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October 2003
IMF Country Report No. 03/324

Turkey: Fifth Review Under the Stand-By Arrangement, Request for Waiver of Performance Criteria and Extension of Repurchase Expectations—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the fifth review under the Stand-By Arrangement, request for waiver of performance criteria and extension of repurchase expectations, the following documents have been released and are included in this package:

- the staff report for the fifth review under the Stand-By Arrangement, request for waiver of performance criteria and extension of repurchase expectations, prepared by a staff team of the IMF, following discussions that ended on **July 18, 2003,** 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 August 1, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 30, 2003** updating information on recent developments.

- a Press Release summarizing **the views of the Executive Board as expressed during its August 1, 2003 discussion** of the staff report that completed the review.

The document listed below have been separately released.

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

*May also be included in Staff Report

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

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

TURKEY

Fifth Review Under the Stand-By Arrangement and Requests for Waiver of Performance Criteria and Extension of Repurchases Expectations

Prepared by European I Department in consultation with other departments

Approved by Michael Deppler and Mark Allen

July 25, 2003

- **Stand-By Arrangement.** The Fund supports Turkey's economic program for 2002–04 under an SBA approved in February 2002. Total access under the arrangement is SDR 12.8 billion, or 1,330 percent of quota, of which about SDR 10.4 billion has been purchased so far (Appendix I). A further SDR 340 million becomes available on the completion of this review.

- **Discussions.** During May 20–30 and July 8-18 the staff team met with Deputy Prime Ministers Şener and Şahin, State Minister for Economic Affairs Babacan, Minister of Finance Unakitan, Treasury Undersecretary Çanakci, Finance Undersecretary Aktan, State Planning Organization Undersecretary Tiktik, Central Bank of Turkey Governor Serdengeçti, Bank Regulation and Supervision Agency Chairman Akçakoca, other senior officials, and representatives of the private banking and business communities.

- **Staff.** Team members included Reza Moghadam (head, July mission), Juha Kähkönen (head, May mission), Brian Aitken, Mark Griffiths, and Marco Rossi (EU1), Mark Flanagan and Ernesto Ramirez Rigo (FAD), Thomas Laryea (LEG), Mats Josefsson (MFD), Chris Lane (PDR), Odd Per Brekk (senior resident representative) and Carlos Piñerúa (MFD resident representative). Selim Çakir (OED) attended most meetings during the May mission. An FAD technical assistance mission (Jean-Paul Bodin and Everardo Maciel) on social security arrears overlapped with the July mission.

- **Publication.** The Turkish authorities have not yet decided on the publication of this staff report but, concerned at possible market sensitivity, have decided against publishing the staff report for the Fourth Review.

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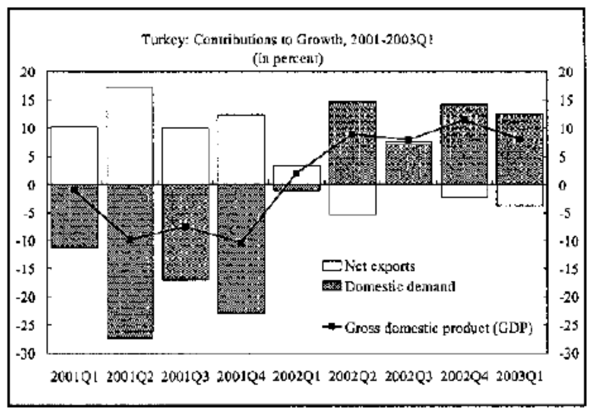
I. Introduction

The acceleration of program implementation paved the way for the completion of the fourth review in mid-April. The rapid conclusion of the war in Iraq, improved market sentiment towards emerging markets, and the prospect of bilateral financing from the United States also helped bolster confidence in the Turkish economy. Unfortunately, the government's focus on program implementation weakened after the completion of the fourth review, and the fifth review mission in May was unable to complete its work on schedule. In recent weeks, the government has regained its determination to act on its policy commitments, and the July mission was able to reach an understanding on the policy actions needed to enable recommending the completion of the fifth review.

II. Recent Developments

1. **Macroeconomic developments have been mostly favorable, despite program deviations and uncertainties associated with Iraq (Tables 1 and 2):**

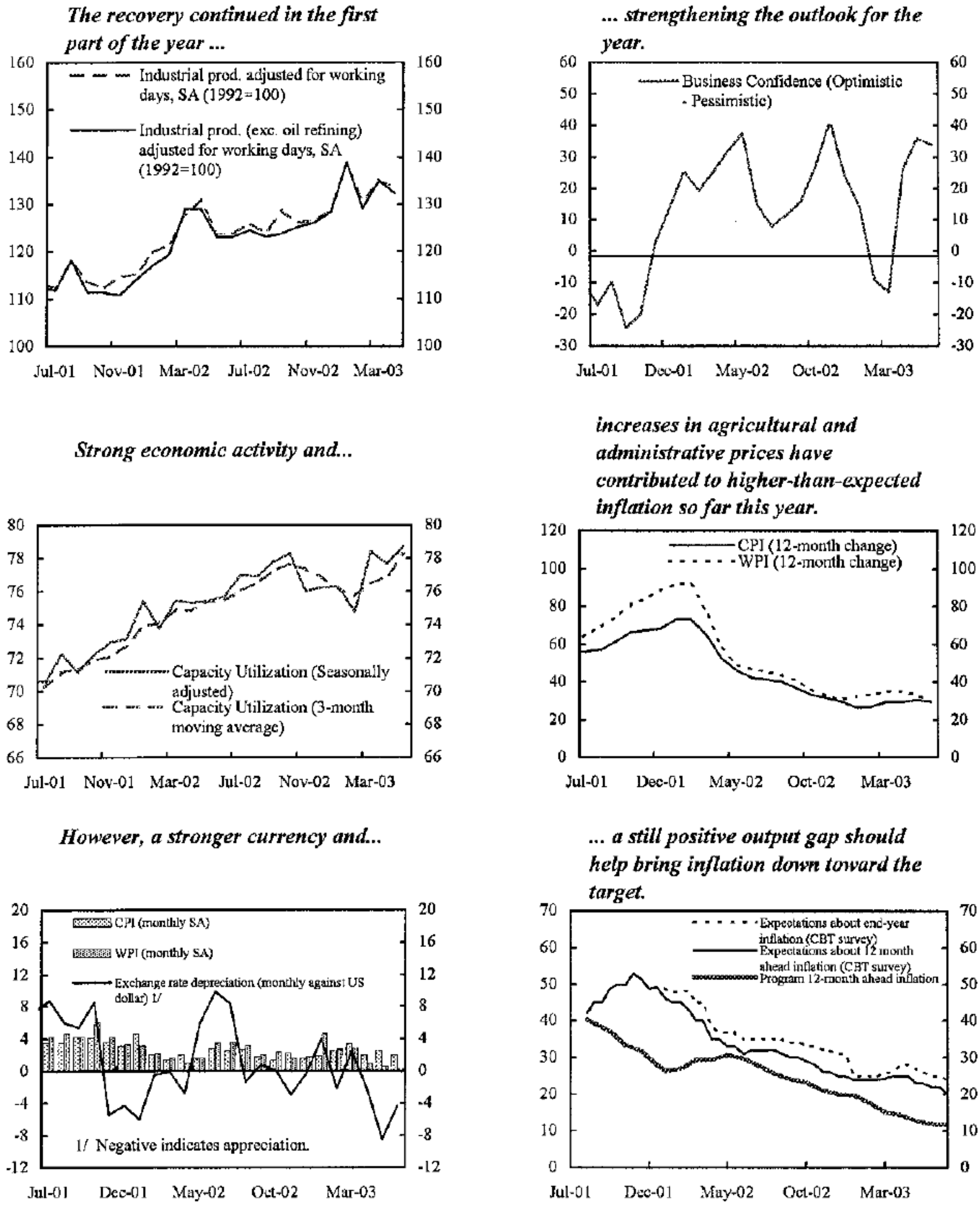
- **Economic recovery continued in the first half of 2003 (Figure 1).** GDP grew by 7.4 percent year on year (2.5 percent quarter on quarter, seasonally adjusted) during the first quarter, led by domestic demand. Stronger capacity utilization and industrial production suggest that the recovery continued in the second quarter. The Central Bank of Turkey (CBT) survey shows an increase of market expectations of growth this year to 4.9 percent, close to the 5 percent program projection.



- **This year's 20 percent inflation target is ambitious but achievable.** During the first five months of the year, inflation was higher than programmed due mainly to sharp increases in food, clothing, and administrative prices. However, prices fell in June, bringing cumulative CPI inflation this year down to 12 percent, somewhat above the program target of 10.3 percent. The recent appreciation of the Turkish Lira (TL) and the still positive output gap should bring down inflation in the second half. The 20 percent target, though a challenge, can still be achieved provided policies remain on track.

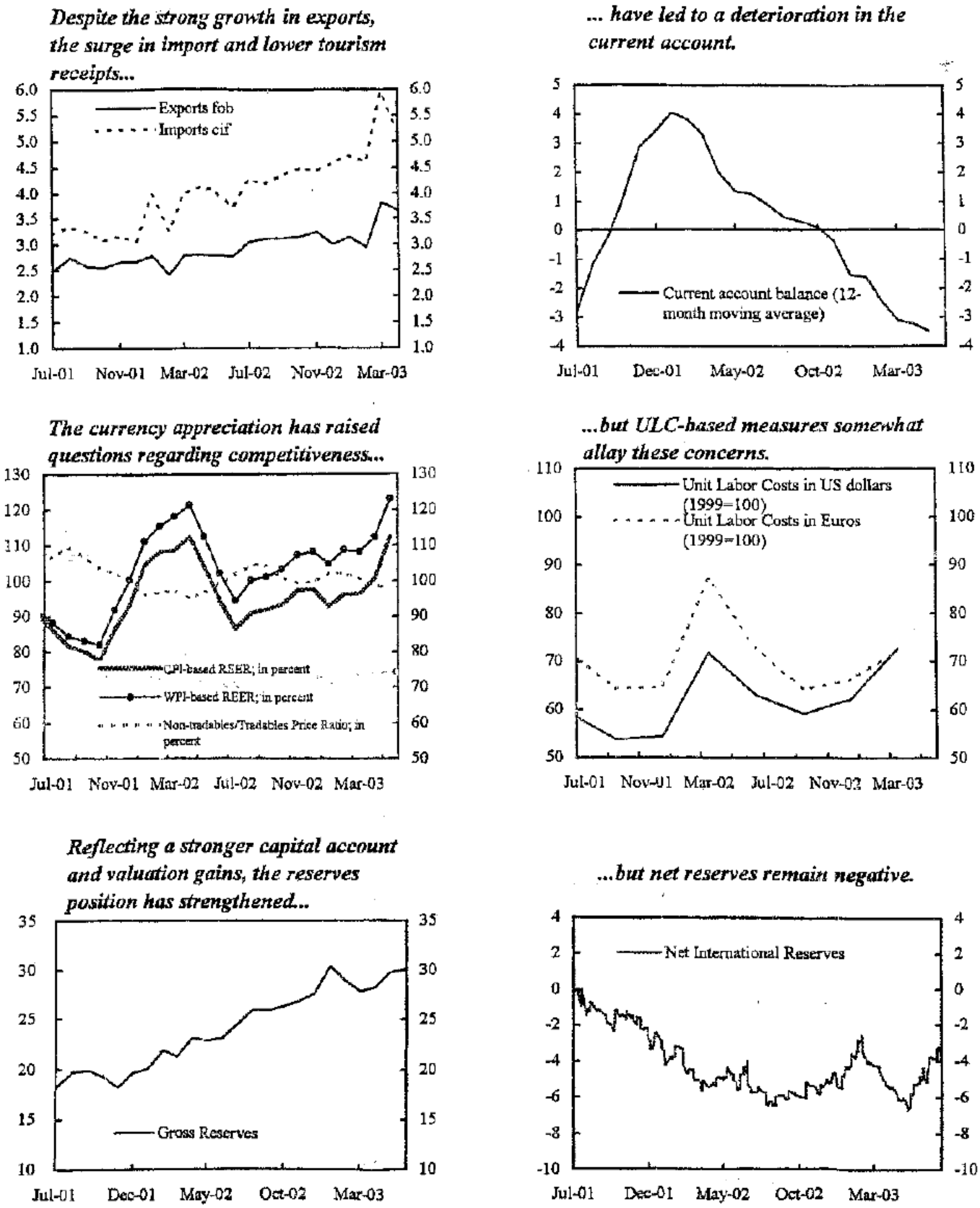
- **The current account deficit has widened (Table 3 and Figure 2).** This year's projection has been raised to 3 percent of GNP, from just under 2 percent of GNP during the Fourth Review. Imports have been much higher than anticipated, due to the recovery in domestic demand and higher oil prices. Export growth has remained

Figure 1. Turkey: Output and inflation, 2001-03
(in percent, unless otherwise indicated)



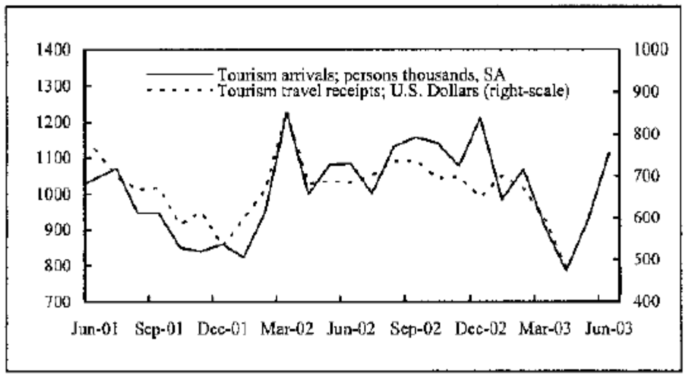
Sources: State Institute of Statistics; and Central Bank of Turkey.

Figure 2. Turkey: External indicators, 2001-03
(in billions of U.S. dollars; unless otherwise indicated)



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

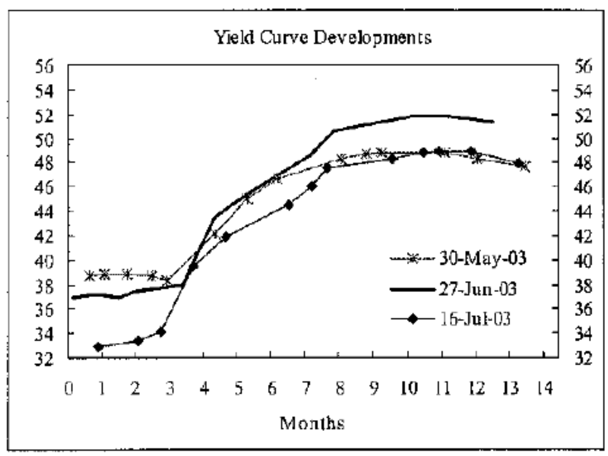
relatively strong, despite the significant real appreciation of the Turkish lira and slowdown in partner country demand. Global uncertainties lowered tourism revenues in the first half of the year but there are indications of a rebound in tourist arrivals. In addition, the services and income account is adversely



affected by record low short-term interest rates, which reduce interest income (on reserves) in the face of mostly fixed interest payments. However, private capital inflows have picked up, financing the higher current account deficit while also augmenting reserves.

2. **Movements in financial indicators have also been generally favorable.** The exchange rate has appreciated strongly and, interest rates have fallen (though remain above program projections):

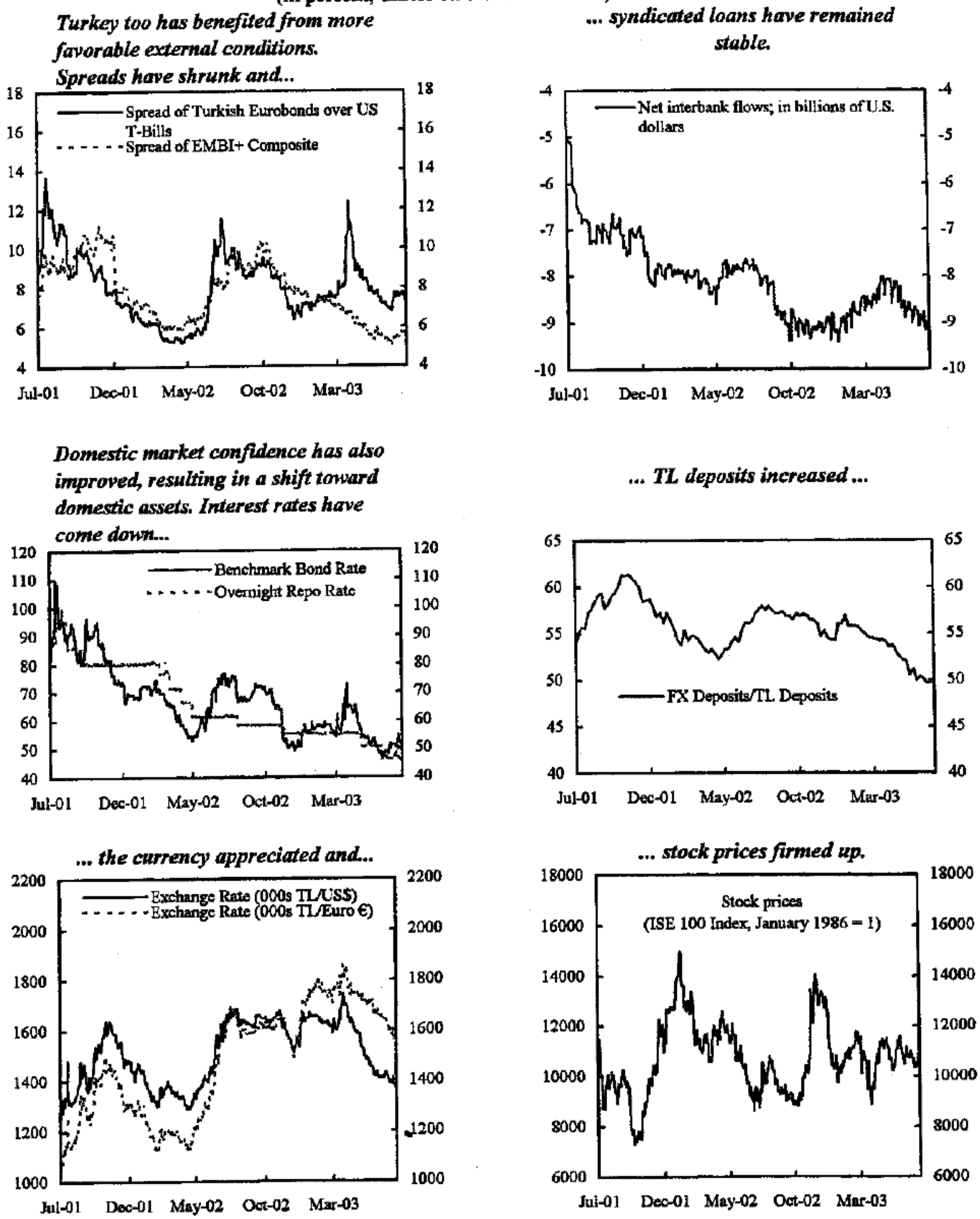
- **With the resolution of the conflict in Iraq, market confidence has improved but is still less than complete (Figure 3).** Since end-April, capital inflows and reverse currency substitution have led to an appreciation of the Turkish lira. The CBT followed by cutting its overnight rate in end-April and early June, from 55 to 46 percent, and then again to 42 percent on July 16. However, longer term



rates have fallen by less and remain high in real terms, suggesting underlying concerns with policy credibility. More recently, the detention of Turkish soldiers in northern Iraq, and concerns regarding the completion of the fifth review, led to a temporary increase in short-term Treasury bill rates.

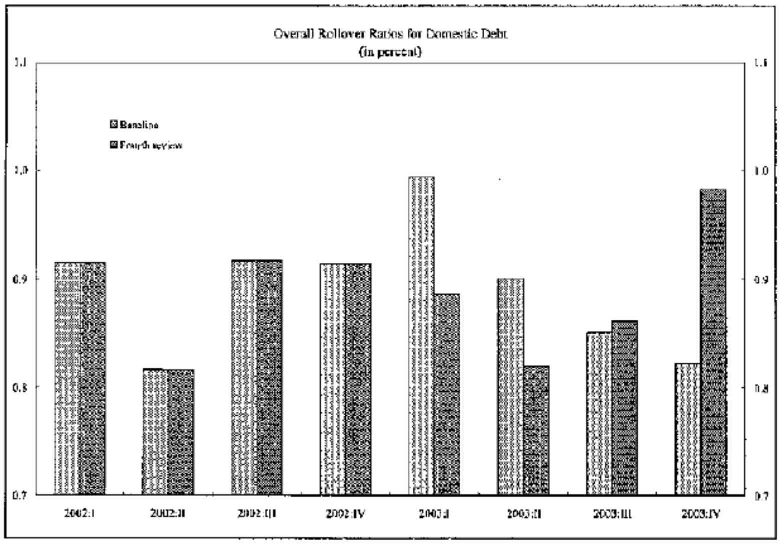
- **The authorities have used the improved market confidence to over finance the budget deficit, considerably easing near-term domestic debt rollover pressures.** Eurobond issuance has already reached US$4 billion, close to the US$4.5 billion full-year target. Private sector rollover ratios for April-June exceeded 100 percent,

Figure 3. Turkey: Financial indicators, 2001-03
(in percent, unless otherwise indicated)



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

well above the 88 percent minimum requirement estimated at the fourth review. Over financing has allowed the central government to increase its deposit cushion at the CBT. It has also allowed the Treasury to redeem part of its debt to the CBT. This has reduced vulnerability in the system by allowing the CBT to reduce its overnight borrowing from banks.



- **Monetary developments have reflected this improvement in market confidence (Tables 4 and 5; Figure 4).** Although foreign currency deposits and TL deposits (in real terms) fell during the Iraq crisis, they have since recovered sharply. Throughout the period there has been a strong increase in nonbank holdings of Treasury paper, taking advantage of the spike in bond rates during the Iraq war, and the exemption from the withholding tax for direct holdings of government paper. There are also signs that the decline in credit is bottoming out. Both Turkish lira loans (in real terms) and foreign currency denominated loans (measured in dollars at constant cross rates) have stabilized. Consumer credit has increased rapidly, as have loans from abroad to Turkish firms.

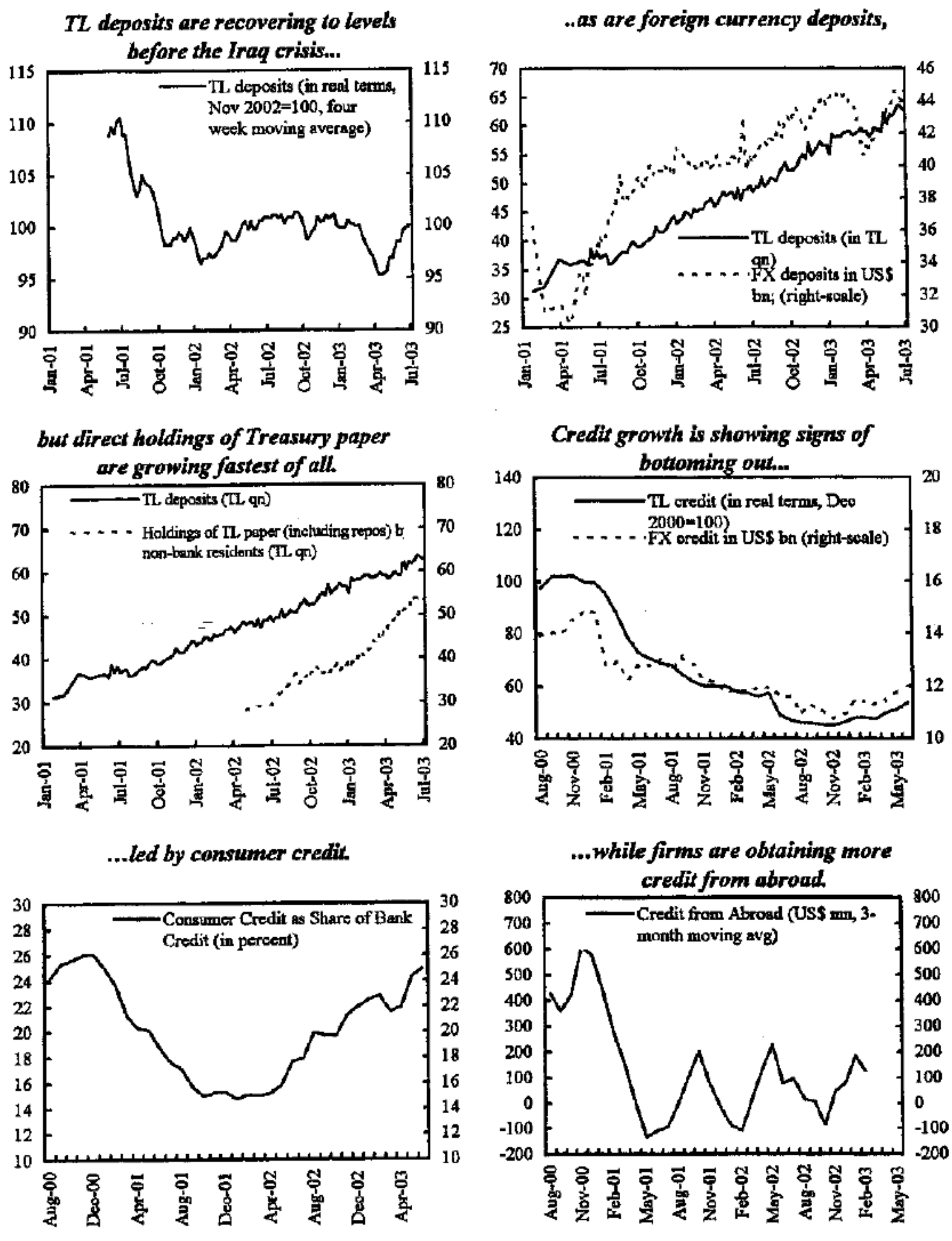
3. **Several factors might help explain why the market reaction to program slippages has not been more pronounced:**

- Turkey has benefited from a generalized improvement in market sentiment toward high-yielding emerging market assets; since mid-April eurobond spreads have fallen in line with (though not as much as) the emerging market average, and nonresident holdings of domestic debt, while still small, have increased sharply, putting downward pressure on bond rates.

