July 2002
IMF Country Report No. 02/136

Turkey: Request for Stand-By Arrangement—Staff Report; Staff Supplement and Staff Statement; and Press Release on the Executive Board Discussion

In the context of the Request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **December 17, 2001**, 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 January 18, 2002.** 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 January 25, 2002 and a staff statement of February 2, 2002, updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its April 15, 2002 discussion** of the staff report that completed the review.

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

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

*May also be included in Staff Report

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

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

TURKEY

Request for Stand-By Arrangement

Prepared by European I Department in Consultation with Other Departments

Approved by Susan Schadler and Liam P. Ebrill

January 18, 2002

- Discussions for the new Stand-By Arrangement (SBA) with Turkey were held in Ankara during December 3–17. The staff team comprised Messrs. Kähkönen (head), Aitken, Griffiths, and Rossi (all EU1), Mr. Flanagan (FAD), Mr. Thorne (ICM), Messrs. Lindgren and Josefsson, and Ms. Gutierrez (all MAE), Mr. McGettigan (PDR), and Ms. Danklou (staff assistant, EU1). Mr. Brekk, senior resident representative, and Mr. Piñerúa, MAE resident representative, assisted the mission, and the mission cooperated closely with World Bank staff on structural issues. Mr. Kiekens, Executive Director for Turkey and Mr. Çakir, Advisor to Mr. Kiekens, attended several meetings.

- The mission met with the Prime Minister, Mr. Ecevit; Deputy Prime Ministers Yilmaz and Özkan; the State Minister for Economic Affairs, Mr. Derviş; the State Minister for Foreign Trade, Mr. Toskay; the State Minister for Labor Relations, Mr. Keçeciler; the Minister of Finance, Mr. Oral; the Minister for Privatization, Mr. Karakoyünlu; the Minister for Transportation, Mr. Vural; the Minister for Agriculture, Mr. Gökalp; The Minister of Justice, Mr. Türk; the Undersecretary of the Treasury, Mr. Öztrak; the Governor of the Central Bank of Turkey, Mr. Serdengeçti; the Chairman of the Bank Regulation and Supervision Agency, Mr. Akçakoca; and other senior officials; as well as representatives of the private banking and business communities.

- The Turkish authorities intend to allow the publication of the staff report.

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I. Introduction

1. **In the attached letter, the Turkish authorities request the cancellation of the existing SBA and the approval of a new SBA in support of their program for 2002–04.** The Fund has supported Turkey's economic program under an SBA covering 2000–02, with total committed resources of SDR 15.0384 billion (1,560 percent of quota, or US$19.4 billion). The Executive Board has approved the completion of ten reviews under the arrangement, with purchases totaling about SDR 11.7 billion, or US$14.9 billion (Appendix I). The requested access under the new SBA is for SDR 12.8212 billion (1,330 percent of quota, or US$16.3 billion), which includes the remaining resources of about SDR 3.3 billion available under the current SBA and facilitates early repurchase of outstanding resources of about SDR 4.9 billion under the Supplemental Reserve Facility (Table 1). With these early repurchases, in an amount equivalent to about US$6.3 billion, net Fund support under the new program would amount to about US$10 billion. Access is requested under the exceptional circumstances clause. The World Bank supports Turkey under a Country Assistance Strategy envisaging lending of up to US$6.2 billion during FY2001–03 (Appendix II). The close collaboration between the Bank and Fund staffs has continued during the preparation of the new program.

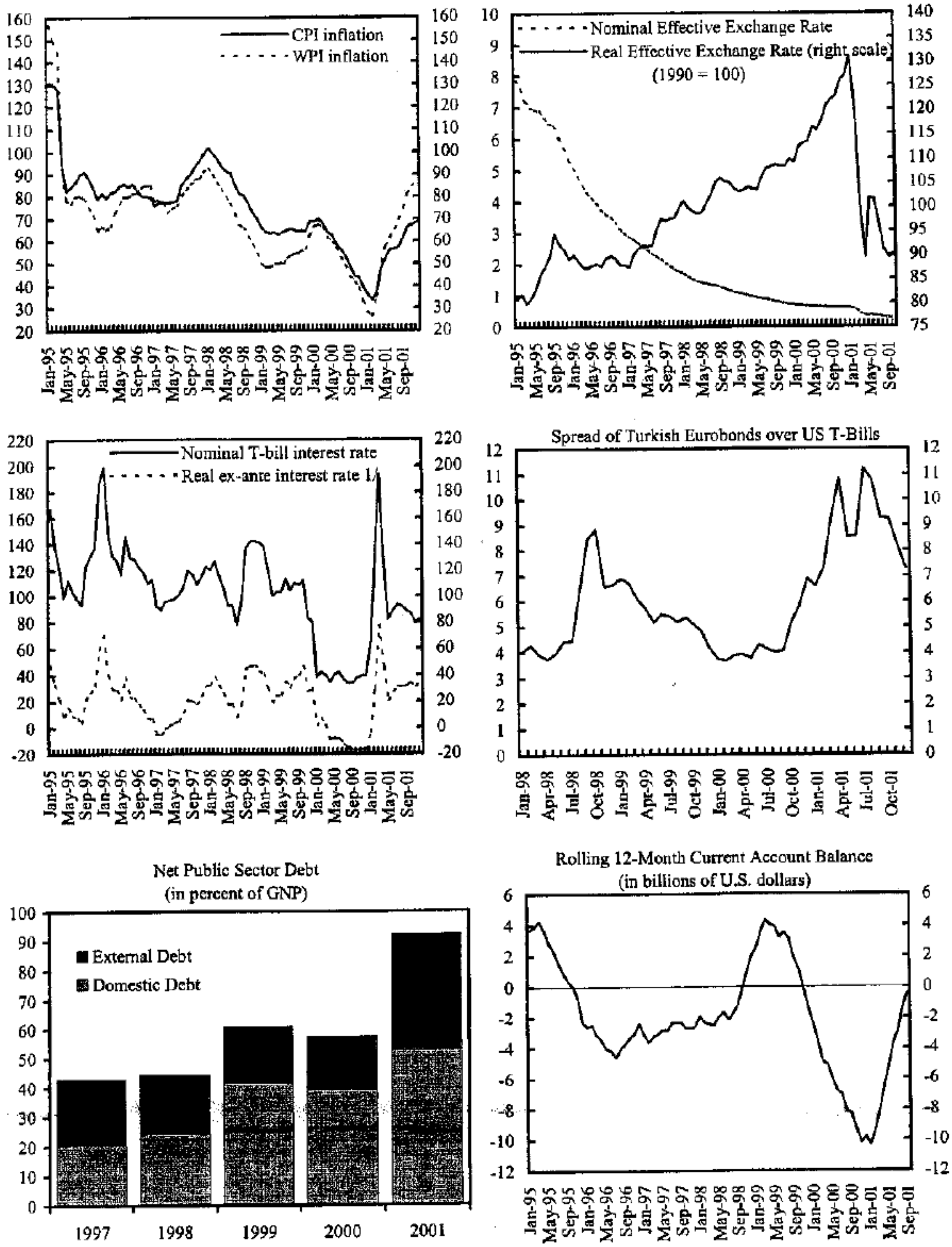
II. Background

2. **Under the existing SBA, Turkey set out to bring its deteriorating public sector debt dynamics and high inflation under control** (Figure 1). During the 1990s, large fiscal deficits led to average annual inflation of almost 80 percent, high real interest rates (averaging 25 percent in the second half of the decade), and stunted growth.[1] The 2000 program instituted strong fiscal adjustment and a preannounced exchange rate crawl to break inflation expectations. It also included a wide-ranging structural reform agenda, especially in banking, social security, privatization, and agriculture.

3. **Despite notable achievements, after only 14 months under the program Turkey had experienced two major economic crises.** In the first year of the program, the authorities implemented an array of structural reforms, raised the primary balance of the public sector by almost 5 percent of GNP, and lowered 12-month inflation to below 40 percent (Table 2). However, against the background of a widening current account deficit and a fragile banking system, in November 2000 a liquidity crisis affecting a few domestic banks turned into a full-blown crisis, with a massive loss of reserves. Despite agreement on an augmented program in December, the first crisis had badly shaken confidence, and strong and sustained policy performance was essential, particularly since both the exchange rate peg and the government

[1] At the time the 2000 program was prepared, the staff estimated that had inflation been in single digits, annual per capita growth could have been 1–1½ percentage points higher in Turkey than the 1.7 percent realized in the 1990s.

Figure 1. Turkey: Economic Developments, 1995-2001
(in percent, unless otherwise indicated)



Sources: State Institute of Statistics; Central Bank of Turkey; Bloomberg; and *Information Notice System.*

1/ Average monthly nominal interest rate divided by 12-month ahead CPI inflation.

debt position remained vulnerable. In the end, resistance to structural reform and political uncertainties culminating in a public dispute between the Prime Minister and the President prompted a further speculative attack, forcing the government to float the currency on February 22, 2001 amidst sky-high interest rates.

