,972 | 9,684 | 12,270 | 12,270 | 10,640 | 12,668 |
| **Rest of the public sector** | **4,603** | **4,728** | **8,106** | **6,291** | **6,545** | **6,546** | **6,200** | **9,344** |
| Extrabudgetary funds | -358 | 594 | 551 | 917 | -665 | -665 | -1,304 | 1,392 |
| Revolving funds 5/ | 407 | 933 | 976 | 966 | 1,287 | 1,287 | 1,137 | 1,108 |
| Social security institutions | -85 | 53 | -293 | -78 | 0 | 0 | 778 | 0 |
| Unemployment insurance fund | 962 | 1,228 | 1,557 | 1,681 | 2,127 | 2,127 | 2,282 | 2,528 |
| Local governments 5/ | 538 | -567 | 766 | 810 | 761 | 761 | 901 | 1,018 |
| State economic enterprises 6/ | 3,139 | 2,487 | 4,548 | 1,992 | 3,036 | 3,036 | 2,407 | 3,298 |
| **Public sector overall balance** | **-37,270** | **-32,089** | **-20,357** | **-3,860** | **-4,770** | **-4,770** | **1,541** | **-6,464** |
| Interest expenditure (net) | 48,516 | 54,771 | 50,339 | 34,243 | 42,123 | 42,123 | 40,344 | 47,467 |
| Domestic | 48,358 | 50,547 | 44,283 | 28,328 | 32,522 | 32,522 | 31,149 | 36,649 |
| External | 159 | 4,224 | 6,056 | 5,915 | 9,600 | 9,600 | 9,195 | 10,818 |
| **Public sector financing** | **37,270** | **32,089** | **20,357** | **3,860** | **4,770** | **4,770** | **-1,541** | **6,464** |
| Amortization | 170,216 | 113,949 | 137,486 | 145,058 | 150,145 | 150,145 | 129,255 | 125,211 |
| External | 19,438 | 11,519 | 12,655 | 14,847 | 20,980 | 20,980 | 18,574 | 18,869 |
| Domestic | 150,779 | 102,430 | 124,830 | 130,211 | 129,165 | 129,165 | 110,681 | 106,342 |
| Borrowing | 206,798 | 146,268 | 159,421 | 165,149 | 146,360 | 146,360 | 129,548 | 130,519 |
| External | 30,917 | 11,706 | 11,293 | 13,619 | 16,306 | 16,306 | 14,805 | 19,022 |
| Domestic | 175,881 | 134,562 | 148,127 | 151,529 | 130,054 | 130,054 | 114,743 | 111,498 |
| Deposits decrease 7/ | -120 | -529 | -3,427 | -21,430 | -5,629 | -5,629 | -13,845 | -2,379 |
| Privatization | 808 | 299 | 1,848 | 5,200 | 14,184 | 14,184 | 12,011 | 3,535 |

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

1/ Adjusted program figures reflect broadened scope of fiscal monitoring, with revenues grossed up by shares and tax rebates distributed.
2/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figures for 2006-07 exclude TÜPRAŞ and Türk Telekom.
3/ Revenues shared with local governments and extrabudgetary funds (shown as gross revenues and expenditures for the first time in 2006).
4/ Tax rebates to pensioners classified as transfers starting in 2004.
5/ Excluded from consolidated government sector subject to quantitative conditionality.
6/ 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).
7/ Including statistical discrepancy.

**Table 9. Turkey: Public Sector Finances, 2002–07 (Concl.)**

| | 2002 | 2003 | 2004 | 2005 | 2006 | | | 2007 |
|---|---|---|---|---|---|---|---|---|
| | | | | | Prog. | Adj. Prog. 1/ | Proj | Proj |
| | | | | (In percent of GNP) | | | | |
| **Public sector primary balance** | **4.1** | **6.4** | **7.0** | **6.2** | **6.7** | **6.7** | **7.5** | **6.5** |
| **Central government** | **2.4** | **5.0** | **5.1** | **5.0** | **5.5** | **5.5** | **6.3** | **5.0** |
| Primary revenue | 23.0 | 25.4 | 24.5 | 25.3 | 27.9 | 27.9 | 29.2 | 28.9 |
| Tax revenue | 21.7 | 23.6 | 23.6 | 24.5 | 23.9 | 24.0 | 24.5 | 25.0 |
| Direct taxes, *of which* : | 7.3 | 7.8 | 7.3 | 7.5 | 7.2 | 7.6 | 7.4 | 7.9 |
| Personal income taxes | 5.0 | 4.8 | 4.6 | 4.7 | 4.6 | 4.9 | 5.0 | 5.4 |
| Corporate income taxes | 2.0 | 2.4 | 2.2 | 2.3 | 2.1 | 2.2 | 1.9 | 1.9 |
| Indirect taxes, *of which* : | 14.4 | 15.9 | 16.3 | 17.0 | 16.7 | 16.4 | 17.1 | 17.1 |
| VAT | 7.4 | 7.6 | 8.0 | 7.9 | 7.9 | 7.2 | 7.6 | 7.9 |
| SCT | 5.0 | 6.3 | 6.1 | 6.7 | 6.5 | 6.7 | 6.6 | 6.4 |
| Nontax revenue 2/ | 3.4 | 4.1 | 3.5 | 3.3 | 3.9 | 3.9 | 4.7 | 3.8 |
| Revenue shares 3/ | ... | ... | ... | ... | 2.6 | ... | ... | ... |
| Tax rebates 4/ | -2.1 | -2.3 | -2.6 | -2.6 | -2.4 | ... | ... | ... |
| Primary expenditure | 20.6 | 20.3 | 19.4 | 20.3 | 22.4 | 22.4 | 22.9 | 23.9 |
| Personnel | 8.4 | 8.5 | 8.3 | 7.9 | 7.9 | 7.9 | 8.1 | 8.6 |
| Goods and services, of which: | 2.5 | 2.3 | 2.2 | 2.1 | 2.3 | 2.3 | 2.3 | 2.4 |
| Defense and security | 1.6 | 1.6 | 1.3 | 1.2 | 1.2 | 1.2 | 1.2 | 1.1 |
| Transfers, of which: 4/ | 7.0 | 7.5 | 7.1 | 8.3 | 10.1 | 10.1 | 10.6 | 10.9 |
| Social security institutions | 3.5 | 4.5 | 4.4 | 4.8 | 4.1 | 4.1 | 4.1 | 4.6 |
| Agricultural subsidies | 0.7 | 0.8 | 0.7 | 0.8 | 0.7 | 0.7 | 0.9 | 0.8 |
| Transfers of revenue shares 3/ | ... | ... | ... | ... | 2.3 | 2.3 | 2.6 | 2.7 |
| Capital transfers | 0.5 | 0.3 | 0.1 | 0.3 | 0.3 | 0.3 | 0.5 | 0.6 |
| Capital expenditure | 2.6 | 2.0 | 1.9 | 2.0 | 2.2 | 2.2 | 1.9 | 2.0 |
| **Rest of the public sector** | **1.7** | **1.3** | **1.9** | **1.3** | **1.2** | **1.2** | **1.1** | **1.5** |
| Extrabudgetary funds | -0.1 | 0.2 | 0.1 | 0.2 | -0.1 | -0.1 | -0.2 | 0.2 |
| Revolving funds 5/ | 0.1 | 0.3 | 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 | 0.1 | 0.0 |
| Unemployment insurance fund | 0.3 | 0.3 | 0.4 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| Local governments 5/ | 0.2 | -0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 |
| State economic enterprises 6/ | 1.1 | 0.7 | 1.1 | 0.4 | 0.5 | 0.5 | 0.4 | 0.5 |
| **Public sector overall balance** | **-13.6** | **-9.0** | **-4.7** | **-0.8** | **-0.9** | **-0.9** | **0.3** | **-1.0** |
| Interest expenditure (net) | 17.6 | 15.4 | 11.7 | 7.0 | 7.5 | 7.5 | 7.2 | 7.5 |
| Domestic | 17.6 | 14.2 | 10.3 | 5.8 | 5.8 | 5.8 | 5.5 | 5.8 |
| External | 0.1 | 1.2 | 1.4 | 1.2 | 1.7 | 1.7 | 1.6 | 1.7 |
| **Public sector financing** | **13.6** | **9.0** | **4.7** | **0.8** | **0.9** | **0.9** | **-0.3** | **1.0** |
| Amortization | 61.9 | 31.9 | 32.1 | 29.8 | 26.8 | 26.8 | 23.0 | 19.8 |
| External | 7.1 | 3.2 | 3.0 | 3.1 | 3.7 | 3.7 | 3.3 | 3.0 |
| Domestic | 54.8 | 28.7 | 29.1 | 26.8 | 23.1 | 23.1 | 19.7 | 16.8 |
| Borrowing | 75.2 | 41.0 | 37.2 | 34.0 | 26.1 | 26.1 | 23.1 | 20.7 |
| External | 11.2 | 3.3 | 2.6 | 2.8 | 2.9 | 2.9 | 2.6 | 3.0 |
| Domestic | 63.9 | 37.7 | 34.5 | 31.2 | 23.2 | 23.2 | 20.4 | 17.7 |
| Deposits decrease 7/ | 0.0 | -0.1 | -0.8 | -4.4 | -1.0 | -1.0 | -2.5 | -0.4 |
| Privatization | 0.3 | 0.1 | 0.4 | 1.1 | 2.5 | 2.5 | 2.1 | 0.6 |

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

1/ Adjusted program figures reflect broadened scope of fiscal monitoring, with revenues grossed up by shares and tax rebates distributed.

2/ Excluding privatization proceeds, transfers from CBT, and interest receipts; figures for 2006-07 exclude TÜPRAŞ and Türk Telekom.

3/ Revenues shared with local governments and extrabudgetary funds (shown as gross revenues and expenditures for the first time in 2006).

4/ Tax rebates to pensioners classified as transfers starting in 2004.

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

6/ 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).

7/ Including statistical discrepancy.

## Table 10. Turkey: Monetary Aggregates, 2001–07

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | | | | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Mar. | Jun. | Sep. | Dec. (proj.) | Proj |
| | | | | | (In billions of new Turkish liras) | | | | | |
| Broad money (M2Y) | 106.6 | 133.7 | 151.0 | 184.4 | 229.5 | 237.4 | 267.0 | 258.9 | 288.6 | 331.9 |
| Lira broad money (M2) | 47.2 | 61.9 | 82.7 | 108.5 | 153.5 | 162.1 | 177.3 | 173.0 | 192.8 | 222.5 |
| Foreign exchange deposits 1/ | 59.3 | 71.8 | 68.3 | 75.9 | 76.1 | 75.4 | 89.7 | 85.9 | 95.7 | 109.5 |
| Repos | 2.8 | 2.8 | 3.1 | 1.7 | 1.5 | 2.1 | 2.6 | 2.3 | 2.6 | 3.0 |
| Broad liquidity | 109.4 | 136.4 | 154.1 | 186.1 | 231.0 | 239.6 | 269.6 | 261.3 | 291.1 | 334.9 |
| Base money | 7.8 | 9.3 | 13.0 | 16.6 | 32.5 | 32.6 | 36.6 | 34.8 | 37.7 | 45.3 |
| Net foreign assets 1/ | -1.9 | -6.3 | -6.8 | -0.1 | 18.0 | 24.7 | 30.3 | 31.5 | 33.4 | 35.8 |
| (in billions of U.S. dollars) | -1.3 | -3.9 | -4.8 | -0.1 | 13.4 | 18.4 | 18.9 | 21.5 | 21.6 | 22.6 |
| Net domestic assets | 108.5 | 140.0 | 157.8 | 184.5 | 211.5 | 212.7 | 236.7 | 227.4 | 255.1 | 296.1 |
| Net claims on government | 89.7 | 122.8 | 139.1 | 151.4 | 152.2 | 151.1 | 151.9 | 146.8 | 157.0 | 185.7 |
| Claims on business sector 2/ | 38.7 | 42.0 | 59.6 | 90.3 | 129.9 | 141.0 | 163.3 | 163.9 | 182.5 | 198.7 |
| Turkish lira claims | 23.1 | 24.5 | 40.7 | 71.2 | 110.2 | 120.3 | 137.1 | 140.0 | 155.9 | 169.7 |
| Foreign exchange claims (est.) 1/ | 15.6 | 17.5 | 18.9 | 19.1 | 19.8 | 20.7 | 26.3 | 23.9 | 26.6 | 29.0 |
| Other items (net) | -20.0 | -24.8 | -40.9 | -57.2 | -70.6 | -79.3 | -78.6 | -83.3 | -84.3 | -88.3 |
| **Memorandum items:** | | | | | (Annual percent change) | | | | | |
| Broad money (M2Y) | 87.5 | 25.4 | 13.0 | 22.1 | 24.5 | 28.1 | 35.1 | 20.7 | 25.7 | 15.0 |
| Lira broad money (M2) | 48.0 | 31.0 | 33.7 | 31.2 | 41.4 | 42.5 | 40.3 | 24.9 | 25.6 | 15.4 |
| Foreign exchange deposits 1/ | 137.9 | 21.0 | -4.9 | 11.1 | 0.3 | 5.3 | 26.1 | 13.1 | 25.8 | 14.3 |
| Claims on business sector 2/ | 22.3 | 8.4 | 42.1 | 51.4 | 43.9 | 43.8 | 49.3 | 39.2 | 40.4 | 8.9 |
| | | | | | (In billions of U.S. dollars) | | | | | |
| Broad money (M2Y) | 74.0 | 81.8 | 108.2 | 137.4 | 170.9 | 176.8 | 166.6 | 176.1 | 186.9 | 209.7 |
| Lira broad money (M2) | 32.8 | 37.9 | 59.3 | 80.9 | 114.3 | 120.7 | 110.6 | 117.7 | 124.9 | 140.5 |
| Foreign exchange deposits | 41.2 | 43.9 | 48.9 | 56.5 | 56.7 | 56.1 | 55.9 | 58.5 | 62.0 | 69.1 |
| Net claims on government | 62.3 | 75.1 | 99.6 | 112.8 | 113.3 | 112.5 | 94.8 | 99.9 | 101.7 | 117.3 |
| Credit to the private sector | 26.9 | 25.7 | 42.7 | 67.3 | 96.8 | 105.0 | 101.9 | 111.5 | 118.2 | 125.5 |
| | | | | | (In percent share) | | | | | |
| Base money/GNP 3/ | 4.4 | 3.4 | 3.6 | 3.9 | 6.7 | 6.5 | 7.0 | 6.4 | 6.7 | 7.2 |
| Broad money (M2Y)/GNP 3/ | 60.4 | 48.6 | 42.3 | 43.0 | 47.2 | 47.6 | 51.1 | 47.8 | 51.3 | 52.6 |
| Lira broad money (M2)/GNP 3/ | 26.8 | 22.5 | 23.2 | 25.3 | 31.5 | 32.5 | 33.9 | 32.0 | 34.3 | 35.2 |
| Private credit/GNP | 21.9 | 15.3 | 16.7 | 21.0 | 26.7 | 28.3 | 31.3 | 30.3 | 32.5 | 31.5 |
| Foreign currency deposits/M2Y | 55.7 | 53.7 | 45.2 | 41.1 | 33.1 | 31.7 | 33.6 | 33.2 | 33.2 | 33.0 |
| Money multiplier | | | | | | | | | | |
| Broad money (M2Y) | 13.7 | 14.4 | 11.6 | 11.1 | 7.1 | 7.3 | 7.3 | 7.4 | 7.6 | 7.3 |
| Lira broad money (M2) | 6.1 | 6.6 | 6.4 | 6.5 | 4.7 | 5.0 | 4.8 | 5.0 | 5.1 | 4.9 |