- The government is seen to be making good progress in EU reforms (Box 1), which has helped offset market reaction to lack of progress in some of the program's structural areas.

- Although U.S. financing has not been secured, it remains available and negotiations are ongoing.

Figure 4. Turkey: Money and Credit, 2001-03



Source: Central Bank of Turkey.

Box 1. Turkey—EU Accession Legislative Agenda

During 2002-2003, Turkey has accelerated legislative reforms aimed at EU accession. These reforms have been concentrated in non-economic areas, in particular improving individual rights, the role of the military, and freedom of association and speech.

In 2002, two reform packages were adopted, in August and December. At the December 2002 Copenhagen Summit, the EU decided that it will assess Turkey's progress at the latest by December 2004, before setting a date for the start of EU membership negotiations. The 2002 reforms covered:

- Improved individual language rights, in education and broadcasting;
- Abolition of the death penalty;
- Easing of restrictions on religious foundations, including their right to own property;
- Easing of restrictions on the work of foreign associations in Turkey, including their work with Turkish counterparts and extension of financial aid; and
- The acceptance that court cases brought before the Human Rights Court in Strasbourg may be retried in Turkey.

The new government has further intensified the EU-related legislative reforms. The government aims to complete the necessary legislative reforms by end-2003, and then demonstrate "implementation" as expected by the EU in the year leading up to the 2004 decision regarding membership negotiations. The sixth reform package was passed in early June 2003, and included:

- Further strengthening of cultural rights, including broadcasting in minority languages;
- Abolition of Article 8 of the Anti-Terror Law, paving the way for the release of prisoners under this Article;
- Further strengthening of property rights of religious foundations; and
- Removal of military representation in the committee for movie censorship.

The government has now prepared a seventh legislative package, which it aims to pass through Parliament by end-July, when the summer recess starts. The draft legislative package would reduce the power of the military, by:

- Making the National Security Council (NSC), where the top generals and the government leaders meet monthly under the chairmanship of the President, more of an advisory than a policy setting body; and
- Allowing a civilian as well as a member of the Turkish Armed Forces to head the NSC's Secretariat, and reducing the number of generals participating in the meetings.

- Domestic treasury bill holders may have believed that the fifth review faced only minor delays, and that an end-July Board meeting was possible.

III. Policy Discussions

Against this background, the discussions focused on the need for steadfast implementation of program policies. The May and July review missions took place against a background of a widening fiscal gap, and delays in a large number of structural reform measures. The authorities cited a number of reasons for the delays and slippages (e.g. EU-legislative agenda and the need for political consensus). The authorities, however, did not question the appropriateness of the program targets, nor the need for the program's structural measures, and reiterated their commitment to carry them out (¶1-5).[1] *However, a major effort was needed to put the program back on track.*

4. **The mission engaged the authorities in resolving the main outstanding issues that prevented the completion of the fifth review.** The staff sought to complete the fifth review discussion provided (a) corrective measures were taken to safeguard the 6½ percent of GNP primary surplus for the year; (b) the authorities abandoned the introduction of a social security amnesty, and made a credible commitment not to introduce amnesties on public sector receivables; (c) structural conditionality for the fifth review was completed, and (d) agreement was reached on re-phasing the structural reform components of the program for the sixth review that came due by end-June, with some intermediate actions taken before the completion of the review. In light of the delay in completing the fifth review and the revised timetable for structural conditionality, the mission sought to re-phase the program by pushing back each of the remaining test dates by roughly two months.

A. Fiscal Policy and Reforms

5. **The May and July missions detected a widening fiscal gap for the year as a whole.** The authorities met the end-April performance criterion (PC). However, the underlying figures revealed a worrying trend, and it seemed likely that the end-June PC would be missed. In particular, the central government primary surplus continued to fall short of program assumptions. This shortfall was offset by better performance by state enterprises than originally envisaged. However, with state enterprise expenditures expected to accelerate, the staff and the authorities agreed that the year-end primary surplus target was in jeopardy.

Turkey: Public Sector Primary Balances, 2000-03

	2000	2001	2002 Est.	2003 Rev. Prog.
	(in percent of GNP)			
Public Sector	**3.0**	**5.5**	**4.0**	**6.5**
Central government	**4.6**	**4.8**	**2.4**	**5.0**
Total revenue	24.2	25.4	23.2	25.3
Tax revenue	21.1	22.5	21.8	24.3
Nontax revenue	4.4	4.5	3.4	3.5
Tax rebates	-1.3	-1.7	-2.1	-2.5
Noninterest expenditure	19.5	20.6	20.7	20.3
Personnel	7.9	8.6	8.5	8.3
Transfers	7.0	6.9	7.1	7.6
Investment and others	4.6	5.1	5.2	4.3
Rest of the public sector	**-1.6**	**0.7**	**1.6**	**1.5**
Unemployment insurance fund	0.3	0.6	0.4	0.3
SEEs	-1.5	0.1	1.1	1.2
Others	-0.4	0.0	0.1	0.0

Sources: Turkish authorities; and Fund staff estimates.

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

6. **The authorities acknowledged a fiscal gap of 0.7 percent of GNP relative to the end-year primary surplus target**. The gap had been about 0.4 percent of GNP during the May mission. The shortfall reflected delays in implementing fiscal measures and the costs of new initiatives that were not included in the projections at the time of the fourth review. By July, the gap had widened to 0.7 percent of GNP due to a higher wage increase for public sector workers than had been assumed, revenue shortfalls, wage increase for civil servants above budget targets, significantly higher tax rebates than originally envisaged, and higher planned off-budget spending which prevented "special" off-budget revenues from being transferred to the budget. The staff attributed a large part of the revenue shortfall to the widely held perception, fueled by ministerial statements, that further tax and social security amnesties were imminent. The authorities had been optimistic in May about higher revenues from an earlier amnesty (Tax Peace Plan). However, by July the negative impact of amnesties on revenues had become more apparent.

Estimate of Fiscal Gap and Measures

	Annual Basis	
	TL	% of GNP
I. Program public sector primary surplus target	**23,358**	**6.50**
II. Projected public sector primary surplus (*May mission*)	21,805	6.07
III. Projected public sector primary surplus (*July mission*)	**21,028**	**5.85**
IV. Additional fiscal gap (II-III)	777	0.22
VAT rebates to pensioners	100	0.03
Other rebates	695	0.19
Higher than program public workers wage increase (5% H1 & 9% H2)	803	0.22
Lower special revenues written over to budget	380	0.11
Others	-1,201	-0.33
V. Measures necessary to hit public sector target (*July mission*)	2,330	0.65
VI. Authorities identified measures	**2,330**	**0.65**
Cut in investment spending	1,000	0.28
Cut in other current spending	100	0.03
Cut in other transfers (agricultural subsidies, duty loss, etc)	115	0.03
Accelerate path of special revenues write over to budget (2003 total TL 1,200 trn)	580	0.16
Increase in tobacco and alcohol excises (SCT list III)	250	0.07
Revaluation of specific excises by 60 percent on June 1	210	0.06
Others	75	0.02
VII. Remaining gap 1/	**0**	**0.00**

1/ Assumes all identified measures are approved and implemented on schedule.

7. **The government has now taken measures to address the emerging fiscal gap, as prior action for the review** (¶7). With only five months of the year remaining, taking corrective action was a challenge, and the government's options limited. With Parliament in recess during August and September, they also sought measures that could be implemented by the Government and not require Parliamentary approval. Given these constraints, they decided to make part of the spending freeze or "sequestration" of 1½ percent of GNP permanent. This amounted to cuts in capital, current, and transfer spending of some 0.4 percent of GNP. The remainder of the gap was filled by increases in tobacco and alcohol prices (about 0.1 percent of GNP), and by cuts in off-budget spending and the transfer of the corresponding "special revenues" to the budget (0.2 percent of GNP). To render the program targets more transparent, they agreed to redefine them to include both special revenues and expenditures, consistent with the budget figures that are made public (¶8).

8. **While these efforts were commendable, the staff noted that the measures carried several implementation risks**. While the authorities were confident that with the spending freeze already in place, the cuts would be easy to implement by simply canceling the allocation to each ministry, they had not yet identified the specific cuts in investment. However, the State Planning Organization has now initiated an exercise to translate the

aggregate cuts into specific items by line ministry. The Bank and Fund staffs also raised concerns about the composition and quality of the cuts. In response, the authorities committed to safeguard spending in health and education.

9. **The staff also expressed concern about the lack of clarity on the wage settlement for public sector workers**. The government had made its "final" offer to both civil servants and public sector (blue collar) workers (5 percent in the first half of the year and 9 percent in the second half). Although the offer to civil servants is now implemented, the public workers had not accepted the government's offer. The authorities were confident that the wage offer would not be increased, as emphasized by the Prime Minister. However, they were prepared to take additional measures, if needed, to compensate for any wage increase above the government's offer. Therefore, they agreed to include some extra margin in the projection of budget revenue, and discussed contingency measures with the staff. Since the mission, the authorities reached agreement with the public sector unions by raising the increase for the first half of the year to 5.5 percent. The impact on the budget will be small and well within the agreed extra margin on revenue.

10. **The government is preparing a 2004 budget with a public sector primary surplus of 6.5 percent of GNP** (¶10). The authorities acknowledged that without new actions, some deterioration in the public sector primary surplus would be inevitable in 2004 due to the large number of one-off measures in 2003 and the already higher-than-planned wage increase. The mission argued that the need for tax increases could be limited by setting appropriate ceilings on expenditure in the 2004 budget call. The authorities agreed that tight limits would be necessary (keeping overall spending constant in real terms), but noted that this could be difficult, given the steep projected increases in non-discretionary spending (e.g. Direct Income Support entitlements). They also agreed on the need to expand the tax base, and would seek technical assistance in this area ahead of the sixth review.

11. **The authorities were anxious to deal with the problem of social security arrears.** At first, they had considered clearing these through a generalized amnesty, believing that this would encourage parts of the informal economy back into the tax system. However, the staff strongly opposed the introduction of a new amnesty, arguing that while it might provide a short-run revenue fix, it would weaken tax compliance, and contradicted the clear commitment made in the last letter of intent. The staff also objected to the earlier introduction of an amnesty for electricity arrears, but the authorities attributed this to a misunderstanding by the management of the electricity company, and pledged that the company was now focused on collection enforcement.

12. **At the conclusion of the discussions, the authorities reaffirmed their commitment not to introduce any new amnesties for public receivables**. To demonstrate their commitment, they agreed to introduce a continuous structural performance criterion on no new amnesties (¶16).

13. **The authorities agreed to restructure social security arrears following the recommendations of an FAD technical assistance mission**, and in line with international best practice. The proposed reform will avoid moral hazard problems by maintaining the

face value of existing arrears.[2] It will also encourage social security contributors who are prepared to restructure their arrears to return to the system by tying future payments to ability to pay. The broad parameters of this reform will be specified in the social security legislation currently going through Parliament. Detailed implementation regulations will be introduced in consultation with the staff (Box 2).

14. **To help achieve the medium-term primary surplus target, the authorities are taking a number of steps to strengthen their revenue and spending frameworks**:

- The Bank and Fund staffs had detailed discussions on the draft **public financial management and control law** that the authorities had prepared. A ministerial agreement was reached to incorporate most of the Bank and Fund comments into the draft law (prior action for the fifth review, ¶15). In particular, the authorities agreed that the operational independence of regulatory boards would be maintained under the new law. The authorities also agreed to make the law applicable in 2005 rather than 2006, to include a medium-term framework in the budget, to incorporate revolving funds into the central government, and to define better the budget appropriation structure. However, they were not prepared to unify fully the current fragmented budget execution procedures by moving the responsibility for the investment budget from the state planning organization to the Ministry of Finance (MOF). The staff expressed regret that the current fragmentation in the budget decision making process would not be addressed sufficiently. Approval of the legislation will be a prior action for the sixth review (delayed benchmark from end-June).

- The authorities presented to the mission preliminary draft legislation for **the second phase of direct tax reform**. While the authorities reiterated their desire to expand the tax base, the business community is strongly advocating expansion of tax incentives and continuation of benefits in free trade zones. Although the draft legislation was originally intended to limit abuse of current tax incentives and tax holidays, the latest version actually expands some incentives and exemptions. To resolve these differences, the authorities agreed to put the legislation on hold until the next review, and in the meantime engage in a process of public consultation and drawing on international practice (¶15).[3]

- The authorities indicated that legislative delays in Parliament meant they would not be able to pass **SEE governance legislation** (delayed structural benchmark for

[2] SSK is the pension fund for employees and Bag-kur is the pension fund for self-employed and farmers. There will be no reduction in existing SSK arrears, but Bag-Kur arrears which are more than 7.5 years old, will be recalculated using the SSK system.

[3] The authorities will seek FAD technical assistance in this process.

Box 2. Turkey—Social Security Reform
Legislation, Arrears Payment Facility, and Changes to the Penalty System

The social security system for the private sector (SSK and Bag-kur) suffers from considerable noncompliance. The financial crisis of 2001 worsened the situation and contribution arrears increased to almost 6 percent of GNP. Despite the economic recovery and some efforts by the authorities to strengthen enforcement, arrears have remained high. Employers' contribution arrears are concentrated in just 4.7 percent of debtor companies. In the case of the social security system for farmers and self employed (Bag-kur), 85 percent of arrears are five years or older.

The enforcement capacity of SSK and Bag-kur is weak, and the penalty system does not provide sufficient incentives for contributors to remain current on their obligations. The authorities are addressing the problem with the passage of legislation. The legislation includes as a general principle that there will be no generalized amnesty, and will empower the executive to implement a payment facility for those in arrears. The legislation for SSK also provides the legal basis to improve the timeliness and breadth of information on delinquent payers. In the case of Bag-kur the legislation allows the institution to contract collection enforcement activities and to fully implement measures included in the budget, such as expelling from the system contributors with arrears five years or older.

The authorities will address the inadequate penalty system by moving to one based on international best practice. The new system will have a range of one time penalty rates and thereafter compounded interest rates will be charged on principal and penalty. The government will apply an interest rate that transparently reflects its borrowing cost. To ease the new penalty system, a payment facility will be offered to those with existing arrears. This mechanism will have the following characteristics:

- The facility will be available only to those with arrears as of December 2002.
- Those joining the payment facility will have to provide collateral.
- Payments will depend on the capacity to pay of the employer or contributor, based on objective criteria such as a percent of gross sales or the social security base.
- The compounded interest on government bonds will be charged on the outstanding stock of arrears.
- Contributors will be required to remain compliant with all their current social security contributions. Failure to comply for a determined period with the facility or other current obligations will terminate participation in the facility and the collateral will be seized.

These changes are a major step forward in changing the incentive structure and providing better tools to the institutions to enforce payment. The new penalty system will penalize more severely those that fall into arrears. The one time payment facility will provide the contributors with the opportunity to become current based on their capacity to pay, rather than on a rigid time dependent schedule.

end-April) until end-year. However, they would extend the new law to cover local governments.

- The authorities intend to introduce changes in the **Public Procurement Law** soon that will provide a new procurement framework for utilities (consistent with EU directives), and for other SEEs. The authorities agreed to revise the draft changes to deal with Bank and Fund staff concerns that the proposed tender period be sufficiently long and the size of projects subject to open tender not be set too small, so that the benefits of more transparent procurement could be felt more widely. The mission emphasized that any amendments to the procurement law should be in line with international standards, and made transparently and only after consultation with Bank and Fund staff.

15. **Finally, although the pace of eliminating redundant state enterprise positions accelerated in May, it has since slowed, and the end-June performance criterion was missed**. Although only about 4,800 positions had been eliminated as of end-April, this had picked up to some 6,800 by end-May. Nevertheless, the end-June target of eliminating 9,900 positions was missed by about 2,500. The authorities attributed the slowdown to the protracted public sector wage negotiations, which would likely increase the size of any early retirement package. The authorities have carried out an enterprise-by-enterprise study and are confident that the end-September PC can be met (¶15). They also indicated that they will resort to involuntary redundancies, as needed. However, the ministries cannot by law initiate involuntary redundancies at government level, and will need the cooperation of enterprise managers.

B. Monetary and Exchange Rate Policy

Discussions with the central bank focused on the appropriate response to the recent exchange rate appreciation, challenges meeting this year's inflation target, and the introduction of formal inflation targeting (¶12–14).

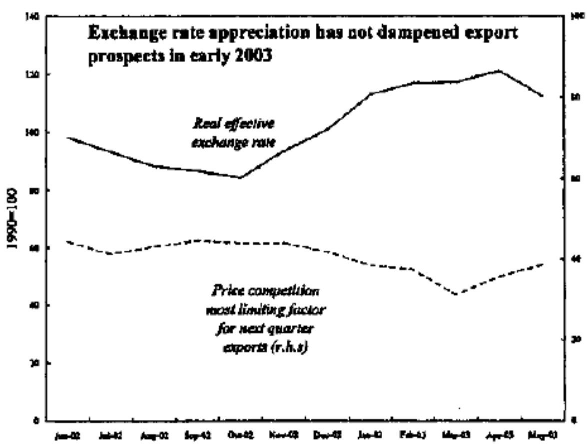
16. **Neither the CBT nor the Treasury saw the recent appreciation of the Turkish Lira as an immediate threat to competitiveness**. Reverse currency substitution, increased demand for treasury paper, and the usual seasonal improvement in the balance of payments have caused the real exchange rate to appreciate significantly, to close to its historical peak. While nominal appreciation against the U.S. dollar has been quite pronounced since April, the appreciation on a trade-weighted basis has been much more moderate. Unit labor cost growth has been weak, suggesting an improvement in exporters' profit margins, as reflected in continued export share gains in clothing, textiles, and vehicles (Box 3). Even so, competitiveness would become a concern if the real appreciation were to persist.

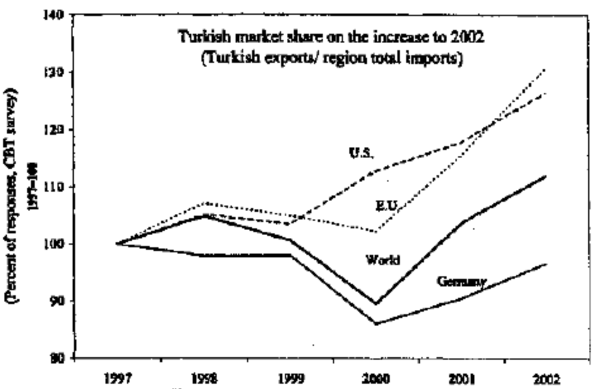
17. **Despite the appreciation, the CBT argued that difficulties meeting this year's inflation target warranted a cautious approach to reducing overnight interest rates.**

Box 3. How Competitive is Turkey?

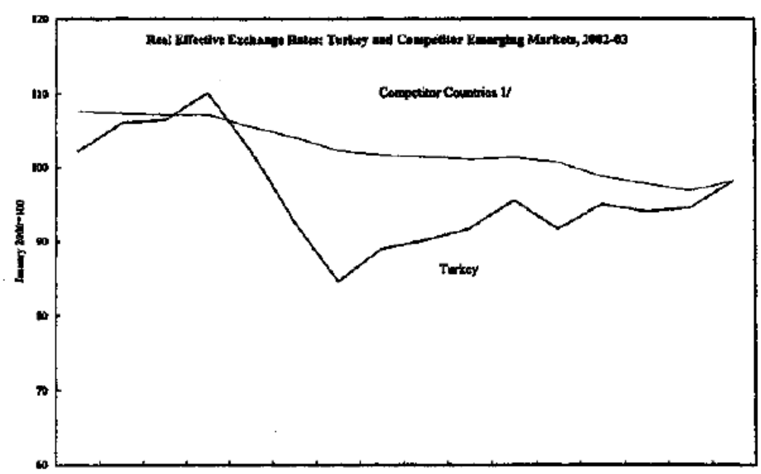
Turkey's external trade performance has been strong since the 2000 financial crisis, but currency appreciation in the first half of 2003 and increases in the current account deficit raise a question as to whether the exchange rate is overvalued. Several factors suggest that the exchange rate is not presently a major concern: real unit labor costs are well below historical averages; changes in real exchange rates remain in line with those of competitors; and the current account is likely to improve in 2004 as temporary factors play out.

The 2001 lira devaluation contributed to a major increase in Turkey's export market shares. Turkey's market share increased by a fifth between 2000 and 2002 and across all major markets. Export volume growth remains around 20 percent in early 2003, although is likely to slow to 10 percent as base effects play out.





The real appreciation has been mitigated by several factors. Price competition concerns are not rising for export orders according to business surveys. Unit labor costs remain well below their 2000 level (Figure 2) while competitors' real exchange rates have not, on balance, weakened relative to Turkey's. Also, one third of the weakening in the current account in 2003 is likely to be reversed in 2004 on account of a strengthening of tourism receipts, which have been adversely affected by conflict in Iraq.



1/ Brazil, Bulgaria, Chile, China P.R., Colombia, Czech Rep., Hungary, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Slovak Rep. Thailand. Weighted by exports in US$ dollars. Source: IMF.

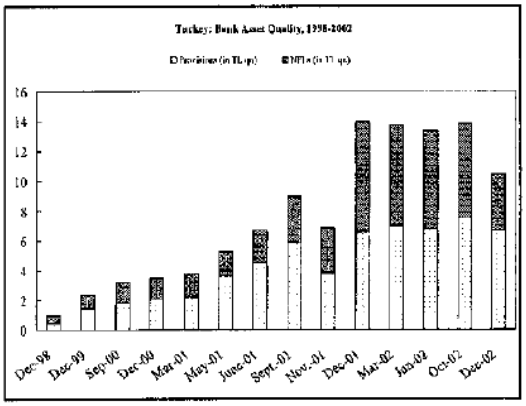
had been higher than anticipated through end-June, which had led the CBT to hold back from cutting interest rates. However, temporary factors—higher agricultural prices, exchange rate depreciation during the war in Iraq, and higher world oil prices—explained much of the overshoot in inflation. With these factors subsiding and, in particular, the exchange rate appreciating considerably, there were strong prospects of a sharp fall in inflation over the summer months, as witnessed by the fall in consumer prices in June. These more favorable developments were starting to be reflected in survey expectations of inflation (though these were still above the end-year 20 percent target). Given the growing evidence that underlying inflation was on a downward trend, the staff believed that the CBT's decision to cut overnight rates in end-April and end-June, and again in mid-July was appropriate.

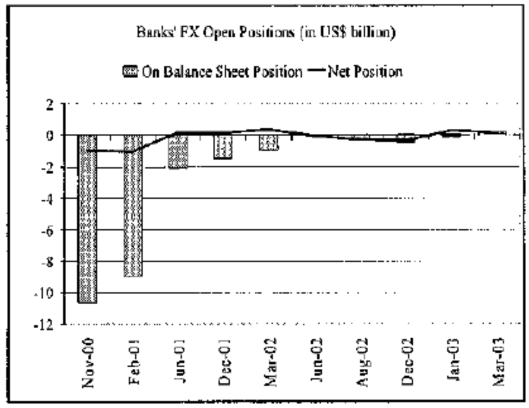
18. **The CBT has taken advantage of the exchange rate's strength to build its international reserve position.** In May the CBT reintroduced preannounced foreign exchange purchase auctions of US$20 million per day. With the strength of the exchange rate persisting, the CBT has gradually increased the purchase amount, to US$50 million in mid-July. The CBT has also stopped setting a maximum TL price at which it would buy foreign exchange; in the past this had resulted in failed auctions on days when the exchange rate depreciated. Finally, in exceptional circumstances, the CBT has supplemented these auctions with discretionary foreign exchange purchases. Together, these measures have allowed the CBT to purchase over US$2.1 billion in May and June.

19. **While the CBT is already targeting inflation informally, the transition to a fully-fledged formal inflation targeting system is still some time away.** The CBT has proposed a delay in introducing formal inflation targeting given Turkey's record of severe economic shocks and continued fiscal difficulties. Despite these misgivings, the CBT agreed that formal inflation targeting would need to be introduced once the authorities had developed a reputation of commitment to the program sufficient to assuage concerns about fiscal dominance. The strengthening of the banking system would also help in this regard. Provided it had the government's full backing, a move to formal inflation targeting could come as early as the fall, alongside the preparations for next year's budget.

C. Financial Sector Reform

Building on the momentum gained over the last two years, banking reforms are continuing apace (Table 7). NPLs are declining, provisioning is relatively high, and banks have almost no net open foreign exchange position. With the restructuring of the banking system nearing completion and with substantial strengthening in the prudential framework, the discussions focused mainly on the restructuring of state and intervened banks, and the remaining legal reforms. In particular, the staff discussed progress on the restructuring of Yapi Kredi and the sale of Pamukbank, state bank restructuring, legislative initiatives aimed at improving the operational independence of BRSA and its accountability, and SDIF asset sales.