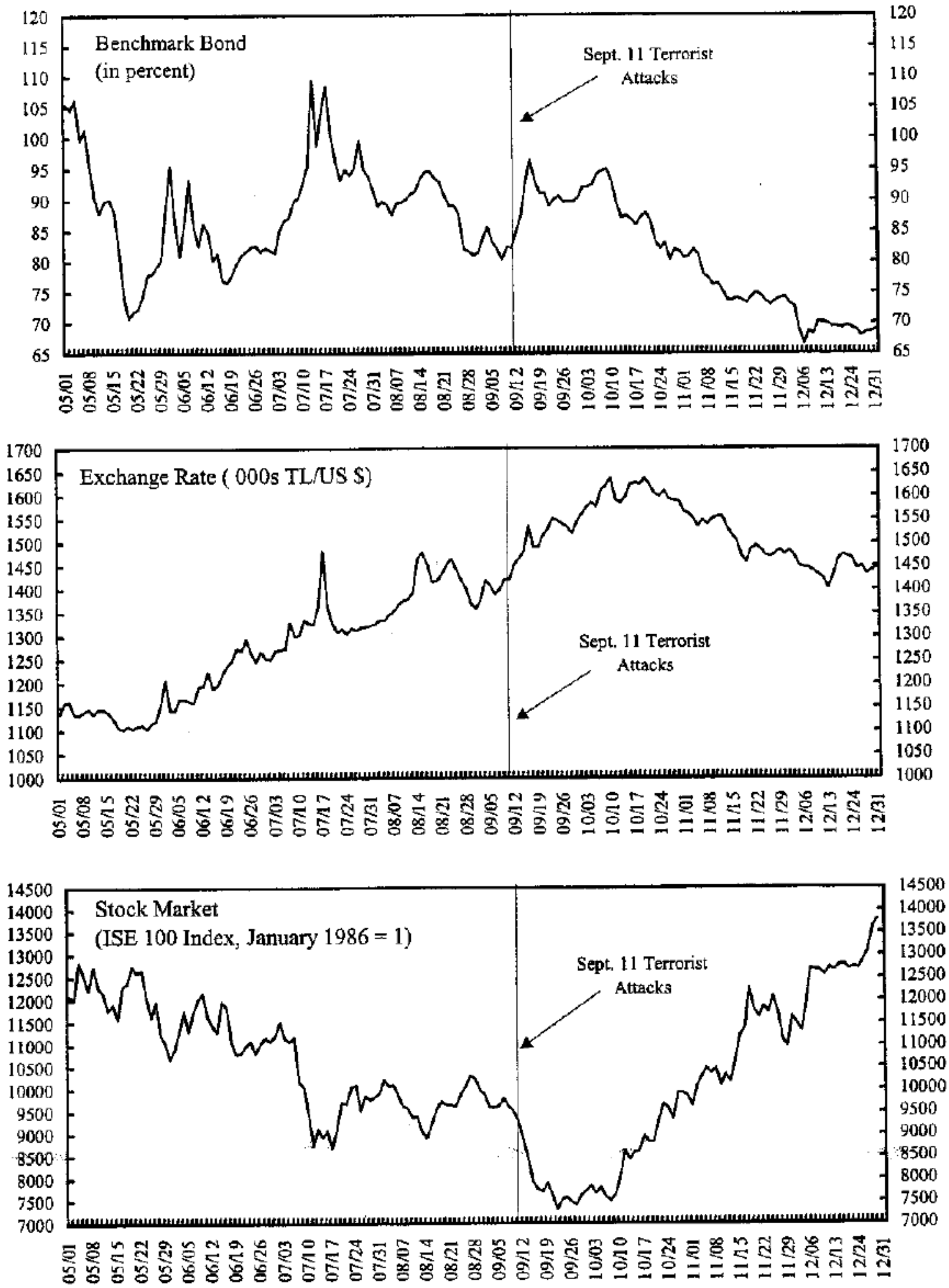
4. **The strengthened program adopted in May 2001 aimed at restoring investor confidence and lowering interest rates by addressing the roots of the crises, with the help of additional external support.** The authorities' revised program featured a fundamental restructuring of the banking sector—a key source of vulnerability in the past—through operational and financial restructuring of public banks, and strengthened regulation and supervision of private banks. The program also pursued continued disinflation under a floating exchange rate regime (reducing vulnerability to shocks), further massive fiscal adjustment to help bring about debt sustainability, and an enhanced role for the private sector in the economy, including through reforms to facilitate privatization and a voluntary agreement by foreign banks to maintain exposure to Turkey. The Fund supported this program by another augmentation of its resources to Turkey.

5. **After some initial delays, the revised program was beginning to show results, when the events of September 11 intervened.** Despite generally strong implementation of the program—all performance criteria were met, and much progress was made in structural reform, especially on the legislative front (Table 3 and Appendix III)—it was only in mid-August that interest rates started to decline and the currency stabilized (Figure 2). However, September 11 hit Turkey with a large exogenous shock, with the country's location and high indebtedness suggesting that it might be harder hit than most countries.

6. **September 11 exposed Turkey's continued vulnerabilities to external events and highlighted its deep-rooted problems.** The September 11 shock is affecting the Turkish economy through lower export demand, loss of tourism receipts, reduced access to international financial markets, and weaker privatization and FDI prospects. These losses in foreign exchange strained domestic financial markets in September–October and led to large increases in domestic interest rates, the opposite of what was sought under the program. At the time of the tenth program review in November 2001, Turkey was estimated to face an external financing gap of US$10 billion for 2002, with gaps of US$1 billion in each of the following two years. At the same time, the two crises have taken their toll on the real economy, leading Turkey into its deepest recession in more than 50 years. Turkey also continues to face deep-rooted macroeconomic and structural problems, including a heavy public debt burden, entrenched high inflation, banking sector difficulties, and pervasive state involvement in the economy. **Although the May program addressed many of these problems, an intensified medium-term approach is now needed, supported by additional external financing, if Turkey is to fulfill its growth potential with disinflation and falling debt ratios.**

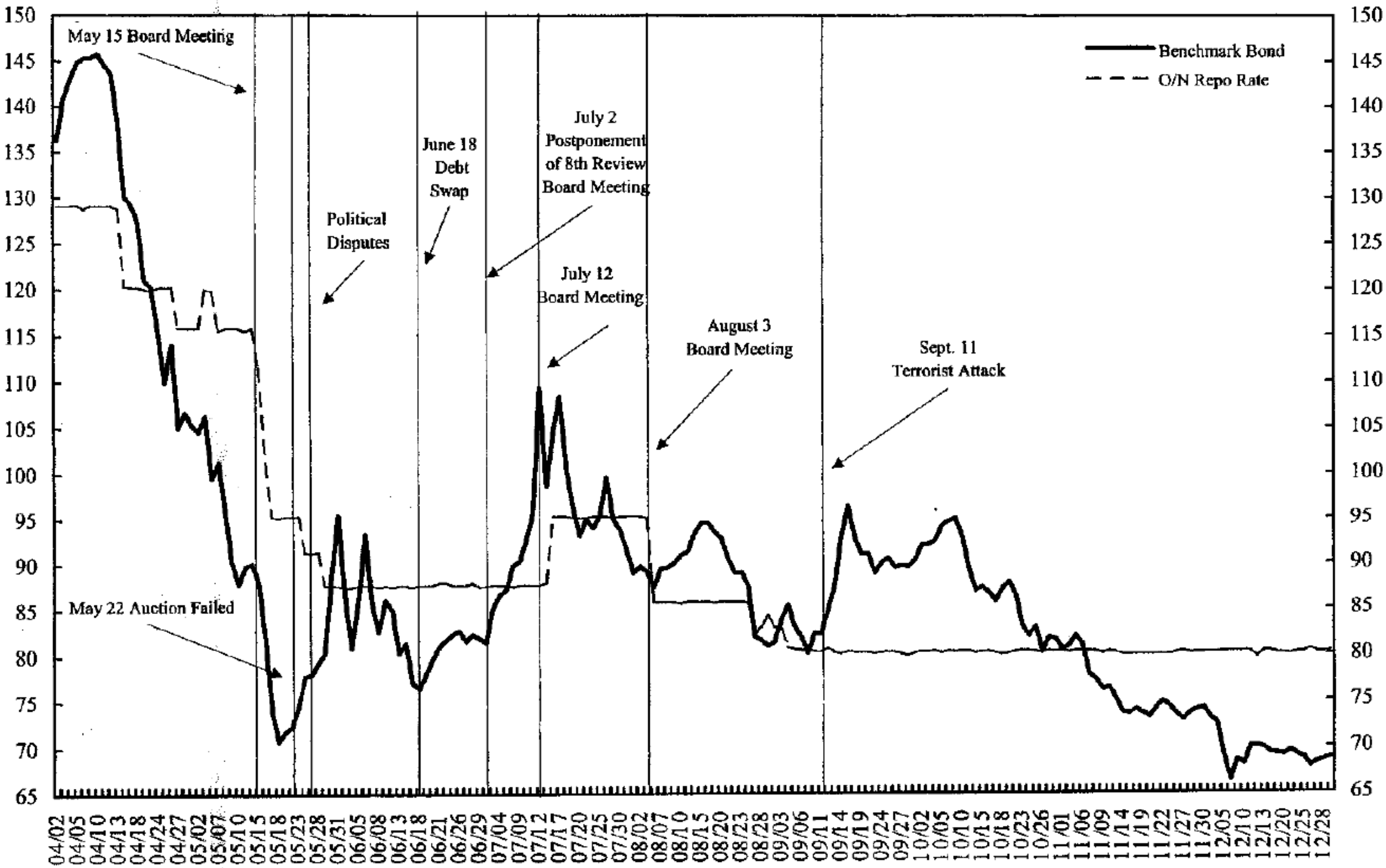
7. **The prospect of additional external financing in the context of a strengthened program has helped to improve market sentiment** (Figures 3–6). Although financial