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

**Table 11. Turkey: Central Bank Balance Sheet, 2001–06**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Mar. | Jun. | Sep. |
| | (In billions of new Turkish liras) | | | | | | | |
| **Central Bank Balance Sheet** | | | | | | | | |
| **Net foreign assets** | -12.7 | 3.9 | 8.8 | 11.0 | 38.7 | 51.1 | 46.6 | 47.2 |
| Gross foreign assets | 28.6 | 37.7 | 42.5 | 53.0 | 80.0 | 90.8 | 86.5 | 88.5 |
| Gross foreign liabilities | 41.2 | 33.8 | 33.6 | 42.0 | 41.4 | 39.7 | 39.9 | 41.3 |
| International reserve liabilities | 20.7 | 11.5 | 9.8 | 5.7 | 2.0 | 1.8 | 1.7 | 1.8 |
| Other reserve liabilities 1/ | 10.1 | 13.2 | 14.5 | 22.3 | 22.3 | 22.0 | 21.5 | 20.8 |
| Banks' FX deposits with CBT | 10.4 | 9.1 | 9.3 | 14.0 | 17.0 | 16.0 | 16.7 | 18.6 |
| **Net domestic assets** | 20.6 | 6.5 | 6.0 | 9.2 | -6.2 | -18.5 | -10.0 | -12.4 |
| **Base money** | 7.8 | 10.4 | 14.9 | 20.2 | 32.5 | 32.6 | 36.6 | 34.8 |
| Currency issued | 5.3 | 7.6 | 10.7 | 13.5 | 19.6 | 20.2 | 23.3 | 23.3 |
| Banks' lira deposits at the CBT | 2.5 | 2.8 | 4.2 | 6.7 | 12.9 | 12.4 | 13.3 | 11.5 |
| | (In billions of U.S. dollars) | | | | | | | |
| **CBT gross international reserves** | 19.8 | 26.2 | 29.5 | 35.4 | 53.4 | 60.6 | 57.7 | 59.1 |
| *at current cross rates:* | 19.8 | 28.1 | 35.2 | 37.7 | 52.5 | 60.5 | 59.1 | 60.8 |
| **CBT gross international liabilities** | 28.6 | 23.5 | 23.4 | 28.1 | 27.6 | 26.5 | 26.6 | 27.6 |
| **CBT net foreign assets** | -8.8 | 2.7 | 6.1 | 7.4 | 25.8 | 34.1 | 31.1 | 31.5 |
| plus CBT forward position | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| plus other reserve liabilities | 7.1 | 9.2 | 10.1 | 14.9 | 14.9 | 14.7 | 14.3 | 13.9 |
| minus Dresdner one year deposits | 0.7 | 1.4 | 2.1 | 3.0 | 2.9 | 2.8 | 2.7 | 2.6 |
| minus defence fund | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| **CBT net international reserves** | -2.9 | 10.0 | 13.6 | 18.9 | 37.5 | 45.7 | 42.4 | 42.6 |
| **Treasury net international reserves 2/** | -1.3 | -14.7 | -14.2 | -17.6 | -15.1 | -13.3 | -11.5 | -11.5 |
| **Net international reserves (Treasury plus CBT)** | -3.5 | -4.6 | -0.5 | 1.3 | 22.4 | 32.4 | 31.0 | 31.0 |
| | (In billions of new Turkish liras, program exchange rate) | | | | | | | |
| Net foreign assets (Treasury) | -1.8 | -21.1 | -20.4 | -26.3 | -22.7 | -19.9 | -17.2 | -17.3 |
| Net foreign assets (Treasury plus CBT) | -14.5 | -17.2 | -11.6 | -15.3 | 16.0 | 31.2 | 29.5 | 29.9 |
| Net domestic assets (Treasury) 3/ | 1.8 | 21.1 | 20.4 | 26.3 | 22.7 | 19.9 | 17.2 | 17.3 |
| Net domestic assets (Treasury plus CBT) | 22.4 | 27.6 | 26.4 | 35.5 | 16.5 | 1.5 | 7.2 | 4.9 |
| Base money (Treasury plus CBT) | 7.9 | 10.4 | 14.9 | 20.2 | 32.5 | 32.6 | 36.6 | 34.8 |
| Exchange rate (TL per US dollar, in millions) | 1.44 | 1.63 | 1.40 | 1.34 | 1.34 | 1.34 | 1.60 | 1.47 |

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

1/ Mainly Dresdner deposit liabilities.

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

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

### Table 12. Turkey: Banking System—Selected Indicators, 2001–06 1/ (Cont.)

(In millions of new Turkish liras)

| | 2001 | 2002 | 2003 | 2004 | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. 1/ | Dec. | Dec. | Dec. | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. |
| | | | | | Banking system | | | | | |
| **Total assets** | **179,675** | **212,681** | **249,693** | **306,448** | **313,722** | **337,267** | **364,241** | **396,963** | **412,466** | **455,238** |
| Cash and claims on CBT | 12,558 | 13,872 | 14,962 | 20,819 | 20,988 | 21,559 | 24,338 | 29,498 | 28,672 | 33,401 |
| Claims on other banks | 19,871 | 15,401 | 15,141 | 21,044 | 15,130 | 20,769 | 25,006 | 25,842 | 20,343 | 24,180 |
| Securities portfolio | 70,026 | 86,105 | 106,844 | 123,681 | 129,196 | 131,394 | 142,016 | 143,016 | 148,348 | 159,674 |
| Loans, net | 41,058 | 52,932 | 67,210 | 100,101 | 108,529 | 122,505 | 133,987 | 150,701 | 165,099 | 195,979 |
| Other assets | 36,162 | 44,371 | 45,536 | 40,803 | 39,879 | 41,038 | 38,894 | 47,906 | 50,004 | 42,003 |
| **Total liabilities** | **179,675** | **212,680** | **249,693** | **306,448** | **313,722** | **337,267** | **364,241** | **396,963** | **412,466** | **455,238** |
| Deposits | 110,298 | 137,973 | 155,312 | 191,065 | 192,552 | 204,607 | 221,195 | 243,121 | 254,734 | 281,764 |
| Borrowing from banks | 23,798 | 21,967 | 25,918 | 33,765 | 34,757 | 42,890 | 48,408 | 54,310 | 58,832 | 70,501 |
| Repos | 10,776 | 6,161 | 11,241 | 10,596 | 12,836 | 14,996 | 15,015 | 17,414 | 12,363 | 20,177 |
| Other liabilities | 20,527 | 21,351 | 21,683 | 25,055 | 26,255 | 27,873 | 32,202 | 28,383 | 30,864 | 31,960 |
| Shareholders' equity (incl. profits) | 14,276 | 25,228 | 35,539 | 45,966 | 47,322 | 46,900 | 47,421 | 53,736 | 55,673 | 50,836 |
| ***Memorandum items:*** | | | | | | | | | | |
| Capital adequacy ratio (%) | 15.3 | 25.3 | 30.9 | 28.8 | 28.4 | 25.6 | 23.3 | 24.2 | 23.5 | 18.6 |
| NPLs (%) total loans | 29.3 | 17.6 | 11.5 | 6.0 | 5.8 | 5.4 | 5.2 | 4.8 | 4.5 | 3.7 |
| Provisions (%) NPLs | 47.1 | 64.2 | 88.5 | 88.1 | 89.2 | 88.4 | 89.6 | 89.8 | 89.6 | 90.8 |
| 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 | 4,989.1 |
| ROA (%) | -5.5 | 1.1 | 2.3 | 2.3 | 0.7 | 1.4 | 1.3 | 1.7 | 0.7 | 1.3 |
| ROE (%) | -69.4 | 9.3 | 16.0 | 16.4 | 5.2 | 9.5 | 8.7 | 11.8 | 5.3 | 9.6 |
| Share in assets (%) | 100 | 100 | 100 | 100.0 | 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 | 100.0 |
| | | | | | Private banks | | | | | |
| **Total assets** | **97,930** | **119,471** | **142,270** | **175,924** | **182,743** | **202,506** | **215,006** | **237,043** | **243,670** | **277,999** |
| Cash and claims on CBT | 8,434 | 9,356 | 9,868 | 14,149 | 13,856 | 14,945 | 15,966 | 20,760 | 17,773 | 20,665 |
| Claims on other banks | 10,494 | 7,623 | 6,369 | 9,483 | 6,244 | 9,861 | 11,385 | 13,425 | 9,392 | 13,312 |
| Securities portfolio | 27,146 | 39,819 | 51,485 | 56,445 | 60,039 | 63,695 | 69,728 | 71,013 | 71,688 | 80,506 |
| Loans, net | 26,506 | 35,752 | 46,402 | 69,011 | 75,330 | 86,367 | 91,145 | 102,916 | 114,352 | 135,693 |
| Other assets | 25,350 | 26,921 | 28,146 | 26,836 | 27,274 | 27,636 | 26,782 | 28,928 | 30,465 | 27,825 |
| **Total liabilities** | **97,930** | **119,471** | **142,270** | **175,924** | **182,743** | **202,506** | **215,006** | **237,043** | **243,670** | **277,999** |
| Deposits | 67,223 | 80,629 | 88,180 | 105,195 | 106,422 | 115,906 | 125,451 | 138,669 | 144,192 | 162,869 |
| Borrowing from banks | 15,585 | 13,703 | 18,158 | 23,920 | 25,672 | 31,882 | 34,578 | 40,243 | 42,420 | 51,065 |
| Repos | 1,803 | 4,074 | 8,103 | 8,954 | 11,077 | 13,698 | 13,255 | 15,692 | 10,498 | 17,204 |
| Other liabilities | 5,779 | 5,871 | 6,872 | 10,455 | 11,749 | 12,995 | 15,561 | 13,043 | 15,768 | 18,059 |
| Shareholders' equity (incl. profits) | 7,540 | 15,194 | 20,958 | 27,399 | 27,823 | 28,023 | 26,161 | 29,396 | 30,792 | 28,801 |
| ***Memorandum items:*** | | | | | | | | | | |
| Capital adequacy ratio (%) | 9.0 | 19.64 | 23.5 | 22.3 | 21.3 | 19.5 | 16.8 | 17.2 | 17.3 | 13.9 |
| NPLs (%) total loans | 27.6 | 8.9 | 6.5 | 4.9 | 4.9 | 4.5 | 4.4 | 4.1 | 3.9 | 3.2 |
| Provisions (%) NPLs | 31.0 | 53.0 | 80.0 | 83.5 | 85.3 | 84.0 | 86.1 | 86.1 | 86.3 | 88.3 |
| 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 | 2,770.0 |
| ROA (%) | -7.5 | 2.0 | 2.1 | 1.8 | 0.7 | 1.2 | 0.5 | 0.7 | 0.7 | 1.2 |
| ROE (%) | -97.9 | 15.9 | 13.9 | 11.8 | 4.4 | 8.0 | 3.2 | 5.0 | 5.5 | 9.5 |
| Share in assets (%) | 54.5 | 56.2 | 57.0 | 57.4 | 58.2 | 60.0 | 59.0 | 59.7 | 59.1 | 61.1 |
| Share in deposits and repos (%) | 57.0 | 58.8 | 57.8 | 56.6 | 57.2 | 59.0 | 58.7 | 59.2 | 57.9 | 59.6 |

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 12. Turkey: Banking System—Selected Indicators, 2001-06 1/ (Cont.)**

(In millions of new Turkish liras)

| | 2001 | 2002 | 2003 | 2004 | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. 1/ | Dec. | Dec. | Dec. | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. |
| | | | | | State banks 2/ | | | | | |
| **Total assets** | **57,583** | **67,831** | **83,134** | **108,841** | **108,496** | **111,318** | **116,426** | **126,344** | **132,185** | **135,025** |
| Cash and claims on CBT | 3,544 | 4,000 | 4,589 | 6,000 | 6,477 | 5,855 | 7,094 | 7,351 | 9,028 | 10,447 |
| Claims on other banks | 5,096 | 3,996 | 5,365 | 6,689 | 4,821 | 6,263 | 7,497 | 5,995 | 6,039 | 5,066 |
| Securities portfolio | 32,756 | 39,245 | 47,716 | 63,333 | 64,781 | 63,482 | 65,486 | 65,444 | 69,474 | 72,067 |
| Loans, net | 9,177 | 8,804 | 12,202 | 21,057 | 22,711 | 24,642 | 27,125 | 31,518 | 32,660 | 39,067 |
| Other assets | 7,011 | 11,786 | 13,263 | 11,763 | 9,706 | 11,074 | 9,224 | 16,037 | 14,984 | 8,377 |
| **Total liabilities** | **57,583** | **67,831** | **83,134** | **108,841** | **108,496** | **111,318** | **116,426** | **126,344** | **132,185** | **135,025** |
| Deposits | 37,258 | 48,489 | 59,862 | 81,156 | 81,265 | 83,426 | 85,948 | 94,472 | 99,539 | 104,886 |
| Borrowing from banks | 2,381 | 2,230 | 2,338 | 4,249 | 2,676 | 4,142 | 5,145 | 5,357 | 5,531 | 7,011 |
| Repos | 3,844 | 1,022 | 1,018 | 1,231 | 1,085 | 999 | 762 | 653 | 1,530 | 2,044 |
| Other liabilities | 9,707 | 9,343 | 10,342 | 10,865 | 11,277 | 11,435 | 12,350 | 11,077 | 10,477 | 9,030 |
| Shareholders' equity (incl. profits) | 4,393 | 6,747 | 9,574 | 11,340 | 12,193 | 11,314 | 12,221 | 14,786 | 15,108 | 12,053 |
| ***Memorandum items:*** | | | | | | | | | | |
| Capital adequacy ratio (%) | 34.0 | 50.2 | 56.3 | 41.5 | 45.2 | 39.1 | 38.2 | 40.9 | 38.2 | 26.6 |
| NPLs (%) total loans | 37.3 | 37.4 | 26.2 | 10.7 | 10.0 | 9.5 | 8.8 | 7.7 | 7.2 | 6.1 |
| Provisions (%) NPLs | 63 | 74 | 98 | 95.2 | 96.1 | 96.4 | 96.4 | 96.7 | 96.5 | 96.6 |
| 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 | 1,618.7 |
| ROA (%) | -1.2 | 1.6 | 2.2 | 3.2 | 0.8 | 1.4 | 2.1 | 2.8 | 0.6 | 1.3 |
| ROE (%) | -15.5 | 15.7 | 18.7 | 31.9 | 8.0 | 14.3 | 19.7 | 25.5 | 5.9 | 11.9 |
| Share in assets (%) | 32.0 | 31.9 | 33.3 | 35.5 | 34.6 | 33.0 | 32.0 | 31.8 | 32.0 | 29.7 |
| Share in deposits and repos (%) | 33.9 | 34.4 | 36.6 | 40.9 | 40.1 | 38.4 | 36.7 | 36.5 | 37.8 | 35.4 |
| | | | | | 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 | - | - | - | - | - | - | - |

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 12. Turkey: Banking System—Selected Indicators, 2001-06 1/ (Concl.)**