20. **A new management and board have been appointed in Yapi Kredi and all the safeguards have been put in place to monitor developments in the bank (¶18).** At the end of July, Yapi Kredi's oversight committee will be ready to present its first report to the BRSA and the board of the Savings Deposit and Insurance Fund (SDIF), and to then publish a summary of its findings. The bank's financial performance is in line with its peers—a small net profit (US$19 million) during the first quarter and a capital adequacy ratio of about 15 percent. The new management is working on a plan for divestiture of shares (held and represented by SDIF) in 2004 after successful resolution of group credits and nonperforming loans, and the sale of fixed assets and equity participations.

21. **The sale of Pamukbank has proven complicated (¶19).** A key problem has been the bank's large portfolio (US$1.8 billion) of nonmarketable government securities, which replaced bad assets when its balance sheet was cleaned up. The deadline for sale has now been extended. If the sale is not successful, the authorities are considering an orderly liquidation of Pamukbank, by selling performing assets with matching deposits and by transferring or selling deposits with matching securities to other operating banks. Assets and liabilities that cannot be sold will be transferred to Bayindirbank (which acts as a bridge bank).

22. **While the BRSA has successfully contained a deposit run in the medium-sized Imar bank, the resolution has been problematic.** After the government confiscated Imar bank's main earning asset, depositors in the bank started to lose confidence. On July 2 the BRSA appointed new management to the bank, and then withdrew the bank's license after depositors started to withdraw funds. As the BRSA decided to liquidate rather than intervene the bank, individual but not commercial deposits will be fully protected. However, compensation of the depositors has been slowed by the apparent loss of the bank's records. In addition, the BRSA's ability to take decisive action against Imar bank was slowed at first by three out of seven BRSA board positions being unfilled, which left the BRSA board without a quorum and unable to take formal decisions. Although the government did appoint one board member on July 1 (which allowed the BRSA to attempt to resolve Imar bank), there are still two vacancies, which again potentially hinders the effectiveness of the BRSA.

23. **The BRSA has also decided to phase out the general bank creditor guarantee scheme (¶23).** In early July, the BRSA announced that all individual depositors (but not commercial depositors) in banks being liquidated (without first being intervened) will be fully protected until July 5, 2004. As a result, in the coming year the following two schemes will be in place: (i) the existing blanket guarantee protecting all depositors and other creditors in intervened banks, and (ii) a limited deposit scheme fully protecting individuals in banks that are liquidated without intervention. On July 5, 2004 both schemes will be abolished and replaced with a limited deposit insurance scheme in line with EU standards.

24. **With a new Board put in place in late March, the privatization of the state banks will likely be delayed (¶25):**

- **The authorities intend to put Halk up for sale by the end of the year, followed by Ziraat in 2004.** These banks' large portfolios of government securities—76 percent of total assets in Halk and 70 percent in Ziraat—may impede their sale. The Bank has proposed merging the two banks, carving out the large amount of government securities with matching deposits to some kind of a mutual fund, and then putting the remaining part of the merged bank up for sale. The authorities, however, believe this process would be protracted and prefer to sell the two banks separately.

- **The authorities are reassessing their strategy for privatizing Vakif,** after abandoning their earlier proposal to sell the bank to its employee pension fund. To be able to privatize the bank, its balance sheet must be cleaned up by selling or removing roughly 30 percent of its non-core banking assets, including nonperforming loans. However, the staff believes that it is unlikely the bank will be able to sell the assets through its own efforts, and recommended legal amendments that would allow the SDIF to remove the bad assets and sell the bank.

25. **The authorities are taking steps to strengthen the BRSA's operational independence (¶20).** They expect the court soon to rule in favor of the BRSA and support the voluntary liquidation of Türk Ticaret. However this case, together with legal challenges to the intervention in Pamukbank, has weakened the BRSA's authority. The government has now prepared amendments to the Administrative Procedures Law and the Banking Act (meeting an end-June structural benchmark) that are aimed at ensuring BRSA's operational independence, and intends to pass these into law by end-October (performance criterion). BRSA has also been excluded from the requirement that regulations issued by independent boards must first be approved by the State Planning Organization.

26. **The new budget systems legislation should preserve the BRSA's independence.** Initial drafts of the new Public Financial Management and Control Law proposed that the BRSA's budget and that of other independent agencies should be reviewed by the relevant ministries before being submitted to Parliament for approval. The staff expressed concern that in practice there was a substantial risk that this process would hamper the BRSA's operations, by opening up the possibility of ad hoc spending cuts, or revisions of priorities set by the BRSA Board. The final draft of the Law takes some of these concerns into

account, by calling for direct submission of the agencies' budgets to Parliament. However, to preserve operational independence, it will be important that Parliament does not use its powers to vet these budgets line by line.

27. **The staff welcomed the SDIF's announcement at end-June of its first loan sale with face value of at least US$250 million (meeting a structural benchmark) (¶22).** However, the staff urged the SDIF to speed up its technical preparations for the sale, including the hiring of a financial adviser and selection of the loan portfolio, so that it could be completed by the revised mid-November target date. Without this, the sale could fail and the strategy for SDIF asset disposition be called into question.

28. **The authorities have prepared an action plan for reducing intermediation costs, but they are reluctant to implement it quickly given the weak fiscal position (¶26).** An inter-agency working committee has prepared extensive information on the extent of financial intermediation costs, and has developed an action plan for their phased reduction (Box 4). However, both the Central Bank and the Ministry of Finance indicated that they were reluctant to introduce any measures aimed at reducing these costs this year, beyond the introduction of inflation accounting. The authorities agreed to draw up a new version of the action plan, which would incorporate more detailed estimates of the costs and benefits of reducing each intermediation cost, and set clearer priorities for the plan's implementation. The authorities also agreed to seek technical assistance from the Fund to refine these estimates, so that in October the Ministry of Finance would announce a detailed schedule for the plan's phased implementation.

D. Private Sector Environment

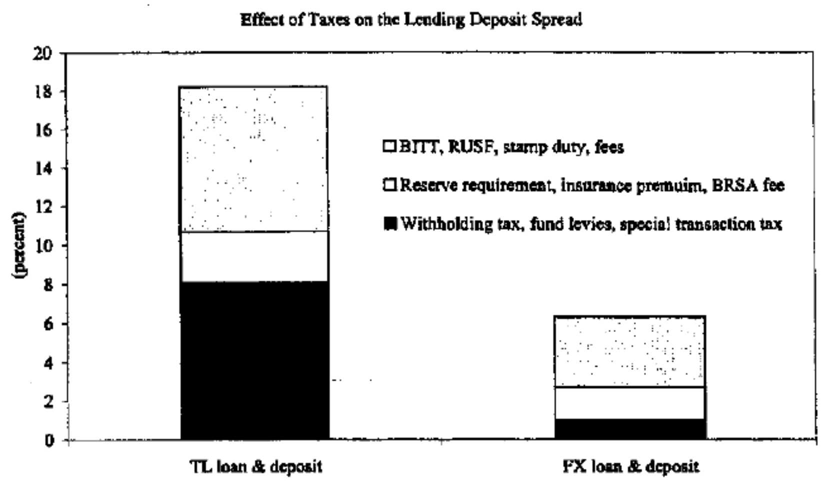
29. **The government has reinforced its efforts to create an environment conducive to private sector-led growth (¶28).** The staff welcomed the passage of the new Foreign Direct Investment Law, whose main aim is to make foreign investment in Turkey no longer subject to prior approval. However, a crucial test of the new law's success will be whether the implementing regulations, still to be finalized, are consistent with this goal. The authorities noted that the forthcoming passage of the legislation on the Investor Promotion Agency and the commitment to an inaugural high-level Investor Advisory Council meeting should further encourage foreign investment. The staff also welcomed the authorities' intention to draft a new framework law to govern the operations of independent agencies, but cautioned that this would need to preserve their operational and financial independence.

Box 4. Financial Intermediation Costs: Causes and Consequences

Turkey's complex system of financial taxes creates large interest rate spreads, promotes dollarization and disintermediation, and makes bank and corporate balance sheets more fragile.

Turkey's complex system of financial taxes creates large interest rate spreads. Banks and their customers pay a wide range of taxes: banking and insurance transaction tax (BITT), foreign exchange transactions tax, special transactions tax, tax levy on checks, and contributions to the resource utilization fund to finance loan subsidies. In addition, depositors pay up to 20 percent in withholding taxes on interest income. This creates large spreads between lending and deposit rates—20 percentage points for loans in Turkish lira, and 7 percentage points for loans in foreign currency.

High spreads on Turkish lira loans encourage corporates to borrow overseas and in foreign currency, increasing the vulnerability of banks and corporates to exchange rate movements. With spreads much lower overseas, banks and corporates have strong incentives to borrow abroad. Turkish banks also book many of their loans offshore to avoid paying taxes. The difference in spreads between TL and dollar loans encourages firms to borrow in foreign currency, even if their earnings are mainly in Turkish lira. This makes the corporate sector more exposed to foreign exchange risk, and also raises banks' credit risk in the event of a depreciation. The high spreads also constrain firms' borrowing, slowing economic growth.



Distortions in withholding taxes also constrain the development of domestic financial markets. While bank depositors face withholding taxes of 5–16 percent, interest income on government securities is effectively tax free. This encourages individuals to shift their wealth out of banks and into government securities directly. The tax exemption on government paper also hinders development of a corporate debt market (corporates pay 12 percent withholding tax), and concentrates bank risk in government paper. The 20 percent withholding tax on repo transactions stymies money market development, and limits the CBT to using a non-tradable deposit instrument to conduct open market operations, rather than tradable repo instruments. Finally, the zero rate on Type A investment funds has created a growing market for short-maturity investments that compete directly with bank deposits.

Although tax revenues from transactions taxes are significant, the cost in terms of high interest rate spreads, increased bank and corporate vulnerability, and distorted financial market development is considerable. Although roughly TL 7.5 quadrillion (US$5.4 billion) is raised from interest income and transaction taxes, this comes at the cost of creating major distortions in the economy. While improving the primary surplus, these revenues also increase interest rates, adding to the overall government deficit. Some initial progress in reducing distortions was made in 2002, with the elimination of stamp duty on forward contracts, removal of the tax on interbank foreign exchange transactions, and increased remuneration of required reserves. However, a more concerted effort, in parallel with fiscal consolidation, is now needed. Without this, the tax system will hinder the banking sector's ability to make profits from normal lending operations, and disrupt the flow of credit to the real economy.

30. **The authorities conceded there had been setbacks to the privatization program, but expressed strong determination to ensure its success** (¶27). Although cash proceeds from privatization through June were only US$50 million, the Privatization Agency (PA) noted that, had the Ministry of Health approved one of the sales on time, the US$90 million indicative target would have been met. The Privatization Agency was also pleased with the Privatization High Council's approval of the sale of PETKIM (petrochemicals) for US$605 million, but accepted that financing difficulties surrounding the successful bidder could unwind the sale. However, it was committed to completing the sale this year, if necessary through a new tender offer. Looking ahead, the PA noted that all tenders planned for the first half of the year had been made as scheduled, including for TÜPRAŞ (petroleum refinery) and for TEKEL (tobacco and alcohol), and that this should help strengthen collections in the second half of the year. Although the staff expressed concern that April's PHC decision on Türk Telecom fell short of what was needed (missing a structural benchmark for end-April), the PA was confident that, working with the Bank, the privatization plan would be ready by end-October (revised structural benchmark).

IV. Financing Issues

Financing prospects are closely linked to the terms of repayment to the Fund, assistance from the United States, and domestic financial conditions (Table 8).

31. **Turkey faces a steep rise in IMF debt payments to US$9.5 billion in 2004 and US$10.1 billion in 2005**. Some of this stand-by credit was drawn after end-2000 and can be extended by one year from an expectations to an obligations basis. The Turkish authorities have now developed a proposal, to be considered in conjunction with the fifth review, for converting from expectations to obligations basis part of the payments falling due in 2004 and 2005, which would smooth, rather than simply delay, the repayments to the Fund. The authorities argue that such an extension would ease market concerns over the 2004 budget financing program, which were already adding to pressure on longer-term rates, and decrease the required domestic rollover rates from 90 to a more manageable 85 percent.

32. **To address these problems, the Turkish authorities have proposed extending some of their total repayments to the Fund in 2004-05 by one year (Attachment II).** They request that part of their repayments due on an expectations basis during 2004-05 be shifted to an obligations basis and made in 2005-06. Specifically, the authorities plan to continue to repay on

Turkey: Projected Payments to the Fund, Under Alternative Repayment Schedules
(Total charges and repurchases)

	Projected Payments during calendar year ending December 31						
	2003	2004	2005	2006	2007	2008	2009
	(In billions of US dollars) 1/						
Expectation schedule	2.6	9.7	10.1	3.6	1.8	0.8	0.0
Obligation schedule	1.6	2.7	9.2	10.0	3.6	1.8	0.8
Schedules with extensions on repurchases resulting from purchases on or after February 2002 in:							
i) 2004	2.6	5.2	14.7	3.6	1.8	0.8	0.0
ii) 2004-05 (authorities' request)	**2.6**	**5.2**	**7.8**	**10.7**	**1.8**	**0.8**	**0.0**
iii) 2004-06	2.6	5.2	7.8	7.3	5.3	0.8	0.0
iv) 2004-08	2.6	5.2	7.8	7.3	3.6	1.8	0.8

Notes: 1/ At U.S.$/SDR 1.369
Source: Staff estimates.

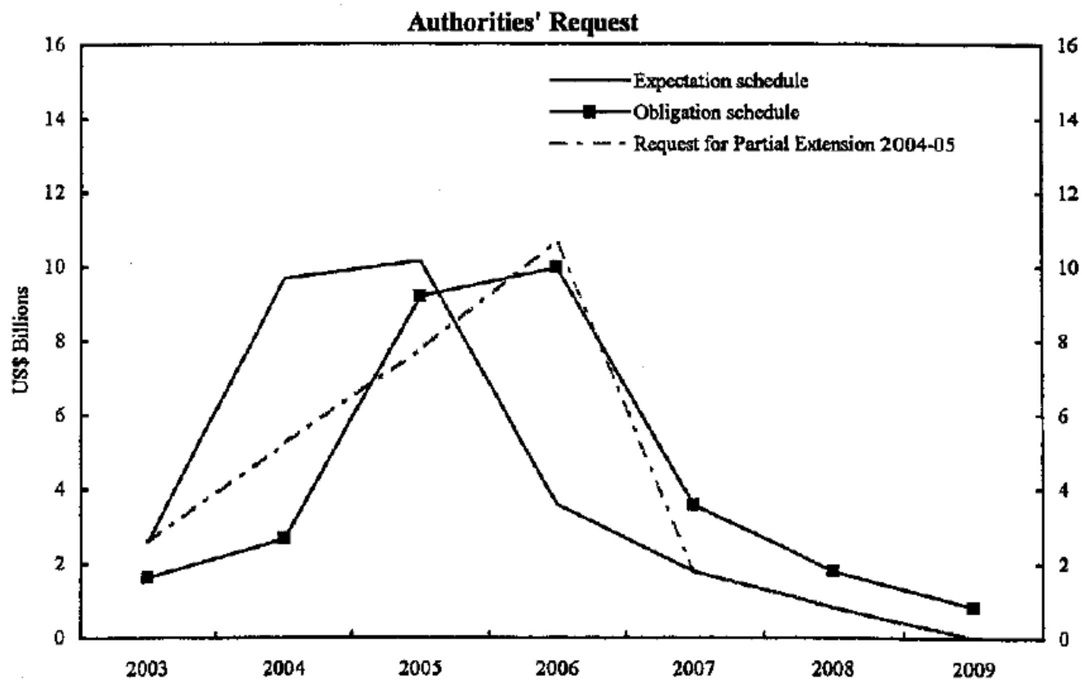
an expectations basis the amounts borrowed before February 2002, but to seek an extension to an obligations basis for the amounts borrowed since February 2002. This partial extension is for the equivalent of US$ 4.5 billion in repayments due at expectations basis in 2004 and for the equivalent of US$ 7.0 billion in 2005. The repayments that would remain on an expectations basis (or cannot be extended) are US$ 4.3 billion in 2004 and US$ 2.6 billion in 2005. With this, total repayments, including charges, would be US$ 5.2 billion in 2004 and US$ 7.8 billion in 2005.

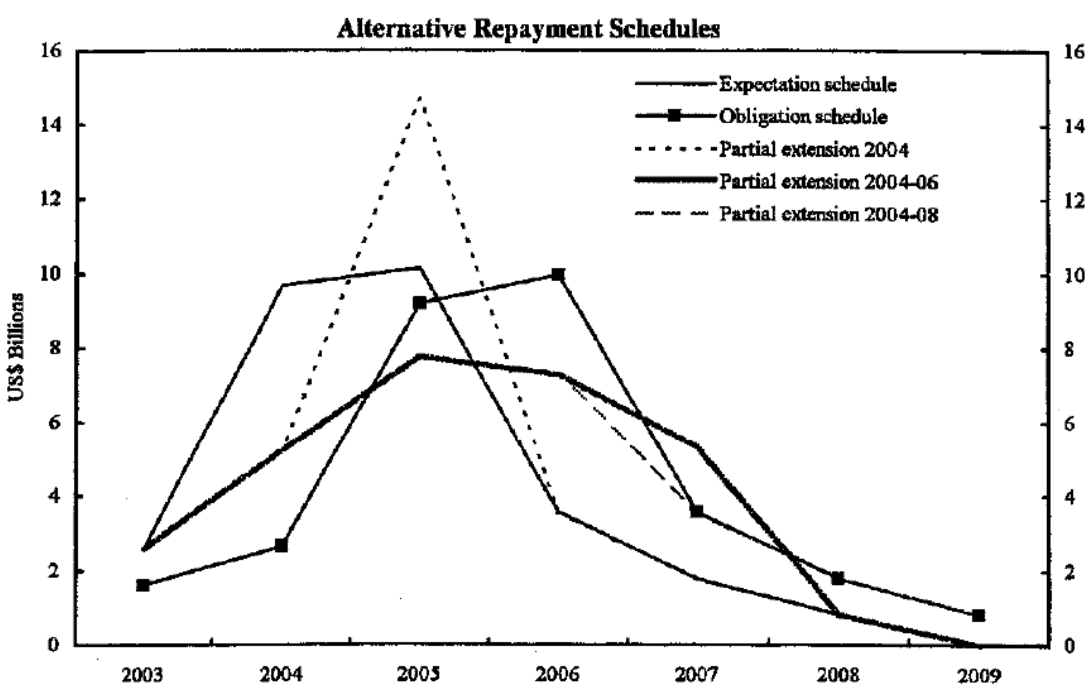
33. **Such an extension would ease debt service but would not significantly affect medium term debt sustainability indicators (Table 9a).** If repayments are maintained at expectations basis, debt service to the Fund would account for about half of all public sector external debt service during 2004-05. The authorities' proposal reduces this ratio to 25 percent in 2004 and 37 percent in 2005. On account of the extension, gross external debt will be 1¾ percent of GNP higher in 2004 and 2½ percent of GNP higher in 2005, before reverting in 2006 to the debt level that would result from repayment at the expectations schedule, assuming that the external borrowing program is otherwise unaffected by the extension. The authorities also indicated that they would advance repayments to the Fund if developments are more favorable than currently expected (Attachment II).

34. **The authorities also intend to follow-up on the prospect of U.S. financing.** During the discussion, they reaffirmed their intention to seek the U.S. financing package, for which negotiations will likely resume after the fifth review is completed (¶7). The authorities see the U.S. financing as a unique opportunity to achieve a significant improvement in the structure of their indebtedness. They intend to use the financing to replace higher cost and shorter-term borrowing, which would lengthen the maturity of their debt and also help with domestic financing needs (see below).

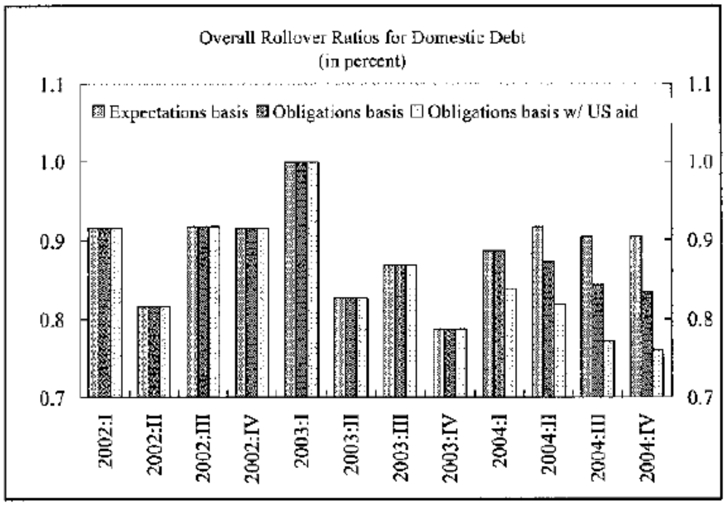
35. **The authorities' request is generally consistent with Fund policy on extending repayments from an expectations to an obligations basis.** The policy calls for an extension in cases where early repayment would cause undue hardship or risk. Members continuing to use Fund resources are expected to qualify for an extension if they have an ongoing balance of payments need. The authorities' proposal is somewhat unusual as it does not cover all repayments coming due on an expectations basis, and was thus not explicitly envisaged in the original Board decision on policy in this area. Indeed, there would be no impediment to a later request for further extensions on amounts they are now planning to pay on expectations basis. Moreover, the authorities are requesting an extension on some payments that fall due two years ahead, rather than the presumption of one year in the policy. Without a two year extension, the repayment profile in 2005 would be prohibitive, undermining market confidence in the viability of the program (Figure 5, and text table).

Figure 5. Turkey: Projected Repayment Schedules at Expectation and Obligation





Source: Fund staff estimates and projections.



36. **Although recent financial market developments have improved domestic debt rollover prospects for the rest of 2003, budget financing in 2004 could prove more challenging.** Even with a shift of part of the payments to the Fund to an obligations basis, the borrowing requirement for 2004 will require higher rollover ratios than for the rest of 2003. Gross redemptions are also expected to rise in real terms leading to a higher short-term rollover ratio. Rollover ratios at this level can only be achieved if there is a sustained improvement in market confidence during 2003.[4] U.S. financing would reduce the minimum domestic borrowing requirement significantly, and could reduce the requirement further if it improved confidence and allowed for lower interest rates and longer maturities of domestic debt.

Domestic Debt Rollover Ratios

	2003	2004				
		Expectations		Obligations		Obligations
			w/ U.S. aid		w/ U.S. aid	weak demand
Overall	87%	90%	84%	87%	80%	90%
Private sector	90%	98%	91%	94%	86%	95%

37. **The debt stock is also highly sensitive to exchange rate movements.** With two thirds of the debt denominated in foreign exchange, the fall in the projected end-2003 debt stock is almost entirely explained by the appreciation of the Turkish Lira. This implies that the revised improved debt dynamics (Box 5 and Table 9b) need to be treated with a degree of caution. Policy slippages or adverse external developments that lead to a decline in the real effective exchange rate could substantially worsen the projected path of the debt.

[4] Under current program assumptions, a rollover rate of 80 percent is consistent with keeping the stock of domestic debt constant in real terms, and a rate of 85 percent with keeping it constant relative to GNP.

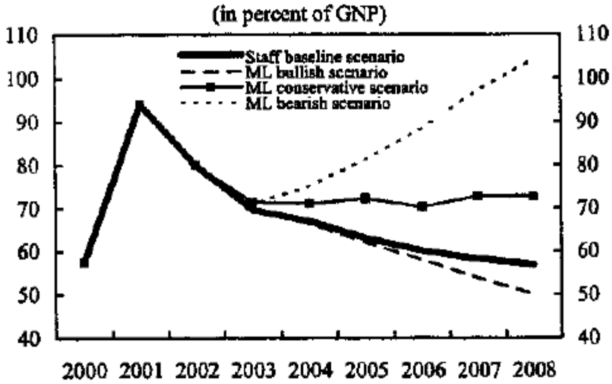
Box 5. Public Sector Debt Dynamics

With the stronger lira, the debt outlook has improved significantly relative to the assessment at the time of the previous review. Reflecting the impact of the exchange rate on both the stock of debt and the real effective interest rate, the debt ratio at end-2003 under the baseline scenario is now projected to fall to 70 percent of GNP compared with 77 percent at the time of the fourth review. Regarding debt dynamics over the medium term, the basic conclusions of the previous staff analysis still hold: sustainability is achieved under the baseline, and could be robust to a series of plausible isolated shocks, but a combination of shocks could produce an unsustainable debt path.[1] With nearly two-thirds of the debt stock denominated in foreign exchange, the debt ratio and medium term dynamics are highly sensitive to the exchange rate: a 30 percent depreciation relative to the baseline exchange rate would increase the stock relative to GNP by 8 percentage points at end-2003, and by over 13 percentage points by end-2008 (Table 9). Keeping all other assumptions the same as in the baseline, a primary surplus of at least 5 percent of GNP would stabilize the debt-to-GNP ratio over the medium term; however, a higher surplus is needed to reduce the debt to a more sustainable level.