Figure 2. Turkey: Market Developments, 2001



Source: Data from the Turkish authorities.

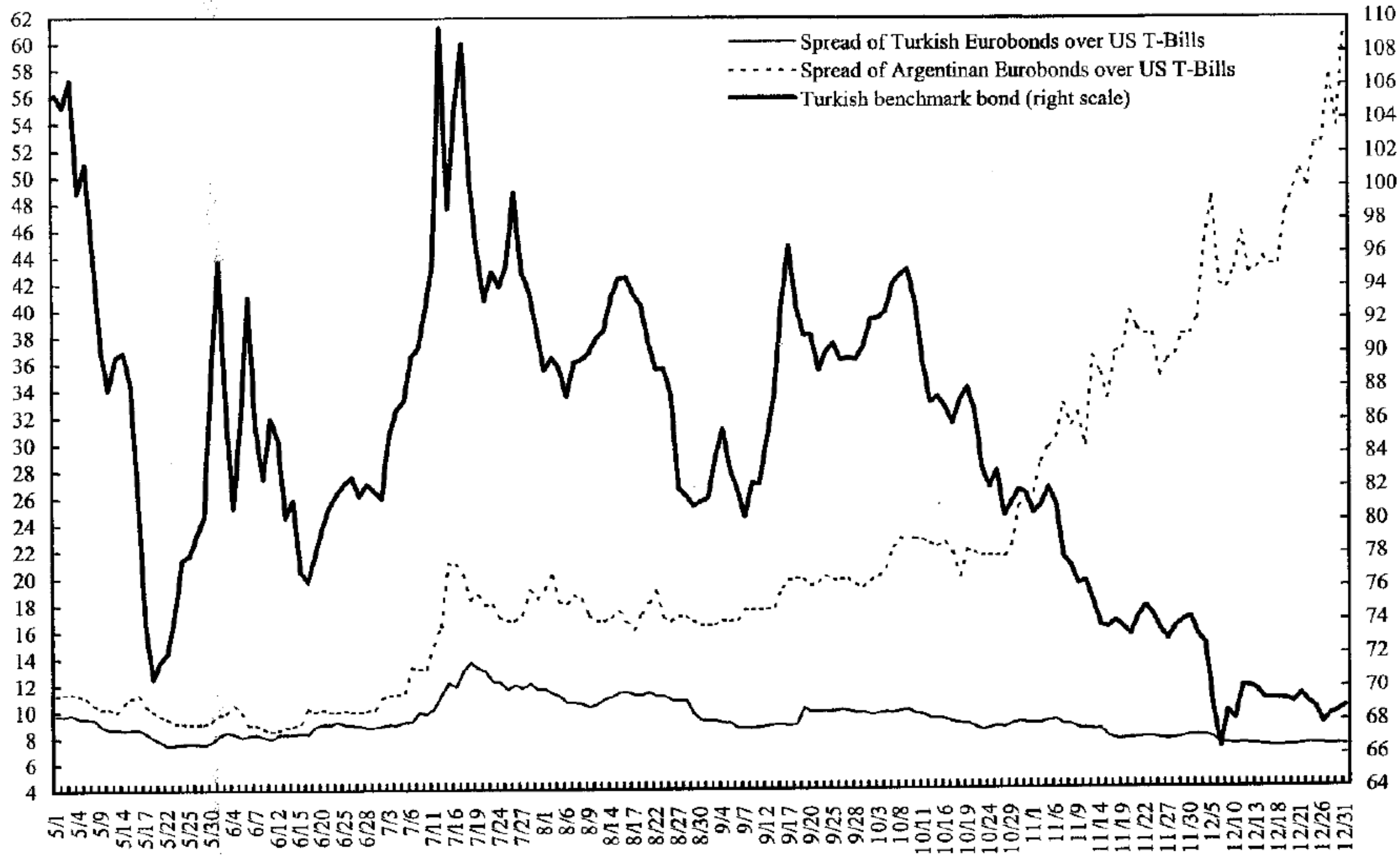
Figure 3. Turkey: Interest Rates, 2001 1/



Source: Data provided by the authorities.

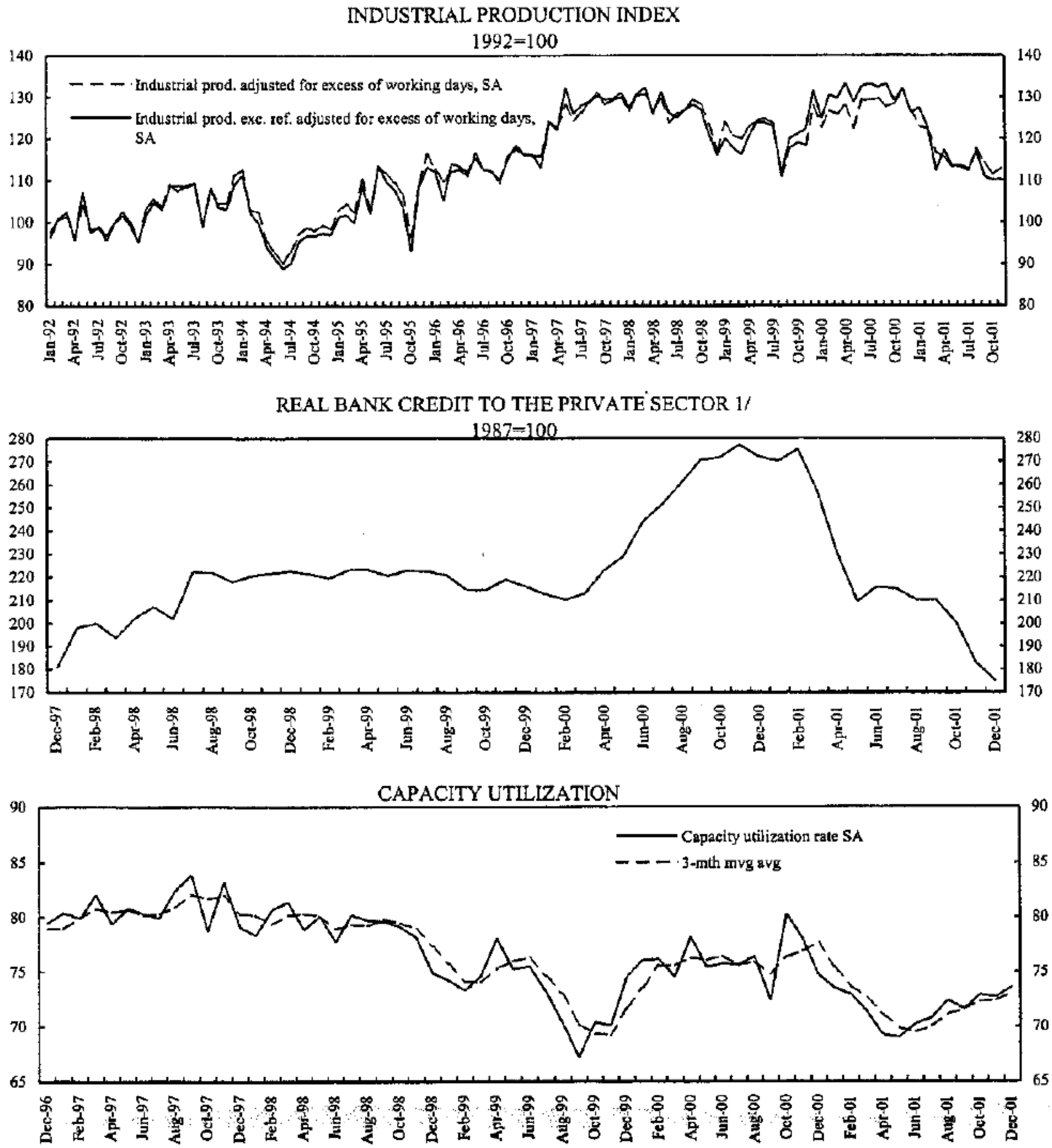
1/ Compounded interest rates.