(In millions of new Turkish liras)

| | 2001 | 2002 | 2003 | 2004 | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. 1/ | Dec. | Dec. | Dec. | Mar. | Jun. | Sep. | Dec. | Mar. | Jun. |
| | **Foreign and investment banks** | | | | | | | | | |
| **Total assets** | **13,126** | **16,068** | **17,213** | **21,683** | **22,483** | **23,442** | **32,809** | **33,576** | **36,611** | **42,214** |
| Cash and claims on CBT | 535 | 454 | 454 | 629 | 594 | 696 | 1,159 | 1,236 | 1,191 | 1,974 |
| Claims on other banks | 3,408 | 3,164 | 2,951 | 4,871 | 4,064 | 4,645 | 6,124 | 6,422 | 4,913 | 5,802 |
| Securities portfolio | 1,673 | 2,386 | 2,680 | 3,903 | 4,376 | 4,215 | 6,803 | 6,559 | 7,186 | 7,101 |
| Loans, net | 4,773 | 6,487 | 7,695 | 10,034 | 10,489 | 11,495 | 15,717 | 16,267 | 18,087 | 21,220 |
| Other assets | 2,738 | 3,577 | 3,434 | 2,246 | 2,960 | 2,389 | 3,007 | 3,092 | 5,234 | 6,117 |
| **Total liabilities** | **13,126** | **16,068** | **17,213** | **21,683** | **22,483** | **23,442** | **32,809** | **33,576** | **36,611** | **42,214** |
| Deposits | 2,252 | 3,086 | 3,137 | 4,714 | 4,866 | 5,275 | 9,796 | 9,980 | 11,004 | 14,008 |
| Borrowing from banks | 3,812 | 4,761 | 4,585 | 5,596 | 6,409 | 6,864 | 8,685 | 8,710 | 10,881 | 12,425 |
| Repos | 105 | 40 | 95 | 411 | 674 | 298 | 998 | 1,069 | 335 | 928 |
| Other liabilities | 4,227 | 3,798 | 3,542 | 3,735 | 3,229 | 3,442 | 4,290 | 4,263 | 4,619 | 4,871 |
| Shareholders' equity (incl. profits) | 2,730 | 4,383 | 5,854 | 7,226 | 7,306 | 7,561 | 9,039 | 9,554 | 9,772 | 9,981 |
| ***Memorandum items:*** | | | | | | | | | | |
| Capital adequacy ratio (%) | 41.0 | 48.37 | 60.8 | 56.0 | 54.3 | 49.4 | 40.3 | 40.25 | 37.90 | 34.17 |
| NPLs (%) total loans | 9.3 | 4.3 | 3.8 | 3.2 | 3.2 | 3.1 | 3.5 | 3.37 | 3.26 | 2.84 |
| Provisions (%) NPLs | 81.2 | 69.3 | 85.5 | 81.5 | 83.1 | 80.7 | 84.9 | 86.07 | 85.57 | 84.90 |
| Net profit (loss) after tax | 498 | 548 | 698 | 557 | 260 | 543 | 924 | 1,196 | 352 | 600 |
| ROA (%) | 3.8 | 3.4 | 4.1 | 2.9 | 1.2 | 2.4 | 3.7 | 4.28 | 1.13 | 1.69 |
| ROE (%) | 18.2 | 12.5 | 11.9 | 8.6 | 3.8 | 7.6 | 12.0 | 14.44 | 3.96 | 6.31 |
| Share in assets (%) | 7.3 | 7.6 | 6.9 | 7.1 | 7.2 | 7.0 | 9.0 | 8.5 | 8.9 | 9.3 |
| Share in deposits and repos (%) | 1.9 | 2.2 | 1.9 | 2.5 | 2.7 | 2.5 | 4.6 | 4.2 | 4.2 | 4.9 |

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

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

2/ SDIF banks group consist of only one bank and Bayındırbank is added to the State Banks group due to Banks Act.

**Table 13. Turkey: Indicators of Fund Credit, 2002–10 1/**

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| Outstanding Fund credit (end of period) | | | | | | | | | |
| In billions of SDRs | 16.2 | 16.2 | 13.8 | 10.2 | 7.3 | 6.0 | 5.5 | 3.6 | 1.4 |
| In percent of quota | 1685 | 1682 | 1436 | 1063 | 611 | 507 | 466 | 299 | 118 |
| In percent of exports of G&NFS | 37 | 32 | 22 | 14 | 9 | 7 | 6 | 4 | 1 |
| In percent of GNP | 13 | 9 | 6 | 4 | 3 | 2 | 2 | 1 | 0 |
| In percent of public sector external debt | 25 | 24 | 22 | 18 | 13 | 11 | 11 | 7 | 3 |
| In percent of overall external debt | 16 | 16 | 13 | 9 | 6 | 4 | 4 | 2 | 1 |
| In percent of end-period foreign reserves | 75 | 65 | 54 | 29 | 20 | 16 | 14 | 9 | 3 |
| Repurchases of Fund Credit | | | | | | | | | |
| In billions of SDRs | 4.9 | 1.2 | 3.2 | 5.3 | 5.0 | 3.5 | 1.2 | 2.0 | 2.2 |
| In percent of quota | 510 | 127 | 328 | 550 | 418 | 292 | 104 | 166 | 181 |
| In percent of exports of G&NFS | 11 | 2 | 5 | 7 | 6 | 4 | 1 | 2 | 2 |
| In percent of GNP | 4 | 1 | 1 | 2 | 2 | 1 | 0 | 1 | 1 |
| In percent of public sector external debt service | 37 | 11 | 23 | 33 | 32 | 25 | 11 | 20 | 21 |
| In percent of overall MLT external debt service | 22 | 6 | 16 | 22 | 19 | 13 | 5 | 7 | 7 |
| In percent of start period foreign reserves | 32 | 6 | 13 | 21 | 14 | 10 | 3 | 5 | 5 |
| In percent gross public sector ext. financing 2/ | 21 | 7 | 16 | 11 | 18 | 13 | 7 | 12 | 12 |
| Net Fund Resource Flows 3/ | | | | | | | | | |
| In billions of SDRs | 4.4 | -0.7 | -3.0 | -4.2 | -3.4 | -1.5 | -0.7 | -2.2 | -2.2 |
| In percent of quota | 455 | -72 | -312 | -438 | -286 | -127 | -62 | -182 | -188 |
| In percent of exports of G&NFS | 10 | -1 | -5 | -6 | -4 | -2 | -1 | -2 | -2 |
| In percent of GNP | 3 | 0 | -1 | -2 | -1 | -1 | 0 | -1 | -1 |
| In percent of public sector external debt service | 33 | -6 | -22 | -27 | -22 | -11 | -7 | -21 | -22 |
| In percent of overall MLT external debt service | 20 | -4 | -15 | -17 | -13 | -5 | -3 | -8 | -7 |
| In percent start period foreign reserves | 29 | -3 | -13 | -17 | -10 | -4 | -2 | -5 | -6 |
| In percent gross public sector ext. financing 2/ | 19 | -4 | -15 | -9 | -12 | -6 | -4 | -13 | -12 |

1/ Projected on an expectations basis, except 2006 repurchase expectations, which are projected on an obligations basis.
Assumes purchases of SDR 750 million in December 2006 and remaining purchases according to Proposed Schedule of Purchases.
Quota was increased effective November 1, 2006 from SDR964 million to SDR 1191.3 million.
2/ Consolidated govt. and CBT. Includes reserve accumulation before repurchases.
3/ Net purchases less repurchases and charges.

## Appendix I. Fund Relations

(As of November 15, 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 | 1,191.30 | 100.00 |
| Fund holdings of currency | 7,591.20 | 637.22 |
| Reserve position in Fund | 112.78 | 9.47 |

| III. **SDR Department:** | **Millions of SDRs** | **Percent of Allocation** |
|---|---|---|
| Net cumulative allocation | 112.31 | 100.00 |
| Holdings | 10.45 | 9.31 |

| IV. **Outstanding Purchases and Loans**: | **Millions of SDRs** | **Percent of Quota** |
|---|---|---|
| Stand-By Arrangements | 6,512.67 | 546.69 |

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 | 2,914.64 |
| 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)**[6]

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

| | Forthcoming | | | |
|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 |
| Principal | 3,481.67 | 1,244.05 | 1,318.53 | 468.42 |
| Charges/Interest | 297.23 | 147.57 | 72.22 | 13.52 |
| Total | 3,778.89 | 1,391.62 | 1,390.75 | 481.94 |

[6] 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)**[7]
(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

| | Forthcoming | | | |
|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 |
| Principal | 2,520.65 | 961.02 | 1,244.05 | 1,318.53 |
| Charges/Interest | 324.02 | 212.90 | 147.10 | 72.47 |
| Total | 2,844.67 | 1,173.91 | 1,391.14 | 1,391.00 |

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 some remaining 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 (IMF Country Report 05/163) was issued on July 9, 2004, and the accompanying Selected Issues paper (to the public as Occasional Paper 242) was issued on July 15, 2004. Board discussion took place on July 30, 2004.

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

X. **ROSCs**

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

XI. **Recent Technical Assistance**:

| Dept. | Timing | Purpose |
|---|---|---|
| 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 | Sept. 05 | Tax and social security administration reforms |
| FAD | Apr. 06 | Tax and social security administration reforms |
| FAD | Aug. 06 | Revenue administration |
| STA | Sept. 06 | National accounts statistics |

## APPENDIX II: EXTERNAL DEBT SUSTAINABILITY

*The external debt ratio will rise in 2006 due to lira depreciation and a wider current account deficit, but it is projected to stabilize over the medium term as the current account adjusts.*

**Gross external debt is expected to jump by 6 percentage points of GNP in 2006 as a result of the May–June lira depreciation and debt financing of the current account**.[8] The depreciation raises the lira value of external debt, adding close to 3 percentage points to the end-2006 debt ratio.[9] Debt inflows are expected to exceed US$22 billion in 2006, driven by long-term bank (US$5 billion) and corporate (US$13 billion) borrowing. Although record levels of FDI in 2006 reduce the need for debt financing, that is largely offset by lower non-debt portfolio inflows (i.e. equities), reflecting a decline in investor demand for Turkish risk.

**The debt ratio is projected to stabilize in the medium term at 2006 levels.** Under revised projections, the gross debt ratio jumps by 6 percentage points of GNP in 2006 and then remains essentially flat over the medium term. The stable trajectory of the debt ratio is based on a gradual narrowing of the current account deficit, which reflects the assumptions that May–June competitiveness gains are permanent and that domestic demand growth moves to a lower path. The medium-term debt-stabilizing current account deficit (excluding interest) is 3.5 percent of GNP (Table II.1).

**External debt remains vulnerable to standardized shocks** (Figure II.1). Turkey's history of macroeconomic volatility implies that the standardized debt sustainability tests are particularly demanding compared to most countries. A permanent ½ standard deviation growth shock would put the debt ratio on an upward trajectory over 2006–10 and lead to an increase of 7 percentage points in the gross external debt ratio by 2010. A permanent current account shock of ½ standard deviation would have a similar effect, as would a ¼ standard deviation joint shock to growth, the current account, and interest rates. A real depreciation shock of 30 percent in 2006 (on top of the depreciation to date) would cause the gross external debt ratio to jump 20 percentage points to 73 percent of GNP, 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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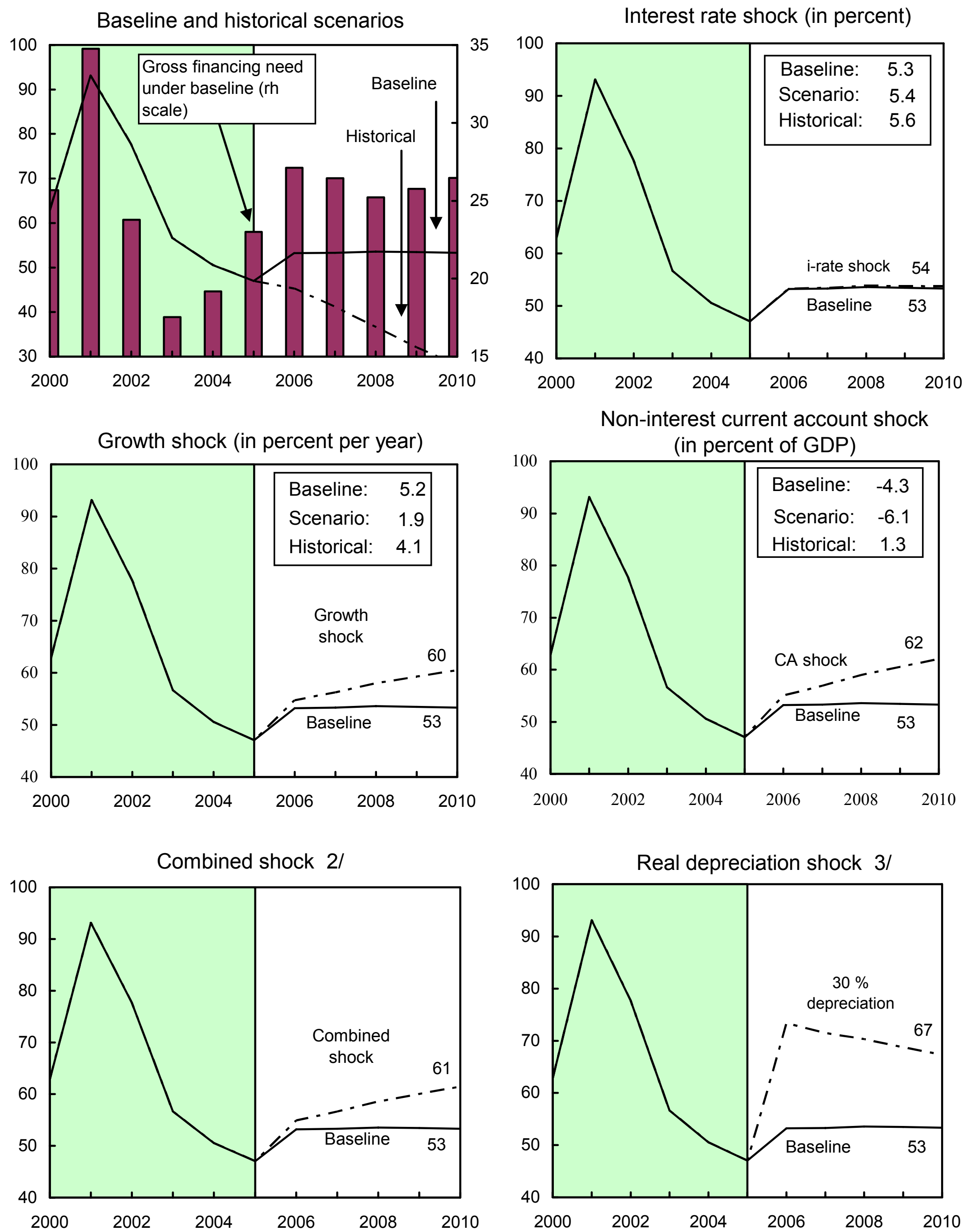
[8] External debt refers to current, non-contingent claims by nonresidents on residents in the form of loans, bonds, leases, etc. It is assumed that: (i) securities issued abroad, e.g., Eurobonds, are held by nonresidents; (ii) domestically issued securities denominated in foreign currencies are held by residents.

[9] Calculated as the increase in the debt ratio due to depreciation against the dollar, net of the effects of inflation on nominal GNP. Each 10 percent lira depreciation adds about 5 percentage points to the external debt ratio.