	2001	2002	2003	2004	2005	2006	2007	2008
Debt Ratio (in percent of GNP)								
Staff baseline scenario	94.0	80.0	69.6	66.2	62.3	59.4	57.7	56.4
Merril Lynch bullish scenario	94.0	80.0	69.7	66.3	62.0	58.0	53.8	50.0
Merril Lynch conservative scenario	94.0	80.0	71.5	71.0	72.3	70.3	72.9	72.8
Merril Lynch bearish scenario	94.0	80.0	71.1	75.1	81.3	88.5	97.2	104.2
Assumptions								
Baseline scenario								
Primary balance (percent of GNP)	5.5	3.9	6.5	6.5	6.5	6.3	6.3	6.3
Real GNP growth rate	-9.5	7.8	5.0	5.0	5.0	5.0	5.0	5.0
Real interest rate on TL debt 1/	38.5	30.6	29.7	19.6	19.8	18.5	18.0	18.0
Merril Lynch bullish scenario								
Primary balance (percent of GNP)	5.5	3.9	6.5	5.5	5.5	5.5	5.5	5.5
Real GNP growth rate	-9.5	7.8	4.2	5.0	5.0	5.0	5.0	5.0
Real interest rate on TL debt 1/	38.5	30.6	20.0	18.0	16.0	14.0	14.0	14.0
Merril Lynch conservative scenario								
Primary balance (percent of GNP)	5.5	3.9	6.5	5.5	4.0	4.0	4.0	4.0
Real GNP growth rate	-9.5	7.8	4.2	4.0	4.0	4.0	4.0	4.0
Real interest rate on TL debt 1/	38.5	30.6	20.0	19.0	18.0	17.0	17.0	17.0
Merril Lynch bearish scenario								
Primary balance (percent of GNP)	5.5	3.9	6.5	4.0	2.5	2.5	2.5	2.5
Real GNP growth rate	-9.5	7.8	4.2	3.0	3.0	3.0	3.0	3.0
Real interest rate on TL debt 1/	38.5	30.6	20.0	25.0	25.0	25.0	25.0	25.0

1/ Ex ante real rate using 12 month ahead GNP deflator.

Public Sector Net Debt
(in percent of GNP)



During the fourth review Board meeting, Directors expressed interest in how the staff's baseline scenario compares with the market's assessment of Turkey's debt dynamics. While there is no systematic consensus forecast covering the medium term, a recent Merrill Lynch report is representative of many market analyses of Turkey's debt dynamics.[2] According to this report, there is a wide range of possible debt paths, depending on key variables such as the primary surplus, growth, and real interest rates. Based on what the report regards as conservative assumptions, debt stabilizes at about 72 percent of GNP, while the debt falls rapidly in a "bullish" scenario and rises unsustainably in a "bearish" scenario. The staff's baseline scenario is somewhat less optimistic than the "bullish" scenario, mainly because real interest rates in the staff's baseline are assumed to fall more gradually.

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[1] See Appendix III of the fourth review staff report (EBS/03/47, 4/10/03), which analyzes public sector debt and external sustainability applying the framework adopted by the Board (SM/02/166, 5/28/02) to the staff's baseline scenario, and considers the impact of several shocks proposed as part of this framework. See also Table 9 for an update of the this analysis.

[2] See Merrill Lynch's June 13, 2003 Emerging Markets Comment "Turkey: Debt Default isn't Inevitable."

38. **However, with strong program implementation, the program should be fully financed going forward.** The authorities are likely to exceed their original US$4.5 billion target for external borrowing this year, provided that implementation of the economic program proceeds smoothly, especially as regards fiscal policies. This additional borrowing should offset a likely US$0.8 billion temporary shortfall in Bank program financing, caused by slippages in structural reform implementation. As discussed above, the continued prospects for U.S. financing together with selected Fund repurchases at expectation would underpin a strengthened external position and give confidence to markets in the authorities' economic program.

V. PROGRAM MODALITIES AND RISKS

A. Program Monitoring

39. **Quantitative performance criteria and reviews.** The attached Letter of Intent describes progress in implementing the program and requests completion of the fifth review under the SBA.

- The authorities request a waiver of nonobservance for the performance criterion on the cumulative primary balance of the consolidated government sector for end-June 2003 as comprehensive monitoring data will not be available until mid-August. The staff and authorities believe that, on the basis of data for end-May and partial data for end-June, the performance criterion will be missed by a small margin. However, new fiscal measures should safeguard attainment of the end-year target.

- To render the program targets compatible with the authorities' budget reporting and data availability, the authorities also request the following modifications to the floor on the primary surplus of the consolidated government sector: (i) to include off-budget "special" revenues and expenditures, with an adjustor to leave the fiscal effort unchanged; (ii) to exclude foreign financed in-kind defense spending until corrective actions are in place to authorize reporting such expenditures (described in subsection D below).

- In view of the delay in completing the fifth review the authorities request a modification of test dates, program reviews, and associated purchases (LOI Annex B). The timing of structural conditionality is modified in accordance with the revised schedule of reviews as detailed in the attached Letter of Intent.

40. **As noted earlier, prior actions for completion of the fifth review are**:

- Implement fiscal measures equivalent to 0.7 percent of GNP to safeguard the 6½ percent of GNP primary surplus for 2003.

- Enact legislation underpinning reforms in SSK, Bag-Kur, and Is-Kur excluding any provision for amnesties.

- Approve the draft of the Public Financial Management and Control Law to be submitted to parliament at a ministerial meeting, taking into account Bank/Fund comments (Done on July 17).

41. **Structural Performance Criteria.** The authorities request a waiver of the structural performance criterion for end-June on eliminating redundant positions at SEEs on the basis that the performance criterion should come back on track by end-September following completion of the public sector wage round which had stalled retirements. To emphasize the authorities' clear commitment against new amnesties, a new continuous structural performance criterion is established prohibiting the introduction of new tax amnesties of public sector receivables.

B. Capacity to Repay the Fund

42. **Turkey should be able to maintain its unblemished record of debt service to the Fund, notwithstanding the trend increase of debt service falling due**. Turkey continues to meet its repurchase obligations to the Fund on a timely basis, and has also met three repurchases of US$190 million in 2003 on an expectations basis. Nonetheless, exposure to the Fund remains high with Fund credit amounting to nearly 35 percent of exports of goods and non-factor services and just over a quarter of public sector external debt (Table 10). Debt service payments to the Fund on the schedule requested by the authorities increase markedly over the next three years, peaking in 2006 (at 4 percent of GNP, equivalent to around 13 percent of exports of goods and services). The macroeconomic framework and policies supported by the Stand-By Arrangement provide adequate assurances that Turkey will be able to meet its obligations to the Fund as they fall due, while at the same time underscoring the need for consistently strong policy implementation to engender confidence and sustainable growth. The staff will therefore continue to monitor closely Turkey's capacity to repay the Fund, and will not hesitate to recommend additional measures if developments turn out to be less favorable than projected.

C. Program Risks

43. **Compared with earlier in the year, the risk of a near-term crisis has decreased,** reflecting the shorter-than-expected conflict in Iraq and the completion of the Fourth Review in April. However, failure to adhere to fiscal and structural reforms and delays in completing the current review have at times weakened market confidence. If markets were to assess that the Fund program was off track, the impact on interest rates and domestic debt rollover would be severe, since this would damage policy credibility and jeopardize Fund support and U.S. assistance.

44. **While the floating exchange rate provides some protection against external shocks, considerable risks remain (Table 11).** The public sector continues to be exposed

to fluctuations in the exchange rate, since the share of foreign currency-denominated and foreign currency-indexed debt in total public debt is high (65 percent). Although the banking sector is broadly covered against exchange rate risk, it remains exposed to credit risk through its foreign currency-denominated lending (about 45 percent of total loans). In addition, the short maturity of domestic public debt implies large monthly redemptions, whose rollover remains vulnerable to reversals in market sentiment. During August–December, about US$35 billion in domestic borrowing is needed to meet forthcoming gross debt redemptions.

D. Data Issues and Safeguards Assessment

45. **The authorities have reassessed fiscal data provided to the Fund to ensure that all such reporting is complete and accurate**. As noted in the last review, foreign financed in-kind investment expenditures were not systematically reflected in expenditure data reported to the Fund to end-2002, resulting in incomplete reporting of the primary surplus performance criterion. The Turkish authorities have taken corrective actions and captured all foreign financed in-kind investment expenditures in their accounting system in 2003, except those relating to defense spending since this kind of spending is not within the scope of the Public Finance and Debt Management Law (¶9). The authorities have provided data for all applicable test dates under Fund programs since January 2000 for foreign financed in-kind investment spending excluding defense. The data indicate that there was no breach of program performance criteria at test dates when previous purchases were made. The authorities have requested data on military in-kind spending but have not yet obtained these data. When these data are available, staff will determine whether the exclusion of in-kind military spending constitutes misreporting under Article VIII, Section 5 or gave rise to non-complying purchases.

46. **The improvements identified under the safeguards assessment conducted in early 2002 have now been completed** (¶29). The CBT has continued strengthening the effectiveness and transparency of its control, accounting, reporting, and auditing systems, including in the context of the Fund safeguards assessment. This process culminated late last year with the establishment of a new internal audit department, which on May 15, 2003 completed its audit of foreign exchange management and program data as of end-2002 (meeting a structural benchmark). The CBT has now met all the actions required by the safeguards assessment and that form program conditionality.

VI. Staff Appraisal

47. **The authorities were slower in taking the measures needed to complete the Fifth Review than initially envisaged**. Announcements of ad hoc tax and spending initiatives, consideration of an amnesty for social security arrears, and statements indicating a desire not to seek a successor Fund-supported program also made the authorities' commitment to the program at times appear less than complete.

48. **The delay in completing the Fifth Review dampened, but did not interrupt, the improvement in financial market conditions.** The relatively rapid conclusion of the war in Iraq, improved sentiment toward emerging markets in general, and the prospect of obtaining bilateral financing from the United States have all helped maintain market confidence. Progress on EU-related reforms has also helped market perceptions, offsetting the impact of the delays in the program's structural reform agenda. However, real interest rates and long-term bond yields have remained high, reflecting underlying fragilities.

49. **Strong efforts at implementation have now brought the program back on track, providing an opportunity to enhance policy credibility.** The authorities have taken steps to safeguard their macroeconomic framework and to put their structural reform agenda back on track. Looking forward, the completion of the fifth review now provides a valuable opportunity to enhance confidence in the Turkish economy through building the needed track record of timely program implementation. Enhancing policy credibility is imperative if real interest rates are to fall and the program to succeed.

50. **If the authorities are to capitalize on the opportunity given by the current favorable environment, they must assume full ownership of the program,** and follow through decisively on program commitments. While budget financing prospects for the rest of 2003 appear to be good, budget financing assurances for 2004 will depend critically on a further improvement in confidence during the remainder of this year. For this, the authorities will need to strengthen policy credibility by acting more forcefully to convince markets of their commitment to the program.

51. **A key test of policy credibility would be maintaining fiscal discipline to ensure the attainment of the 6½ percent of GDP primary surplus target.** The authorities need to demonstrate that the fiscal program is on track by taking pre-emptive measures to address any budget shortfalls, and refrain from announcing ad hoc spending and revenue initiatives. They also need to ensure fiscal adjustment is durable by following through on budget reforms. Key areas include completing the delayed direct tax reform and, importantly, the enactment of the institutional reforms in public financial management and tax administration. Meeting the future targets for the reductions in the redundant positions of state enterprises would also be a test of the authorities resolve in putting in place the conditions for a sustainable medium-term budgetary position.

52. **Looking forward, the 2004 budget will be an important test of commitment to durable adjustment**. With significant one-off measures put in place in 2003, and the already higher-than-planned wage increase, the 2004 budget may once again need to incorporate substantial adjustment. An expansion of the tax base and permanent expenditure cuts are most likely needed to ensure the attainment of the 6½ percent of GNP primary surplus target in 2004. The work on the 2004 budget needs to begin well in advance of the sixth review discussions.

53. **The authorities should be commended for skillful conduct of monetary policy.** The CBT has navigated monetary policy successfully during a difficult period of market

uncertainty associated with the conflict in Iraq and program slippages. In doing so, it has managed to cut rates successively and accumulate reserves. Given the need to build reserves further, the staff supports continued foreign exchange purchases in the daily auctions while the balance of payments position is favorable during the summer months.

54. **Stability has returned to the financial sector but the momentum for reform needs to continue**. The agenda for consolidating the banking system reforms is still large and includes resolving the intervened banks, preparing state banks for privatization, and further reform of bankruptcy procedures. Strengthening the operation and financial management of the independent agencies, including BRSA, would also enhance policy credibility and help dispel market fears of an interventionist approach by the government.

55. **The high level and complex system of intermediation costs need to be addressed.** The authorities have now formulated an action plan for reducing these costs. Understandably, they are concerned about the fiscal impact of this reform. However, these direct costs need to be balanced against the indirect costs of high interest rate spreads and financial market distortions. Therefore, action in this area should not be postponed, and development of a more concrete step by step plan ahead of next year's budget would be important.

56. **The authorities make a compelling case in their request for extension—from expectations to obligations—of part of their repayments falling due during 2004–05.** The authorities' concern regarding the financing outlook for 2004 is valid. Market anxiety is putting pressure on long-term rates, weakening the prospects for the program's success. The authorities' request would also help smooth the profile of repayments to the Fund. The authorities' proposal could, therefore, help reduce undue risk, and the staff recommends accepting this request in the context of completion of the fifth review.

57. In light of the recent actions to safeguard the fiscal target and accelerate the structural reform agenda, the staff recommends the completion of the Fifth Review. With strong policy actions, the macroeconomic targets and sustainable debt dynamics are achievable. Although there have been some policy delays, the authorities have taken corrective action to bring the program back on track. These steps form a good basis for the government to begin demonstrating greater political ownership of the program and building the track record of implementation required to bring down interest rates to sustainable levels. On this basis the staff supports the authorities' request for the completion of the fifth review and for their requests for waivers of nonobservance for the performance criteria.

Table 1. Turkey: Quantitative Targets and Structural Conditionality due by Mid-2003

Action	Type 1/	Status as of July 20, 2003
A. Measures for end-May		
I. Quantitative Targets		
Meet (i) performance criteria on primary balance, contracting or guaranteeing of external public debt, issuance of short-term external public debt, net international reserves, and base money, and (ii) indicative targets on primary and overall balances, net domestic assets and privatization proceeds.		**Met.** All monetary performance criteria and indicative targets for end-April were met. Other end-April targets were also met, except for the privatization proceeds (US$23 million received against an indicative target of US$30 million). Primary balance PC for end-April and the indicative target for end-May were likely met, but data are not yet available on in-kind foreign-financed military spending.
II. Structural Conditionality		
Fiscal policy and public sector reform		
Parliament to pass direct tax reform legislation by end-April 2003.	PC	**Met,** approved April 9, 2003.
Have in place an integrated system to monitor total general government and SEE employment levels on a quarterly basis by mid-May 2003 (original date: September 2002).	BM	**Met with delay.** In early June the authorities produced the table that shows that the system works.
Enact legislation for SSK, İş-Kur, and Bağ-Kur which establishes administrative mechanisms to support earlier pension reforms, and provides firm legal grounds to implement 2003 social security measures by end-April 2003.	BM	**Missed and converted into prior action for the fifth review.** The legislation for İş-Kur has been passed by parliament. SSK and Bağ-Kur laws likely to be passed by end-July.
Corporate debt restructuring		
Enactment of the reforms of the Execution and Bankruptcy Act by end-May 2003 (original date: end-January 2003).	BM	**Met with delay.** Reforms were submitted to parliament on June 6, 2003 and were passed on July 17. Amendments on pre-packaged bankcruptcy were removed from the law and will be enacted seperately.
Banking reform		
Inter-agency working committee will develop an action plan to reduce the intermediation costs of the banking sector by end-May 2003.	BM	**Met with delay.** An action plan was circulated to the July mission.
Enhancing the role of the private sector		
Enact new law on Foreign Direct Investment by end-April 2003.	BM	**Met with delay.** Parliament passed the law on June 5.
CoM to adopt a privatization plan for Türk Telekom by end–April 2003 (previous target: end-November 2002).	BM	**Missed.** The decision on Türk Telekom (TT) privatization taken by the CoM in April is not enough to give a formal start for the privatization of TT. The authorities and the World Bank have worked out a road map that clarifies dates and actions to allow a new CoM decision, with the benchmark to be met by end-October 2003.
Safeguards Assessment		
Internal audit department to conduct an audit of foreign exchange management and program data as of end-2002 by May 15, 2003	BM	**Met.** Audit completed on May 15 as scheduled.

Table 1. Turkey: Quantitative Targets and Structural Conditionality due by Mid-2003

Action	Type 1/	Status as of July 20, 2003
B. Measures for end-June		
I. Quantitative Targets		
Meet (i) performance criteria on primary balance, contracting or guaranteeing of external public debt, issuance of short-term external public debt, net international reserves, and base money, and (ii) indicative targets on primary and overall balances, net domestic assets and privatization proceeds.		All monetary targets for end-June were met. The performance criterion for SEE redundancies was missed. The primary balance for end-June is likely to have been missed. Full information will be available only in mid-August. All other indicative targets were met.
II. Structural Conditionality		
Fiscal policy and public sector reform		
Parliament to approve legislation that further rationalizes direct taxation (by minimizing geographical, sectoral, and other investment incentives) by end-June 2003.	BM	Missed. Authorities had prepared draft laws, but they were not satisfactory. Aggrement on a draft law is a prior action for the sixth review.
Eliminate redundant state enterprise positions by the following revised targets (cumulative from end-January 2003): (a) 9,900 by end-June 2003, (b) 19,400 by end-September 2003, and (c) 25,074 by end-December 2003.	PC	Missed by some 2500. With wage negotiations underway, elimination of redundant positions slowed down in June as severance packages depend on the final salary.
Parliament to pass legislation to improve state enterprise governance by end-June 2003 (previous target: end-December 2002).	BM	Missed. The draft law is being prepared for passage by end-year.
Parliament to pass Law on Financial Management and Internal Control by end-June 2003 (previous target: end-March 2003).	BM	Missed. Bank/Fund comments were considered by concerned Ministers on July 17. Reset as prior action for sixth review
Banking reform		
The SDIF to announce the sale of a loan portfolio with a total face value of at least US$250 million by end-June 2003 (original date: end-October 2002).	BM	Met in part. Announcement was made by end-June, with bids due by end-October 2003. But technical preparations were not complete.
Prepare legislation that will strengthen the effectiveness of the BRSA, including amendments to the Banking Act and related laws that will set out clear grounds for legal appeal of BRSA decisions, with firm deadlines and time limits for their consideration by end-June 2003.	BM	Met. Draft legislation has been prepared by the BRSA and submitted to DPM Sener's Office.
Enhancing the role of the private sector		
Improve the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators by end-July 2003 (previous target: end-2002).	BM	Missed. The draft has been submitted to the Prime Minister office. Parliament is not expected to pass it until end-year.

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

Table 2. Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	Projections 2003	Projections 2004
			(In percent)			
Real sector						
Real GNP growth rate	-6.1	6.3	-9.5	7.8	5.0	5.0
GNP deflator	55.8	50.9	55.3	43.8	25.2	12.9
Nominal GNP growth rate	46.3	60.4	40.5	55.0	31.4	18.6
WPI (12-month, end-of-period)	62.9	32.7	88.6	30.8	20.0	12.0
CPI (12-month, end-of period)	68.8	39.0	68.5	29.7	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.1	63.5	46.4	31.3
Average ex-ante real interest rate 1/	32.0	-9.5	35.5	29.5	29.0	18.9
			(In percent of GNP)			
Central government budget						
Primary balance 2/ 3/	2.5	4.3	4.8	2.4	5.0	5.5
Net interest payments 4/	13.1	15.8	24.7	17.7	16.0	13.6
Overall balance	-10.6	-11.5	-19.9	-15.3	-11.0	...
Consolidated public sector						
Primary balance 3/	-0.2	2.7	5.5	4.0	6.5	6.5
Net interest payments 5/	22.1	21.9	26.6	16.3	15.8	13.3
PSBR (including CBT profits)	22.3	19.2	21.1	12.3	9.3	6.8
Operational balance	-12.4	-6.9	-4.8	-4.8	-4.1	-3.3
Net debt of public sector	61.0	57.7	94.0	80.0	69.6	66.2
Net external	20.1	18.5	37.7	32.1	27.3	25.1
Net domestic	40.9	39.2	56.3	47.8	42.3	41.0
Net debt of public sector (in percent of centered GNP) 6/	48.6	51.5	72.8	68.6	62.6	60.3
External sector						
Current account balance	-0.7	-4.9	2.4	-0.8	-3.2	-2.0
Gross external debt	55.0	59.0	79.1	72.4	58.3	54.4
Net external debt	33.6	38.8	53.9	54.6	45.9	43.6
Short-term external debt (by remaining maturity)	19.0	21.8	22.7	17.2	15.3	14.6
Monetary aggregates						
Seignorage 7/	3.2	1.8	1.1	1.0	1.1	...
Nominal growth of M2Y broad money (in percent)	100.7	40.2	87.5	25.4	25.9	17.1
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	0.1	3.3	2.8	0.5	2.1	1.5
Net external financing of central government	1.4	4.1	-2.3	-1.4	-1.5	0.5
Amortization	6.0	6.2	7.8	6.8	8.8	8.3
Gross borrowing	7.4	10.3	5.5	5.3	7.3	8.7
Of which: Eurobond issues	5.0	7.5	2.2	3.3	4.5	4.7
GNP	187.4	201.3	144.0	...	...	...
GNP (in quadrillions of Turkish lira)	78.3	125.6	176.5	273.5	359.4	426.2

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

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation. With average maturity of newly issued debt less than one year, and with FRNs paying quarterly coupons, this measure overstates the effective real interest rate when inflation is declining.
2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds
3/ For 2003 and 2004, program projections.
4/ Interest payments minus interest receipts plus profit transfers from the central bank.
5/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
6/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.
7/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

Table 3. Turkey: Balance of Payments, 2000–07 1/
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007
Current account balance	-9.8	3.4	-1.5	-7.5	-5.3	-3.1	-0.6	-0.3
Trade balance	-22.4	-4.5	-8.4	-12.3	-11.3	-9.7	-8.4	-8.3
Exports (f.o.b.)	30.7	34.4	39.8	47.5	52.5	58.2	64.0	69.8
Of which:								
Exports (f.o.b.) in trade returns	27.8	31.3	35.8	43.5	48.1	53.3	58.6	64.0
Shuttle trade	2.9	3.0	4.1	4.0	4.4	4.9	5.4	5.9
Imports (f.o.b.)	-53.1	-38.9	-48.2	-59.8	-63.8	-67.9	-72.4	-78.2
Of which:								
Imports (c.i.f.), incl. non-monetary gold	-56.4	-41.4	-51.3	-63.6	-67.9	-72.3	-77.0	-83.2
Energy imports (c.i.f.)	-9.5	-8.3	-9.0	-10.1	-9.5	-9.5	-9.6	-10.1
Services and Income (net)	7.4	4.1	3.3	1.2	2.0	2.1	3.1	3.1
Services and Income (credit)	23.2	18.8	17.3	18.2	20.3	21.2	23.1	24.2
Of which:								
Tourism receipts	7.6	8.1	8.5	8.5	9.8	10.2	10.6	11.0
Services and Income (debit)	-15.8	-14.7	-13.9	-17.0	-18.3	-19.1	-20.0	-21.1
Of which:								
Interest	-6.3	-7.1	-6.4	-8.0	-8.4	-8.6	-8.9	-9.3
Private transfers (net)	5.0	3.6	3.0	3.1	3.5	4.0	4.2	4.4
Official transfers (net)	0.2	0.2	0.5	0.5	0.5	0.5	0.6	0.6
Capital account balance	9.6	-14.2	2.2	8.4	7.9	9.2	10.9	11.4
(including errors and omissions)	6.8	-16.3	1.3	8.0	7.9	9.2	10.9	11.4
Direct investment 1/	0.1	2.8	0.9	1.3	1.0	1.3	1.6	1.9
Portfolio investment in securities 1/	-5.2	-4.6	-1.2	0.2	1.1	1.1	1.2	1.3
Public sector (central & local governments & EBFs)	6.2	-1.9	0.4	0.7	1.2	1.8	2.3	2.0
Bonds (net)	6.1	0.1	1.0	0.8	1.2	2.2	2.5	1.9
Eurobond drawings	7.5	2.1	3.3	4.5	4.7	5.0	5.0	5.0
Eurobond repayments	-1.4	-2.0	-2.3	-3.7	-3.5	-2.8	-2.5	-3.1
Loans (net)	0.1	-2.0	-0.7	-0.1	0.0	-0.4	-0.2	0.1
Loan disbursements	3.7	1.6	2.3	3.3	3.4	2.8	2.8	2.9
Loan repayments	-3.6	-3.6	-3.0	-3.4	-3.4	-3.2	-3.0	-2.9
Central Bank of Turkey, (excl. reserve assets, liabiltie	0.7	0.8	1.4	0.4	0.3	0.3	0.3	0.4
Domestic money banks (net)	2.3	-9.4	-1.8	3.6	1.0	1.0	1.1	1.0
Domestic money banks (FX deposits abroad, -: accum	-1.7	0.9	0.6	2.3	-0.2	-0.2	-0.3	-0.3
Domestic money banks (other, net)	4.0	-10.3	-2.4	1.3	1.2	1.2	1.4	1.4
Other private sector (net)	5.5	-1.8	2.6	2.2	3.3	3.7	4.3	4.8
Errors and omissions 2/	-2.8	-2.1	-0.9	-0.4	0.0	0.0	0.0	0.0
Overall balance	-3.0	-12.9	-0.2	0.5	2.7	6.2	10.3	11.1
Overall financing	3.0	12.9	0.2	-0.5	-2.7	-6.2	-10.3	-11.1
Change in net international reserves (+ denotes decline)	3.0	12.9	0.2	-0.5	-2.7	-6.2	-10.3	-11.1
Change in gross official reserve assets (+ denotes decli	-0.4	2.7	-6.2	-0.5	-0.6	1.2	0.4	-9.3
Change in reserve liabilities (IMF)	3.4	10.2	6.4	0.0	-2.1	-7.3	-10.7	-1.8
Purchases	3.4	11.3	12.5	1.7	2.4	0.0	0.0	0.0
Repurchases	-0.1	-1.1	-6.1	-1.7	-4.4	-7.3	-10.7	-1.8

Table 3 (concluded). Balance of Payments, 2000–07
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, incl. shuttle trade	-4.9	2.4	-0.8	-3.2	-2.0	-1.1	-0.2	-0.1
Trade account balance, incl. shuttle trade	-11.1	-3.2	-4.6	-5.3	-4.4	-3.5	-2.8	-2.6
Exports of goods and non-factor services	26.2	36.1	31.0	27.9	27.8	28.2	28.5	28.9
Imports of goods and non-factor services	31.1	32.2	30.7	29.4	28.5	28.1	27.9	28.1
Percent change								
Value growth in exports of goods (incl. shuttle trad	6.5	11.9	15.9	19.2	10.6	10.9	9.9	9.1
Value growth in exports of goods (excl. shuttle trad	4.5	12.8	14.1	21.6	10.6	10.9	9.9	9.1
Value growth in imports of goods	35.1	-26.8	23.8	24.0	6.8	6.4	6.6	7.9
Volume growth in exports of goods	7.5	16.2	10.6	10.6	9.0	9.7	8.7	8.0
Volume growth in imports of goods	30.2	-23.2	21.2	12.6	6.4	5.9	6.1	7.0
Terms of trade	-6.2	1.6	1.0	-0.2	1.1	0.6	0.6	0.2
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey)								
In billions of U.S. dollars	23.2	19.8	27.9	28.3	29.0	27.8	27.4	36.7
Months of goods & NFS imports	4.0	4.4	5.4	4.4	4.2	3.8	3.6	4.4
External debt (end-of-period)								
In billions of U.S. dollars	118.7	113.9	131.6	136.2	140.4	140.3	138.2	145.1
Percent of GNP	59.0	79.1	72.4	58.3	54.4	50.3	46.1	45.3
Percent of exports of goods & NFS	225.0	219.1	233.6	208.6	195.3	178.3	161.6	157.0
Net external debt (end-of-period) 3/								
In billions of U.S. dollars	78.1	77.7	99.3	107.3	112.6	108.6	95.7	90.9
Percent of GNP	38.8	53.9	54.6	45.9	43.6	39.0	31.9	28.4
Short-term debt (end-of-period)								
In billions of U.S. dollars	28.3	16.2	15.2	18.1	20.1	22.2	24.4	26.9
Ratio to foreign reserves	122.0	81.8	54.4	63.7	69.3	79.9	89.2	73.3
Short-term debt plus MLT repayments								
In billions of U.S. dollars	43.8	32.6	31.3	35.7	37.7	39.8	41.8	45.5
Ratio to foreign reserves	189.0	164.5	112.4	126.0	130.1	143.2	152.6	123.8
Debt service ratio 4/	37.1	41.5	37.5	37.3	34.1	31.4	28.7	28.3

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

1/ On the basis of CBT new reporting format. Transit trade receipts and payments are reclassified from visible trade to non-factor services. In 2002 in the current account, this reclassification resulted in a reduction of exports f.o.b. by US$804 million and imports f.o.b.by US$759 millio For details of capital account classification changes see https://tcmb.gov.tr.