Figure 4. Turkey: Bond Spreads, 2001
(Percentage Points)



Source: Data provided by the authorities; and Bloomberg.

Figure 5. Turkey: Output and Demand, 1992-2001

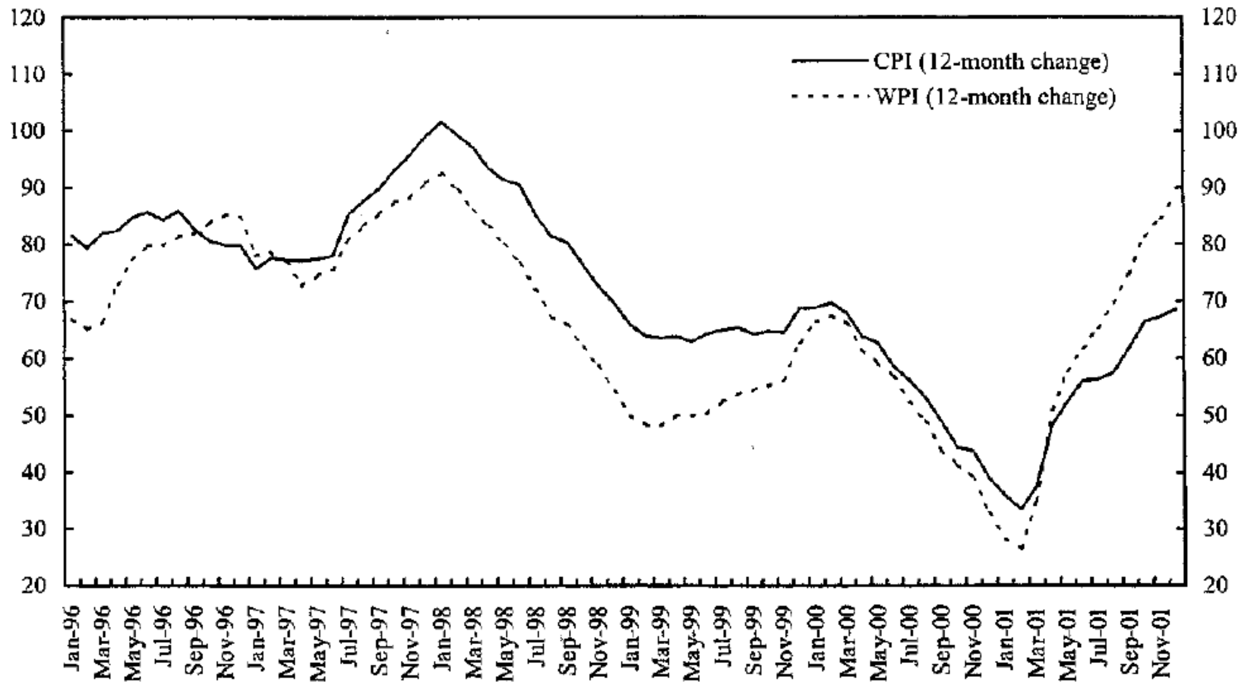


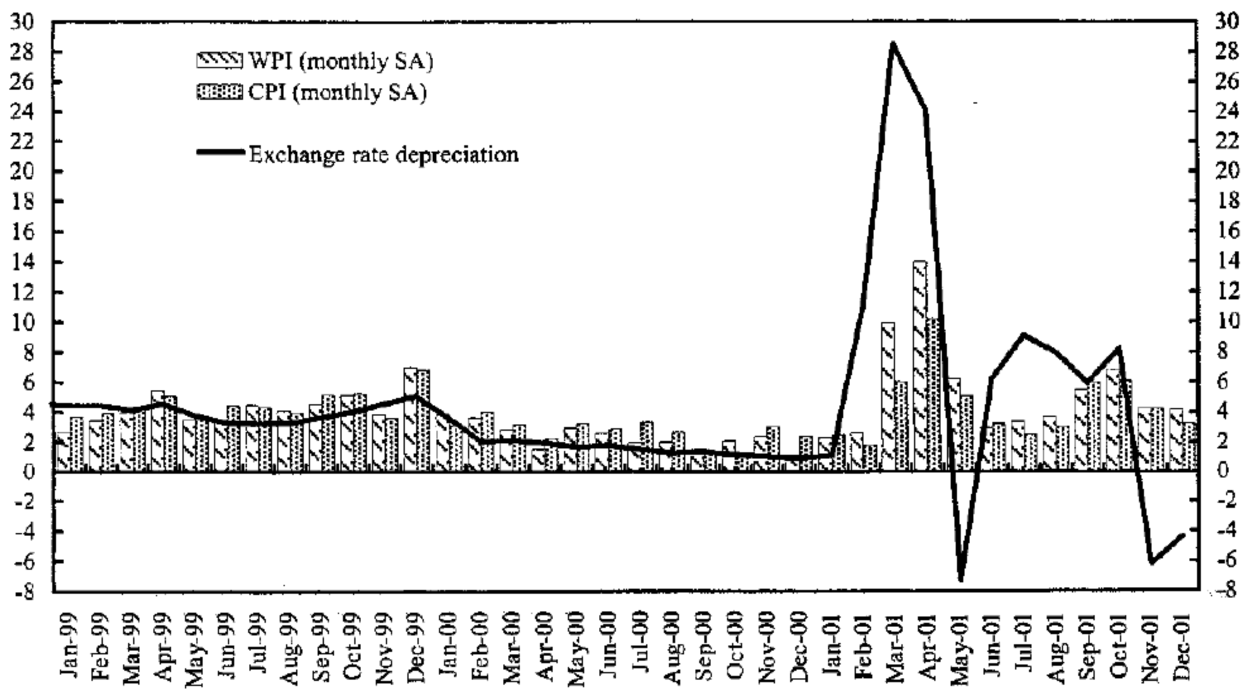
Source: Data provided by the Turkish authorities.

1/ The stock of loans has been adjusted for the shift to nonperforming loans of the loans of the banks taken over in December 1999 by the Saving Deposit Insurance Fund.

2/ Seasonally adjusted; the total VAT has been adjusted for tax changes.

Figure 6. Turkey: Inflation, 1996-2001





Source: Data provided by the Turkish authorities.

markets reacted negatively in the immediate aftermath of September 11, since mid-October they have rallied, at least in part in anticipation of additional external financing. Between mid-October and end-December 2001, benchmark bill interest rates fell by 18 percentage points (to the lowest level since February 2001), the Turkish lira appreciated by 11 percent, and the stock market rose by 60 percent. Building on this optimism, Turkey has been in a position to tap international markets successfully, with U.S. dollar and euro-denominated issues in the last quarter of 2001 totaling US$1.5 billion, while spreads on dollar-denominated Eurobonds have declined by more than 200 basis points since mid-October. As regards the real sector, third-quarter GNP figures showed an annualized increase of activity of about 4 percent, suggesting that the economy has started to recover. Following two months of higher-than-expected CPI increases owing to currency depreciation, markets reacted positively to the November and December increases of 4.2 percent and 3.2 percent, with 12-month inflation at 68.5 percent at end-year.

8. **Nevertheless, Turkey remains vulnerable to external and domestic shocks** (Appendix IV and Table 4). If the current international conflict extends in time and scope, Turkey will be negatively affected. Also, while the coalition government has shown increased unity in recent months, a turnaround in market sentiment triggered by political disagreement cannot be excluded. A continuation of the recent positive trends will require steadfast implementation of strong stabilization and reform policies.

III. The Authorities' Program for 2002–04

9. **With the authorities and the staff largely agreeing on the diagnosis, discussions focused on policies for 2002 and beyond to address both the aftermath of September 11 and Turkey's longstanding economic problems.** Although accepting that an ambitious reform agenda was needed, the authorities emphasized that this would not be an entirely new program, but one that deepens and extends existing efforts. The staff urged strong upfront measures to strengthen confidence in the program. The authorities agreed that such an approach had merit, but cautioned that a successful program also needed to be realistic, and give due respect to political and social concerns. This approach had already delivered results in the last few months, including passage of a difficult budget, together with far-reaching constitutional reforms. Moreover, the government had cut short parliament's end-year recess to introduce critical reform legislation, and was fostering closer cooperation on economic reform both within the ruling coalition and with the opposition. This renewed commitment was evident in the mission's numerous contacts with government ministers, all of whom expressed their strong backing for continued economic reform. This commitment is also underlined in the forthcoming letter of political support for the program, which the three coalition leaders have agreed to sign.