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




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 one-quarter 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, 2000-2010**

(In percent of GNP, unless otherwise indicated)

| | Actual | | | | | | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 10-Year Historical Average | 10-Year Standard Deviation | 2006 | 2007 | 2008 | 2009 | 2010 | Debt-stabilizing non-interest current account 7/ |
| **Baseline: External debt 1/** | 63.4 | 93.1 | 77.5 | 56.6 | 50.5 | 47.2 | | | **53.2** | **53.3** | **53.6** | **53.5** | **53.3** | **-3.5** |
| Change in external debt | -7.8 | 29.7 | -15.6 | -20.9 | -6.0 | -3.4 | | | 6.1 | 0.1 | 0.3 | -0.1 | -0.2 | |
| Identified external debt-creating flows (4+8+9) | -10.7 | 28.8 | -24.7 | -24.0 | -7.7 | -1.0 | | | 0.1 | 1.4 | 1.7 | 1.5 | 1.1 | |
| Current account deficit, excluding interest payments | 1.9 | -8.6 | -2.9 | 0.4 | 2.6 | 4.1 | | | 5.7 | 4.8 | 4.0 | 3.6 | 3.3 | |
| Deficit in balance of goods and services | 7.8 | -0.3 | 2.4 | 3.5 | 5.2 | 6.8 | | | 8.9 | 8.1 | 6.9 | 6.4 | 6.0 | |
| Exports | 28.8 | 43.6 | 34.2 | 28.3 | 28.9 | 29.4 | | | 32.2 | 33.3 | 33.5 | 33.5 | 33.5 | |
| Imports | 36.6 | 43.2 | 36.6 | 31.9 | 34.1 | 36.2 | | | 41.1 | 41.4 | 40.4 | 39.8 | 39.5 | |
| Net non-debt creating capital inflows (negative) | -0.3 | -2.2 | -0.2 | -0.4 | -1.1 | -4.0 | | | -5.6 | -3.8 | -2.3 | -2.1 | -2.1 | |
| Automatic debt dynamics 2/ | -12.2 | 39.6 | -21.6 | -24.0 | -9.2 | -1.1 | | | -0.1 | 0.4 | 0.0 | 0.0 | -0.1 | |
| Contribution from nominal interest rate | 3.4 | 5.8 | 3.8 | 2.7 | 2.3 | 2.3 | | | 2.7 | 2.8 | 2.5 | 2.4 | 2.4 | |
| Contribution from real GNP growth | -3.5 | 9.3 | -5.4 | -3.0 | -4.4 | -3.4 | | | -2.8 | -2.4 | -2.5 | -2.5 | -2.5 | |
| Contribution from price and exchange rate changes 3/ | -12.1 | 24.5 | -20.0 | -23.7 | -7.0 | ... | | | ... | ... | ... | ... | ... | |
| Residual, incl. change in gross foreign assets (2-3) 4/ | 2.9 | 1.0 | 9.1 | 3.1 | 1.6 | -2.4 | | | 6.0 | -1.3 | -1.5 | -1.6 | -1.2 | |
| External debt-to-exports ratio (in percent) | 219.8 | 213.7 | 226.5 | 199.8 | 175.1 | 160.3 | | | 165.2 | 160.2 | 159.9 | 159.7 | 159.2 | |
| **Gross external financing need (in billions of US dollars) 5/** | 48.0 | 42.4 | 39.9 | 44.9 | 61.6 | 83.2 | | | 98.7 | 105.5 | 108.8 | 119.6 | 132.2 | |
| in percent of GNP | 25.7 | 34.8 | 23.8 | 17.5 | 19.2 | 23.0 | | | 27.1 | 26.5 | 25.2 | 25.8 | 26.5 | |
| **Scenario with key variables at their historical averages 6/** | | | | | | | | | **45.3** | **41.2** | **36.6** | **32.1** | **28.1** | **-2.6** |
| **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 | 6.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.2 |
| GNP deflator in US dollars (change in percent) | 20.5 | -27.9 | 27.4 | 44.2 | 14.1 | 4.7 | 8.2 | 20.5 | -5.0 | 4.3 | 3.0 | 2.5 | 2.5 | 1.5 |
| Nominal external interest rate (in percent) | 6.1 | 6.0 | 5.6 | 5.3 | 5.0 | 5.1 | 5.6 | 0.4 | 5.8 | 5.7 | 5.1 | 4.9 | 4.8 | 5.3 |
| Growth of exports (US dollar terms, in percent) | 12.4 | -1.4 | 8.0 | 26.3 | 27.8 | 14.9 | 11.1 | 12.8 | 10.3 | 13.1 | 8.9 | 7.5 | 7.6 | 9.5 |
| Growth of imports (US dollar terms, in percent) | 26.3 | -23.0 | 16.3 | 32.9 | 34.1 | 19.7 | 12.9 | 18.7 | 14.2 | 10.3 | 5.7 | 6.2 | 6.7 | 8.6 |
| Current account balance, excluding interest payments | -1.9 | 8.6 | 2.9 | -0.4 | -2.6 | -4.1 | 1.3 | 3.7 | -5.7 | -4.8 | -4.0 | -3.6 | -3.3 | -4.3 |
| Net non-debt creating capital inflows | 0.3 | 2.2 | 0.2 | 0.4 | 1.1 | 4.0 | 0.8 | 1.6 | 5.6 | 3.8 | 2.3 | 2.1 | 2.1 | 3.2 |

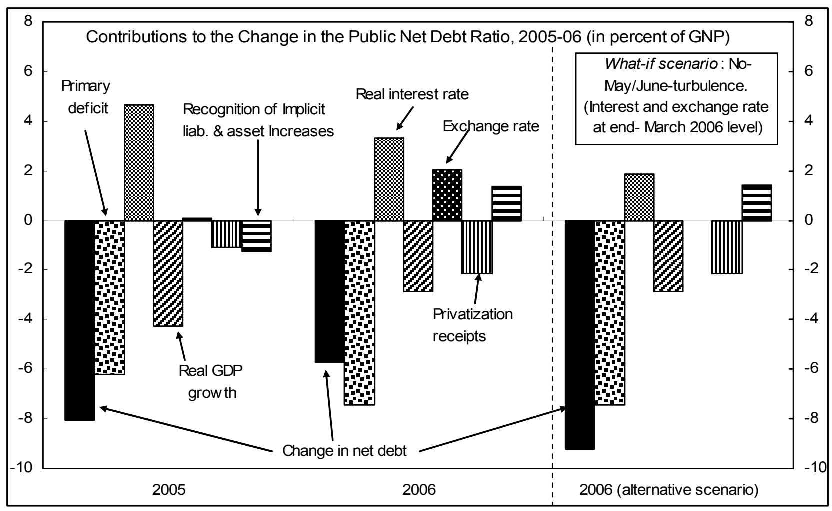
1/ Debt ratios valued at end-year exchange rates (in IMF Country Report 06/268, valued at annual average exchange rates).
2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GNP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
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 public debt ratio is expected to continue declining, even after accounting for the effect of the May-June turbulence. Debt dynamics remain sustainable under most plausible shocks, provided that fiscal discipline is maintained.*

**Public sector debt ratios will fall further this year, despite the impact of the May-June turbulence**. On the back of stronger-than-previously-projected outcomes for the primary fiscal surplus and output growth, high privatization receipts (over 2 percent of GNP), and a partial rebound of the lira, the gross and net public debt ratios are expected to fall by about 5 percentage points in 2006, to around 66 and 50 percent of GNP, respectively.

**However, higher interest rates and a weaker lira did slow debt reduction, while adding to the interest burden**. If exchange and interest rates had remained at their end-March levels, debt would have fallen by another 3.5 percentage points in 2006. Put differently, everything else unchanged, the exchange rate depreciation and the interest rate increase added about 2 and 1½ percentage points to the debt ratio, respectively. From a flow perspective, this implies additional interest payments of 1½ percentage points of GNP in 2006 and around 2½ percentage points of GNP in 2007.



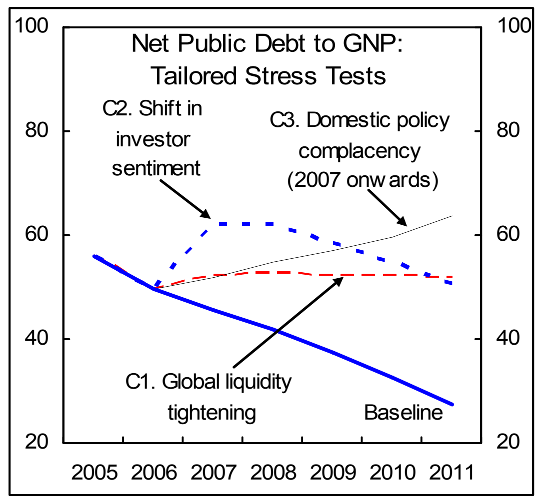

**Nonetheless, even under higher baseline interest rates assumptions, debt ratios are projected to continue declining steadily over the medium term**. Assuming annual economic growth stays at 5 percent and the primary surplus at 6.5 percent of GNP (but no further privatization receipts are realized after 2007), the net debt ratio would fall to below 30 percent by 2011, even if real interest rates remain at 10 percent in outer years.

**Debt dynamics remain robust under most of the standard *alternative scenarios* and *bound tests*—only placing key variables at historical averages or combinations of large shocks would undermine sustainability**. (Table III.1, panel A and B). In scenarios where key variables return to historical averages (A1), real interest rates increase dramatically (B1), or a combination of shocks occurs (B4), debt sustainability would be at risk. Debt ratios are either on a rising trend (A1) or they jump to uncomfortably high levels in response to a shock and decline only slowly afterwards (B1 and B4).

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

- **Deterioration in global environment** (C.1.). This test assumes an unexpected slowdown in global growth combined with a sharp tightening of liquidity in industrial countries, which triggers risk aversion among investors and a rise in emerging market risk premia. As a consequence, the lira would depreciate by 20 percent in 2007, and interest rates would increase by 500 bps in 2007–11. In response, growth would fall to half of its baseline rate, but fiscal policy would remain unchanged. As a result, the debt ratio would rise to about 52 percent of GNP in 2007 and remain there for the rest of the projection period.

- **Turkey-specific shift in investor sentiment** (C.2.). This assumes that a Turkey-specific event triggers a loss in investor confidence and a sudden large outflow of capital in 2007. The lira would depreciate by 40 percent, interest rates rise by 1000 bps and 500 bps above the baseline in 2007 and 2008, respectively, while growth would fall to zero in 2007 (baseline assumption afterwards). With fiscal policy unchanged, the debt ratio would jump by over 12 percentage points to 62 percent of GNPs in 2007 and remain at that level in 2008. However, it would then decline steadily during 2009−2011 as all variables return to baseline values.




- **Domestic policy complacency** (C.3.). It is assumed that, starting in 2007, the primary surplus is lowered, while structural reforms are no longer pursued, including an immediate halt of privatizations. This causes a permanent increase in the real interest rate; and while the initial fiscal stimulus helps to maintain output in the first year, growth falls to a lower trend rate in the following period. Taken together, this places debt dynamics on a steadily increasing path, with the debt ratio climbing by roughly 10 percentage points by the end of the decade.

**While these tests highlight Turkey's exposure to market risks, they also show the key role played by fiscal policy in preserving debt sustainability**. The first two tests illustrate how maintaining fiscal discipline can help prevent a lasting deterioration of debt dynamics, even under severe financial market pressures. In contrast, fiscal policy complacency by itself could set in motion an adverse scenario of higher interest rates and lower growth that would place public debt on an unsustainable path.

**Table III.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** | **107.3** | **93.4** | **83.2** | **77.3** | **71.6** | | | **65.8** | **60.4** | **55.5** | **50.9** | **46.8** | **42.9** |
| 1 **Public sector net debt 1/** | **90.4** | **78.4** | **70.3** | **63.4** | **55.3** | | | **49.6** | **45.6** | **41.8** | **37.3** | **32.5** | **27.5** |
| *Of which:* foreign-currency denominated | 55.4 | 45.1 | 30.5 | 25.2 | 14.3 | | | 12.9 | 10.5 | 9.6 | 8.6 | 7.5 | 6.3 |
| 2 Change in public sector debt | 33.3 | -12.0 | -8.1 | -6.9 | -8.0 | | | -5.7 | -4.1 | -3.8 | -4.5 | -4.7 | -5.0 |
| 3 Identified debt-creating flows (4+7+12) | 28.5 | -13.0 | -14.9 | -8.7 | -6.8 | | | -9.1 | -4.4 | -3.9 | -4.7 | -4.9 | -5.1 |
| 4 Primary deficit | -5.5 | -4.1 | -6.4 | -7.0 | -6.2 | | | -7.5 | -6.5 | -6.5 | -6.5 | -6.5 | -6.5 |
| 5 Revenue and grants | 26.1 | 24.8 | 26.7 | 26.9 | 27.9 | | | 29.2 | 28.9 | 29.0 | 29.0 | 29.0 | 29.0 |
| 6 Primary (noninterest) expenditure | 20.6 | 20.6 | 20.3 | 19.9 | 21.7 | | | 21.8 | 22.4 | 22.5 | 22.5 | 22.5 | 22.5 |
| 7 Automatic debt dynamics 2/ | 34.0 | -8.6 | -8.4 | -1.3 | 0.5 | | | 0.4 | 2.7 | 2.6 | 1.8 | 1.6 | 1.4 |
| 8 Contribution from interest rate/growth differential 3/ | 6.1 | -14.7 | -2.6 | -0.1 | 0.4 | | | 0.4 | 2.7 | 2.6 | 1.8 | 1.6 | 1.4 |
| 9 *Of which:* contribution from real interest rate | 2.3 | -10.1 | 1.0 | 5.7 | 4.6 | | | 3.3 | 4.9 | 4.7 | 3.8 | 3.3 | 2.9 |
| 10 *Of which:* contribution from real GDP growth | 3.9 | -4.6 | -3.5 | -5.8 | -4.3 | | | -2.9 | -2.2 | -2.1 | -1.9 | -1.7 | -1.5 |
| 11 Contribution from exchange rate depreciation 4/ | 27.8 | 6.2 | -5.9 | -1.2 | 0.1 | | | ... | ... | ... | ... | ... | ... |
| 12 Other identified debt-creating flows | 0.0 | -0.3 | -0.1 | -0.4 | -1.1 | | | -2.1 | -0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| 13 Privatization receipts (negative) | 0.0 | -0.3 | -0.1 | -0.4 | -1.1 | | | -2.1 | -0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 15 Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 16 Residual, including asset changes (2-3) 5/ | 4.8 | 1.0 | 6.8 | 1.7 | -1.3 | | | 3.4 | 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 | 6.0 | 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 | 14.1 | 56.8 | 35.5 | 16.5 | 18.5 | 16.0 | 14.0 | 14.0 | 14.0 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 11.3 | 7.9 | 15.9 | 10.6 | 8.7 | 17.8 | 16.1 | 7.5 | 11.5 | 11.5 | 10.0 | 10.0 | 10.0 |
| 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 | 9.0 | 7.0 | 4.5 | 4.0 | 4.0 | 4.0 |
| 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 | 6.5 | 8.1 | 5.5 | 5.0 | 5.0 | 5.0 |
| Primary deficit | -5.5 | -4.1 | -6.4 | -7.0 | -6.2 | -3.0 | 3.4 | -7.5 | -6.5 | -6.5 | -6.5 | -6.5 | -6.5 |
| | | | | | | | | **II. Stress Tests for Public Debt Ratio** | | | | | |
| **A. Alternative Scenarios** | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2007-11 | | | | | | | | **49.6** | **52.3** | **55.9** | **60.0** | **64.7** | **70.0** |
| A2. No policy change (constant primary balance) in 2007-11 | | | | | | | | **49.6** | **43.7** | **38.8** | **33.2** | **27.3** | **21.2** |
| A3. 2007 GDP growth is reduced (relative to baseline) by one standard deviation | | | | | | | | **49.6** | **48.6** | **44.6** | **39.7** | **34.7** | **29.4** |
| A4. Selected variables are consistent with market forecast in 2007-11 | | | | | | | | **49.6** | **45.6** | **42.3** | **38.8** | **35.6** | **32.3** |
| **B. Bound Tests** | | | | | | | | | | | | | |
| B1. Real interest rate is at historical average plus two standard deviations in 2007 and 2008 | | | | | | | | **49.6** | **62.7** | **82.0** | **79.4** | **76.6** | **73.7** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2007 and 2008 | | | | | | | | **49.6** | **53.5** | **58.9** | **55.2** | **51.3** | **47.2** |
| B3. Primary balance is at historical average minus two standard deviations in 2007 and 2008 | | | | | | | | **49.6** | **55.8** | **62.9** | **59.4** | **55.7** | **51.9** |
| B4. Combination of B1-B3 using one standard deviation shocks | | | | | | | | **49.6** | **55.4** | **75.8** | **72.9** | **69.8** | **66.6** |
| B5. One time 30 percent real depreciation in 2007 8/ | | | | | | | | **49.6** | **52.6** | **49.3** | **45.1** | **40.7** | **36.1** |
| B6. 10 percent of GDP increase in other debt-creating flows in 2006 | | | | | | | | **49.6** | **55.6** | **52.4** | **48.4** | **44.1** | **39.7** |
| **C. Tailored Tests** | | | | | | | | | | | | | |
| C1. Deterioration in global environment (liquidity tighetning and low world growth). 9/ | | | | | | | | **49.6** | **52.1** | **52.5** | **52.3** | **52.1** | **51.8** |
| C2. Turkey-specific shift in investor sentiment (sharp capital flow reversal) 10/ | | | | | | | | **49.6** | **62.1** | **62.1** | **58.6** | **54.8** | **50.9** |
| C3. Domestic policy complacency starting in 2007 11/ | | | | | | | | **49.6** | **51.8** | **54.6** | **57.0** | **59.7** | **63.7** |

1/ Consolidated nonfinancial public sector, net debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2 as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
9/ Assumes a 20 percent depreciation in 2007, and a 500 bps increase in real interest rates, which persists until 2011; annual GNP growth falls to 2.5 percent in 2007−11.
10/ Assumes a 40 percent depreciation in 2007, interest rates 1000 bps and 500bps above baseline in 2007 and 2008, res[ectively. Zero growth in 2007. 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.