2/ Including privatization receipts.

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

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

Table 4. Turkey: Monetary Aggregates, 1999-2003
(In quadrillions of Turkish Lira)

	1999	2000	2001	2002				2003
	Dec.	Dec.	Dec.	Mar. Actual	Jun. Actual	Sep. Actual	Dec. Actual	Mar. Proj.
Broad money (M2Y)	40.6	56.8	106.6	103.1	116.8	125.4	133.6	131.5
Lira broad money (M2)	22.4	31.9	47.2	49.5	53.1	56.2	61.9	62.9
Foreign exchange deposits 1/	18.2	24.9	59.3	53.5	63.7	69.3	71.7	68.6
Repos	4.1	6.0	2.8	3.7	3.7	3.4	2.8	3.9
Broad liquidity	44.6	62.8	109.4	106.8	120.5	128.8	136.3	135.5
Base money	3.9	5.8	7.8	8.4	9.0	10.6	10.4	12.2
Net foreign assets 1/	6.0	2.8	-1.9	-5.1	-11.2	-8.0	-6.5	-10.2
(in billions of U.S. dollars)	11.1	4.1	-1.3	-3.8	-7.0	-4.8	-4.0	-6.0
Net domestic assets	34.6	54.1	108.5	108.1	128.0	133.4	140.1	141.8
Net claims on government	19.3	31.6	89.7	101.3	110.9	117.4	122.7	123.9
Claims on business sector 2/	18.3	31.7	38.7	35.9	34.3	38.3	42.1	47.2
Turkish lira claims	11.2	22.3	23.1	22.3	19.3	22.0	24.6	26.5
Foreign exchange claims (est.) 1/	7.1	9.4	15.6	13.6	15.0	16.3	17.6	20.7
Other items (net)	-3.0	-9.1	-20.0	-29.0	-17.3	-22.3	-24.8	-29.3
Memorandum items:				(annual percent change)				
Broad money (M2Y)	100.7	40.2	87.5	42.7	37.9	24.0	25.3	27.6
Lira broad money (M2)	96.1	42.5	48.0	28.7	31.5	33.4	31.0	27.1
Foreign exchange deposits 1/	106.6	37.3	137.9	58.8	43.7	17.2	20.8	28.2
Claims on business sector 2/	50.8	73.0	22.3	4.2	-3.3	3.2	8.8	31.5
				(billions of U.S. dollars)				
Broad money (M2Y)	75.4	84.6	74.0	77.3	72.9	76.1	81.7	77.4
Lira broad money (M2)	41.6	47.5	32.8	37.2	33.1	34.1	37.9	37.0
Foreign exchange deposits	33.7	37.1	41.2	40.2	39.7	42.0	43.9	40.4
Net claims on government	35.8	47.0	62.3	76.0	69.2	71.2	75.1	72.9
Credit to the private sector	34.0	47.1	26.9	26.9	21.4	23.2	25.8	27.7
				(in percent share)				
Base money/GNP 3/	5.0	4.6	4.4	4.2	4.1	4.3	3.8	4.2
Broad money (M2Y)/GNP 3/	51.8	45.3	60.4	51.4	52.6	50.4	48.8	45.3
Lira broad money (M2)/GNP 3/	28.6	25.4	26.8	24.7	23.9	22.6	22.6	21.7
Private credit/GNP	23.4	25.2	21.9	17.9	15.5	15.4	15.4	16.2
Foreign currency deposits/M2Y	44.8	43.9	55.7	52.0	54.5	55.2	53.7	52.2
Money multiplier								
Broad money (M2Y)	10.5	9.8	13.7	12.2	12.9	11.8	12.8	10.8
Lira broad money (M2)	5.8	5.5	6.1	5.9	5.9	5.3	5.9	5.2

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 5. Turkey: Central Bank Balance Sheet, 2000-03 1/

	2000	2001	2002				2003			
	Dec Actual	Dec Actual	Mar Actual	Jun Actual	Sep Actual	Dec Actual	Apr Actual	Jun Actual	Sep Program	Dec Program
1. Central Bank Balance Sheet					(in quadrillions of Turkish lira) 1/					
Net foreign assets	3.3	-12.7	-2.1	-0.2	2.8	3.9	3.0	4.1	5.9	6.3
Gross foreign assets	15.6	28.6	30.9	32.0	36.0	37.7	36.3	38.1	40.2	40.7
Gross foreign liabilities	12.3	41.2	33.0	32.1	33.1	33.8	33.4	34.0	34.2	34.5
International reserve liabilities	3.1	20.7	11.8	11.5	11.5	11.5	11.4	11.2	11.1	10.9
Other reserve liabilities 2/	4.9	10.1	11.5	11.4	12.6	13.2	13.3	13.8	14.0	14.4
Banks' FX deposits with CBT	4.3	10.4	9.7	9.3	9.1	9.1	8.7	9.0	9.1	9.2
Net domestic assets	2.5	20.6	10.5	9.2	7.8	6.5	8.8	8.5	8.1	7.9
Claims on central government (net)	0.4	30.1	27.4	24.9	22.0	25.6	26.0	24.6	24.3	24.3
Claims on other public sector (net)	-0.3	-1.0	-0.8	-1.0	-1.1	-1.2	-1.4	-1.4	-1.2	-1.2
Claims on banks	5.7	-0.5	-5.5	-7.9	-6.0	-9.3	-8.2	-6.3	-7.8	-7.3
Other items (net)	-3.3	-8.1	-10.6	-6.9	-7.1	-8.5	-7.6	-8.4	-7.3	-7.9
Base money	5.8	7.8	8.4	9.0	10.6	10.4	11.8	12.9	14.1	14.3
Currency issued	3.8	5.3	5.6	6.6	6.9	7.6	8.2	9.2	10.1	10.0
Banks' lira deposits at the CBT	2.0	2.5	2.9	2.4	3.7	2.8	3.6	3.7	3.9	4.2
Required reserves	1.4	1.6	1.8	1.4	1.6	1.7	1.8	1.9	2.0	2.1
Free reserves	0.6	0.9	1.0	1.0	2.1	1.1	1.8	1.8	1.9	2.1
Memorandum items					(in billions of U.S. dollars)					
Gross international reserves	23.2	19.8	21.5	22.2	25.0	26.2	25.2	26.4	27.9	28.3
Gross international liabilities	18.3	28.6	22.9	22.3	23.0	23.5	23.2	23.4	23.8	23.9
Net foreign assets	4.9	-8.8	-1.5	-0.1	2.0	2.7	2.1	3.0	4.1	4.3
plus CBT forward position	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
plus other reserve liabilities	7.3	7.1	8.0	7.9	8.8	9.2	9.3	9.6	9.8	10.0
minus Dresdner one year deposits	0.6	0.7	1.0	1.1	1.4	1.4	1.5	1.6	1.6	1.7
minus defence fund	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net international reserves	11.1	-2.9	5.1	6.3	8.9	10.0	9.4	10.6	11.8	12.2
2. 2002 program definitions (CBT plus Treasury)					(in billions of U.S. dollars)					
Net international reserves (Treasury) 3/	...	-1.3	-10.5	-12.0	-14.8	-14.7	-15.4	-14.4	-16.4	-16.9
Net international reserves (Treasury plus CBT)	...	-4.2	-5.4	-5.8	-5.9	-4.6	-6.0	-3.9	-4.6	-4.7
					(in quadrillions of Turkish Lira, program exchange rate)					
Net foreign assets (Treasuey)	...	-1.8	-15.1	-17.3	-21.3	-21.1	-22.1	-20.8	-23.6	-24.3
Net foreign assets (Treasury plus CBT)	...	-14.5	-17.2	-17.5	-18.5	-17.2	-19.1	-16.4	-17.7	-18.0
Net domestic assets (Treasury) 4/	...	1.8	15.1	17.3	21.3	21.1	22.1	20.8	23.6	24.3
Net domestic assets (Treasury plus CBT)	...	22.4	25.6	26.5	29.1	27.6	30.9	29.3	31.7	32.2
Base money (Treasury plus CBT)	...	7.9	8.4	9.0	10.6	10.4	11.8	12.9	14.1	14.3
Exchange rate (TL per US dollar, in millions)	0.67	1.44	1.33	1.60	1.65	1.63	1.58	1.42	...	...

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

2/ Mainly Dresdner deposit liabilities.

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

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

Table 6. Turkey: Public Sector Primary Balances, 2000-03

	2000	2001 Est.	2002 Est.	2003 Jan.-May.	2003 Prog.	2003 Revised. Prog.	2003 Diff.
				(in trillions of TL)			
Public Sector	**3,760**	**9,741**	**11,045**	**8,093**	**23,085**	**23,368**	**283**
Central government 1/	**5,831**	**8,420**	**6,644**	**7,422**	**18,218**	**17,911**	**-307**
Total revenue	30,346	44,766	63,369	31,363	90,941	90,780	-161
Tax revenue	26,514	39,768	59,634	30,748	84,776	87,143	2,367
Direct taxes	10,849	16,080	20,077	10,368	27,783	27,908	125
Indirect taxes	15,665	23,687	39,557	20,379	56,993	59,235	2,242
Nontax revenue 1/	5,463	7,916	9,402	3,958	12,927	12,558	-369
Tax rebates	-1,632	-2,918	-5,666	-3,343	-6,762	-8,921	-2,159
Noninterest expenditure	24,515	36,346	56,726	23,941	72,723	72,870	147
Personnel	9,982	15,204	23,160	11,952	29,537	29,965	428
Other current	1,193	1,431	2,510	388	3,035	2,935	-100
Defense and security	2,327	3,591	4,485	914	5,965	5,965	0
Transfers	8,763	12,218	19,289	9,910	26,587	27,406	819
Social security institutions	3,320	5,910	9,946	7,354	16,026	16,521	495
State enterprises and banks 2/	1,280	1,777	2,245	326	2,016	2,016	0
Agricultural subsidies	359	1,033	1,868	1,142	2,545	2,780	235
Other transfers	3,804	3,499	5,230	1,088	6,000	6,088	88
Investment	2,251	3,902	7,282	777	7,599	6,599	-1,000
Rest of the public sector	**-2,071**	**1,321**	**4,401**	**671**	**4,867**	**5,457**	**590**
EBFs	-225	149	-249	1	-586	-365	221
Unemployment insurance fund	334	1,098	962	404	1,157	1,236	79
Local governments	-284	94	338	...	58	2	-56
SEEs 3/	-1,920	149	3,139	...	4,210	4,382	172
Social insurance institutions	24	-170	-85	266	-56	0	56
Revolving funds 4/	99	95	296	...	84	204	120
				(in percent of GNP)			
Public Sector	**3.0**	**5.5**	**4.0**	**6.7**	**6.5**	**6.5**	**0.0**
Central government 1/	**4.6**	**4.8**	**2.4**	**6.2**	**5.1**	**5.0**	**-0.2**
Total revenue	24.2	25.4	23.2	26.0	25.6	25.3	-0.4
Tax revenue	21.1	22.5	21.8	25.5	23.9	24.3	0.3
Direct taxes	8.6	9.1	7.3	8.6	7.8	7.8	-0.1
Indirect taxes	12.5	13.4	14.5	16.9	16.1	16.5	0.4
Nontax revenue 1/	4.4	4.5	3.4	3.3	3.6	3.5	-0.2
Tax rebates	-1.3	-1.7	-2.1	-2.8	-1.9	-2.5	-0.6
Noninterest expenditure	19.5	20.6	20.7	19.8	20.5	20.3	-0.2
Personnel	7.9	8.6	8.5	9.9	8.3	8.3	0.0
Other current	0.9	0.8	0.9	0.3	0.9	0.8	0.0
Defense and security	1.9	2.0	1.6	0.8	1.7	1.7	0.0
Transfers	7.0	6.9	7.1	8.2	7.5	7.6	0.1
Social security institutions	2.6	3.3	3.6	6.1	4.5	4.6	0.1
State enterprises and banks 2/	1.0	1.0	0.8	0.3	0.6	0.6	0.0
Agricultural subsidies	0.3	0.6	0.7	0.9	0.7	0.8	0.1
Other transfers	3.0	2.0	1.9	0.9	1.7	1.7	0.0
Investment	1.8	2.2	2.7	0.6	2.1	1.8	-0.3
Rest of the public sector	**-1.6**	**0.7**	**1.6**	**0.6**	**1.4**	**1.5**	**0.1**
EBFs	-0.2	0.1	-0.1	0.0	-0.2	-0.1	0.1
Unemployment insurance fund	0.3	0.6	0.4	0.3	0.3	0.3	0.0
Local governments	-0.2	0.1	0.1	...	0.0	0.0	0.0
SEEs 3/	-1.5	0.1	1.1	...	1.2	1.2	0.0
Social insurance institutions	0.0	-0.1	0.0	0.2	0.0	0.0	0.0
Revolving funds 4/	0.1	0.1	0.1	...	0.0	0.1	0.0
Memorandum item:							
Social spending 5/	14.24	15.65	17	...	17	17	...

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

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

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

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

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

5/ World Bank definition, including education, health and social security.

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

	1998	1999	2000	2001	2002		2003
	Dec.	Dec.	Dec.	Dec. 1/	June	Dec.	March
			Banking System				
Total assets	**40,988**	**79,763**	**117,649**	**179,675**	**189,568**	**212,599**	**220,245**
Cash and claims on CBT	2,665	5,097	6,235	12,558	11,831	13,872	4,874
Claims on other banks	3,923	7,766	13,599	19,871	16,163	15,401	11,491
Securities portfolio	9,688	22,040	31,251	70,026	76,574	86,105	90,717
Loans, net	14,689	22,601	35,789	41,058	45,463	52,963	56,038
Other assets	10,024	22,258	30,775	36,162	39,537	44,259	57,125
Total liabilities	**40,988**	**79,763**	**117,649**	**179,675**	**189,568**	**212,599**	**220,245**
Deposits	24,194	48,272	68,143	110,298	120,851	137,973	136,984
Borrowing from banks	4,663	10,070	15,996	23,798	23,106	21,967	24,481
Repos	4,153	7,645	12,843	10,776	7,202	6,161	7,968
Other liabilities	4,689	9,539	12,207	20,527	22,701	21,360	22,688
Shareholders' equity (incl. profits)	3,290	4,235	8,461	14,276	15,707	25,138	28,124
Memorandum items:							
Capital adequacy ratio (%)	...	...	17.3	15.3	15.7	26.4	26.7
NPLs (%) total loans	6.7	9.7	9.2	29.3	25.5	17.5	15.3
Provisions (%) NPLs	44.2	61.9	59.8	47.1	50.9	63.9	67.6
Net profit (loss) after tax	760	-305	-888	-9,910	338	1,819	652
ROA (%)	1.9	-0.4	-0.8	-5.5	0.2	0.9	0.3
ROE (%)	23.1	-7.2	-10.5	-69.4	2.1	7.2	2.3
Share in assets (%)	100	100	100	100	100	100	100
Share in deposits and repos (%)	100	100	100	100	100	100	100
			Private Banks				
Total assets	**23,596**	**42,165**	**56,179**	**97,930**	**102,433**	**119,471**	**128,817**
Cash and claims on CBT	1,514	2,707	3,362	8,434	7,581	9,356	2,976
Claims on other banks	2,688	5,386	9,769	10,494	7,327	7,623	5,076
Securities portfolio	6,478	14,335	13,491	27,146	33,597	39,819	44,787
Loans, net	8,793	12,445	19,587	26,506	29,373	35,752	39,891
Other assets	4,124	7,292	9,971	25,350	24,555	26,921	36,087
Total liabilities	**23,596**	**42,165**	**56,179**	**97,930**	**102,433**	**119,471**	**128,817**
Deposits	13,652	23,160	30,827	67,223	67,362	80,629	84,405
Borrowing from banks	3,006	6,508	10,045	15,585	14,578	13,703	16,592
Repos	2,633	4,654	3,918	1,803	3,202	4,074	5,447
Other liabilities	1,894	3,036	3,503	5,779	6,169	5,871	7,516
Shareholders' equity (incl. profits)	2,411	4,806	7,886	7,540	11,122	15,194	14,857
Memorandum items:							
Capital adequacy ratio (%)	...	...	18.3	9.0	16.0	19.7	17.3
NPLs (%) total loans	6.9	3.5	3.5	27.6	21.0	8.9	10.7
Provisions (%) NPLs	41.2	62.2	63.0	31.0	37.0	53.0	58.5
Net profit (loss) after tax	660	1618	1276	-7,382.6	611.8	2409.6	468.0
ROA (%)	2.8	3.8	2.3	-7.5	0.6	2.0	0.4
ROE (%)	27.4	33.7	16.2	-97.9	5.5	15.9	3.1
Share in assets (%)	57.6	52.9	47.8	54.5	54.0	56.2	58.5
Share in deposits and repos (%)	57.4	49.7	42.9	57.0	55.1	58.8	62.0

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

	1998	1999	2000	2001	2002		2003
	Dec.	Dec.	Dec.	Dec. 1/	June	Dec.	March
State Banks							
Total assets	14,150	27,104	40,655	57,583	61,878	67,831	72,427
Cash and claims on CBT	1,067	1,999	2,588	3,544	3,649	4,000	1,711
Claims on other banks	652	1,088	1,639	5,096	3,760	3,996	3,263
Securities portfolio	2,660	4,671	8,139	32,756	36,920	39,245	42,011
Loans, net	4,267	6,521	10,025	9,177	8,833	8,804	9,132
Other assets	5,503	12,825	18,265	7,011	8,717	11,786	16,310
Total liabilities	14,150	27,104	40,655	57,583	61,878	67,831	72,427
Deposits	9,838	19,204	27,606	37,258	42,370	48,489	49,656
Borrowing from banks	368	630	1,339	2,381	2,681	2,230	2,575
Repos	1,284	1,922	4,949	3,844	2,550	1,022	1,769
Other liabilities	2,116	4,317	5,659	9,707	9,466	9,343	10,697
Shareholders' equity (incl. profits)	544	1,031	1,101	4,393	4,811	6,747	7,730
Memorandum items:							
Capital adequacy ratio (%)	...	...	7.9	34.0	32.0	50.2	54.6
NPLs (%) total loans	5.3	9.1	11.1	37.3	40.1	37.4	36.4
Provisions (%) NPLs	30.2	35.1	30.3	63	67	74	76
Net profit (loss) after tax	78	284	-177	-681	329	1,056	149
ROA (%)	0.5	1.0	-0.4	-1.2	0.5	1.6	0.2
ROE (%)	14.3	27.6	-16.1	-15.5	6.8	15.7	1.9
Share in assets (%)	34.5	34.0	34.6	32.0	32.6	31.9	32.9
Share in deposits and repos (%)	39.2	37.8	40.2	33.9	35.1	34.4	35.5
SDIF Banks							
Total assets	667	5,480	12,912	11,035	10,513	9,228	2,614
Cash and claims on CBT	9	248	103	45	114	62	11
Claims on other banks	47	211	535	874	1,053	619	373
Securities portfolio	351	2,511	8,572	8,451	4,048	4,655	1,541
Loans, net	158	1,052	2,533	602	2,189	1,919	222
Other assets	102	1,458	1,169	1,064	3,109	1,973	467
Total liabilities	667	5,480	12,912	11,035	10,513	9,228	2,614
Deposits	446	5,363	8,827	3,566	8,587	5,770	207
Borrowing from banks	29	263	819	2,020	1,266	1,274	161
Repos	226	1,426	3,993	5,023	1,424	1,024	701
Other liabilities	69	968	1,329	814	3,080	2,331	748
Shareholders' equity (incl. profits)	-104	-2,540	-2,056	-388	-3,845	-1,171	797
Memorandum items:							
Capital adequacy ratio (%)	...	...	...	-17.8	-45.0	-7.5	51.1
NPLs (%) total loans	49.7	61.9	41.4	67.3	50.2	69.4	38.1
Provisions (%) NPLs	80.9	75.3	80.3	89.1	59.7	59.1	85.0
Net profit (loss) after tax	-127	-2547	-2314	-2,344	-1,230	-2,178	162
ROA (%)	-19.0	-46.5	-17.9	-21.2	-11.7	-23.6	6.2
ROE (%)	...	...	...	...	...	...	20.4
Share in assets (%)	1.6	6.9	11.0	6.1	5.5	4.3	1.2
Share in deposits and repos (%)	2.4	12.1	15.8	7.1	7.8	4.7	0.6

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

	1998	1999	2000	2001		2002	2003
	Dec.	Dec.	Dec.	Dec. 1/	June	Dec.	March
			Foreign and Investment Banks				
Total assets	2,576	5,014	7,903	13,126	14,744	16,069	16,387
Cash and claims on CBT	75	143	182	535	487	454	175
Claims on other banks	536	1,082	1,657	3,408	4,023	3,164	2,778
Securities portfolio	199	523	1,049	1,673	2,009	2,386	2,378
Loans, net	1,471	2,583	3,645	4,773	5,069	6,487	6,793
Other assets	295	683	1,370	2,738	3,156	3,579	4,262
Total liabilities	2,576	5,014	7,903	13,126	14,744	16,069	16,387
Deposits	258	546	882	2,252	2,532	3,086	2,716
Borrowing from banks	1,259	2,670	3,792	3,812	4,582	4,761	5,153
Repos	10	-357	-17	105	26	40	51
Other liabilities	609	1,218	1,716	4,227	3,985	3,815	3,727
Shareholders' equity (incl. profits)	439	937	1,529	2,730	3,620	4,367	4,741
Memorandum items:							
Capital adequacy ratio (%)	...	...	29.4	41.0	54.2	58.2	49.8
NPLs (%) total loans	2.1	2.1	1.8	9.3	4.5	4.3	4.3
Provisions (%) NPLs	54.0	31.3	51.8	81.2	60.5	69.3	68.9
Net profit (loss) after tax	150	340	328	498	627	531	-127
ROA (%)	5.8	6.8	4.1	3.8	4.3	3.3	-0.8
ROE (%)	34.1	36.3	21.4	18.2	17.3	12.2	-2.7
Share in assets (%)	6.3	6.3	6.7	7.3	7.8	7.6	7.4
Share in deposits and repos (%)	0.9	0.3	1.1	1.9	2.0	2.2	1.9

Sources: Data provided by Turkish authorities; and Fund staff estimates
1/ Data for December 2001 onward reflect the results of the audits conducted during the first half of 2002.