10. **Against this background, the authorities' program sets the goals of protecting the economy against future crises, while laying the basis for sustained economic growth** (¶6 and ¶9):[2]

- **Three key elements of the program are designed to reduce the risk of future crises.** First, continuation of the floating exchange rate regime will limit the potential for speculative attack, allowing greater interest rate stability. Second, efforts to reform and strengthen the financial system will make banks less vulnerable to withdrawal of funds, and boost confidence in domestic financial assets. Third, expenditure and tax reforms will help sustain the fiscal adjustment needed in the medium term to ensure debt sustainability.

- **The program aims to generate sustained economic growth through macro stability, to be achieved by fiscal adjustment, disinflation under the planned inflation targeting framework, and structural reform.** Structural priorities under the program are threefold: banking (to restore credit flows to the real sector), public sector reform (including greater transparency of government operations, and state enterprise restructuring), and private sector development (privatization—where recent progress has been limited—and steps to foster greater foreign direct investment).

A. Macroeconomic Framework and Financing Needs

11. **The medium-term macroeconomic framework envisages gradual economic recovery, continued disinflation, improved external accounts, and government debt sustainability** (¶7–8, Figure 7, and Table 5). The key objectives include sustained growth of at least 5 percent in the medium term, and a decline in inflation to close to single digits by the end of the program. The authorities stressed the upside potential for GNP growth both in 2002 and over the medium term. They agreed with staff, however, that the uncertain world economic outlook, the inevitable lag with which their banking and corporate restructuring strategies will help the real sector, and their continued commitment to disinflation were all factors that suggest conservative growth projections. The authorities reaffirmed their commitment to conduct monetary policy consistent with ambitious inflation targets. The staff indicated that the importance and strength of that commitment should be underscored by an early introduction of a formal inflation targeting framework. The staff also welcomed the authorities' intention to support a viable debt position by maintaining the public sector primary surplus in the medium term at the level of 6½ percent of GNP targeted for 2002. Both sides agreed that the macro objectives and policies under the program were consistent with a marked decline in government debt ratios and a fully financed external current account.

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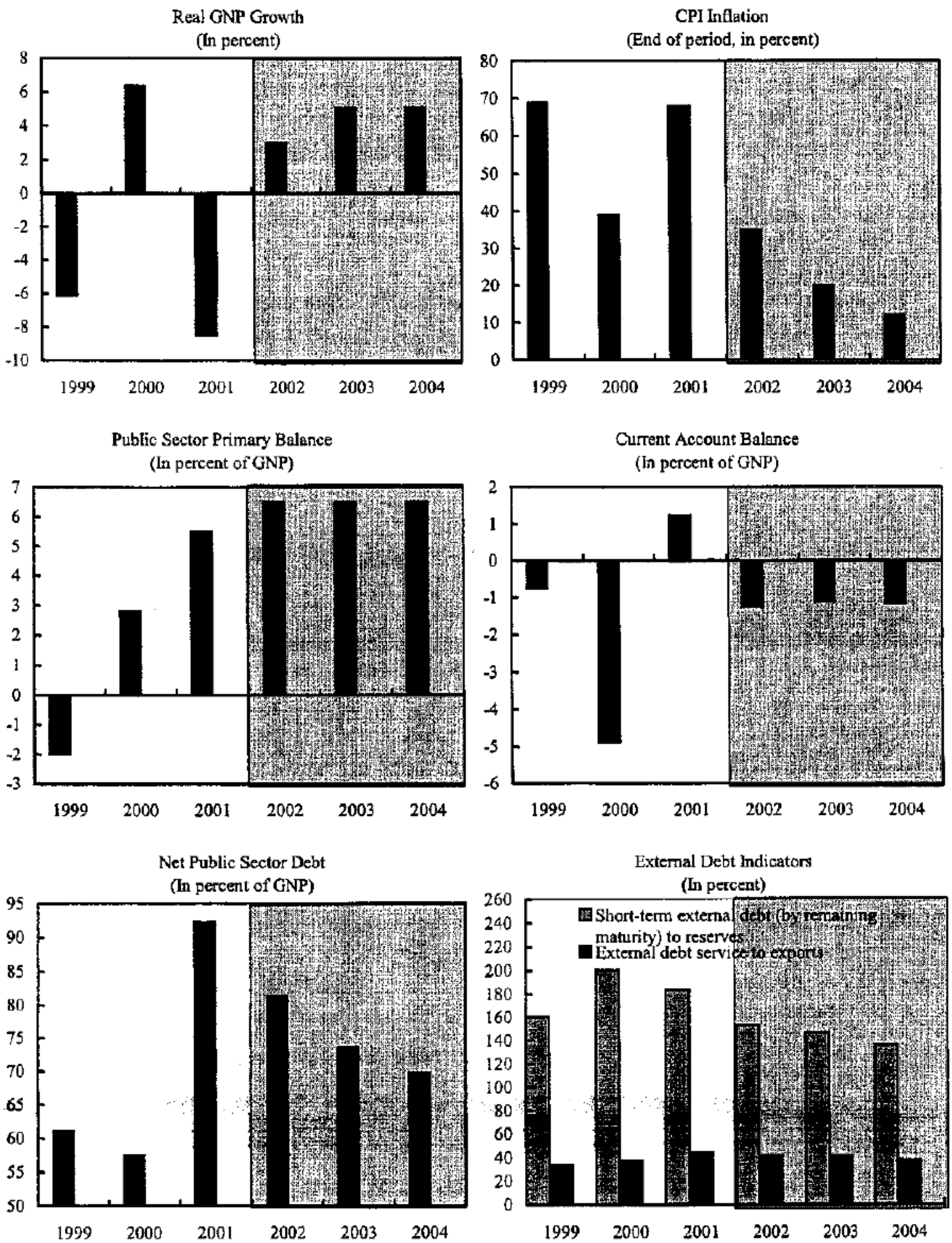
[2] ¶ refers to relevant paragraph in the attached Letter of Intent.

Figure 7. Turkey: Macroeconomic Indicators, 1999 - 2004



Source: Fund staff estimates and projections.

12. **Recent developments justified some adjustment to the macroeconomic framework for 2001–02 compared with that underlying the tenth review**:

- Notwithstanding the better-than expected third-quarter national accounts figures, the authorities and staff agreed to maintain the **GNP growth** projection at –8½ percent for 2001 in light of the negative impact of September 11 on net exports. For 2002, the authorities were keen to retain the 4 percent target underlying the 2002 budget estimates. In the end, however, they concurred with the staff that the consensus forecast at 2 percent and uncertainty about the strength of the recovery suggested that a 2002 GNP growth target of 3 percent was more credible. Both sides agreed that this projection had upside potential, given the depth of the 2001 recession.

- Given the large pass-through of the currency depreciation in recent months and increases in administered prices, 12-month CPI **inflation** in December 2001 at 68.5 percent exceeded the earlier projection of 65 percent. For 2002, the authorities reaffirmed their commitment to the 35 percent target set at the time of the tenth review.

13. **As for the balance of payments, the discussions confirmed the assessment made at the time of the tenth program review that Turkey is likely to face an external financing gap of about US$12 billion in 2002–04** (Box 1 and Table 6). The new information that had become available since November (suggesting for 2001 higher export and import levels, lower services balance, and a better capital account outcome) and revised macroeconomic and global assumptions (including for 2002 lower oil prices, weaker growth in both Turkey and its partner countries, and a more appreciated real exchange rate) had a broadly offsetting impact on the projected gap. The current account was still projected to move from a surplus of about US$2 billion in 2001 to a deficit of a similar magnitude in 2002. The capital account deficit was projected at US$3 billion in 2002, compared with US$13 billion in 2001, reflecting mainly the expected improvement in portfolio and banking sector flows as a result of a gradual restoration of confidence. These projections indicated that additional external financing of US$10 billion was needed in 2002 (with additional financing of US$1 billion in each of the following two years) to allow Turkey's international reserves to return to prudent levels, with a gross reserves build-up of US$3 billion projected for 2002, after an estimated decline of US$4 billion in 2001, followed by further moderate buildups in the following two years.