## ATTACHMENT I. SUPPLEMENTARY LETTER OF INTENT

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

Ankara, November 27, 2006

Dear Mr. de Rato,

1. The Third and Fourth program reviews were conducted earlier this year against the background of turbulence in Turkish financial markets brought about by an increase in global risk aversion. Conditions have since broadly stabilized, with the lira recovering about half of the ground lost earlier, and debt and equity markets also making gains. This turnaround reflects both our continued prudent macroeconomic policy stance and an improved investment climate for emerging markets.

2. More broadly, economic performance under our program continues to be satisfactory. Growth has proven resilient, with the economy expanding by 7 percent (annualized) in the first half of this year. The current account deficit has continued to widen, but financing remains ample, including through record FDI flows. And, although inflation has increased, this largely reflects adverse supply shocks—in particular high commodity prices—and the weaker lira. Finally, on fiscal, the public sector primary and overall balances have been substantially stronger than programmed and should easily exceed the end-year targets, and the net debt ratio is expected to stay on a declining trajectory.

3. As for program implementation, we have met most targets.

- *End-September quantitative performance criteria* (Annex A). We met the external debt and net international reserves targets, although inflation exceeded the outer band (the central bank has explained the reasons for the deviation and the policy response in a letter to the Government which is also forwarded to the Fund, in accordance with the inflation consultation clause, Annex D). We also met the target for the primary surplus of the consolidated government sector excluding state enterprises and the ceiling on the social security deficit. The target for the primary surplus of the consolidated government sector including state enterprises is expected to have been met. The ceiling on primary expenditure, however, was missed by a narrow margin, partly on account of the earlier-than-expected execution of some spending plans.

- *Structural reforms* (Annex B). We will shortly submit to Parliament legislation implementing a second-stage of personal income tax reform (prior action). The functional reorganization of the Revenue Administration (RA) was completed in August, including at the provincial level, and substantial progress has been made towards making the Large Taxpayer Unit operational by end-December 2006. As for the financial sector, a timetable for phasing out special privileges and obligations of state banks was announced in July; a detailed timetable for the privatization of Halkbank will be announced shortly (prior action); and Banking Law regulations—needed to enhance the supervisory framework—were issued on November 1, meeting the associated benchmark with a minor delay.

4. In light of this strong performance, our continued 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 Fifth Review under the Stand-By arrangement. We also propose a rephasing of purchases as per Annex C of this Letter of Intent. We also request a waiver for the nonobservance of the end-September performance criterion on the consolidated primary spending of central government and social security institutions, in light of the corrective measures taken (spending cuts and measures to control health spending already implemented, see paragraphs 11−12) and a modification of the end-December 2006 ceiling for this criterion. We also request a waiver of applicability of the end-September target for the primary surplus of the consolidated government sector including state enterprises, as complete data for the state enterprise sector are not yet available and we expect this target to have been met. Finally, we request a waiver for nonobservance of the end-September performance criterion on the submission of draft legislation for second-stage personal income tax reform, as there was only a minor delay, and a resetting of the date for parliamentary passage of this legislation from end-December 2006 to end-February 2007 (structural performance criterion). Quantitative and structural performance criteria through end-August 2007 are set out in Annexes A and B of the TMU, respectively.

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 for 2006–07**

6. Despite the May-June financial market turbulence, the economy is expected to grow by 6 percent this year—a testimony to its resilience. Although economic growth has slowed lately (reflecting tighter credit conditions, and wealth and consumer confidence effects) these effects are expected to be short-lived, as market confidence has strengthened in recent months. In 2007, growth is expected to be 5 percent, with an improved contribution from external demand.

7. With year-to-date inflation of 8 percent, this year's inflation outturn is expected to exceed considerably the original 5 percent target. However, this largely reflects the likely temporary impact of supply shocks and lira depreciation. Hence, based on our prudent monetary policy stance, we expect the disinflation process to restart soon and inflation to converge towards the 4 percent inflation target set for 2007–08 (with 2 percent uncertainty bands, as explained in Annex D).

8. On the external side, we project a further widening of the current account deficit to about 8½ percent of GNP this year, although the slowdown in domestic demand, easing oil prices, and weaker lira should help stabilize the deficit going forward. Moreover, continued strong FDI receipts and private flows (to both banks and corporates) should make for a continued benign financing picture. In keeping with our prudent approach in setting policies, we will continue to monitor current and financial account developments closely and adjust policies as needed.

**Monetary policy**

9. We will continue with our cautious monetary policy stance. Factors beyond our control, including supply shocks (commodity and unprocessed food prices) and the weaker lira have contributed to a significant inflation overshoot this year. That said, helped by a strong and rapid monetary policy response—policy interest rates have been raised by a total of 425 basis points since June—underlying inflation has remained broadly under control and inflation expectations have been partly reined in. Given these developments, we expect these adverse shocks to play out over time and to be in a position to keep inflation within reach of next year's 4 percent inflation target. However, with mainly upside risks to the inflation outlook, the central bank will retain a tightening bias and stands ready to take whatever additional actions are needed to meet its inflation goals. To increase the efficacy of monetary policy, we have also taken steps to improve liquidity management by expanding the set of instruments for open market operations (reintroducing term deposit auctions and, more recently, laying the groundwork for tradable central bank papers).

10. Building international reserves for prudential reasons remains a key objective of the program. We have therefore reinstated daily reserve purchase auctions, with daily minimum purchase amounts fixed in advance at US$15 million, with an option to banks to sell up to US$30 million in additional foreign exchange to the CBT at the average auction price. To provide predictability in the auction mechanism, these daily minimum amounts will remain unchanged through end-2007, although there will continue to be provisions to allow temporary suspension of the auctions in extreme circumstances. We will also continue to retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

**Fiscal policy**

11. We expect to exceed our end-2006 primary surplus target under the program by a significant margin, mostly on account of buoyant revenues, including one-off collections of social security arrears under the new installment payment facility and strong one-off collections of tax arrears by SDIF. At the same time, there have been expenditure overruns—including on health and agricultural subsidies—which led to a breach of the end-September spending ceiling by 0.15 percent of GNP. To partly compensate for the projected spending overruns for the year as a whole, we have implemented some 0.2 percent of GNP in cuts by blocking appropriations on current spending and, as an additional safeguard, we stand ready to cut appropriations by end-March 2007 to offset any spending in excess of the proposed new end-2006 program ceiling, which will be reflected in an adjuster to the (end-April, end-August and end-December 2007) expenditure ceilings and primary balance targets. Despite continued health overruns, the social security deficit has been smaller than programmed, given buoyant exceptional revenues from the arrears restructuring scheme. Thus, we expect to meet the end-year performance criterion on the social security deficit.

12. To increase our flexibility in containing health spending, by end-November we will submit to Parliament legislation authorizing the Social Security Institution to alter copayments for medical treatments and pharmaceuticals; we expect passage of this legislation by end-December (structural performance criterion). We will also, by end-November, change the structure of compensation in state hospitals for 2007. Using a new performance assessment model for hospitals we will (i) monitor the quality of the provided health services against indicators of international best practice; (ii) adjust the bonus payments based on this quality assessment, keeping the total of these payments at the 2006 level; (iii) restructure the pay system in a cost neutral way with a view to increasing compensation to general practitioners in primary health care centers. These measures will be designed to generate efficiency gains in the production, provision and utilization of health care services, as well as to induce a more efficient distribution of doctors across the healthcare system. Next, we plan by end-December at the latest to take a number of measures to control spending on pharmaceuticals, including: (i) reducing the reimbursable margin between the cheapest and most expensive reimbursed drugs in a given bioequivalence group from 22 to 20 percent; (ii) reducing the price ratio of generic to original drugs from 80 to 72 percent; (iii) increasing the number of comparator countries used to determine reference prices; (iv) training physicians in the appropriate use of drugs, particularly antibiotics. Finally, we intend by the first quarter of 2007 to (i) introduce a payment per case system for outpatient services; (ii) move to prescribing pharmaceuticals in smaller packages as appropriate; (iii) begin expanding the family medicine system to 10 additional provinces; (iv) combine the provisioning systems of the three existing social security institutions and introduce benefit eligibility checks at pharmacies to achieve better monitoring.

13. Looking ahead, fiscal discipline remains essential to reduce inflation and ease the debt burden, interest-rate pressures, and the external current account deficit. Consistent with these objectives, our 2007 budget, submitted to Parliament in mid-October (prior action), targets a primary surplus of at least 6½ percent of GNP, of which 5 percent of GNP is to be achieved at the central government level (the overall public sector deficit (program definition) would widen to 1.0 percent of GNP). We have also retained the performance criterion on the social security deficit (Annex F). At the same time, in the context of future program reviews, we will explore the feasibility of using overperformance in tax revenues realized through end-May (over and above any unplanned one-off collections) to cut the Banking and Insurance Transaction Tax or—as part of a broader labor market reform package that aims to increase flexibility and promote formalization—to reduce social security contributions. Inflation and current account developments permitting, in the second half of 2007, we will also consider allocating part of any residual revenue overperformance to high-quality investment spending.

14. Turning to the details of the budget itself, although the wage bill will rise considerably next year, this reflects in part the government's two-year commitment to compensate civil servants for the increase in their social security contributions (as provided for in the new pension law). Consistent with our intention to contain personnel costs, we have incorporated in the 2007 budget a slowdown in the pace of hiring of civil service employees (structural benchmark). We are also committed to implementing a broad-ranging reform of the civil service sector aiming at rationalizing the wage structure, including by ensuring that the pay scale does not become further compressed and containing budgetary costs. The reform will include the following possible elements: (i) simplifying the pay structure; (ii) bringing almost all components of the wage into the tax base; and (iii) determining salary increases during the budget process; (iv) allowing for merit and performance pay; and (v) introducing the principle of equal compensation for the same rank public employees in different public institutions. Given the need to consult broadly with civil society, we expect implementation of this reform in early 2008. Finally, we stand ready to adapt our fiscal policy to ensure the achievement of the program's fiscal targets and, as an additional safeguard, we have issued an instruction to the TMO to ensure that its operations are consistent with budget allocations and programmed financing and parameters. More generally, we shall ensure that state enterprise prices are kept in line with the assumptions underlying the 2007 program (continuous structural benchmark).

**Structural fiscal reforms**

15. To put Turkey's medium-term public finances on a secure footing, we will begin implementing the new pension parameters, including the pension indexation formula, by January 1, 2007. To this end, we are unifying the three social security institutions—Bağ-Kur, SSK, and Emekli Sandığı. Also, databases have been merged, a common software has been adopted, and all staff were placed under common management. More work is needed,

however, including reinforcing obligations to pay social security contribution premia, strengthening arrears clearance at Bağ-Kur, broadening SSK's audit program, and instituting modern debt collection practices at the unified institution. Milestones have been drawn up to guide this process. To facilitate enforcement, we have begun outsourcing arrears collection and we intend to put in place the legal framework requiring payment of salaries through bank accounts by end-June 2007. Our objective is to make the system operational as soon as possible thereafter. In order to ensure the fiscal sustainability of the Universal Health Insurance scheme to be introduced at the start of 2007, we will not hesitate to promptly take additional measures that may be needed to keep health spending in line with program targets.

16. We have made substantial progress in strengthening tax administration. The General Directorate of Revenue Policies at the Ministry of Finance is now fully operational and chiefly responsible for advising the Minister on tax policy formulation, leaving the RA to concentrate on tax collection and administration. We have also completed the functional restructuring of the RA, including at the provincial and local level. Looking ahead, it will be necessary to extend control over the remaining town offices. We have also made progress towards the start of operations of the Large Taxpayer Unit by January 1, 2007. In particular, we have: (i) established selection criteria, under which 800 firms will come under the LTU's purview; (ii) determined the taxes to be administered by the LTU; (iii) designed the organizational structure and appointed a new vice president responsible for the LTU; (iv) decided on the staffing of the audit function; (v) prepared the office buildings; and (vi) defined work processes. In other areas too, we have made substantial progress, but work here remains to be done, including on: (i) acquiring the necessary IT (by November 30); (ii) selecting audit and other staff (by November 30); (iii) planning the transition period (by November 30); (iv) training staff (by December 15); and (v) determining performance-based criteria for staff (by June 30, 2007). Also in the tax administration area, we are planning to draw up measures to address the large and continuing VAT tax fraud with support from Fund technical assistance.

17. In our second-stage personal income tax policy reform, we intend to: (i) introduce standard and family deductions as a revenue-neutral replacement for existing consumption VAT-related credits; (ii) broaden the tax base by lengthening the holding period defining taxable long-term real estate capital gains; and (iii) introduce enhanced administrative powers for the tax authorities to cross-check income and expenditures. A comprehensive PIT reform, which would, *inter alia*, simplify the system of small business taxation, will be studied next year, for implementation in 2008. Given the need for extensive consultations with key stakeholders, the submission to Parliament of the second stage PIT reform had to be delayed and its approval is now expected by end-February 2007, with the base-broadening and administrative measures effective retroactively back to January 1, 2007 (structural performance criterion). To preserve the income tax base, we expect that the planned mortgage law will not provide for tax deductability of interest payments. We will also continue to refrain from introducing new ad-hoc initiatives and sectoral tax cuts, and will

make further progress in quantifying existing tax expenditures, a report on which will be published by end-June 2007 (structural benchmark). Finally, we remain committed to avoiding further rate reductions or exemptions that undermine the structure of the VAT.

18. We attach high importance to improving fiscal transparency. To this end, we have now recalculated previous years' fiscal figures in the new "central government budget" format, facilitating comparability across years, and plan to publish the results by end-January 2007. We are also working on improving the accounting and reporting systems of local governments. We plan to collect the 2006 budget realization figures by end-February 2007 and to publish them by end-March 2007. We also plan to publish their budgetary realization figures on a quarterly basis in 2007. We are also working on a public-private partnership (PPP) law that would lay out a framework for the management and accounting of such projects across all sectors.

**Financial sector reforms**

19. The implementation of the new banking law through the issuance of supporting regulations will bring supervisory practices closer to best international practice. These new regulations will substantially strengthen supervisory practices in a number of key areas. In addition, the committee looking into the merits of a further consolidation of supervisory functions is expected to present its findings before end-2006. Beyond this, we intend to use the findings of the Financial Sector Assessment Program (FSAP) for Turkey to guide our future reform efforts in the financial sector.

20. Although credit growth has slowed in light of the earlier financial market volatility, the BRSA has intensified its examinations and monitoring of banks. To build up reserves as loan portfolios are growing, general provisioning requirements have been doubled to 1 percent for new loans (to 0.2 percent for new off-balance sheet commitments). If needed, BRSA stands ready to take further measures in its responsibility to ensure that banks have sufficient cushions to cope with unforeseen shocks.

21. We are making further progress on laying the groundwork for the privatization of state banks. The Privatization Agency has been formally put in charge of the privatization of Halkbank. The tender announcement, including a detailed timetable, will be made soon (prior action). According to the announced timetable, the tender process is expected to be completed by end-May 2007 (structural benchmark). We remain committed to preparing a strategy for Ziraat, drawing on the experience of Halkbank.