Table 8. Turkey: External Financing Requirements and Sources, 2000 -07
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006	2007
Gross financing requirements	58.9	49.0	44.0	56.3	54.3	54.1	53.5	56.7
Current account deficit (excluding official transfers)	10.0	-3.2	2.0	8.0	5.8	3.6	1.1	0.9
Amortization on debt securities	1.7	2.1	2.7	3.8	3.5	3.1	2.6	3.3
Of which:								
Public sector	1.4	2.0	2.3	3.7	3.5	2.8	2.5	3.1
Deposit money banks	0.4	0.0	0.4	0.1	0.0	0.3	0.1	0.2
Medium and long-term debt amortization	13.8	14.3	13.4	16.4	14.1	14.5	14.7	15.3
Of which:								
Public sector 1/	3.6	3.6	3.0	3.4	3.4	3.2	3.0	2.9
Private sector	7.9	8.9	8.8	11.9	9.6	9.9	10.2	10.7
Deposit money banks	2.3	1.9	1.6	1.1	1.2	1.4	1.5	1.7
Short-term debt amortization	33.3	35.8	25.8	28.0	30.9	32.9	35.0	37.3
Public sector 1/	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Private sector 2/	20.2	17.9	17.9	21.6	23.0	24.1	25.3	26.6
Deposit money banks	13.2	16.9	8.0	6.3	7.9	8.7	9.7	10.7
Available financing	58.9	49.0	44.0	56.3	54.3	54.1	53.5	56.7
Foreign direct investment (net)	0.1	2.8	0.9	1.3	1.0	1.3	1.6	1.9
Portfolio flows	3.4	-1.7	4.2	5.5	6.6	7.1	7.2	7.3
Public sector	7.5	2.1	3.3	4.5	4.7	5.0	5.0	5.0
Deposit money banks	0.5	0.0	0.0	0.2	0.2	0.3	0.3	0.3
Private sector (net)	-4.6	-3.8	0.9	0.8	1.7	1.8	1.9	2.0
Medium and long-term debt financing	18.1	13.2	15.7	17.2	19.5	19.9	21.0	22.0
Of which:								
Public sector 1/	3.4	3.2	2.9	3.5	3.6	3.0	3.1	3.2
Private sector	12.8	9.2	11.5	13.1	14.2	15.0	15.9	16.6
Deposit money banks	1.9	0.9	1.3	0.6	1.6	1.8	2.0	2.2
Short-term debt financing, currency and deposits	36.9	23.7	23.4	32.7	29.4	31.4	33.6	36.1
Official transfers	0.2	0.2	0.5	0.5	0.5	0.5	0.6	0.6
Other 3/	-2.8	-2.1	-0.9	-0.4	0.0	0.0	0.0	0.0
Net reserves (+/- = decrease/increase)	3.0	12.9	0.2	-0.5	-2.7	-6.2	-10.3	-11.1
Accumulation of gross reserves	-0.4	2.7	-6.2	-0.5	-0.6	1.2	0.4	-9.3
IMF (net)	3.4	10.2	6.4	0.0	-2.1	-7.3	-10.7	-1.8
Purchases	3.4	11.3	12.5	1.7	2.4	0.0	0.0	0.0
Repurchases	-0.1	-1.1	-6.1	-1.7	-4.4	-7.3	-10.7	-1.8

1/ General government and Central Bank of Turkey.
2/ Series revised from 1999 to reflect gross flows of short term trade credits.
3/ Errors and omissions.

Table 9a: External Sustainability Framework, 1999-2008

	Actual				Projections					
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline medium-term projections										
1 External debt/Exports of G&S	214.6	220.1	214.4	230.4	207.4	192.9	176.6	158.6	154.3	149.7
2 External debt/GNP	55.0	59.0	79.1	72.4	58.3	54.4	50.3	46.1	45.3	45.5
3 Change in external debt/GNP	8.1	4.0	20.2	-6.7	-14.1	-3.9	-4.0	-4.3	-0.7	0.1
4 Net debt-creating external flows/GNP (5+9+12)	5.0	1.1	19.2	-15.8	-13.3	-7.8	-3.6	-4.1	-3.7	-3.8
5 Current account deficit, excluding interest payments/GNP	-2.2	1.7	-7.3	-2.7	-0.2	-1.2	-2.0	-2.8	-2.8	-3.1
6 Deficit in balance of G&S/GNP	3.5	7.5	0.3	2.8	4.8	3.6	2.7	1.8	1.6	1.4
7 Exports of G&S/GNP	25.6	26.8	36.9	31.4	28.1	28.2	28.5	29.1	29.4	30.4
8 Imports of G&S/GNP	29.1	34.3	37.2	34.2	32.9	31.8	31.2	30.8	31.0	31.8
9 Minus net non-debt creating capital inflows/GNP	-0.3	-0.3	-1.9	-0.2	-0.4	-0.7	-0.7	-0.8	-0.9	-1.0
10 Net foreign direct investment, equity/GNP	0.1	0.1	1.9	0.2	0.3	0.4	0.5	0.5	0.6	0.7
11 Net portfolio investment,equity/GNP	0.2	0.2	-0.1	0.0	0.0	0.3	0.2	0.2	0.3	0.3
12 (r-g-(r+gr))/(1+g+r+gr))debt/GNP (14/13)	7.4	-0.3	28.4	-12.9	-12.7	-5.9	-0.9	-0.6	0.0	0.3
13 Adjustment factor: 1+g+r+gr	0.9	1.1	0.7	1.3	1.3	1.2	1.1	1.1	1.1	1.1
14 (r-g-(r+gr))debt/GNP (15+16+17)	6.8	-0.3	20.3	-16.2	-16.3	-7.0	-1.0	-0.6	0.0	0.3
15 r (interest rate) times debt/GNP	2.6	3.4	3.5	4.4	4.4	3.6	3.3	3.2	3.1	3.1
16 minus g (real GNP growth rate) times debt/GNP	2.9	-3.5	5.6	-6.2	-3.6	-2.9	-2.7	-2.5	-2.3	-2.3
17 minus (r + gr) (r = US dollar value of GNP deflator, growth rate) times debt/GNP	1.3	-0.2	11.2	-14.5	-17.1	-7.6	-1.6	-1.3	-0.8	-0.5
18 Residual, incl. change in gross foreign assets/GNP (3-4)	3.2	2.8	0.9	9.1	-0.9	3.8	-0.4	-0.1	2.9	3.9
Memorandum Items: Key macro and external assumptions										
Nominal GNP (TL quadrillions)	78	126	176	273	359	426	491	548	598	652
Nominal GNP (US dollars, billions)	187	201	144	182	234	258	279	300	320	336
Real GNP growth (in percent per year)	-6.1	6.3	-9.5	7.8	5.0	5.0	5.0	5.0	5.0	5.0
Consumer price index (change, in percent per year)	65	55	54	45	25	14	10	6	4	4
Exchange rate ('000s TL/US dollar)	418	624	1225	1505	1538	1650	1762	1826	1867	1940
Nominal GNP deflator (in US dollars, change in percent per year)	-2.9	0.4	-20.9	17.0	22.5	12.5	2.8	2.5	1.6	1.1
External interest rate (percent per year)	5.7	6.1	6.0	5.6	6.1	6.2	6.1	6.3	6.8	6.8
Growth of exports of G&S (US dollar terms, in percent per year)	-15.0	12.4	-1.4	7.4	15.0	10.8	9.1	9.7	7.9	8.6
Growth of imports of G&S (US dollar terms, in percent per year)	-9.4	26.5	-22.3	16.0	23.6	7.0	6.0	6.2	7.4	7.5
II. Sensitivity analysis for external debt-to-GNP ratio					Baseline Projections					
1. If interest rate, real GNP growth rate, US$ GNP deflator growth, non-interest current account, and non-debt flows (in percent of GNP) are at average of past 10 years					71.3	74.9	74.3	74.0	76.8	80.6
2. If interest rate in 2003 and 2004 is average plus two standard deviations, others at baseline					58.6	54.9	50.8	46.6	45.9	46.0
3. If real GNP growth rate in 2003 and 2004 is average minus two standard deviations, others at baseline					69.3	75.8	71.4	66.9	66.2	66.5
4. If US$ GNP deflator in 2003 and 2004 is average minus two standard deviations, others at baseline					100.7	144.1	138.5	133.3	132.6	133.3
5. If non-interest current account (in percent of GNP) in 2003 and 2004 is average minus two standard deviations, others at baseline					61.7	61.9	57.7	53.4	52.7	52.9
6. Combination of 2-5 using one standard deviation shocks					93.2	124.6	119.4	114.3	113.6	114.2
7. Repeat 6 using "standard" standard deviations 1/										
7. One time 30% depreciation in year 2003 (-30% GNP deflator shock), others at baseline.					103.1	94.6	89.9	85.2	84.5	84.9

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

Table 9b. Turkey: Public Sector Sustainability Framework, 1999-2008

						Projections					
		t-4	t-3	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5
		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I.	**Baseline Medium-term Projections**										
2	Public debt/GNP (staff baseline)	61.0	57.4	94.0	80.0	69.6	66.2	62.1	59.1	57.1	55.7
3	Change in public debt/GNP	17.3	-3.6	36.6	-14.0	-10.4	-3.4	-4.1	-3.0	-1.9	-1.5
4	Net debt-creating flows/GNP (lines 5+8+11)		-1.7	1.1	-9.7	-9.8	-3.8	-3.7	-3.8	-3.5	-3.2
5	Primary deficit/GNP	2.0	-2.4	-5.5	-3.9	-6.5	-6.5	-6.5	-6.3	-6.3	-6.3
8	Minus net non-debt creating inflows/GNP		-0.8	-3.4	-1.8	-2.0	-1.3	-1.1	-1.0	-1.0	-0.9
9	Change in reserve money/GNP		0.8	1.4	1.5	1.1	0.7	0.6	0.5	0.5	0.4
10	Privatization receipts/GNP		0.0	1.9	0.3	0.9	0.6	0.5	0.5	0.5	0.5
11	(r-g-(pi+gpi))/(1+g+pi+gpi))debt (lines 13/12)		1.5	10.0	-4.1	-1.3	4.0	3.9	3.5	3.8	4.1
12	Adjustment factor: 1+g+pi+gpi		1.6	1.4	1.5	1.3	1.2	1.2	1.1	1.1	1.1
13	(r-g-(pi+gpi))debt/GNP (lines 14+15+16)		2.4	14.0	-6.3	-1.7	4.8	4.5	4.0	4.2	4.5
14	r (interest rate) times debt/GNP		39.5	37.4	45.4	23.5	17.7	14.6	12.3	10.9	10.3
15	minus g (real GNP growth rate) times debt/GNP		-3.8	5.4	-7.3	-4.0	-3.5	-3.3	-3.1	-3.0	-2.9
16	minus (pi+gpi) (pi = GNP deflator, growth rate) times debt/GNP		-33.2	-28.8	-44.3	-21.1	-9.5	-6.8	-5.2	-3.7	-3.0
17	Residual, incl. change in assets/GNP (lines 3-4)		-1.9	35.5	-4.3	-0.7	0.3	-0.3	0.8	1.5	1.7
	Memorandum items:										
	Real GNP growth	-6.1	6.3	-9.4	7.8	5.0	5.0	5.0	5.0	5.0	5.0
	Nominal GNP deflator (in local currency, change in percent per year)	55.8	51.2	55.3	43.8	25.2	12.9	9.8	8.0	6.0	5.0
	Effective nominal interest rate on government debt		64.7	65.6	30.9	27.8	23.2	20.8	18.8	18.1	18.1
	Benchmark bond rate	106.2	38.0	99.1	63.5	46.4	31.3	29.3	25.7	23.9	23.9
	memo: Ex-ante real rate (using GNP deflator)	36.4	-11.2	38.5	30.6	29.7	19.6	19.8	18.5	18.0	18.0
	Nominal TL rate on dollar debt	–	112.1	32.7	10.3	14.8	16.9	13.9	13.4	13.4	13.4
	memo: Nominal dollar rate on dollar debt		8.0	8.0	8.0	7.0	7.0	7.0	8.0	8.0	8.0
	Share of FX-linked debt (average)		36.0	50.4	61.2	59.1	55.8	55.0	55.5	55.3	55.1
	Effective real interest rate on government debt (using GNP deflator)		6.0	15.2	4.6	13.1	12.3	11.9	12.1	12.5	12.5
II.	**Sensitivity Analysis for Public Debt-to-GNP Ratio**										
1	If real GNP growth rate is average of past 10 years, primary balance is 3.25 percent, and the real interest rate is the maximum over 10 years					75.8	79.2	81.1	84.1	88.9	94.9
2	If real GNP growth rate in year t and t+1 is average minus two standard deviations, others at baseline					84.1	98.0	95.8	94.6	95.0	96.2
3	If primary balance (in percent of GNP) is 0 percent in year t and t+1, others at baseline					76.0	79.4	76.2	73.9	72.9	72.6
4	If the real interest rate in year t and t+1 is 10-year maximum plus 10 points, others at baseline					72.2	75.9	77.0	74.8	73.9	73.6
5	Combination of 2-4 using one standard deviation for growth, and 3.25 percent for primary surplus, and maximum real interest rate.					81.7	95.7	97.1	96.1	96.5	97.9
6	One time 30% depreciation from current exchange rate by end-year t, others at baseline					78.0	76.8	73.0	70.4	69.3	68.9
7	If debt ratio in year t rises by 10 percent of GNP, others at baseline.					79.6	76.7	73.3	70.9	69.7	69.2
8	Using consensus forecasts for growth, fiscal balance, and interest rates 1/					71.9	70.8	69.3	68.5	69.1	69.6

1/ Assumes growth of 3.8 percent in 2003, 4.6 percent in 2004, and 4.2 percent thereafter. Real interest rates are assumed to be 30 percent in 2003 and 25 percent thereafter. The primary balance is assumed to be 5 percent of GNP in 2003 and 2004, and 6 percent thereafter.

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

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Outstanding Fund credit (end of period)									
In billions of SDRs	3.2	11.2	16.2	16.2	14.8	9.5	1.9	0.6	0.0
In percent of quota	333	1,165	1,685	1,682	1,530	988	195	62	1
In percent of exports of G&NFS	8	27	37	35	29	17	3	1	0
In percent of GNP	2	10	12	10	8	5	1	0	0
In percent of public sector external debt	7	20	24	26	24	16	4	1	0
In percent of overall external debt	4	13	16	17	15	10	2	1	0
In percent of foreign reserves	18	72	76	80	72	48	10	2	0
Debt service due to the Fund									
In billions of SDRs	0.1	1.2	5.5	1.9	3.8	5.8	7.8	1.3	0.6
In percent of quota	11	125	575	196	397	605	808	132	62
In percent of exports of G&NFS	0	3	13	4	7	10	13	2	1
In percent of GNP	0	1	4	1	2	3	4	1	0
In percent of public sector external debt service	2	15	51	22	37	50	58	18	9
In percent of overall MLT external debt service	1	7	25	9	18	25	30	6	3
In percent of foreign reserves	1	8	26	9	19	29	40	5	2
In percent gross public sector ext. financing 2/	1	30	23	14	21	30	31	5	2
Net Fund Resource Flows 3/									
In billions of SDRs	2.5	7.7	4.4	-0.7	-2.1	-5.8	-7.8	-1.3	-0.6
In percent of quota	259	798	455	-72	-220	-605	-808	-136	-62
In percent of exports of G&NFS	6	19	10	-1	-4	-10	-13	-2	-1
In percent of GNP	2	7	3	0	-1	-3	-4	-1	0
In percent of public sector external debt service	46	95	41	-8	-21	-50	-58	-18	-9
In percent of overall MLT external debt service	16	42	20	-3	-10	-25	-30	-6	-3
In percent of end-year foreign reserves	14	49	20	-3	-10	-29	-40	-5	-2
In percent gross public sector ext. financing 2/	18	193	19	-5	-11	-30	-31	-5	-2

1/ Projected on an expectations basis, except repurchase expectations on purchases made from February 2002 falling due in 2004 and 2005 which are projected on an obligations basis.

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

3/ Purchases less repurchases and charges.

Table 11. Turkey: Indicators of External Vulnerability, 1999–2004 1/
(In percent, unless otherwise noted)

	1999	2000	2001	2002	Projections 2003	2004
CPI inflation (end year)	68.8	39.0	68.5	29.7	20.0	12.0
Public sector borrowing requirement (percent of GNP)	22.3	19.2	21.1	12.3	9.3	6.8
Net debt of the public sector (percent of GNP)	61.0	57.7	94.0	80.0	69.6	66.2
Export volume (percent change)	1.9	7.5	16.2	10.6	10.6	9.0
Import volume (percent change)	-10.4	30.2	-23.2	21.2	12.6	6.4
Current account balance, in percent of GNP	-0.7	-4.9	2.4	-0.8	-3.2	-2.0
Capital account balance (in billions of US$)	6.6	6.8	-16.3	1.3	8.0	7.9
Of which: Foreign direct investment	0.1	0.1	2.8	0.9	1.3	1.0
Foreign portfolio investment	0.2	-5.2	-4.6	-1.2	0.2	1.1
Gross official reserves, in billions of US$ 2/	24.3	23.2	19.8	27.9	28.3	29.0
In months of imports of goods and NFS	5.3	4.0	4.4	5.4	4.4	4.2
In percent of broad money	32.2	27.4	26.8	34.1	32.5	30.9
Gross total external debt, in billions US$	103.0	118.7	113.9	131.6	136.2	140.4
In percent of GNP	55.0	59.0	79.1	72.4	58.3	54.4
In percent of exports of goods and NFS	219.5	225.0	219.1	233.6	208.6	195.3
Gross short-term external debt, in billions US$ 3/	35.5	43.8	32.6	31.3	35.7	37.7
In percent of gross total external debt	34.5	36.9	28.6	23.8	26.2	26.8
In percent of gross official reserves	146.2	189.0	164.5	112.4	126.0	130.1
Debt service 4/	34.1	37.1	41.5	37.5	37.3	34.1
REER appreciation (CPI based, period average)	3.7	11.0	-18.3	9.5	...	...
REER appreciation (CPI based, end of period) 5/	5.1	15.4	-21.3	4.8	-9.9	...
Capital adequacy ratio 6/	...	17.3	15.3	26.4	...	...
State and SDIF banks	...	7.9	25.5	33.5	...	...
Private banks	...	18.3	9.0	19.7	...	...
Foreign banks	...	29.4	41.0	58.2	...	...
Nonperforming loans (in percent of total) 6/	...	9.2	29.3	17.5	...	...
Real broad money, percentage change 7/	18.9	0.8	11.2	-3.3	4.9	4.5
Real credit to the private sector, percentage change 7/	-10.7	24.5	-27.5	-19.0	9.6	4.5
Banks' net foreign asset position, in billions of US$	-2.9	-5.8	2.4	2.5	...	...
Banks' net open exchange position, in billions of US$ 8/	-2.6	-5.4	-0.1	-0.5	0.7	...
Spread on Turkish dollar Eurobonds (in basis points) 9/	550	443	718	716	667	...

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

1/ For 2003-04, program projections.

2/ As of July 17, 2003, reserves stood at US$28.9 billion (at actual exchange rates).

3/ By residual maturity.

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

5/ For 2003, as of April 2003.

6/ For 2002, CARs as of end-September 2002; NPLs as of end-October. For end-2001 Pamuk Bank is treated as a private bank, for 2002 as an SDIF bank.

7/ Deflated by the CPI.

8/ For 2003, as of March 31, 2003.

9/ For 2003, as of July 18, 2003.

TURKEY: FUND RELATIONS
(As of April 30, 2003)

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

II.	**General Resources Account:**	**Millions of SDRs**	**Percent of Quota**
	Quota	964.00	100.00
	Fund holdings of currency	17,433.97	1,808.50
	Reserve position in Fund	112.78	11.70

III.	**SDR Department:**	**Millions of SDRs**	**Percent of Allocation**
	Net cumulative allocation	112.31	100.00
	Holdings	185.39	165.07

IV.	**Outstanding Purchases and Loans:**	**Millions of SDRs**	**Percent of Quota**
	Stand-by Arrangements	16,311.62	1,692.08
	First credit tranche	271.13	28.13

V. **Latest Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved**	**Amount Drawn**
			In millions of SDRs	
Stand-By	02/04/02	12/31/04	12,821.20	10,439.80
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00
Stand-By	07/08/94	03/07/96	610.50	460.50

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

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	1,050.36	6,339.43	7,026.60	2,038.70	127.65
Charges/Interest	480.09	538.61	232.10	22.76	1.05
Total	1,530.45	6,878.04	7,258.70	2,061.46	128.70

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

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

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	256.67	1,307.03	5,964.68	6,888.02	2,038.70
Charges/Interest	483.92	637.76	528.56	230.82	22.76
Total	740.59	1,944.78	6,493.24	7,118.85	2,061.46

VII. **Safeguard Assessments**:

Under the Fund's safeguards assessment policy, the Central Bank of the Republic of Turkey (CBRT) is subject to a full safeguards assessment with respect to the SBY arrangement, which was approved on February 04, 2002 and is scheduled to expire on December 31, 2004. An off-site safeguards assessment of the CBRT was completed on February 25, 2002. The assessment concluded that high risks may exist in the financial reporting framework and the internal audit mechanism, and recommended an on-site assessment. The on-site assessment was completed on April 4, 2002. Staff's findings and recommendations are reported in Section IV of EBS/02/61.

VIII. **Exchange Rate Arrangement**:

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

IX. **Article IV Consultations**:

The 2002 Article IV staff report (EBS/02/61) was issued on April 4, 2002, and the accompanying Statistical Appendix (SM/02/16) was issued on April 8, 2002. Board discussion took place on April 15, 2002.

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

X. ROSCs

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

XI. Technical Assistance: (1993–present)

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

Department	Timing	Purpose
MAE	July 2000	Inflation targeting
STA	September 2000	Balance of payments statistics
MAE	Sept. 2000–April 2001	Banking sector reform
MAE	April 2001	Debt management
FAD/STA	May 2001	Fiscal accounting and reporting
MAE/RES	September 2001	Inflation targeting
STA	October 2001	Data Dissemination ROSC
STA	April 2002	National accounts statistics
MAE/RES	April/May 2002	Inflation targeting
STA	July 2002	Public finance statistics
FAD	July 2003	Social security

TURKEY: WORLD BANK RELATIONS

Partnership in Support of Turkey's Development Strategy

1. Turkey's vision is of a modern and secular participatory democracy, fully integrated into the European community, playing a critical role in the regional context, with an export-oriented, highly competitive production structure. The long-term development agenda is articulated in the National Development Plan (2001–23) while priorities for the new government under the leadership of Prime Minister Erdogan are spelt out in the program presented to Parliament in March 2003 which is closely linked to the Urgent Action Plan announced in January 2003. To achieve its vision, Turkey has embarked on fundamental changes in economic and social policies over the last three years while responding to a series of economic shocks and crises.

2. The key elements of Turkey's reform program have been: (i) a macro-framework designed to restore financial stability and ensure public debt sustainability—principally through a further tightening of fiscal policy with a primary surplus target of 6.5 percent; (ii) rapid restructuring of the banking sector—especially of state banks and insolvent private banks intervened by the regulatory authority (BRSA)—based on large resource transfers from the budget; (iii) an ambitious program of public sector reforms centered on deep structural fiscal reforms and institutional reforms to improve public expenditure management and public governance; (iv) a renewed privatization drive in combination with further liberalization measures (particularly in energy, telecommunications and agriculture), (v) establishment of independent regulatory bodies to improve the climate for private investment; and (vi) strengthening of social assistance to help low-income groups adversely affected by crisis and the adjustment process. Taken together, these are the most far reaching reforms since the early 1980s when Turkey opened up its economy to the world. The single-party government, which came to power following early elections in November 2002, has pledged to continue the reforms with a stronger emphasis on social policies. The Fund and World Bank teams have collaborated closely in Turkey, and standard working arrangements already broadly follow the guidelines for enhanced Bank-Fund collaboration. This has included regular participation of Bank staff in the meetings with government of the Fund's program review missions and Fund staff participation in seminars and workshops organized by the Bank. The Fund has taken the lead in macroeconomic stabilization and the World Bank in social and structural areas, with close collaboration in structural areas that have a particular impact on macroeconomic stability. The Bank's dialogue and conditionality has maintained consistency with the macroeconomic framework endorsed by the Fund.

3. The Bank's Poverty and Social Impact Analysis (PSIA) has focused on the impact of the crises on the poor; and on the impact of the privatization program on workers. This analysis has underpinned interventions to protect social spending envelopes with support from the Fund; a project to mitigate the impact of privatization on laid-off workers; the financing of high priority social projects to meet immediate needs and promote Turkey's longer-term development agenda; and improved targeting of Bank supported programs.

World Bank Country Assistance Strategy

4. The World Bank's assistance to Turkey has been guided by the Country Assistance Strategy (CAS) discussed by the Bank's Board of Directors in December 2000 and further revised as per the CAS Progress Report discussed in July 2001 which provided for additional support to Turkey following the financial crisis. Policy-based lending under the revised CAS is centered around the Programmatic Financial and Public Sector Adjustment (PFPSAL) program, which focuses on structural and institutional reforms in the banking and public sectors. A new CAS is being prepared to cover World Bank Group support to Turkey over the period FY2004–06 and is expected to be discussed by the Bank's Board in fall 2003.

5. The Bank's assistance to Turkey under the CAS has centered on five themes: (i) Reforms for Growth and Employment Creation, (ii) Improvements in Public Management and Accountability, (iii) Expansion of Social Services and Social Protection, (iv) Strengthening Disaster Mitigation and Environmental Management, and (v) Accelerating Connectivity and Technological Capabilities. A strong program of Economic and Sector Work has underpinned the Bank's financial support.