14. **The authorities and staff estimated that of the US$10 billion additional external financing in 2002 some US$7 billion would need to be made available to the budget to support a smooth rollover of domestic debt in 2002** (Appendix V provides a full discussion). In the baseline scenario, the central government overall deficit would be 13 percent of GNP, of which less than ½ percentage point could be filled from identified net external financing and privatization proceeds. With public banks and nonbank lenders expected to provide about 6 percent of GNP in financing, private banks would need to provide the remainder. However, with an expected decline in external interbank lending to

Box 1. Turkey: External Financing Gap, 2002–04

The staff estimates that Turkey is facing an external financing gap of US$10 billion in 2002, and a further gap of about US$2 billion in the following two years (Table 6). Taking into account projected current and capital account developments, the availability of the additional US$10 billion in 2002 would allow Turkey's gross official reserves to recover by US$3 billion in 2002, a prudent increase after a projected decline of US$4¼ billion in 2001. With the availability of US$1 billion each in 2003 and 2004, reserves would recover moderately further. Updated post-September 11 macroeconomic and global assumptions are used in these projections, and the underlying premise for the capital account is that international markets will remain difficult to tap, at least through mid-2002.

Current account

The current account balance is projected to move from a surplus of US$2 billion (1¼ percent of GNP) in 2001 to a deficit of US$2 billion (1¼ percent of GNP) in 2002. Following the strong growth in 2001, in 2002 exports are projected to increase by just 6 percent in U.S. dollar terms and 4 percent in volume terms. The volume increase is in line with growth in projected foreign trading partner import demand, on the assumption that Turkey's market share remains constant. As for imports, although lower oil prices should moderate dollar import growth, the projected economic recovery, of which a large part is expected to come from import-intensive stock-building, should lead to an overall import turnaround in 2002. Specifically, after a sharp drop in 2001, in 2002 imports are projected to increase by 7 percent in U.S. dollars and by 8 percent in volume.

On the services side, travel receipts are projected to fall to US$6 billion, a decline of 25 percent over the record performance of 2001. Indicators such as cancellations and tourist arrivals since September 11 indicate that Turkey's travel industry is likely to be badly hit, just as it was during the Gulf War period. The projection assumes that the decline in seasonally adjusted travel receipts from the peak pre-shock base period—about 40 percent—is the same as during the Gulf War period.

Capital account

Net FDI is projected to reach US$1 billion in 2002, compared with US$2.5 billion in 2001. In April 2001, a one-off US$1.4 billion was received in connection with the GSM license. In 2002, while sales of shares in the state oil refinery and petroleum distribution companies are expected, any FDI component is likely to be minor.

The large portfolio outflows in 2001 are not expected to be repeated in 2002. The US$4¼ billion outflow in 2001 has reflected a withdrawal of foreign investors from Turkey's stock and government securities markets, leaving existing holdings relatively small. The net portfolio outflow of US$1.1 billion projected for 2002 comprises a US$0.9 billion increase in Turkish resident holdings of securities abroad, and a US$0.2 billion decline in nonresident holdings of equities and paper.

Eurobond drawings, which were expected to reach US$3.5 billion in 2002 in the pre-September 11 scenario, are now projected conservatively at US$2.5 billion. Turkey has not, however, lost access to the Eurobond market, as the successful recent issuances have shown, making a borrowing target of US$2.5 billion in 2002 readily achievable.

A modest increase of US$0.3 billion is projected in so-called Dresdner deposits. Dresdner deposits are deposits at the Central Bank of Turkey from migrant workers abroad, especially in Germany.

Net banking sector outflows are expected to decline from US$9 billion in 2001 to less than US$5 billion in 2002:

- Most important, the net decline in **interbank credits of foreign commercial banks** is projected to fall from US$6¼ billion to US$3.5 billion. The decline in 2001 occurred despite agreements in December 2000 and June 2001 by foreign banks to maintain exposure. The projected US$3.5 billion outflow in 2002 represents a rollover ratio of about 60 percent.
- **Banks' FX reserve holdings in correspondent accounts abroad** are projected to remain unchanged.
- **Banks' medium- and long-term net outflows** are projected to reach US$0.7 billion in 2002, comprising net bond outflows of US$0.4 billion and net medium- and long-term debt outflows of US$0.3 billion.
- **FX deposits of foreign residents are assumed** to decline by about a third, or US$0.4 billion, compared with a decline of 45 percent in such deposits in 2001.

Private sector rollover of medium- and long-term loans is assumed to remain at about 95 percent in 2002, giving a net **outflow of US$0.5 billion, while short-term flows are projected to increase from a net outflow of US$1 billion in 2001 to a net inflow of US$0.8 billion in 2002, reflecting higher imports.**

private banks of US$3½ billion, projected deposit growth suggested that only 2 percentage points could be filled from private banks at projected real interest rates, leaving some US$7 billion (4 percent of GNP) as the remaining financing need. Private banks could be induced to fill part of this need only through higher real interest rates, leading to crowding out of lending to the private sector, slower output growth, and a larger budget deficit. An additional US$7 billion in external financing to the budget would reduce the domestic borrowing requirement from private sector banks to a level consistent with their absorptive capacity, leaving room for lending to the private sector in line with the projected recovery in output. At the same time, the private sector rollover ratio (the government's borrowing from the private sector as a ratio to redemptions of government debt to the private sector, including interest payments) would be reduced to about 85 percent, a level markets would likely regard as manageable. This would be consistent with banks maintaining their Treasury bill holdings both in real terms and as a share of total assets.

15. **The authorities stressed that given the uncertain economic outlook they would be prepared to respond flexibly to positive as well as adverse developments** (¶10). Economic prospects and the balance of payments would depend on domestic performance and external events, such as the duration of the September 11 shock and oil price movements. In the event that the balance of payments outturn is better than predicted, the program calls, in the first instance, for larger reserve accumulation and for monetary policy adjustment to safeguard the inflation target. Should the overperformance be large and persistent, with a comfortable overall debt position, the program also calls for Fund repurchases ahead of schedule, or for the authorities to refrain from making scheduled purchases. As for downside risks, the program aims in the first instance to increase the economy's resilience to negative shocks, helping to reassure markets about the robustness of the program. However, in the event of a large and prolonged negative exogenous shock, the authorities are committed to a further strengthening of fiscal policy to help ensure that the debt situation remains manageable.

16. **With the implementation of the program's policies, the external position and public debt were expected to remain sustainable over the medium term:**

- **With the external gaps covered by the additional Fund financing requested under the new SBA, Turkey's external position should be sustainable—that is, current account positions would be financed by identified inflows while reserves remain at safe levels.** The current account was projected to record moderate deficits of about US$2 billion (1 percent of GNP) over the medium term. At the same time, the capital account balance was projected to move from a US$3 billion deficit in 2002 to a surplus of US$3–8 billion over the medium term, reflecting an improvement in confidence. External medium- or long-term financing should help lower the ratio of short-term debt (by remaining maturity) to reserves—a key indicator for market borrowers—to below 140 percent by end-2004. Although under current assumptions the ratio would begin to pick up again in 2005, reserves may turn out to be higher in the medium term than currently projected, if the strengthened program succeeds in restoring market confidence.

- **Turkey's public debt would be sustainable in the medium term—that is, it would shift to a declining trend relative to GNP—provided interest rates converge to program levels and the primary surplus remains strong.** The public sector's net debt-to-GNP ratio was expected to peak in 2001 at about 92 percent (up from 57 percent in 2000), reflecting the one-off factors of the costs of bank recapitalization, the fall in output, and the real depreciation of the exchange rate (Box 2). With US$7 billion in additional external financing to the budget, and with conservative assumptions for real interest rates, the public sector debt-to-GNP ratio was expected to fall substantially in 2002, to the low 80s. Much of this decline reflected a one-time effect as the nominal depreciation in 2001 would become fully reflected in prices and nominal GNP only during 2002. In 2003 and beyond, the debt-to-GNP ratio was projected to continue its decline, albeit more gradually, assuming continued public sector primary surpluses of 6½ percent of GNP throughout the program period, a recovery of growth to 5 percent, a small real appreciation, and continued moderate declines in interest rates.

B. The Program for 2002

Fiscal policy and debt management

17. **The overarching objective of fiscal policy would remain to cement debt sustainability.** The authorities and staff saw no room to relax the 2002 public sector primary surplus target of 6½ percent of GNP, given Turkey's high indebtedness. The staff noted that continuing high primary surpluses may not impose a major constraint on economic growth in the near term, as fiscal easing would likely drive up real interest rates, crowding out investment and purchases of consumer durables. In any event, on a cyclically adjusted basis, fiscal policy was not being tightened over the program period, as the primary surplus was targeted to remain constant while the economy returns to potential.