22. We expect passage of the mortgage law by Parliament soon. Consistent with BRSA's responsibility in implementing consolidated supervision, the law gives the BRSA the 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 institutions. Supporting regulations on mortgage lending will be issued shortly after the law's passage. These regulations will set appropriate norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value.

23. SDIF is winding down its activities as planned and by end-2007 will have disposed of all its assets taken over from intervened banks. At that point, Treasury will resolve its receivables arising from earlier bank restructurings.

**Investment climate**

24. Our ongoing efforts to improve Turkey's investment climate are rewarded in terms of record privatization and foreign direct investment receipts. FDI is on track to well exceed last year's record levels—driven by private mergers and acquisition and an improved investment environment. Several large privatization deals were finalized this year, including TÜPRAŞ refineries, Erdemir steelworks, and the mobile phone operator Telsim (sold by SDIF). We intend to continue our ambitious privatization program in 2007, led by the sale of TEDAŞ electricity distribution networks, power generation facilities, the tobacco unit of TEKEL, the National Lottery, as well as Halkbank.

25. We are also committed to pressing forward with the recommendations of the Investment Advisory Council, including deregulation, reducing administrative barriers, increasing the efficiency of judicial processes, and enhancing corporate governance. In this context, we look forward to passage by Parliament of the new Turkish Commercial Code. A recent OECD assessment concluded that Turkey had a strong regulatory framework for corporate governance and identified remaining challenges, which we will work to incorporate into our reform agenda.

Very truly yours,

| /s/ | /s/ |
| --- | --- |
| Ali Babacan<br>Minister of State for Economic Affairs | Durmuş Yilmaz<br>Governor of the Central Bank of Turkey |

Annexes

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

| | Ceiling/ Floor | Outcome | Ceiling/ Floor | Outcome | Ceiling/ Floor | Outcome | Ceiling/ Floor | Ceiling/ Floor | Ceiling/ Floor | Ceiling/ Floor |
|---|---|---|---|---|---|---|---|---|---|---|
| | Mar. 31, 2006 | | June 30, 2006 | | Sept. 30, 2006 | | Dec. 31, 2006 | April 30, 2007 | August 31, 2007 | Dec. 31, 2007 |
| | (in millions of new Turkish liras, unless otherwise specified) | | | | | | | | | |
| I. Quantitative Performance Criteria 1/ | | | | | | | | | | |
| 1. Floor on the cumulative primary balance of the consolidated government sector 2/ | 7,771 | 10,562 | 17,366 | 25,038 | 29,705 | | 34,050 | 10,450 | 30,450 | 37,850 |
| 2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/ | 7,471 | 8,362 | 16,414 | 22,091 | 28,072 | 31,396 | 31,350 | 9,850 | 29,250 | 35,350 |
| 3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/ | | | | | 124,046 | 124,874 | 174,000 | 58,250 | 122,000 | 194,200 |
| 4. Ceiling on contracting or guaranteeing of new external pubic debt with original maturities of more than one year (in millions of US$) | 8,500 | 4,196 | 14,000 | 4,806 | 18,000 | 6,829 | 21,500 | 9,000 | 15,000 | 22,000 |
| 5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$) | 1,000 | 0 | 1,000 | 0 | 1,000 | 0 | 1,000 | 1,000 | 1,000 | 1,000 |
| 6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$) | 19.7 | 32.4 | 24.3 | 31.0 | 25.7 | 31.0 | 22.6 | 28.0 | 28.0 | 29.0 |
| 7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/ | -6,100 | -6,634 | -12,000 | -10,554 | -18,400 | -16,486 | -24,300 | -5,000 | -8,850 | -12,850 |
| II. Inflation Consultation Bands (12-month change, in percent) 4/ | | | | | | | | | | |
| Outer Band (upper limit) | 9.4 | | 8.5 | | 7.8 | | 7.0 | | | |
| Inner Band (upper limit) | 8.4 | | 7.5 | | 6.8 | | 6.0 | | | |
| *Central Point* | 7.4 | 8.2 | 6.5 | 10.1 | 5.8 | 10.5 | 5.0 | N/A | N/A | N/A |
| Inner Band (lower limit) | 6.4 | | 5.5 | | 4.8 | | 4.0 | | | |
| Outer Band (lower limit) | 5.4 | | 4.5 | | 3.8 | | 3.0 | | | |
| III. Indicative Targets | | | | | | | | | | |
| 1. Floor on the cumulative overall balance of the consolidated government sector 2/ | -3,429 | 1,162 | -3,934 | 7,129 | -5,445 | | -6,900 | -8,500 | -5,500 | -8,400 |
| 2. Privatization Proceeds (in millions of US$) | 1,900 | 4,579 | 2,800 | 7,970 | 3,200 | 8,008 | 4,200 | N/A | N/A | N/A |

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

## ANNEX B: STRUCTURAL CONDITIONALITY 2006-07 1/

| Action | PC/SB |
|---|---|
| **Prior actions** | |
| 1. Submit to parliament 2007 central government budget consistent with achieving a headline 6.5 percent primary surplus (¶13) | Done on October 17 |
| 2. Submit to parliament legislation for second-stage personal income tax reform (¶17) | Five days before board meeting |
| 3. Announce detailed timetable for privatization of Halkbank (¶21) | Five days before board meeting |
| **Fiscal measures** | |
| 4. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19, MEP April 26, 2005) | Continuous PC |
| 5. 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, MEP April 26, 2005) | Continuous SB |
| 6. Maintain excise taxes and SEE prices in line with 2006-07 program assumptions (¶14) | Continuous SB |
| 7. Replace no more than 50 percent of civil servants leaving for attrition (¶14) | Quarterly SB |
| 8. Establish a large-taxpayers unit within the Revenue Administration (¶17, LOI July 7, 2006) | SB. End-December 2006 |
| 9. Parliamentary approval of legislation authorizing the Social Security Institution to alter copayments for medical treatments and pharmaceuticals (¶12) | PC. End-December 2006 |
| 10. Parliamentary approval of second stage personal income tax reform (¶17) | PC. End-February 2007 |
| 11. Publish report on existing tax expenditures (¶17) | SB. End-June 2007 |
| **Financial Sector Measures** | |
| 12. Complete tender process for Halkbank (¶21) | SB. End-May 2007 |

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the November 27, 2006 supplementary Letter of Intent.

## ANNEX C: PURCHASES AND PROPOSED SCHEDULE OF PURCHASES, 2005-08

| | SDR millions | Percent of quota | Test date 1/ | Earliest possible purchase date | Date of Board Approval |
|---|---|---|---|---|---|
| **Approval** | 555.2 | 57.6 | | | 11-May-05 |
| **2005** | | | | | |
| 1st & 2nd Reviews | 1,110.3 | 115.2 | 30-Sep-05 | | 9-Dec-05 |
| **2006** | | | | | |
| 3rd Review 2/ | 624.6 | 64.8 | 31-Dec-05 | 1-Mar-06 | 28-Jul-06 |
| 4th Review 2/ | 624.6 | 64.8 | 31-Mar-06 | 1-Jun-06 | 28-Jul-06 |
| 5th Review | 749.5 | 62.9 | 30-Sep-06 | 1-Dec-06 | |
| **2007** | | | | | |
| 6th Review | 749.5 | 62.9 | 31-Dec-06 | 1-Mar-07 | |
| 7th Review | 749.5 | 62.9 | 30-Apr-07 | 1-Jul-07 | |
| 8th Review | 749.5 | 62.9 | 31-Aug-07 | 1-Dec-07 | |
| **2008** | | | | | |
| 9th Review | 749.5 | 62.9 | 31-Dec-07 | 1-Mar-08 | |
| Total 3/ | 6,662.0 | 559.2 | | | |

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

## ANNEX D: INFLATION CONSULTATION BANDS

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:

| | December 2006 | March 2007 | June 2007 | September 2007 | December 2007 |
|---|---|---|---|---|---|
| Outer band (upper limit) | 7.0 | 11.2 | 8.7 | 7.3 | 6.0 |
| Inner band (upper limit) | 6.0 | 10.2 | 7.7 | 6.3 | 5.0 |
| Central point | 5.0 | 9.2 | 6.7 | 5.3 | 4.0 |
| Inner band (lower limit) | 4.0 | 8.2 | 5.7 | 4.3 | 3.0 |
| Outer band (lower limit) | 3.0 | 7.2 | 4.7 | 3.3 | 2.0 |

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 Targets 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 | 31.0 | 42.4 |
| September 30, 2006 (performance criterion) | 20.3 | 25.7 | 31.0 | 42.6 |
| December 31, 2006 (performance criterion) | 22.6 | | | |
| April 30, 2007 (performance criterion) | 28.0 | | | |
| August 31, 2007 (performance criterion) | 28.0 | | | |
| December 30, 2007 (indicative target) | 29.0 | | | |

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

2. Net international reserves of the 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 September 30, 2006). Reserve assets as of September 30, 2006 amounted to US$58.8 billion (evaluated at program exchange rates).

4. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL/YTL-denominated liabilities indexed to any exchange rate) to residents and non-residents with an original maturity of up to and including one year (including reserves against foreign currency deposits of the banking sector), claims from central bank letters of credit, overdraft obligations of the central bank, and central bank liabilities arising from balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On September 30, 2006 reserve liabilities thus defined amounted to US$16.2 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of September 30, 2006 these amounts were zero.

6. As of September 30, 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$11.5 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 of US$, 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.

11. The 2007 targets assume that privatization receipts will be US$1.0 billion in the fourth quarter of 2006. In the event that the realized figure departs from that figure, the NIR floors for April, August, and December 2007 will be adjusted upward (downward) by the excess (shortfall) of actual fourth quarter 2006 receipts relative to the US$1 billion assumption.

## ANNEX F: FISCAL TARGETS

### A. Primary Balance of the Consolidated Government Sector

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

| | Floor<br>(In millions of YTL) |
|---|---|
| Cumulative primary balance from January 1, 2006, to: | |
| December 31, 2006 | 34,050 |
| Cumulative primary balance from January 1, 2007, to: | |
| April 30, 2007 | 10,450 |
| August 31, 2007 | 30,450 |
| December 31, 2007 | 37,850 |
| Cumulative primary balance (excluding SEEs) from January 1, 2006, to: | |
| December 31, 2006 | 31,350 |
| Cumulative primary balance (excluding SEEs) from January 1, 2007, to: | |
| April 30, 2007 | 9,850 |
| August 31, 2007 | 29,250 |
| December 31, 2007 | 35,350 |

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of: the central government; the 3 extra budgetary funds (EBFs) identified below; the 3 social security institutions (SSIs) identified below (and unified into a single institution as of the beginning of 2007); the unemployment insurance fund; and the 22 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 central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported accrual-based transfers to the social security institution(s) will be converted to a cash basis.

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 SSI(s) and the unemployment insurance fund from above the line on a cash basis.

d) For the SEEs, from below the line as described in paragraph 7.

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 dividend payments from Ziraat Bank. (Dividend payments from Halkbank that are determined not to stem from income derived from recapitalization bonds shall be counted as primary revenues.) 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.

**Extrabudgetary funds**

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

**State economic enterprises**

6. The 22 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, TİGEM, KIYEM, TDİ, and DMO.

7. The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing from the banking system (excluding pre-export financing from Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net

advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

8. Net financing from the banking system (excluding pre-export financing from Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2005 the stock of net banking claims on SEEs as defined above stood at YTL 1,243 million, valued at the exchange rates on that day.

9. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2005 the stock of external loans stood at YTL 6,932 million, valued at the exchange rates on that day.

**Social security institutions**

10. The three social security institutions (SSIs) included in the definition of the performance criterion for end-December 2006 are SSK, Bağ-Kur, and Emekli Sandığı. For the 2007 targets, the object of monitoring will be the unified social security institution (SSI), including the activities of SSK, Bağ-Kur, and Emekli Sandığı, as well as other health-insurance related activities, such as coverage for Green Card, civil servant, and non-poor populations. The deficits of the SSI(s) will be covered by transfers from the central government budget, and they are thus expected to be in primary balance.

**Adjusters**

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

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

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

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

c) For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 300 million.

13. The floor on the primary surplus of the CGS will be adjusted upward (downward) 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, 2007.

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

The 2007 (end-April, end-August, end-December) floors on the primary surplus of the CGS will be adjusted upward to the extent that the end-2006 target on the primary spending of the central government and the SSIs (section B below) is missed.

## B. Primary Spending of the Central Government and the Social Security Institution(s)

Table 1. Turkey: Performance Criteria on the Cumulative Consolidated Primary Spending of the Central Government and the Social Security Institution

| | Ceiling (In millions of YTL) |
|---|---|
| Cumulative primary spending from January 1, 2006 to: | |
| December 31, 2006 | 174,000 |
| Cumulative primary spending from January 1, 2007 to: | |
| April 30, 2007 | 58,250 |
| August 31, 2007 | 122,000 |
| December 31, 2007 | 194,200 |

15. The December 2006 ceiling in Table 1 is 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. The 2007 ceilings relate to the expenditures of the fully consolidated central government and social security institution; i.e., not only are government transfers to social security consolidated out, but so too are government payments of social security contributions (both the employer portion and the compensation to civil servants for the increase in employee contributions due to the premium base broadening).

**Adjusters**

16. The ceilings 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 extrabudgetary funds.

17. The 2007 (end-April, end-August, end-December) spending ceilings will be adjusted downward to the extent that the end-2006 spending target is missed.

## 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: | |
| December 31, 2006 | -6,900 |
| Cumulative overall balance from January 1, 2007 to: | |
| April 30, 2007 | -8,500 |
| August 31, 2007 | -5,500 |
| December 31, 2007 | -8,400 |

18. 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 SSI(s) and EBFs; (iv) transfers of profits from the CBT and net special revenues of the Turkish Mint to the consolidated central government; (v) Ziraat Bank dividend payments and recapitalization-bond-related dividend payments from Halkbank; and (vi) expenditures under the risk account (net lending).

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

20. 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, 2007.

## D. Overall Balance (before transfers) of the Social Security Institution

Table 1. Turkey: Performance Criteria on the Cumulative Overall Balance (before transfers) of the Social Security Institution

| | Floor<br>(In millions of YTL) |
|---|---|
| Cumulative overall balance (before transfers) from January 1, 2006 to: | |
| December 31, 2006 | -24,300 |
| Cumulative overall balance (before transfers) from January 1, 2007 to: | |
| April 30, 2007 | -5,000 |
| August 31, 2007 | -8,850 |
| December 31, 2007 | -12,850 |

21. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı for the end-December 2006 test date, and the balance of the unified social security institution for the 2007 test dates. It excludes additional payments made to pensioners in lieu of phased-out tax rebates (up to YTL 1.772 billion) for 2006, but these are included as of 2007.

## E. Amnesties and Public Sector Receivables

22. 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.

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

## F. Structural Benchmark on New Civil Servants Hires

24. A quarterly benchmark will be used to monitor the 50 percent ceiling on the replacement ratio for civil servants as provided for in the 2007 Budget Law. The replacement ratio will be computed as the cumulative number of entries in each quarter in 2007 divided by the total number of attritions in 2006. Attritions comprise retirements, deaths, resignations, and transfers to other agencies; entries comprise appointments and transfers from other agencies. These data will be provided for the total of civil servants, divided into the following sub-categories: general administration, education services, health services, technical services, and other positions. These data will be prepared by the Ministry of Finance (General Directorate of Budget and Fiscal Control) on a quarterly basis and will be submitted to the Fund within 6 weeks of the end of the corresponding quarter.

## 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, 2006 to: | | |
| December 31, 2006 | 335 | 490 |
| Cumulative net lending from January 1, 2007 to: | | |
| April 30, 2007 | 125 | 185 |
| August 31, 2007 | 225 | 335 |
| December 31, 2007 | 335 | 500 |

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 |
| April 30, 2007 (performance criterion) | 1,000 |
| August 31, 2007 (performance criterion) | 1,000 |
| December 31, 2007 (indicative target) | 1,000 |

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

## ANNEX I: MEDIUM- AND LONG-TERM EXTERNAL 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 |
| Cumulative flows from end-December 2006 | |
| April 30, 2007 (performance criterion) | 9,000 |
| August 31, 2007 (performance criterion) | 15,000 |
| December 31, 2007 (indicative target) | 22,000 |

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 |

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.