6. To promote growth and employment, the Bank has supported major banking sector reforms, helped the real sector overcome crisis, assisted market reforms and preparation for privatization in telecommunication and energy, and facilitated the transition to a modern, private sector-led agriculture sector. Analytical underpinnings for this work included financial sector mission reports, a Country Economic Memorandum on structural reform prepared in 2000, and a Corporate Sector Study prepared in 2001–02. Policy-based lending in support of improvements to the investment climate centers on the Economic Reform Loan (ERL), PFPSAL and Agriculture Reform Implementation Project (ARIP). Key outcomes have included: (i) unbundling of state monopolies, establishment of independent regulatory bodies, introduction of markets for electricity and gas, and liberalization of telecommunications, (ii) introduction of a system of direct income support (DIS) to some three million farmers to replace fiscally unsustainable indirect subsidies, (iii) passage of a new Banking Act and accompanying regulation to align Turkey with Basle and EU standards, (iv) the re-capitalization and operational restructuring of state banks, (v) closing of insolvent banks and a bank re-capitalization scheme for remaining private banks, (vi) preparation of new bankruptcy legislation, and (vii) introduction of the Istanbul approach for corporate sector restructuring that assists debt-laden firms to recover.

7. The Bank's assistance for public sector management and accountability has focused on strengthening Turkey's public expenditure management system while maintaining fiscal discipline. Key analytical inputs include the Public Expenditure and Institutional Review, Country Procurement Assessment Report (CPAR) and Country Financial Accountability Assessment (CFAA) all completed in 2001. Lending support came from the ERL and PFPSAL operations. Key outcomes have included: (i) a major parametric reform of the pension system, (ii) the development of a new public procurement framework based on the new public procurement law enacted in 2002 and the establishment of an independent

public procurement agency, (iii) development of a modern public liability management framework based on the public debt law enacted in 2002 and establishment of a "middle office" for public debt and risk management in Treasury, (iv) preparation of a new framework for budget management under the new public financial management and financial control law submitted to Parliament in 2002, and (v) reform of indirect taxes through introduction of the special consumption tax in 2002. The CPAR and CFAA also support continuing improvement in the performance of the Bank's operations in Turkey which already compare favorably to Bank-wide averages.

8. The Bank's assistance program in human development has been targeted to supporting a major expansion of basic education and social protection for the most vulnerable groups in Turkey. The reform of Basic Education has increased national enrollment by 1.3 million students with an emphasis on girls. The Bank's activities have focused on quality improvement by providing in-service training to 370,000 inspectors, teachers and school-administrators, providing educational materiel to over 22,000 rural schools and providing access to education to over 600,000 children in underserved areas. Social protection support has included provision of winter heating and food support to 400,000 poor households, provision of back-to-school support to over 1 million poor school children and financing of a conditional cash transfer scheme which will eventually support 2 million children. Under the PFPSAL program expenditure targets have been established with the Government to ensure adequate public resources for health, education and social protection as Turkey goes through the structural adjustment process. The DIS program and the targeted programs of the Social Solidarity Fund are core elements of Turkey's improved social protection system. The Bank is also providing support to workers affected by privatization including severance payments and retraining programs.

9. In the areas of disaster mitigation and natural resource management, the Bank provided critical support to victims of the Marmara earthquake in 1999, and has since helped strengthen the framework for recovery from natural disasters. Urgent cash assistance to 200,000 families was provided and 15,000 housing units were constructed. The Turkish Catastrophic Insurance Pool was launched in September 2001 and 2.4 million policies have been issued. A targeted trauma program was launched including the design and implementation of a national mental health strategy with special emphasis on emergency preparedness. The Bank's response to the 1999 earthquake was guided by the Marmara Earthquake Assessment and supported by the Emergency Earthquake Recovery Loan and the Marmara Earthquake Emergency Reconstruction Project. Bank support to Turkey on managing natural resources has led to 20,000 hectare of forest rangeland being rehabilitated, another 27,000 hectares being afforested for soil conservation purposes and 1,500 technical staff from Ministries being trained in participatory watershed management. A Bank-financed project has provided financial assistance to firms to phase out the use of ozone depleting substances.

10. The Bank has promoted connectivity and technological development through a variety of assistance activities. These have included support for the establishment of a regulatory agency for telecommunication reform and for the privatization of Turk Telecom.

The industrial property rights regime has been strengthened innovation in firms has been facilitated through the provision of matching loans for technology development. A knowledge economy assessment is underway. Bank support for the Basic Education Program has led to the provision of computers to 6,000 urban and 22,000 rural schools all over Turkey.

11. As of June 30, 2003, the portfolio of World Bank financed projects in Turkey comprised 16 active projects with total net commitments just over US$4.8 billion. In addition, the World Bank portfolio also includes two grant financed projects with net commitments of US$22.2 million. Net IBRD commitments have increased significantly since 1999 as the Bank's policy dialogue has strengthened and investment lending has expanded—particularly in agriculture and social protection—in direct support of Turkey's reform program.

12. The International Finance Corporation (IFC) has been active in the financial sector, manufacturing, oil and gas, infrastructure and health and education. As of June 30, 2003, IFC's total portfolio in Turkey was US$805 million. With a gross exposure of US$232 million as of February 2003, Turkey is an important country for MIGA. To date, the total amount of foreign direct investment facilitated by MIGA is estimated at approximately US$1 billion.

Fund-World Bank Collaboration

13. In terms of the CAS areas of focus mentioned earlier, the Fund has been actively involved in Reforms for Growth and Employment Creation and Improvements in Public Management and Accountability where the reforms have macro-economic relevance. The Fund has not been directly involved in Expansion of Social Services and Social Protection, Strengthening Disaster Mitigation and Environmental Management, and Accelerating Connectivity and Technological Capabilities.

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

15. **Areas in which the World Bank leads.** The Bank has taken the lead in most of the structural areas related to improving the investment climate where both institutions have conditionality. These areas have included bankruptcy reform, corporate sector restructuring (the Istanbul Approach), FDI promotion, regulatory and market reforms in telecommunication and energy, agriculture reform, and privatization. A key focus has been on the development of independent regulators. Another important Bank focus has been on restructuring of state owned enterprises (including, notably, Turk Telecom and electricity utilities) and privatization (including the state owned banks and public utilities). In the area of privatization, the Bank is following up on the initiatives supported by the ERL. This includes dialogue with the Government on selected case-by-case privatization strategies and technical advice. A further focal point has been work by the Foreign Investment Advisory

Service (FIAS) including an investment climate review, an administrative barriers study and a study on the establishment of an investment promotion agency (IPA). This work has supported the government's efforts to prepare a new FDI law and draft legislation to establish an IPA.

16. **Areas of shared responsibility.** The work on public sector management and governance has focused on strengthening public expenditure management system while maintaining fiscal discipline. The Fund has taken the lead in the short-term measures needed for the fiscal adjustment such as incomes policy, urgent revenue and expenditure measures, and budget monitoring and reporting. The Bank has taken the lead in assisting Government with preparation and implementation of the medium-term public expenditure management strategy including budget management reforms, rationalization of the public investment program, public procurement reform, accounting reform, and public liability management. Public employment policy, medium-term tax strategy, anti-corruption strategy and civil service reform are further areas of Bank involvement. Both Bank and Fund conditionality include recommendations that have arisen through the Bank's work in the public sector reform area. Looking forward, the Bank intends to continue its support for public sector reform with a mix of policy-based lending, financing for investments and technical advice.

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

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Ankara, July 25, 2003

Dear Mr. Köhler:

1. **Our economic program, supported by a stand-by arrangement with the Fund, is producing results.** Following the completion of the fourth review on April 18 and the end of hostilities in Iraq, market confidence has improved. Since end-March, benchmark bond rates have fallen by 15 percentage points and the Turkish lira has appreciated by 16.5 percent against a trade-weighted U.S. dollar and euro basket. This more benign environment has also been reflected in improved expectations for growth and disinflation in recent surveys, and should help in achieving our macroeconomic targets for 2003.

2. **We have achieved these successes through our strong policy implementation.** All monetary performance criteria and indicative targets for end-April and end-June have been met. The performance criterion on the consolidated government sector primary balance for end-April has also been met, but the end-June performance criterion may have been missed by a small margin. We have also made good progress in structural reform, in spite of a heavy parliamentary agenda. We met a structural performance criterion on April 9, when Parliament approved direct tax reform legislation. We have also met several structural benchmarks, by: (i) putting in place a general government and state economic enterprise (SEE) employment monitoring system; (ii) preparing an action plan to reduce banking sector intermediation costs; (iii) announcing the sale of an SDIF loan portfolio with a total face value of US$250 million; (iv) enacting a new law on FDI; (v) completing an internal CBT audit of foreign exchange management and program data as of end-2002; (vi) preparing legislation to strengthen the BRSA's effectiveness; and (vii) enacting reforms to the Execution and Bankruptcy Act.

3. **We are also taking steps to complete a number of structural reforms which have faced delays.** Although the end-June performance criterion on reductions in redundant positions in state economic enterprises (SEEs) was missed (since SEE workers delayed their decision to retire pending the outcome of the ongoing wage negotiations, which will entail higher retirement payments). We are taking steps to ensure that we are back on track toward meeting the end-September and end-December targets. There have been delays in other elements of our structural reform agenda. Accordingly, we have rephased a number of structural benchmarks, including (i) adoption of a privatization plan for Türk Telekom; (ii) passage of a second phase of direct tax reform; (iii) passage of the Public Financial Management and Control Law; (iv) passage of legislation improving state enterprise governance; and (v) improving the public sector personnel system, including establishing an ethical code of conduct for civil servants. Details are given below and are summarized in Annex A.

4. **On this basis, we request completion of the fifth review under the Stand-By Arrangement.** We request waivers for the nonobservance of the end-June performance criteria on reductions in SEE positions and the primary balance of the consolidated government sector. As prior actions for the fifth review we are: (i) taking measures to ensure that the budget will remain on course to achieve the 6.5 percent public sector primary surplus target for 2003; (ii) passing social security legislation in July. We have also approved the draft of the Public Financial Management and Control Law at a Ministerial meeting (another prior action) on July 17, taking into account Bank/Fund comments. We are also taking action to accelerate the reduction of redundant SEE positions. Finally, we are introducing a continuous performance criterion on refraining from any amnesty for public receivables.

5. **In light of the delay in completing the fifth review and the rephasing of some policy actions, we propose a number of technical revisions to the program.** First, we request that the schedule of program reviews be revised as set out in Annex B. Consistent with this revised schedule, the ceilings and floors for the quantitative performance criteria and indicative targets under the arrangement will be set for the respective test dates through December 31, 2003 as shown in Annex C. Except for the cumulative primary balance of the consolidated government, these levels correspond to the indicative targets in our April 5, 2003 Letter of Intent. As described in paragraph 9 below, for this criterion we propose a broader and more transparent definition and revised targets which remain consistent with our public sector primary surplus target of 6.5 percent of GNP.

Macroeconomic framework

6. **With external uncertainties now much reduced, we believe that through continued strong program implementation we can achieve our main macroeconomic objectives in 2003.** The short duration of the military conflict in Iraq, strong performance of industrial production and exports in the first five months, and buoyant demand for consumer durables and intermediate goods in recent months suggest that 5 percent GNP growth in 2003 is readily achievable.

Turkey: Main Macroeconomic Indicators, 2002-03

	Projection	
	2002	2003
	(In percent)	
Real GNP growth rate	7.8	5.0
CPI inflation (12-month, end-of-period)	29.7	20.0
	(In percent)	
Central government primary balance	2.4	5.0
Consolidated public sector primary balance	4.0	6.5
Net debt of public sector	80.0	69.6
Gross external debt	72.4	58.7
GNP (in quadrillions of Turkish lira)	273.5	359.4

As we expect private consumption and fixed investment to replace stock building as the main source of growth this year, fostering consumer and investor confidence with strict program implementation will be key to realizing our growth objective. Owing to prospects for stronger private demand and the effect of the Iraq war on tourism receipts, we have raised our projection of the external current account deficit to about 3 percent of GNP from the original 1.9 percent of GNP. On inflation, although exceptional food price increases earlier in the year resulted in consumer price inflation somewhat above projections, the improved outlook for oil prices, the stronger lira, and the unclosed output gap should all contribute to keeping CPI inflation within our end-year target of 20 percent.

7. **We will use prospective bilateral financing to reinforce our debt reduction strategy of lowering interest rates and lengthening debt maturities.** We expect our discussions with the United States on the terms of assistance, the grant-equivalent of US$1 billion convertible into loans of up to US$8.5 billion, to conclude shortly. The presence of these funds would further boost market confidence, allowing the Treasury to lengthen debt maturities and lower interest rates on domestic debt. As we are determined to adhere to our primary surplus targets, additional bilateral assistance will not be used to finance additional government spending.

Fiscal policy

8. **We are taking steps to keep our fiscal program on track.** We expect that the fiscal performance criteria for end-June was missed by a small margin. Delays in implementing some measures, higher-than-expected tax rebates and wage increases, shortfalls in social security contributions, and our plans for higher transfers to agriculture have opened a fiscal gap relative to our full-year public sector primary surplus target of 6.5 percent of GNP. Moreover, while gross payments under the Tax Peace Plan have exceeded expectations, the plan has led to additional tax refund claims. To preserve our fiscal target, as a **prior action** we are taking measures to close this gap, equivalent to about 0.7 percent of GNP. These measures include:

- Cuts in current, transfer, and investment spending of TL 1.2 quadrillion, while safeguarding health and education spending;

- Writing over of TL 0.5 quadrillion in special revenues to the budget, thus preventing the issuance of additional appropriations; and

- An increase in tobacco and alcohol prices yielding TL 0.25 quadrillion.

We stand ready to implement additional measures if needed to attain the 6½ percent of GNP primary surplus target.

9. **To improve transparency, we propose to modify the program definition of the primary surplus.** Annex D sets targets through end-year under the new definition, which includes both special revenues and special expenditures. The new targets are fundamentally the same as the previous ones (which excluded both), but the new definition will help outside observers to better follow our fiscal performance relative to the program. In addition, consistent with the 2002 Public Finance and Debt Management Law, data are not available. Therefore, we propose to exclude foreign-financed in-kind military spending from the

definition of the primary surplus performance criterion. Debt stock data include such spending. We will make every effort to improve the coverage of the primary surplus data. The definition will also cap the contribution to revenue of land sales at TL 500 trillion, since these transactions are akin to financing. Owing to the change in the primary surplus targets, we are also proposing corresponding changes in our indicative targets for the overall balance (Annex E).

10. **We are also taking steps to ensure that next year's primary surplus target is on a sound footing.** To offset the expiration of some one-off measures and to ensure no increase in the overall tax burden, we will need to tightly restrict expenditure growth in 2004. To this end, in our budget call for 2004, we have provided indicative ceilings which restrict overall non-interest expenditure growth to zero in real terms. In addition, pending further rationalization of the investment program, we will not introduce new investment projects, except in a limited number of cases including emergencies. These steps will help us formulate a budget consistent with next year's 6.5 percent of GNP primary surplus target in time for submission to Parliament in mid-October.

Labor market policies

11. **Our labor market policies aim at ensuring a competitive economy.** To improve the flexibility of labor markets, on May 22 Parliament passed a new Labor Law. To improve flexibility and increase job creation in the economy, the new law allows for differentiation of labor contracts by introducing provisions for part-time and temporary employment. The new law also improves workers' rights, including through requiring employers to prove that the termination of employment is based on a valid reason as set forth in the law.

Monetary policy

12. **The CBT's monetary policy will continue to focus on reaching this year's 20 percent inflation target.** Consistent with this goal, we met all monetary performance criteria and indicative targets for end-April and end-June. With our main macroeconomic targets unchanged, we are retaining the monetary targets set out at the last review. Although inflation in the opening months of this year was somewhat higher than projected, the decline in world oil prices and the strengthening of the Turkish lira have already helped bring about a marked reduction in the inflation rate. This decline has resulted in the recent decline in private expectations of future inflation. In light of these favorable developments, the CBT lowered its interest rates in April and June, and again in mid-July.

13. **We are determined to build up a strong record of program implementation before introducing inflation targeting.** With the new fiscal measures identified in this Letter of Intent, we believe that we will soon be able to demonstrate a track record of meeting our primary surplus targets, and establish a reputation for fiscal discipline. We are also directing our incomes policy towards supporting our inflation objective. While these efforts to fulfill the preconditions for inflation targeting continue, we are advancing our technical preparedness, including making further refinements to our modeling and forecasting of inflation.

14. **We remain committed to the floating exchange rate regime.** We demonstrated this commitment during the external tensions associated with the war in Iraq, when we made only modest foreign exchange lending operations, and the market soon stabilized. Following the end of the hostilities, in light of the increased supply of foreign exchange as evidenced by the reversal of currency substitution, on May 6 we reintroduced our daily foreign exchange purchase auctions, consistent with our long-stated objective of strengthening our international reserve position. We have also intervened, on a few occasions, to dampen excessive exchange rate volatility. However, such discretionary intervention will be strictly limited.

Fiscal reforms

15. **We remain committed to implementing key fiscal structural reforms in the period ahead:**

- Preparation of the second phase of **direct tax reform** is facing delay. We are still working towards a consensus on the general principles guiding the draft laws in this area (progressive reduction of benefits in free trade zones, and minimizing geographical, sectoral, and other investment incentives). We were therefore unable to meet the end-June structural benchmark to pass this legislation. Accordingly, we will complete the draft laws after a process of consultation, drawing on international practice. Preparation of the legislation will be a **prior action** for the sixth review. We intend to pass this legislation by end-November 2003 (**prior action** for the seventh review).

- While we missed the objective of eliminating 9,900 **redundant SEE positions** between end-January and end-June (structural performance criterion) by some 2,500 positions, we expect the process to gain speed as more employees seek early retirement following the completion of wage negotiations. Going forward, we will continue to rely on voluntary retirements, supplemented by implementation of the regulation adopted March 26, 2003 which lifted restrictions on retirement of public sector workers. To help ensure that the targets are met, we are intensifying our monitoring and enforcement of the reduction of redundant position at the level of individual SEEs. Our public employment monitoring system was put in place in late May (meeting a structural benchmark), and it shows that our retrenchment and attrition program has reduced state enterprise staffing by 36, 796 employees during January 2002–March 2003.

- We have finalized the draft **Public Financial Management and Control law** for submission to Parliament. Although Parliament's heavy workload has meant that it has been unable to pass this law (missing a structural benchmark for end-June), we now expect Parliament to do so by end-October (as a **prior action** for the sixth review). The law sets out a comprehensive framework for budget preparation, execution, and control. It consolidates into the central government budget, under a common classification, revolving and extra budgetary funds, annexed institutions, and all regulatory agencies, bringing the latter under parliament's oversight while preserving their financial and administrative autonomy. It also eliminates earmarking mechanisms (separate legislation to bring the existing earmarked revenues on budget will be passed this year). The bill clarifies the roles and responsibilities of the key institutions involved in fiscal management, with the Ministry of Finance responsible for the budget and for setting standards for accounting, financial control, and reporting throughout the general government. The law also expands the coverage of Turkish Court of Accounts (TCA) external audits to all of general government and brings internal audit to EU standards. Finally, as we no longer see a role for TCA in budget execution, internal audit and ex-ante control functions will shift to line ministries.

- We will also prepare new **state enterprise governance legislation**, with appropriate transparency and fiscal control arrangements. Owing in part to a legislative backlog, this legislation could not be passed by end-June as originally planned. We now expect Parliament to pass this legislation by end-2003 (accordingly, the structural benchmark for end-June 2003 has been rescheduled to end-December 2003).

- As a result of an extensive inter-agency consultation process, and in close collaboration with the World Bank, we have drafted a series of amendments to bring the **Public Procurement Law** in line with international standards. We expect these amendments to be passed by Parliament by end-July.

- Finally, we are preparing **legislation on public administration reform,** to create a more favorable legal and institutional environment for the efficient, transparent, and participatory provision of public services. As a first stage, a framework law will set out principles of governance and clarify the division of labor between central agencies and local governments. Informed by a forthcoming functional review of government, adjustments will be made in ministry laws and a new regulatory board law will be prepared to set standards and increase accountability (while preserving the financial and administrative autonomy of regulatory boards). New laws to regulate local governments will refine their budget systems, and ensure strict control of their borrowing.

16. **We are striving to upgrade our revenue collection administrations, to improve taxpayer compliance and provide a lasting solution to our arrears problem:**

- As a **prior action for the fifth review**, we expect Parliament to pass social security administrative reform legislation for Is-Kur, Bag-Kur and SSK (which was a structural benchmark for end-April). This legislation provides the legal basis for improved collection enforcement and, reflecting our commitment in the Letter of Intent of April 5, does not include any elements of amnesty of arrears. The legislation introduces a new system of penalties and interest in line with the best international practice (e.g. penalty interest at the government's borrowing cost). While the past stock of arrears remains unchanged, to ease the application of the new system those who are in arrears will be offered the opportunity to restructure. Payments will be in line with capacity to pay, as measured by gross sales or social security premia base.

- In parallel with the second phase of direct tax reform, we expect Parliament to pass legislation to reform tax administration by end-2003. The legislation will provide for reorganizing along functional lines, upgrading the status of the General Directorate of Revenues (GDR) within the Ministry of Finance, and establish clear vertical lines of accountability (to the local level) within the GDR. This, and information from the Tax Peace Plan, will help us to better target our audit program.

- To underline our commitment not to introduce any further amnesties, we are making this a **continuous structural performance criterion.** An amnesty 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.

Financial sector reform

17. **We are continuing to strengthen the banking system.** Progress is being made in resolving Yapi Kredi and Pamuk banks, and in selling the assets held by the Collection Department of the Savings Deposit Insurance Fund (SDIF). We remain committed to privatizing the state banks, and to sustaining the financial and operational independence of the Banking Regulation and Supervision Agency (BRSA).

18. **Yapi Kredi's financial position has stabilized, with the integrity of its operations preserved.** The special oversight committee created in February will soon present its first quarterly report to the BRSA and SDIF Board, and a summary of its findings will be published. The bank's financial performance has been in line with that of its peers. Its management, with the assistance of an advisory firm, is developing a restructuring plan that will facilitate the eventual divestiture of shares both held and represented by the SDIF.

19. **The SDIF is completing the resolution of the remaining three intervened banks still under its portfolio.** The sales process of Pamukbank has been extended but is in its final stages. The three potential investors have completed or are in the process of conducting due diligence with bids to be submitted by July 31. The strategy for Bayindirbank will be evaluated once the sale of Pamukbank is concluded. Voluntary liquidation of Türk Ticaret is still delayed by a court injunction in favor of the minority owner. On July 3, the BRSA revoked the license of Imar, a medium seized-bank. The BRSA took this action after uncertainties increased about the financial condition of the bank, and depositors started to withdraw their funds.

20. **The BRSA's financial and operational independence is being strengthened.** Draft legislation setting out clear grounds and time limits for legal appeal of BRSA decisions has been prepared (meeting a structural benchmark) and is being reviewed by government agencies. Amendments will be made to the Administrative Procedures Law and the Banks Act to achieve the goals outlined in our Letter of Intent of April 5, 2003. We expect Parliament to pass these laws by end-October 2003 (a structural performance criterion). The Government will also ensure the BRSA's **financial independence** by providing for direct

submission to Parliament of its budget in the new Public Financial Management and Control Law. The Government would also consider favorably requests by BRSA to ease restrictions on its spending decisions in carrying out its operations.

21. **On July 17, 2003, Parliament passed amendments to the Execution and Bankruptcy Act,** which are expected to be enacted shortly (meeting an end-May structural benchmark with delay). These amendments will enhance the effective enforcement of creditor rights. In addition, by end-November 2003 we will enact a new section of the Execution and Bankruptcy Act on pre-packaged bankruptcy that incorporates the latest comments of the World Bank and Fund staff. Regulations on the implementation of these pre-packaged bankruptcy provisions will be introduced by December 15, 2003 (**new structural benchmark**). These laws should significantly improve the regime for corporate insolvency and creditor rights in Turkey.

22. **The SDIF asset sales have commenced.** The SDIF on June 30 announced the auction of loan portfolios with face value of at least US$250 million (meeting a structural benchmark), with bids to be submitted by November 20, 2003. After this first sale, we intend to put up new portfolios of loans (except small consumer loans) for sale every four months. The sales process should benefit significantly from our recent reform of the Execution and Bankruptcy Act.

23. **The removal of the general bank guarantee has been announced.** The BRSA announced on July 3 changes in the general guarantee protecting all depositors and other creditors in banks. The guarantee will be effective until July 5, 2004, after which it will be replaced by a limited deposit protection scheme. Until then, the following two schemes will be in place: (i) the general scheme protecting all depositors and creditors in intervened banks, and (ii) a scheme fully protecting individual depositors, but not commercial deposits, in banks being liquidated directly without intervention.

24. **We are also taking necessary measures to further strengthen the regulatory and supervisory framework:**

- We will transfer **the regulation and supervision of nonbank credit institutions** from the Treasury to the BRSA effective January 1, 2004 following passage of the relevant legislation, now postponed until after the Parliamentary recess. In preparation for this transfer, the BRSA has completed a reorganization study to fully integrate supervision of nonbank credit institutions with that of banks.

- The Treasury is working on a new draft law to **regulate insurance companies** in line with applicable EU Insurance Directives. To allow this work to benefit from World Bank technical assistance, the expected date of passage has been delayed until end-2003.

- BRSA is creating a **database** which will standardize, harmonize, and speed up the collection of banking data, and produce timelier and higher quality data. This will also reduce the number of ad hoc and overlapping reporting requirements imposed on banks. With the database up and running, the BRSA expects to reduce the lag in publishing banking data from about four months currently to about one month by end-2003.

- We have introduced an **exemption from value-added tax** for: (i) sales of collaterals of loans which are transferred by banks, special finance houses and other financial institutions to asset management companies established according to the provisions of Act No 4743; (ii) sales of collaterals of loans which are restructured under the Istanbul Approach by financial institutions; and (iii) sales of assets and rights which are transferred to the SDIF according to the provisions of Banks Act. This will promote the disposal of nonperforming loans and the eventual creation of private asset management companies. The revenue impact of this measure was already built into the 2003 budget.