18. **The authorities intended to continue their strict implementation of fiscal policy in 2002** (¶11–15, and Tables 10–12). The staff commended the authorities for a strong fiscal effort in 2001, which had allowed the public sector primary surplus target of 5½ percent of GNP to be met despite the deep recession. As regards 2002, the authorities had already at the time of the tenth review committed themselves to taking measures amounting to 2 percent of GNP to reach the 6½ percent of GNP target. While the macroeconomic framework for 2002 had been revised slightly, no additional fiscal measures would be necessary, as a higher-than-expected revenue base in 2001 was estimated to fully offset the impact of lower growth and higher wage and pension payments resulting from indexation in 2002. To safeguard the 2002 target, the authorities agreed to put in place all fiscal measures prior to the Board meeting where technically feasible, and to refrain from introducing new tax exemptions or state enterprise discounts during the year. Parliament had already approved the central government

Box 2. Turkey: Recent Public Sector Debt Dynamics and Medium-Term Sustainability

The crisis in early 2001 had a large one-off effect on Turkey's public debt. The public sector debt-to-GNP ratio is estimated to have risen from 57 percent at end-2000 to 92 percent at end-2001 (Table 7). The main factors explaining the increase in the debt ratio are the cost of recapitalizing public banks, currency depreciation, and the fall in output:

- Recapitalizing the state and SDIF banks in May 2001 resulted in an increase in debt for bank recapitalization relative to end-2000 of about TL 30 quadrillion (or 16 percent of 2001 GNP), and added 7 percent of GNP to the public sector interest bill in 2001. A contingency for possible future recapitalization needs of 3 percent of GNP has also been included in the end-2001 debt stock.

- The devaluation in February had a large immediate impact on the Turkish lira value of the FX-linked debt stock (at that time mostly external debt). Since then, further exchange rate depreciation, which also affected FX-linked debt issued since February both to public banks for recapitalization and to the domestic private sector has increased the debt ratio further.

- The real output decline, through its effect on the denominator alone, increased the debt-to-GNP ratio at end-2001 by some 6 percentage points.

During 2001, the debt stock became much more sensitive to exchange rate and interest rate changes. The share of debt linked to the exchange rate rose sharply in 2001, reflecting additional external borrowing (including from the Fund), debt for bank recapitalization, FX-indexed debt swapped for t-bills in June, and an increase in FX-linked borrowing (Table 8). The higher share of Floating Rate Notes, mostly reflecting bonds issued for bank recapitalization, and a shortening of maturities for bills have increased the sensitivity of interest payments to changes in the nominal interest rate (Figure 8).

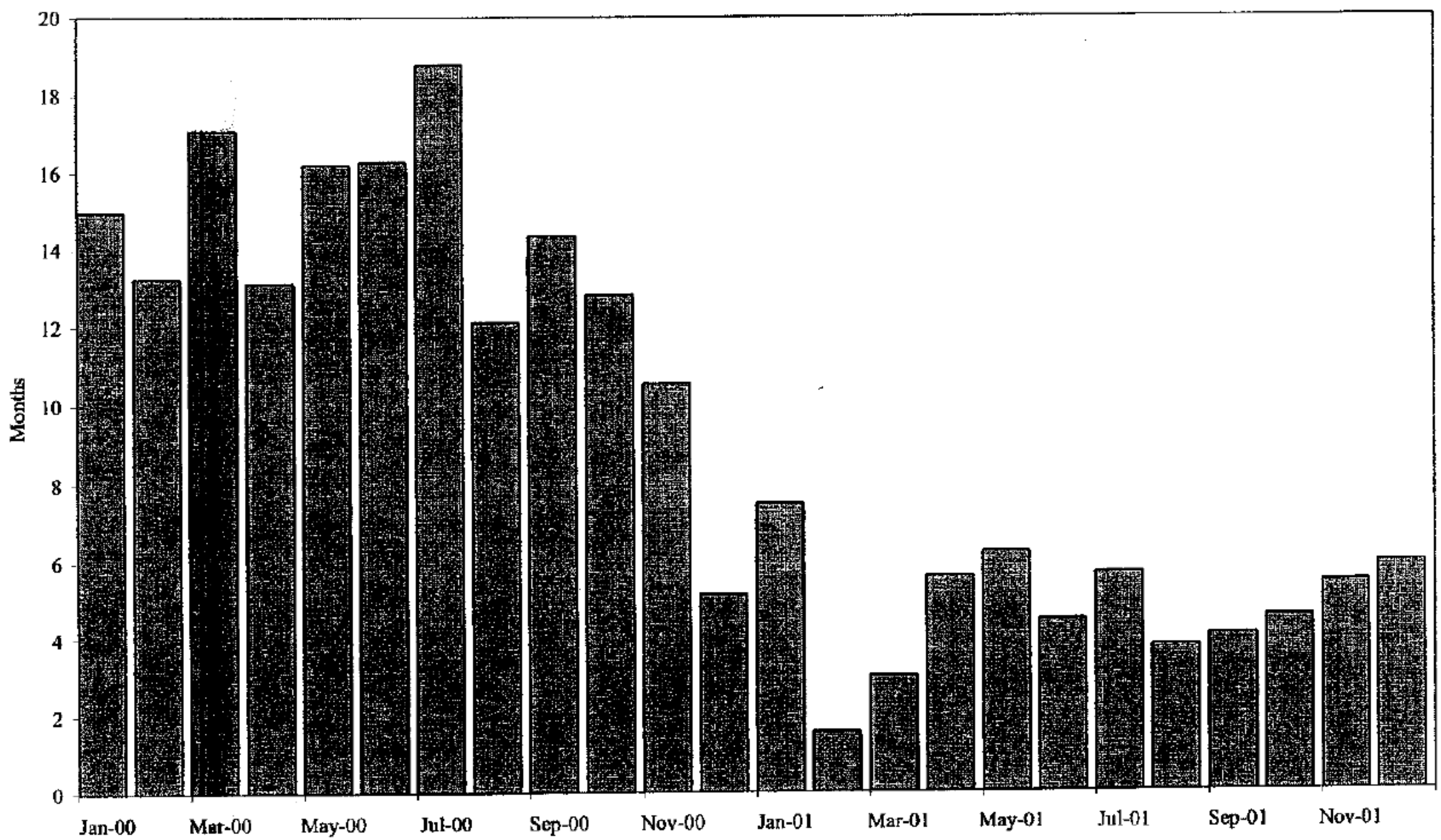
Nearly all of the increase in the debt stock in 2001 was in the form of debt to public institutions. Indeed, the bulk of the increase in the stock and its riskiness represents the bringing onto the balance sheet of previous state bank borrowing (mostly in the form of TL or FX overnight borrowing) and the Treasury's contingent liabilities from its earlier guarantee of the liabilities of private banks which were intervened during 2001. A large part of the new debt issued for bank recapitalization was transferred to the CBT as state and SDIF banks reduced their short-term borrowing from the private sector, with part of the debt sold along with deposits to the private sector with the resolution of SDIF banks. In addition, much of the Treasury's debt is held by public sector funds (mainly the Unemployment Insurance Fund and the Compulsory Savings Scheme). Overall, more than one-half of the Treasury's domestic debt is now held by public sector institutions.

The debt ratio is expected to fall sharply under the 2002 program, despite conservative assumptions on real interest rates. Much of the decline reflects a one-time effect, as the nominal depreciation in 2001 becomes reflected in prices and nominal GNP only during 2002.[1/] Other factors contributing to the decline are a strong primary budget surplus, a recovery of output, and a modest rebound in the real exchange rate. This decline occurs despite cautious assumptions for real interest rates on TL debt. Assuming the programmed decline in inflation takes some time before it is reflected in inflation expectations, high real rates are projected for the first half of 2002, resulting in an average of 29 percent for the year, compared with 21 percent in 2001 and a current rate of 15 percent using market expectations for inflation. However, the implied interest rate in US dollar terms on external borrowing and domestic debt linked to the exchange rate is about 8 percent (taking into account official lending), implying a real interest rate even lower in light of some projected real appreciation in 2002. With the increase in the share of FX-indexed debt during 2001, the average real interest rate on total debt in 2002 would be less than 12 percent.

Over the medium term, Turkey's public debt is sustainable (that is, it declines relative to GNP) provided interest rates converge to program levels and the primary surplus remains strong. Assuming a continued strong public sector primary surplus, a recovery of growth to 5 percent, a small real appreciation, and continued moderate declines in real interest rates, the debt to GNP ratio stabilizes in the mid-60s over the medium term (Table 9). Annual growth at 1½ percentage points below the baseline would increase the debt stock by about 5 percentage points by 2006. Higher real interest rates on TL debt of 5 percentage points above the baseline raise the debt stock by 5 percentage points by 2006. A combination of higher interest rates and lower growth would result in a rising debt ratio over the medium term (Figure 9).