Attachment II. CBT Letter on Inflation

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

HEAD OFFICE
Please refer to :
**Communication Department**
**2006-OKM-D/153**

ANKARA, .............1 NOV 2006

67107

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

Dear Mr. de Rato,

Please find enclosed the English translation of our Open Letter to the Government explaining the reasons for inflation exceeding the upper limit of the uncertainty band 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**

DYılmaz

**Durmuş YILMAZ**
**Governor**

**Dr. Erdem BAŞÇI**
**Vice Governor**

-Enclosed 10 pages

İSTİKLAL CAD. 10 06100 ULUS - ANKARA
TEL: (90 - 312) 310 36 46 FAKS: (90 - 312) 310 74 34 E-POSTA: iletisimbilgi@tcmb.gov.tr SWIFT: tcmbtr2a
WEB: http:// www.tcmb.gov.tr

**No:**

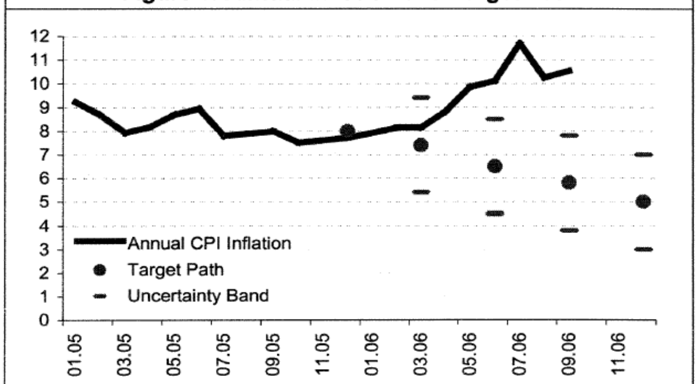
**Ankara, October 30, 2006**

**Ali BABACAN**
**Minister of State**
**ANKARA**

Central Bank of Turkey (CBT) adopted a formal inflation-targeting framework at the beginning of 2006. Accordingly, the end-year inflation target for 2006 was set as 5 percent, defined as the annual change in Consumer Price Index (CPI). To facilitate the accountability principle, the CBT has 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. In adherence with the Article 42 of the Central Bank law, the CBT committed to 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.

Annual CPI inflation in September 2006 was 10.55, breaching the upper limit of the uncertainty band announced for end-September 2006 at 7.8 percent (Figure 1). This open letter explains the reasons why inflation exceeded the predetermined target path by a large margin, evaluates the measures taken by the Central Bank of Turkey to bring inflation back to the target, and finally presents the medium term outlook and the horizon in which inflation converges to the medium term target. 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, this Open Letter will also be presented to the IMF as part of the program conditionality.

**Figure 1: Annual Inflation and Target Path**




Source: TURKSTAT, CBT

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### *The Reasons For Exceeding The Target*

Before starting to present the developments in the last quarter, it would be useful to recall that in the Open Letter and the Inflation Report published in July 2006, breaching the upper limit of the uncertainty band was attributed to a combination of several supply shocks such as rising oil prices, increases in the tobacco product prices, high unprocessed food price inflation, the continued increases in the gold prices, and the portfolio shock originated from the change in global liquidity conditions. 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 suggested that the role of the supply factors in breaching the target, by and large, was dominant. The short-term inflation outlook has improved since the publication of the July Open Letter. Although the expected correction in unprocessed food prices has not been observed in the third quarter, the oil and other commodity prices followed a more favorable course than our baseline assumptions. This development was particularly important to contain the second round effects of the high oil prices. The rebound of the New Turkish Lira has also contributed to the short-term inflation outlook.

The accumulated impact of previous shocks has kept the annual inflation at high levels. The negative course of unprocessed food prices and the lagged impact of the exchange rate pass-through drove annual inflation up to 10.55 percent in September—a figure just about in line with our projections which stood between 10 and 11 percent for end-September inflation in the July Inflation Report.

A close look at the 9-month cumulative price increases in certain subgroups of CPI unveils the main factors behind the rise in inflation in 2006 (Figure 2). It is clear from the figure that one of the main reasons for the rise in inflation was the substantial increase in the unprocessed food prices. The figure also reveals the role of energy prices as an adverse factor in the first 9 months of 2006 inflation. Rising inflation in prices of goods excluding energy and unprocessed food can be explained by the exchange rate pass-through. The services inflation, on the other hand, exhibited a gradually declining pattern in the past three years.

**Figure 2: First Nine Months Cumulative Inflation**

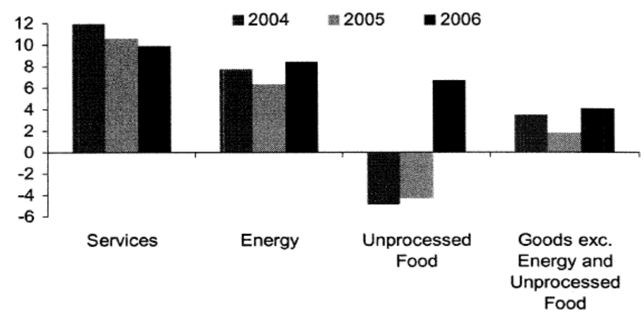



**Table 1: Contribution to Nine-Month CPI Inflation**

| | Services | Energy | Unprocessed Food | Goods exc. Energy and Unprocessed Food |
|---|---|---|---|---|
| 2004 | 3.08 | 1.15 | -0.64 | 1.62 |
| 2005 | 2.73 | 0.95 | -0.57 | 0.85 |
| 2006 | 2.70 | 1.21 | 0.86 | 1.88 |

Source: TURKSTAT, CBRT

The research conducted by the CBT staff suggests that the pass-through from exchange rate to consumer prices is close to 20 percent in a 5-month period. Given that the depreciation in the New Turkish Lira has been around 15 percent since April, our calculation of the cumulative pass-through impact on annual inflation is close to 3 percentage points in the May-September period. In other words, it can be claimed as a rough cut that annual inflation could have been around 7.5 percent in the absence of the sell-off in May-June period.

The first round effect of the exchange rate pass-through is almost complete. The pass-through is expected to be visible through clothing and apparel prices in October, yet remain at low levels thereafter. Accordingly, we estimate the cumulative impact of exchange rates on headline inflation to reach 3.5 percentage points until the end of the year. Assuming that the second round effects are limited, the base effect should drive annual inflation downwards starting from the second quarter of 2007.

Annual change in the most widely cited core CPI (excluding energy, unprocessed food, tobacco-alcohol and gold), denoted by H, also continued to increase during the last quarter due to lagged effects of the exchange rate pass-through, reaching 8.7 percent at the end of September. However, it should be emphasized that this is an expected outcome since a big fraction of the H index is durable goods, which is highly sensitive to exchange rate developments. Accordingly, the fact that inflation measured by H index has been rising in the last couple of months should not be interpreted as news to the monetary policy. Although the first round effects of the exchange rate pass through is largely complete, we expect core inflation figures to stay at high levels due to past cumulative effects until the second quarter of 2007.

## Measures Taken to Ensure the Convergence of Inflation to the Targets

In the July Open Letter, we already mentioned that the volatility in the exchange rates, coupled with the other cost-push factors such as the strong commodity prices and rising food prices, has led to a serious deterioration in inflation expectations in May and June. Central Bank of Turkey implemented a two-pillar package as a reaction to the volatility in the financial markets and the consequent rise in inflation expectations. The first pillar of the policy response was a rate hike of 400 percentage points in June, which sent the markets a clear signal of the Central Bank's commitment to the medium-term inflation targets. It was also a manifestation of the end of the "fiscal dominance".

The second pillar of the package was to withdraw the excess domestic currency liquidity in the financial markets via deposit purchase auctions and FX sales, while raising the lending rate up by a total of 6 percentage points. By doing so, the CBT aimed to reduce the potential volatility in the markets by designing a flexible mechanism to deal with sudden shifts in the market sentiment. The plan worked well and the financial markets calmed down. Markets reacted favorably to all these decisive policy measures and the long-end of the yield curve shifted down.

In the following meeting held on July 20th, the Monetary Policy Committee (MPC) raised the policy rates by a further 25 basis points and stated that a measured tightening might be necessary to meet 2007 end-year target. By giving such a signal, the CBT aimed at containing the second round effects of the exchange rate pass-through and eliminating the mismatch between inflation expectations and the medium-term targets.

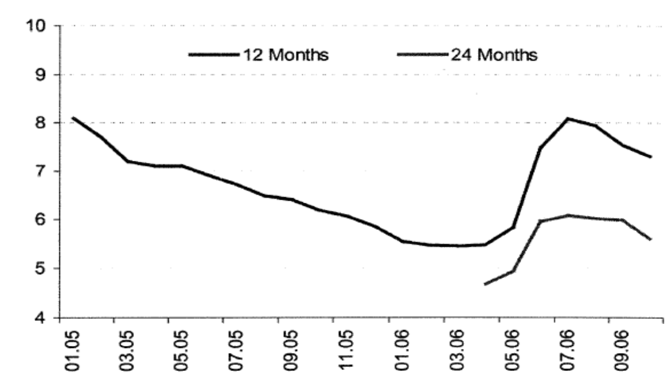
The medium-term inflation outlook has been affected by many factors since the July letter. On the positive side, new data suggested that the risks of high inflation in industrial countries have been easing. The Federal Reserve's decision, at their meeting on 8th of August to keep Federal funds rate on hold, has further mitigated the impact of the May-June sell-off on the domestic markets. This development has also reduced the risk premium, which further tightened the monetary conditions. Another positive development was the decline in commodity prices. On the other hand, domestic demand conditions have not slowed as much as expected, reflecting sooner-than-expected recovery of the confidence and partly the increase in government spending. Given these counteracting factors, the uncertainties over the transmission mechanism and over the impact of the large June-July interest rate hikes, the MPC did not change the policy rates in August and September meetings (Table 1).

The September wage award to civil servants is also likely to add to inflationary pressures, particularly in services. Accordingly, while keeping rates on hold in the October meeting, MPC stressed the need to maintain a tight policy stance in the face of continued global imbalances, high inflation expectations, and the increased risks related to services inflation.

| Table 2: Monetary Policy Committee (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 |
| July 20th, 2006 | +0.25 | 17.50 |
| August 24th, 2006 | No Change | 17.50 |
| September 26th, 2006 | No Change | 17.50 |
| October 19th, 2006 | No Change | 17.50 |
| (1) Extraordinary | | |

The decisive policy measures taken by the CBT and the demonstration of its firm commitment to the medium term targets helped to contain the inflation expectations. The deterioration in medium-term expectations stopped in July. Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern in the past 2 months (Figure 3). However, the improvement in medium term expectations was limited, possibly owing to the adaptive behavior coupled with the elevated headline inflation figures. We expect that inflation expectations will come down gradually as inflation decelerates in the medium term. The fact that currently 24-month ahead inflation expectations are significantly higher than our medium term target of 4 percent, however, necessitates a tight policy stance.

**Figure 3: Inflation Expectations for the Next 12 and 24 Months***




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

**Outlook For Inflation and Monetary Policy**

*The Background and Current Conditions*

We assess that monetary policy has been tightened significantly. Implied real policy rate is 11 percent – a reasonably high figure even if it is corrected with various kinds of country risk premium measures. The longer-term interest rates such as the interest rates on government securities and consumer loans suggest even tighter monetary conditions. Other indicators, such as the slowdown in credit expansion and the monetary indicators confirm this view. Therefore, although there are uncertainties over the impact of the policy rates on economic activity, it is reasonable to assume that current financial conditions and monetary policy stance in Turkey are non-accommodative.

The tight monetary policy stance is expected to contain the inflationary pressures starting from the first quarter of 2007. The post-2001 data suggests that the impact of the real interest on the economic activity is mostly visible in 1 to 3 quarters in the Turkish economy. Indeed, there are some signs of a slowdown in the domestic demand, although not as pronounced as expected in July: The rapid credit expansion has been easing since June; the quarter on quarter consumer credit growth exhibited a significant deceleration in the third quarter of 2006 (Table 2). Automobile and housing sales registered a sharp decline in the last couple of months. Consumer confidence index dropped in June and July before it rebounded modestly. In the meanwhile, annual growth in monetary indicators displayed a noticeable decline. In sum, recent indicators suggest a considerable slowdown in the *private* domestic demand, especially on interest rate sensitive sectors such as car sales, durable goods and housing. It remains unclear, however, whether *aggregate* domestic demand will slowdown at the same pace, especially given the noticeable public spending and wage increases, and the prevailing uncertainties regarding the impact of real interest rates on demand conditions.

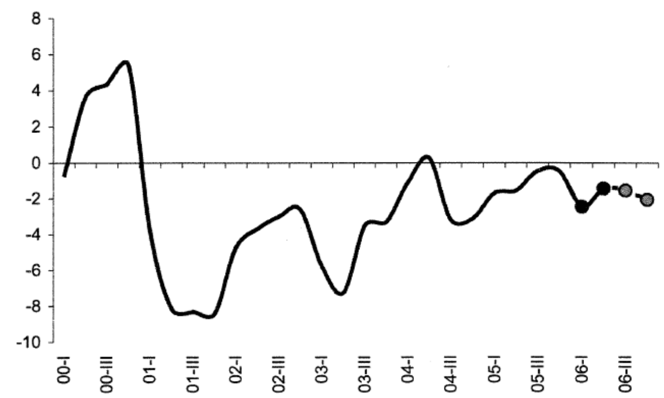
**Table 3: Recent Developments in Consumer Loans**
**(3-month real percentage change)**

| | 2005Q2 | 2005Q3 | 2005Q4 | 2006Q1 | 2006Q2 | 2006Q3 |
|---|---|---|---|---|---|---|
| Consumer Loans | 23.4 | 23.3 | 18.6 | 18.7 | 24.3 | 3.2 |
| Housing Loans | 61.9 | 50.6 | 38.1 | 30.8 | 27.2 | 2.6 |
| Automobile Loans | 11.7 | 11.4 | 9.9 | 3.2 | 8.9 | -4.8 |
| Other Credits | 11.7 | 11.3 | 5.3 | 13.1 | 28.7 | 7.8 |
| Credit Cards | 8.4 | 6.3 | 6 | 3.2 | 10.6 | 3.8 |

Source: CBT

Although our projections suggest an increase in the contribution of net exports on the growth rate in the second half of the year, we expect the slowdown in the domestic demand to surpass the rise in net exports. In sum, we expect a continued growth slowdown in the next couple of quarters. The seasonally adjusted figures for the August industrial production index and the September capacity utilization rate confirm the slowdown in the growth of the aggregate demand.

**Figure 4: Output Gap**




Source: CBRT

The main changes to the background of the forecast since the publication of July Inflation Report are the decline in the risk premium, output gap estimation (related in turn to stronger than expected domestic demand), the larger than envisaged civil service wage award, and the assumption on oil prices. The July inflation forecast assumed that the risk premium would remain constant. We envisaged that the decline in the confidence of the domestic agents after the May-June sell-off would induce a rapid and sharp drop in the domestic activity. However, the deterioration in global liquidity conditions turned out to be short-lived, and thus, business confidence rebounded sooner than we have expected. Consequently, although we still estimate that economic activity will operate below capacity, we now view the output gap in the second half of 2006 as slightly narrower than previously thought (Figure 4). On the other hand, the decline in the risk premium since end-July has induced a tightening in monetary conditions. That is, although the policy rates were kept constant since July, currently the risk adjusted real rate is higher than assumed in the July Inflation Report projections.