25. **Working with the World Bank, we continue to make progress in reforming the state banks.** We have introduced new safeguards to ensure that state banks only extend credits based on commercial principles, Ziraat has adopted plans to restructure its agricultural loans, and we are proceeding with our plans to prepare Ziraat and Halk, together with Vakif, for privatization:

- The Government will continue to **refrain from interfering in the commercial decisions of state-owned banks.** The Sworn Bank Auditors of the BRSA will complete the first of its new quarterly certifications of the State Banks in August 2003, covering the first six months of this year. Certifications thereafter will be made quarterly, and completed no later than two months after the end of each quarter.

- **Ziraat** is restructuring its nonperforming and fully provisioned agricultural loans in line with the commitments in the April 5 Letter of Intent. The legislation relating to the restructuring was adopted on June 6, and the restructuring process is proceeding as planned. The restructuring applies to such loans extended and fully utilized before January 31, 2002. Of the outstanding debt as of May 1, 2003, within 60 days of enactment of the Law, borrowers have the option of either (i) repaying 10 percent upfront and the remaining amount in three equal installments every October, or (ii) repaying the whole amount, in which case a 30 percent discount will be given. Borrowers participating in the scheme will not be eligible for new loans from Ziraat until they have paid the rescheduled amounts in full.

- A strategic study by independent consultants for the privatization of **Halk** will be completed by end-September 2003. We intend to put Halk up for sale by end-2003, with Ziraat following in 2004.

- On **Vakif,** the proposal to sell part of the bank to its pension fund proved unworkable. Alternative approaches to divesting the bank are now being considered in close consultation with the World Bank.

26. **We also intend to reduce intermediation costs to facilitate credit extension by the banking system to the real sector.** The inter-agency working committee to reduce intermediation costs has met regularly since its inception. It has already prepared and published a quantitative assessment of the intermediation cost burden. On July 15, 2003 it completed an action plan with specific initiatives for tackling such costs in the near future (meeting an end-May structural benchmark with delay). As part of this plan, the BRSA/SDIF have reduced deposit insurance premia, the BRSA has reduced the fee charged to institutions under its supervision, and the Capital Markets Board has reduced registration and listing fees. With the Ministry of Finance in the lead, and drawing on technical assistance from the Fund, the committee is now preparing more precise estimates of the economic and fiscal impact of each intermediation cost. Based on this work, by mid-October 2003, the Ministry of Finance will issue a detailed schedule of the phased implementation of the plan through end-2004 and beyond.

Enhancing the role of the private sector

27. **We have given privatization renewed impetus, making all tender announcements for the first half of 2003 as planned, although the actual sales of most of the large companies are still some time away:**

- The winning bid for PETKIM (petrochemicals) was announced on June 6 and approved by the Privatization High Council.
- In June we made tender announcements for the privatization of TEKEL (tobacco and alcohol) and TÜPRAŞ (petroleum refinery). In light of the strong interest shown by both domestic and international investors, we are confident of completing the sale of the two companies by end-2003.
- A comprehensive privatization strategy for ŞEKER (sugar) was adopted by the Privatization High Council (PHC) on June 26, 2003. It envisages putting some plants up for sale in early 2004.
- While the end-April benchmark relating to the privatization plan for Türk Telekom was missed, we have built on the Council of Ministers' principle decision of April 30, 2003 and have agreed with the World Bank on the next steps that need to be taken. We expect that the Council of Ministers will adopt the privatization plan by end-October 2003 (the structural benchmark will be moved accordingly, from end-April to end-October).
- In the electricity sector, the PHC approved the transfer of 19 distribution entities, three portfolios of multiple generation plants and 55 hydropower plants under the scope of privatization.
- Along with the work on all these larger privatizations, we have also completed the sale of a number of smaller companies. As regards privatization revenue, cash proceeds in the first half were about US$50 million, below our indicative target.

However, given the tender announcements already made, we are still confident that we will meet our US$2.1 billion end-year target.

28. **We are also moving ahead with the planned actions to promote foreign investment, improve the business climate, and address corruption.** The Foreign Direct Investment Law has been enacted, meeting a structural benchmark. Also, the new legislation establishing the Investment Promotion Agency, developed in collaboration with the World Bank, is expected to be enacted after the Parliamentary recess. After the postponement last year owing to political uncertainty, we have decided to hold the inaugural Investor Advisory Council meeting late this year or early in 2004. We are also making progress in introducing the numerous other initiatives to improve the business climate, which were detailed in the April 5 Letter of Intent. We were unable to pass legislation establishing a code of conduct for civil servants and public administrators (missing a structural benchmark for end-July), but intend to do this by year-end (revised structural benchmark).

Safeguards assessment

29. **We have further strengthened the CBT's internal control, accounting, and audit functions.** On May 15, 2003 the newly established Internal Audit Department completed the audit of foreign exchange management and program data as of end-2002, meeting a structural benchmark. With this, the CBT has completed all the actions under program conditionality in the context of the safeguards assessment, which is required for all new Fund arrangements.

Very truly yours,

/s/
Ali Babacan
Minister of State for Economic Affairs

/s/
Süreyya Serdengeçti
Governor of the Central Bank of Turkey

Turkey: Structural Conditionality

Action	Type 1/	Status
April 2003		
Parliament to pass first phase of direct tax reform into law.	PC	Met, approved April 9, 2003.
Enact legislation underpinning reforms in SSK, İş-Kur, and Bağ-Kur.	BM	Prior action for the fifth review.
Enact new Foreign Direct Investment law.	BM	Met with delay.
CoM to adopt a privatization plan for Türk Telekom (previous targets: April 2002, end-November 2002).	BM	*Reset for October 2003.*
May 2003		
Implement general government employment monitoring system.	BM	Met in late May.
Enact reforms of the Execution and Bankruptcy Act (previous target: end-January 2003).	BM	Met on July 17.
Inter-agency working committee to develop an action plan to reduce the intermediation costs of the banking sector.	BM	Met in mid-July.
Internal audit department to conduct an audit of foreign exchange management and program data as of end-2002 by May 15, 2003	BM	Met.
June 2003		
Parliament to approve second phase of direct tax reform.	BM	*Reset. Preparation of legislation will be a prior action for the Sixth Review, and passage (intended for November 2003) a prior action for the Seventh Review.*
Eliminate 9,900 redundant state enterprise positions	PC	Waiver requested.
Pass legislation improving state enterprise governance (previous target: December 2002).	BM	*Reset for end-December 2003.*
Pass Financial Management and Internal Control Law (previous target: end-March 2003).	BM	*Reset as prior action for Sixth Review.*
SDIF to announce sale of loan portfolio with face value of at least US$250 million.	BM	Met. Announcement made end-June, but technical preparations ongoing.
Prepare legislation to strengthen the BRSA's effectiveness.	BM	Met.
July 2003		
Improve the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators by end-July 2003 (previous target: end-2002).	BM	*Reset for end-December 2003.*
Prior Actions for the Fifth Review		
Authorize fiscal measures equivalent to 0.7 percent of GNP to safeguard the 6 1/2 percent of GNP primary surplus for 2003	PA	
Enact legislation underpinning reforms in SSK, Bag-Kur, and Is-Kur excluding any provision for amnesties	PA	
Approve the draft of the Public Financial Management and Control Law at a ministerial meeting on July 17, taking into account Bank/Fund comments	PA	
September 2003		
Eliminate 19,400 redundant state enterprise positions.	PC	
October 2003		
Pass legislation strengthening the BRSA's effectiveness.	PC	
December 2003		
Eliminate 25,074 redundant state enterprise positions.	PC	
Introduce regulations implementing new legislation covering pre-packaged bankruptcy provision (December 15).	BM	
Continuous		
No new amnesties of arrears on public sector receivables.	PC	

1/ PA=prior action, PC=structural performance criterion, and BM=structural benchmark.
Italics denotes conditionality that is either new or is being rephased at the Fifth Review.

Turkey: Revised Performance Criteria Test Dates and Review Schedule, 2003-04

Review	Purchase (SDR millions)	4th Review Schedule		Proposed Revised Schedule		
		PC Test Dates: Debt, NIR, Base Money, and Primary Surplus of the CGS	Earliest Possible Purchase Date	PC Test Dates: Primary Surplus of the CGS, External Debt	PC Test Dates: NIR, Base Money	Earliest Possible Purchase Date
Actual Purchases	10,439.8					
5th Review 1/	340.2	April 30, 2003	June 15, 2003	June 30, 2003	June 30, 2003	...
6th Review	340.2	June 30, 2003	August 15, 2003	August 31, 2003	September 30, 2003	October 20, 2003
7th Review	340.2	September 30, 2003	November 5, 2003	October 31, 2003	December 31, 2003	January 15, 2004
8th Review	340.2	December 31, 2003	February 5, 2004	December 31, 2003	March 31, 2004	April 15, 2004
9th Review	340.2	March 31, 2004	May 5, 2004	April 30, 2004	June 30, 2004	July 15, 2004
10th Review	340.2	June 30, 2004	August 5, 2004	July 31, 2004	September 30, 2004	October 15, 2004
11th Review	340.2	September 30, 2004	November 5, 2004	October 31, 2004	November 30, 2004	December 15, 2004
Total purchases	12,821.2					

1/ Owing to deferred completion of this review the controlling test dates shift from April 30 to June 30.

Turkey: Quantitative Performance Criteria and Indicative Targets for 2003

	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome
I. Quantitative performance criteria	April 30, 2003		June 30, 2003				August 31, 2003		October 31, 2003		December 31, 2003 1/	
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)	6,600	7,056	11,000				18,180		21,490		22,900	
2. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$) 2/	6,200	2,015	8,500				11,000		13,000		15,000	
3. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$) 3/	1,000	0	1,000				1,000		1,000		1,000	
	April 30, 2003		June 30, 2003				September 30, 2003		December 31, 2003			
4. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	-6.5	-6.0	-7.0	-3.9			-6.0		-6.0			
5. Ceiling on base money (in quadrillions of Turkish lira)	12.8	11.9	13.2	13.0			14.1		14.3			
II. Indicative targets	May 31, 2003		September 30, 2003				November 30, 2003					
1. Floor on the cumulative primary balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)	9,500	9,540	20,580				24,190					
	April 30, 2003		June 30, 2003		August 30, 2003		September 30, 2003		October 31, 2003		December 31, 2003	
2. Floor on the cumulative overall balance of the consolidated government sector since January 1, 2003 (in trillions of Turkish lira)	-13,840	-15,173	-22,300		-24,190		...		-36,270		-36,320	
3. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in quadrillions of Turkish lira)	32.8	31.0	34.1	29.4	...		33.8		...		34.2	
	March 31, 2003		June 30, 2003				September 30, 2003		December 31, 2003			
4. Privatization proceeds cumulative from January 1, 2003 (in millions of US$)	30	23	90	50			790		2,100			

1/ The December 31, 2003 ceilings and floors for the cumulative primary balance and the contracting of external debt performance criteria are only applicable for purchases after February 14, 2004. Therefore, the October 31, 2003 performance criteria would be applicable for the scheduled January 15, 2004 purchase.

2/ Applies to nonconcessional external debt with an original maturity of more than one year from end-December 2002. Excludes purchases from the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank and sales of treasury bills and bonds denominated in TL or Fx to nonresidents in either the domestic primary or secondary markets.

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

PRIMARY BALANCE OF THE CONSOLIDATED GOVERNMENT SECTOR

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

	Floor (In trillions of Turkish lira)
Cumulative primary balance from January 1, 2003, to:	
August, 31 2003	18,180
September, 30 2003	20,580
October 31, 2003	21,490
November 30, 2003	24,190
December, 31 2003	22,900

1. The primary balance of the *consolidated government sector* (COGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the 3 extra budgetary funds (EBFs) identified below, the 12 state economic enterprises (SEEs) identified below, the social security institutions (SSIs), and the unemployment insurance fund. The floors on the primary balance of the COGS will be monitored:

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

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

3. For the purposes of the program, primary expenditure of the COGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. It will also exclude severance payments made to retire or retrench redundant public workers

in state enterprises, net of projected wage savings during 2003 from this retrenchment, up to a cap of TL 500 trillion (above which they would count towards the target). Projected wage savings are defined as the employees' salary and bonuses for the remainder of the year less the pension to be received (from the point of retrenchment). Redundant workers are defined by company by the exercise completed in May 2002, and total 45,792 for all companies.

4. Net lending of any component of the COGS will be considered as a no interest expenditure item. Payment of guaranteed debt by treasury on behalf of non-COGS components of the public sector will not be treated as net lending up to the baseline reported in Annex E.

Extra budgetary funds

5. The three EBFs included in the definition of the performance criterion for 2003 are: the defense fund, the privatization fund, and the social aid fund. The balance of the promotion fund—which does not have the legal authority to borrow, and will not be given such authority during the duration of the stand-by arrangement—is excluded from the definition of the performance criterion.

State economic enterprises

6. The 12 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal company), TSFAS (sugar company), TMO (soil products office), TEKEL (tobacco and alcoholic beverages company), TCDD (state railways), Telekom (telecommunications), BOTAS (natural gas), TEDAS (electricity distribution), EUAS (electricity generation), TETTAS (electricity trade), TEIAS (electricity transmission), and TPAO (petroleum exploration and extraction).

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

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, 2002 the stock of external loans stood at TL 11,200 trillion, valued at the exchange rates on that day.

Social security institutions

10. The deficits of the social security institutions (SSIs) will be covered by transfers from the central government budget, and they are thus expected to be in primary balance in 2003.

Adjusters

11. The floor on the primary surplus of the COGS 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 60 days (from the date of invoice receipt); and (iii) other payments overdue by more than 30 days (from the date of invoice receipt). In the case of Bag Kur they exclude arrears to the common retirement fund. The stock of arrears for Bag Kur stood at TL 296 trillion; for SSK stood at TL 314 trillion; and for ES stood at TL 0 trillion on December 31, 2002.

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

- for any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;
- for any overdue Direct Income Support as of December 31, 2003 (payments due during 2003 are programmed as TL 2,310 trillion);
- for any off-balance sheet expenditure of any component of the COGS (excluding military foreign financed in-kind spending).

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

OVERALL BALANCE OF THE CONSOLIDATED GOVERNMENT SECTOR

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

	Floor (In trillions of TL)
Cumulative overall balance from January 1, 2003 to:	
August 31, 2003	-24,190
October 30, 2003	-27,000
December 31, 2003	-36,320

14. The overall balance of the consolidated government sector (COGS), Table 1, comprises the primary balance of the COGS as defined in Annex D, the net interest payments of the COGS and profit transfers from the CBT to the consolidated central government.

15. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of Annex D. Revenues of the COGS will be as defined in paragraph 2 of Annex D; i.e., excluding privatization proceeds.

16. All definitions and adjusters specified in Annex D to apply to the primary balance of the COGS will also apply to the overall balance of the COGS. In particular, the overall balance will be adjusted for the overall balance of any new government funds and institutions established after January 1, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Ankara, July 25, 2003

Dear Mr. Köhler:

The Fund's support has been critical in helping to stabilize the Turkish economy and restore strong economic growth. We are pleased to report that we have now completed the discussions for the fifth review of the Fund supported program. We remain fully committed to implementing the program as we move forward.

In the context of the fifth review discussions, we have also made an assessment of our overall external position, and our level of international reserves. In this regard, we would like to request that for the period January 2004 to end-December 2005 repurchases due on the expectations schedule on Fund credits drawn since February 2002 be extended to the obligations schedule.

Should developments be more favorable than currently expected, we would advance these repurchases. To smooth the profile of repayments to the Fund we will continue to make repurchases on Fund credits drawn before February 2002 at expectation, as indeed has been the case to date. We also appreciate that we have the option to request an extension of payments falling due in 2006 at a later date.

We would be most grateful for your support in presenting this request to the Fund's Executive Board.

With warm personal regards,

Sincerely yours,

/s/
Ali Babaçan
Minister of State for Economic Affairs

/s/
Süreyya Serdengeçti
Governor of the Central Bank of Turkey

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/135
FOR IMMEDIATE RELEASE
August 1, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fifth Review of Turkey's Stand-By Arrangement, Approves Request for Extension of Repurchase Expectations

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of Turkey's economic performance under its Stand-By Arrangement. Completion of the review enables Turkey to draw SDR 340.2 million (about US$476 million) immediately under the arrangement.

The Executive Board also approved a one-year extension to the obligation dates of time-based repurchase expectations for the period 2004 and 2005 in an aggregate amount equivalent to SDR 8.2 billion (about US$11 billion).

Turkey's Stand-By Arrangement was approved on February 4, 2002 (see Press Release No. 02/7) in a total amount of SDR 12.8 billion (about US$18 billion). So far, Turkey has drawn SDR 10.4 billion (about US$15 billion) under the arrangement.

Following the Executive Board discussion, Horst Köhler, Managing Director and Chairman, said:

"The Turkish authorities have made strong and welcome efforts in recent weeks to implement their program of stabilization and economic reform. These include the measures put in place to safeguard the primary surplus target of 6½ percent of GNP, the enactment of legislation to underpin social security reform while excluding amnesties, and the progress made on the program's structural reform agenda. These actions bring policies back on track to achieve the basic objectives of the Fund-supported program, namely, disinflation, debt reduction, and sustained economic growth.

"Economic conditions have improved following the rapid conclusion of the war in Iraq. Progress on European Union-related legislation is also welcome; this has undoubtedly contributed to improved market sentiment. With strong output recovery and continued disinflation so far this year, the program's projections of 5 percent output growth and 20 percent inflation in 2003 are within reach. However, real interest rates remain high reflecting underlying fragilities.

"Completion of the review provides a valuable opportunity for the Turkish authorities to demonstrate full program ownership, and continue with consistent and steadfast program implementation. Key in this regard would be the maintenance of fiscal discipline to safeguard the 6½ percent of GNP primary surplus target, not only for this year but also in 2004.

"The Central Bank of Turkey (CBT) is to be commended on its skillful conduct of monetary policy. The CBT has successfully managed to increase confidence in its inflation objective, cut interest rates and accumulate reserves. The diligence shown by the Banking Regulation and Supervision Agency (BRSA) in its supervision of banks is welcome, as are other banking sector reforms. The authorities need to build on this progress by further improving bankruptcy procedures, privatizing state banks, and resolving the intervened banks. To enhance policy credibility, the authorities need to strengthen the operational and financial independence of regulatory agencies, including the BRSA.

"In line with Fund policy, the Fund's Executive Board supported moving part of Turkey's repayments from 2004-05 to 2005-06 to strengthen debt management and thereby contribute to the success of the authorities' reform program.

"Continued strong policy actions will allow Turkey to achieve its macroeconomic targets and maintain a viable debt position in the medium term. The Government's recent actions bode well for the success of the Fund-supported program. On this basis, Turkey's efforts deserve the continued support of the international community," Mr. Köhler stated.

INTERNATIONAL MONETARY FUND

TURKEY

Fifth Review Under the Stand-By Arrangement, Request for Waiver of Performance Criteria, and Extension of Repurchases Supplementary Information

Prepared by European I Department

(In consultation with other departments)

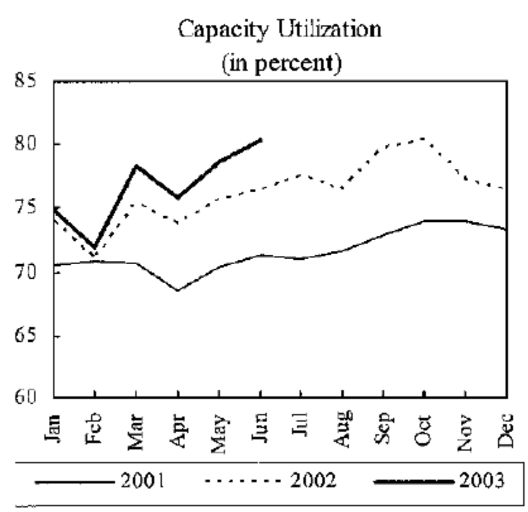
Approved by Michael Deppler and Mark Allen

July 30, 2003

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

Economic and Market Developments

1. **Market expectations are converging toward the program's 2003 inflation and growth targets.** Two surveys released in the past week—the CBT's bi-monthly survey of domestic analysts and the consensus forecast of domestic and foreign analysts—show that market expectations about the 2003 outturn are converging towards program targets. While the market still expects end-2003 inflation to exceed the 20 percent target, expected inflation has fallen steadily since April. In the same vein, growth forecasts have risen over the last several months, with the CBT's survey now showing expected growth at the program projection of 5 percent. Strong growth is supported by the recently released figure for June capacity utilization, which exceeded market expectations and marks the highest level since October 2002.



Macroeconomic Projections for 2003

		July 2003	
	Staff baseline	CBT survey	Consensus forecast
Growth	5.0	5.0	4.6
Inflation (end-year CPI)	20.0	23.7	23.0
Current account deficit (US$ billion)	7.5	6.5	6.3

2. **There has been little change in financial markets over the past week.** The lira has remained relatively stable at just over TL 1,400 thousand per dollar, and the benchmark bond rate remains at just below 50 percent. The yield curve has also been stable since mid-July. Standard and Poor's upgraded Turkish debt, citing "the progress that the new government has made under its IMF-supported program, albeit with delays". The rating agency also held out prospect of a further upgrade if the government perseveres with fiscal adjustment through the upcoming local elections.

Financial sector update

3. **Following the decision to liquidate Imar bank in early July, the BRSA has uncovered potentially serious wrongdoings in the bank, and has intervened a second bank controlled by the same group.** The BRSA has discovered that Imar bank had unregistered deposits several times its official deposit base of close to TL 1 quadrillion. However, the BRSA also believes that a large part of the unregistered deposits is likely fraudulent. Legitimate individual depositors would be eligible to benefit from the blanket guarantee on bank liabilities. The staff has been in close contact with the authorities on the resolution of this problem. It has emphasized the importance of honoring the guarantee and acting promptly to address the problem. The direct fiscal impact of dealing with this problem is likely to be small in 2003; and the authorities have re-confirmed their intention to take whatever corrective action needed to keep the program on track. In line with standard regulatory practices, on July 25, the BRSA also replaced the board and management of Adabank, another bank controlled by the same group.[1]

[1] The banks are owned by the Uzan family's conglomerate. This group won the privatization bid for PETKIM (petrochemicals) in June, and has until August 6 to make the first payment and finalize the contract. Given that the government has earlier taken over the group's electricity generation and distribution assets, which were Imar bank's main earning assets, and now Adabank, the group may not have the financial resources needed to finalize the PETKIM purchase.

Progress on prior actions

The authorities have completed all the prior actions for Board consideration of the Fifth Review:

4. **The authorities have implemented fiscal measures equivalent to 0.7 percent of GNP to safeguard the 6½ percent of GNP primary surplus for 2003 (prior action, ¶ 8)**[2]:

- On July 25, the Ministry of Finance issued a circular (N 310) cutting TL 1.2 quadrillion (about 0.4 percent of GNP) of spending by making permanent part of the spending freeze that had been put in place earlier in the year. The staff have suggested to the authorities to identify clearly the projects and programs to be cut, with a view also to protect health and education spending.

- On July 21, the state owned tobacco an alcohol company (TEKEL) increased the prices of tobacco and alcohol products. These increases will provide additional revenue of some TL 250 trillion (about 0.1 percent of GNP) for the rest of the year.

- On July 24, the authorities confirmed in writing that TL 480 trillion of special revenues had been written over to the budget (this amounts to cutting off-budget spending by an equal amount). Instructions have also been given for another TL 100 trillion to be transferred to the budget by September, in line with earlier understanding with the staff (bringing the total impact of this measure to about 0.2 percent of GNP).

- In addition, on July 17, the Council of Ministers had revalued some specific excises by 60 percent. The final decision was printed in the official gazette on July 22. This is expected to increase revenues by TL 210 trillion (under 0.1 percent of GNP) for the remainder of the year.

5. **Although not formally a prior action, the authorities have also passed new legislation to ensure that the additional motor vehicle tax, introduced at the time of the Fourth Review, can be collected fully.** On July 23, the Constitutional Court had declared this tax unconstitutional, since it only applied to those who had purchased cars prior to April 11, 2003. Revised legislation, applying to all car owners, was passed by parliament on July 29, thereby securing the TL 1.1 quadrillion (0.3 percent of GNP) expected to be collected from this source in 2003. (Because it is so recent, this issue is not covered in the Letter of Intent.)

6. **The three social security reform legislations have been passed by parliament, without any amnesty provision (prior action, ¶ 16).**[3] The final legislations are in line with

[2] ¶ refers to the relevant paragraphs of the Letter of Intent.

the understandings reached with the staff.[4] The laws reform collections administration, and enable the restructuring of arrears in line with international best practice and without another amnesty. The staff will be working closely with the authorities on the implementing regulations that will be put in place over the next month.

7. **Finally, the authorities had completed on July 17 the prior action on Public Financial Management and Control law (¶ 4).** Since then, the staff has received written confirmation that the ministerial agreement on the content of the new draft is in line with the description in the main staff report. The staff will review the final draft version ahead of its submission to parliament (Parliamentary approval of this law is a prior action for the next program review.)

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[3] The SSK legislation was formally approved by parliament on July 29 (less than five days before the scheduled Board meeting) but all individual articles of the law had been approved on July 25, enabling the staff to assess its content. The Bag-kur legislation was approved on July 24, and the Is-Kur law was passed in early July.

[4] The only exeption is the staff's recommendation on introduction of a graduated penalty system. Instead, the authorities opted for introducing a single penalty.