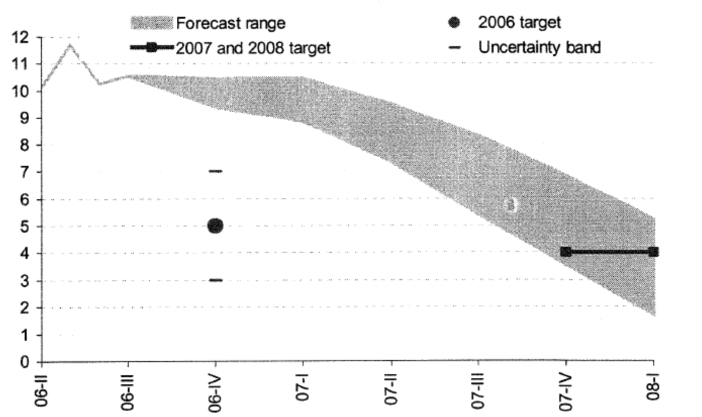
Civil service wage increases were higher than we had assumed, and could put additional pressures on services inflation in particular. Although, our assumption on oil prices was revised downwards from 70 to 60 USD per barrel, the forecasts take into account that the accumulated past increases in oil prices are most likely to yield hikes in the prices of household utilities such as natural gas and electricity, due to lagged effects. Throughout the forecast horizon, we expect that the unprocessed food prices will normalize, oil prices will remain unchanged, the world growth rate will gradually moderate, and the risk premium will stay constant.

*Outlook*

Our computations point out a 1-percentage point inertial impact on 2007 inflation due to the second round effects of the pass-through, which can largely be attributed to the presence of backward-looking price setting behavior especially in services inflation. We expect that the tight monetary conditions and the slowdown in the overall economic activity will ease the inflationary pressures and should limit the additional second-round effects of the exchange rate pass-through.

Against this background, we assess that bringing inflation back to the target necessitates a tight policy stance for a considerable period. Our latest forecast suggests that inflation will be between 9.2 and 10.6 percent at the end of 2006 and between 1.7 and 5.2 percent by the end of the first quarter of 2008, with 70 percent probability. Therefore, we expect inflation to converge to the target in about 6 quarters, i.e. by the end of 2008 Q1 (Figure 5).[1] The underlying policy path is an unchanged interest rate for the next four quarters and a gradual easing thereafter. It is noteworthy to stress that the policy path is conditional on the current available information, and therefore, subject to change as the new information arrives.

**Figure 5: Inflation Projections***




* The shaded region indicates the 70 percent confidence interval for the forecast. To make it compatible with the Inflation Report, we have decided to present the forecasts for a 6-quarter horizon–up through the first quarter of 2008.

**Risks**

The first risk factor is a weaker-than-envisaged aggregate demand slowdown. This could be due to hikes in government spending or a slower-than-expected transmission mechanism of the current monetary stance. Accordingly, we will closely monitor evolving developments in the economy in light of the cumulative increase in the policy rates since June.

[1] Inflation forecast for end-2007 is between 3.5 and 6.8 percent.

The second risk factor is a deterioration in global financial market sentiment. Global liquidity is still the major factor in shaping risk appetite and volatility in financial markets. Whether it is the risk of inflation or the risk of a global slowdown, a drop in the global risk appetite might lead to another wave of portfolio shock in emerging markets, which may necessitate a policy response through its impact on expectations. It should be stressed that in June we have designed a flexible tool to cope with such possible sudden changes in the market sentiment. The current liquidity conditions in the domestic money market allow us to engineer a rapid tightening in operational policy rates between the two MPC meetings. We have already announced in our policy statements that the CBT will not hesitate to resort to this kind of tightening, should the market conditions exhibit a sharp but temporary deterioration. In case the deterioration turns out to have permanent effects on the medium term inflation outlook, the MPC will revise the borrowing rate upwards. It is worth to note that, not all the scenarios regarding the global outlook are negative. Although a slowdown in the global economic growth could have an immediate adverse impact on the domestic inflation through its impact on the risk appetite, it could mean lower commodity prices and thus lower inflation in the medium term as well.

The third risk for the inflation outlook is higher-than-expected inflation inertia, as currently manifested in the medium term inflation expectations. Given that we plan to bring inflation down from 10 percent to 4 percent in a fairly short period of time, the degree of stickiness in services inflation emerges as a major risk to our forecast, especially if one considers the recent real increase in civil service wages. The inflation in services (apart from the relatively low productivity growth in this sector) displays a strong backward looking component, and thus it usually lags behind the headline inflation under a disinflation episode. Currently, the annual percentage change in services price index is around 12 percent. Our projections suggest that the moderation in domestic demand may drive services inflation down to as low as 9 percent next year—contributing 2.5 percentage points to the headline inflation in 2007. This means the goods inflation has to stay close to 2 percent, for the headline inflation to adhere to the 4 percent target at the end of 2007.

**Conclusion**

Monetary policy has been tightened significantly since mid-June. This non-accommodative monetary stance is expected to slow demand and bring inflation down to its target by the end of 2008 Q1. Although the accumulated impact of the various cost-push shocks combined with the continued exchange rate pass-through has kept inflation at high levels, the policy measures we have taken in June 2006 have been successful in containing further deterioration in medium term inflation expectations. However, there are significant upside risks to our baseline inflation projection. Materialization of such risks will lead the CBT to further tighten the policy stance by raising policy rates. That is why we will conduct monetary policy with a tightening bias in the period ahead. In other words, monetary policy will stay more attentive to adverse developments than favorable developments regarding inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

Against this backdrop, we decided jointly with the government to keep the 4 percent target for 2007. The volatility in the financial markets in May-June period in Turkey, by all means, can be considered as a significant shock. Some countries have chosen the strategy to change their targets when they were faced with similar shocks (See Brazil 2003, for example). Although our baseline projections suggest that it may take around 6 quarters to bring inflation back to the target, we see a considerable chance that inflation can be brought close to the 4 percent target at the end of 2007, particularly given our tightening bias. More importantly, we believe that changing the end-2007 target at this stage could not only have adverse implications for expectations and wage setting process for 2007 but also undermine the credibility of future policy commitments.

High primary budget surpluses have supported the disinflation process to a large extent during the past years. Maintaining and advancing the gains achieved thus far would benefit from the continuation of the reforms related European Union accession process, and the implementation of structural reforms, which will ensure the sustainability of fiscal discipline in the long run.

INTERNATIONAL MONETARY FUND

TURKEY

**Fifth Review and Inflation Consultation Under the Stand-By Arrangement, Request for Waiver of Nonobservance and Applicability of Performance Criteria, Modification of Performance Criteria, and Rephasing of Purchases**

**Supplementary Information**

Prepared by the European Department in consultation with other departments

Approved by Michael Deppler and Matthew Fisher

December 8, 2006

*This supplement provides an update on the status of implementation of the prior actions for the review. The thrust of the staff appraisal remains unchanged.*

1. **Two out of three prior actions have been implemented**. A satisfactory 2007 budget and the second-stage personal income tax reform have been submitted to Parliament.

2. **However, the announcement of a timetable for the privatization of Halkbank, the remaining prior action, had to be delayed**. On December 6, the High Administrative Court issued an injunction on the sale of Halkbank, suspending the process indefinitely. Overcoming this legal impediment will require approval of new legislation extending parliamentary mandate to the government to carry forward the sale of the bank. New legislation has already been submitted and the authorities expect it to be approved sometime in January, in which case it would be still feasible to complete the tender process for Halkbank by end-May (structural benchmark).

3. **Staff supports completion of the fifth review, notwithstanding the nonobservance of the prior action on Halkbank**. Staff considers that the legal challenge to the privatization of the bank is beyond the authorities' control and that the prompt submission of legislation needed to overcome the legal obstacle is a tangible demonstration of their commitment to the privatization process.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/272
FOR IMMEDIATE RELEASE
December 13, 2006

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Executive Board Completes Fifth Review Under Stand-By Arrangement for Turkey and Approves US$1.13 billion Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review under the three-year SDR 6.66 billion (about US$10.05 billion) Stand-By Arrangement for Turkey, which was approved on May 11, 2005 (see Press Release 05/104). In this regard, the Board approved Turkey's requests for waivers of nonobservance of the performance criteria pertaining to the end-September central government primary spending ceiling and the submission to parliament of legislation to reform personal income tax.

The completion of the review will enable Turkey to draw immediately an amount equivalent to SDR 749.5 million (about US$1.13 billion).

Following the completion of the Board's discussion, Mr. John Lipsky, First Deputy Managing Director and Acting Chairman, made the following statement:

"Helped by Turkey's sound policy framework, the economic consequences of the May–June turbulence were contained, with growth remaining robust and balance sheets proving resilient. Buoyed by the central bank's decisive policy response, financial markets stabilized quickly. However, inflation remains well above target, the current account deficit continues to widen, and public debt remains high.

"In light of this, the authorities' commitment to the 6.5 percent of GNP primary surplus target for 2007 is welcome. Achieving this target will require keeping spending under tight control, improving health spending efficiency, and preserving the tax base. Over the medium term, budget quality needs to improve, including by lowering distortionary taxes and increasing investment spending.

"Given the challenging inflation outlook, the central bank's tightening bias is appropriate and should help bring inflation towards announced targets over time. The resumption of pre-scheduled daily foreign exchange purchase auctions will help increase reserves without interfering with the floating exchange rate regime.

"The authorities' structural reform agenda will help sustain growth, maintain market confidence, and reduce vulnerabilities. On the fiscal side, efforts to improve tax revenue collection, including through the establishment of a large taxpayer unit by end-year, and timely implementation of social security reform legislation will be key to safeguard the medium-term fiscal position. In the financial sector, the regulatory framework is being further strengthened through the adoption of supporting regulations for the Banking Law and the introduction of stricter provisioning requirements. Passage of the mortgage law and privatization of state banks will help deepen financial markets, enhance the efficiency of the financial system, and strengthen the investment climate.

"Close adherence to the authorities' policies under the Fund-supported program will be key to ensuring continued stable growth with lower inflation, and to reducing the vulnerability of the economy to any sudden shift in market sentiment. The authorities' commitment to maintain tight monetary and fiscal policies and advance structural reforms deserves the support of the international community," Mr. Lipsky said.

**Statement by Willy Kiekens, Executive Director for Turkey and Levent Veziroglu, Senior Advisor to Executive Director December 13, 2006**

Turkey has made significant progress under its Fund-supported economic program. It is true that the volatility in financial markets last spring affected Turkey more than some other emerging-market economies. However, improved economic fundamentals, credibility built up during the past few years and prompt policy action all ensured that this volatility was short lived. The most significant remaining effects of this episode are an overshooting of the inflation target and higher interest rates. Growth bounced back and is now projected to be 6 percent this year, 1 percentage point above the program target. Medium-term prospects have also been strengthened as the authorities remain committed to prudent macroeconomic policies and to accelerate structural reforms.

With lower private sector investment and slowing of credits due to the higher interest rates, real growth should be close to the potential rate of 5 percent next year.

The current account deficit for 2006 is now projected to reach 8.5 percent of GNP, as against the 6.5 percent stated in the program. The authorities and the staff are carefully analyzing the factors behind this increase. Structural transformation of the Turkish economy and the rapid growth of household consumption and private investment have been identified among the major causes. Another significant cause is the rising energy prices. Indeed, the non-oil current deficit is only 2.2 percent of GNP. Energy imports now represent 7.3 percent of GNP against 4.7 percent in the years 2003—04.

The composition of the current account deficit is now significantly different from that in the period before the 2001 crisis. At that time, both investment and domestic savings were low because of loose fiscal policy. However, today public savings have increased dramatically as a result of tight fiscal policy over the past five years, while private investment has also gone up significantly. Moreover, the financing of the deficit has improved markedly. Mergers and acquisitions in various sectors, privatization and favorable international borrowing conditions have helped Turkey secure a record level of capital inflows. Foreign Direct Investment flows are estimated to reach US$ 18.3 billion in 2006. This trend is expected to continue with more green-field investments, as structural reforms steadily improve the investment climate in Turkey.

Strong fiscal performance was sustained in 2006. Collection of tax arrears and of other receivables resulted in a significant revenue over performance. The government is committed to saving this windfall gain but must acknowledge some expenditure overruns in the social security sector. However, on balance, this year the consolidated fiscal sector may reach a primary surplus of about 7.5 percent and the overall fiscal balance may be slightly positive for the first time in many years.

In 2007, fiscal discipline will continue to be the main pillar of macroeconomic policies. The authorities are committed to maintain a primary surplus of 6.5 percent of GNP in 2007 for the fifth year in a row. The draft budget, which is consistent with this target, has been submitted to Parliament. This signals the authorities' strong adherence to fiscal prudence even in an election year.

The sources of expenditure overruns in 2006 have been identified and actions have been taken to contain expenditure increases, including in the health care sector. These measures will have positive effects on the 2007 budget as well.

The authorities are focusing on improving the quality of fiscal adjustment and making the progress of the past years sustainable. Their strategy focuses on enhancing the efficiency of public expenditures, including growth-enhancing investment. The recent social security reform is a centerpiece of this strategy. Its administrative implementation is well advanced. The government is preparing a civil service reform that will address the deficiencies in the system. Investment decisions will be carefully prepared.

The tax system will be made more efficient by broadening the tax base and reducing distortions and inequities associated with the existing system. A second phase of the personal income tax (PIT) reform has been submitted to Parliament. This reform will improve the efficiency of the PIT and reduce the cost of tax collection. The costly and ineffective repayment of VAT for some selected private consumption will be replaced by standard credit and income tax reductions for spouses and children. A real estate capital gains tax will be introduced.

The authorities are keen to eliminate distortionary taxes, particularly in the banking sector. However, fiscal constraints prevent them from acting more quickly. If revenue over-performs in 2007, the government might be able to phase out the Banking Transaction and Insurance Tax in the second half of the year.

The Central Bank of Turkey (CBT) continues to target an inflation rate of 4 percent for 2007 and beyond. The recent data confirm that aggregate demand continues to slow-down. While private sector demand indicators show a significant slowdown, foreign demand remains relatively strong. Supply shocks for certain goods, the stickiness in service sector prices, and the uncertainties in the global economy are major contributors to the inflationary trends in Turkey. Therefore, the CBT would maintain a tightening bias until inflation shows a clear sign of abating. The CBT closely monitors the lagged effects of monetary tightening and considers the potential impact of recent developments in incomes policy and non-interest public sector expenditures on inflation and inflation expectations. The CBT will take any action needed to keep inflation in check.

The CBT is improving its communication strategy, which is crucial for reflecting the authorities' policy stance and enhancing the credibility and effectiveness of monetary policy. During the period of volatility last spring, the flexible exchange rate regime served Turkey well. It supported the inflation-targeting framework and helped cushion exogenous shocks.

On November 10, 2006, the CBT resumed foreign exchange buying auctions in order to build up international reserves. These auctions had been suspended last May. Their resumption now should boost confidence in the current economic program. This policy of building up reserves is justified by the still high level of short-term debt and with the aim of gradually reducing the amount of the so-called “Dresdner accounts”. These accounts are high-interest rate deposits made by Turkish workers abroad with the CBT.

Under the floating exchange rate regime, the CBT does not target any exchange rate. Carrying out pre-announced fixed amount auctions should minimize the effects on supply and demand conditions in the foreign exchange market or on the level of the exchange rate, while achieving for a moderate increase in reserves.

The soundness of the financial sector has strengthened significantly. The Turkish banking sector was able to weather well the latest market turbulence, despite the capital outflows and a sharp increase in interest rates which accompanied the currency depreciation. The Banking Regulation and Supervision Agency (BRSA) is closely monitoring developments in the sector and taking the appropriate measures. General provisioning requirements for new loans have been doubled.

The decision of the Privatization High Council to sell the state-owned Halkbank was suspended by the High Administrative Court because the needed parliamentary authorization may be missing. However, the government remains strongly committed to selling Halkbank and has, very soon after the court’s ruling, introduced in parliament a new draft law authorizing the sale of Halkbank. The authorities are confident that the tender process of Halkbank would still be completed by end May 2007.