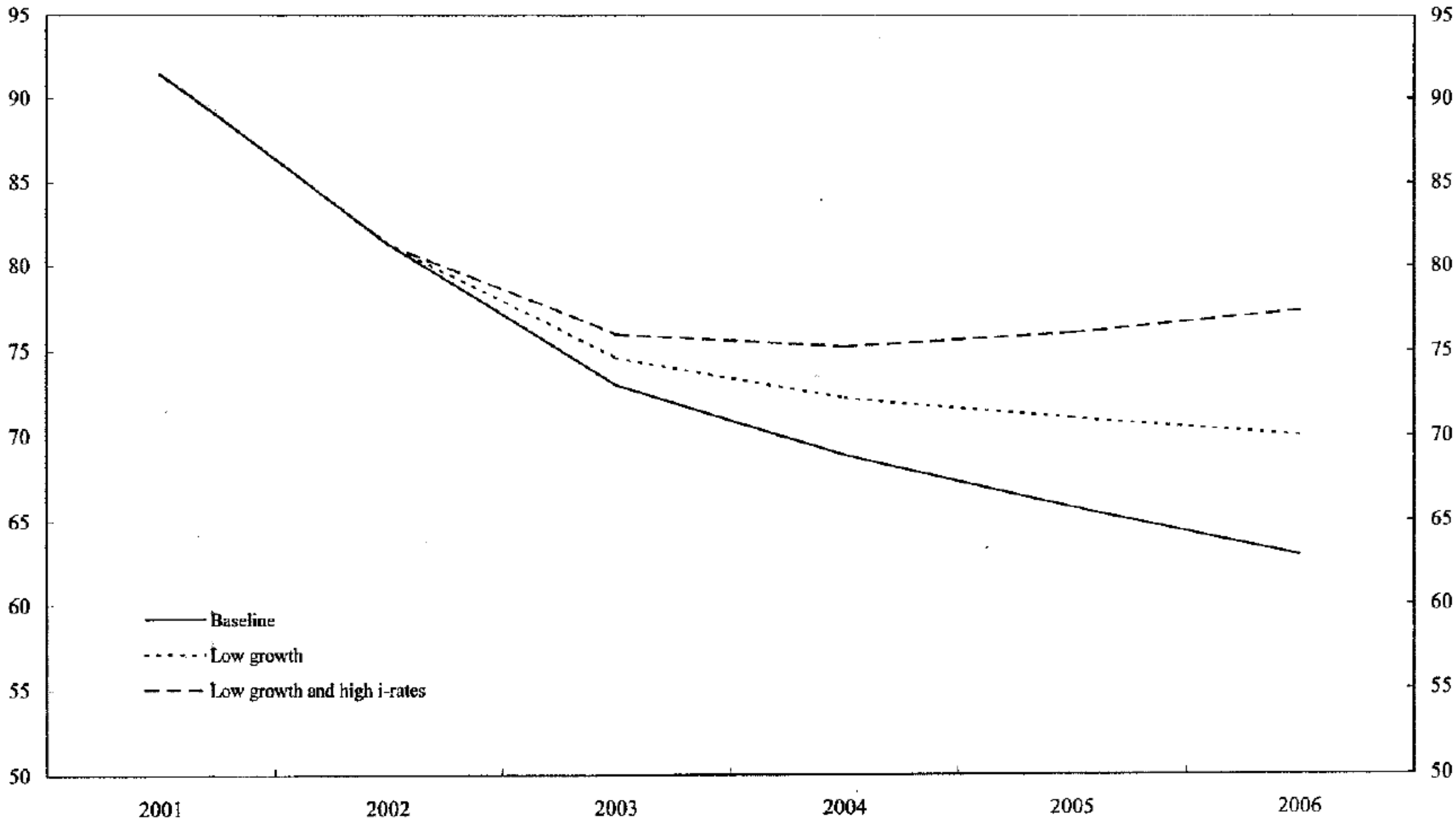
1/ As highlighted in previous staff reports, conventional debt-to-GNP ratios tend to overstate the rise in debt when inflation accelerates following a devaluation (as in 2001), and thus overstate the fall when inflation decelerates. One simple way to correct for this bias is to use a measure of GNP that is centered around the end of the year. Indeed, using centered GNP, the debt ratio increases by less in 2001 (from 51 percent to 74 percent), and falls by less in 2002 (from 74 percent to 72 percent) than when using annual GNP.

Figure 8. Turkey: Maturity of Newly Auctioned Debt, 2000-01



Source: Data provided by the Turkish authorities.

Figure 9. Turkey: Domestic Debt Sensitivity Analysis, 2001-06



Source: Fund staff estimates and projections.

budget in line with understandings reached at the time of the tenth review. The one exception concerned agricultural subsidies for three products, which were reinstated for 2002, and would now disappear only in 2003. However, the authorities agreed to cut other transfers (especially to the energy sector which was benefiting from lower international prices) to stay within the overall budget limit. The staff and authorities agreed that the less direct control over state enterprises than the central government called for vigilant oversight, built into the program through quarterly audits of the implementation of program measures by Treasury auditors.

19. **The authorities agreed to take further steps to build on the recent achievements in debt management** (¶16–19). The staff commended the authorities for their skillful debt management over the past few months, which had helped to widen the investor base and lengthen average maturities, considerably easing market concerns about the rollover of public debt. Looking forward, the authorities were determined to take additional steps to further safeguard the government debt position:

- **Securities being offered would be closely matched with investors' needs.** Specifically, the staff noted that an early resumption of the floating-rate note (FRN) program and continued foreign exchange-linked issuance, to supplement the regular Bill auctions, would help meet the needs of domestic banks—the largest government debt holders—as their liabilities are mainly short-term and mostly in foreign currency. The authorities generally agreed with these proposals, and in early January announced an FRN issue for the second half of the month.

- **The investor base would be widened further to make it more stable.** Although the setting up of a new Investor Relations Office should help (¶48), the staff also argued for close cooperation between the foreign and domestic debt management arms of the Treasury, as both forms of borrowing contributed to meeting rollover needs and they shared overlapping investor bases. The authorities indicated that this issue would be a focus area in a comprehensive study they were undertaking to further improve the Treasury's risk and debt management operations.

- **More would be done to lengthen the maturity of government debt and deepen the liquidity of benchmark issues.** The authorities accepted that issuance of FRNs and foreign exchange-linked debt would help lengthen maturities, while longer-term fixed rate issuance in Turkish lira would take some time. Moreover, the introduction in due course of a new and improved primary dealer system would help increase the liquidity of government paper over the medium term.

Monetary policy

20. **The authorities reaffirmed that the goal of monetary policy would be to lower inflation to 35 percent by end-2002** (¶20, and Tables 13 and 14). Accordingly, the Central Bank of Turkey (CBT) had set targets for base money growth of 40 percent, in line with

targeted inflation and growth in real output. The base money targets—the program's nominal anchor until formal inflation targeting is introduced later in 2002—would be performance criteria under the new program. The staff welcomed these targets as appropriately ambitious; if adhered to, they should deliver a marked inflation reduction. To achieve the targets, the staff cautioned against a reduction in interest rates (the overnight rate had been kept at 80 percent since early September) until inflation expectations came closer to the 35 percent target. However, there could be some scope for interest rate cuts in coming months in line with the envisaged decline in monthly inflation. On money demand, the authorities expressed concern over potential instabilities (Figure 10). Although changes in money demand would be difficult to detect in a timely manner, both sides agreed on the need to monitor closely indicators such as dollarization of deposits, and the potential for lower inflation to increase money demand.

21. **The authorities agreed to set program targets on a consolidated basis (the CBT and Treasury combined), as the Fund would now disburse directly to the Treasury** (¶26). Under the existing arrangement, Fund disbursements were made to the CBT. This increased CBT gross reserves, but had no effect on net international reserves (NIR). Under the new program, disbursements will be made to the Treasury.[3] When deposited with the CBT, this will increase both CBT gross reserves and NIR, even though Fund lending typically should not increase central bank NIR. To correct for this, the NIR target is now defined on a consolidated basis. In addition, the new target also subtracts Treasury short-term foreign currency borrowing, to prevent such borrowing and depositing with the CBT from leading to a spurious increase in measured NIR.

22. **The authorities were making further strong efforts to put in place the preconditions for successful inflation targeting** (¶21–22). While the important step of CBT independence was already in place and technical work (including the recent release of a Monetary Policy Report) was advancing quickly, the authorities were making additional efforts to ensure that the conditions for initiating inflation targeting could be in place by mid-year. The staff noted that agreement on the measures needed to meet the primary surplus target, together with improved debt management, were improving the outlook for debt sustainability, and alleviating concerns over fiscal dominance. This had contributed to the recent decline in nominal interest rates, and would provide greater scope for monetary policy flexibility. Looking ahead, with financial market conditions improving and the exchange rate showing signs of stabilizing, the staff and the authorities agreed that rebuilding confidence in the financial system would be critical in freeing monetary policy to target inflation.

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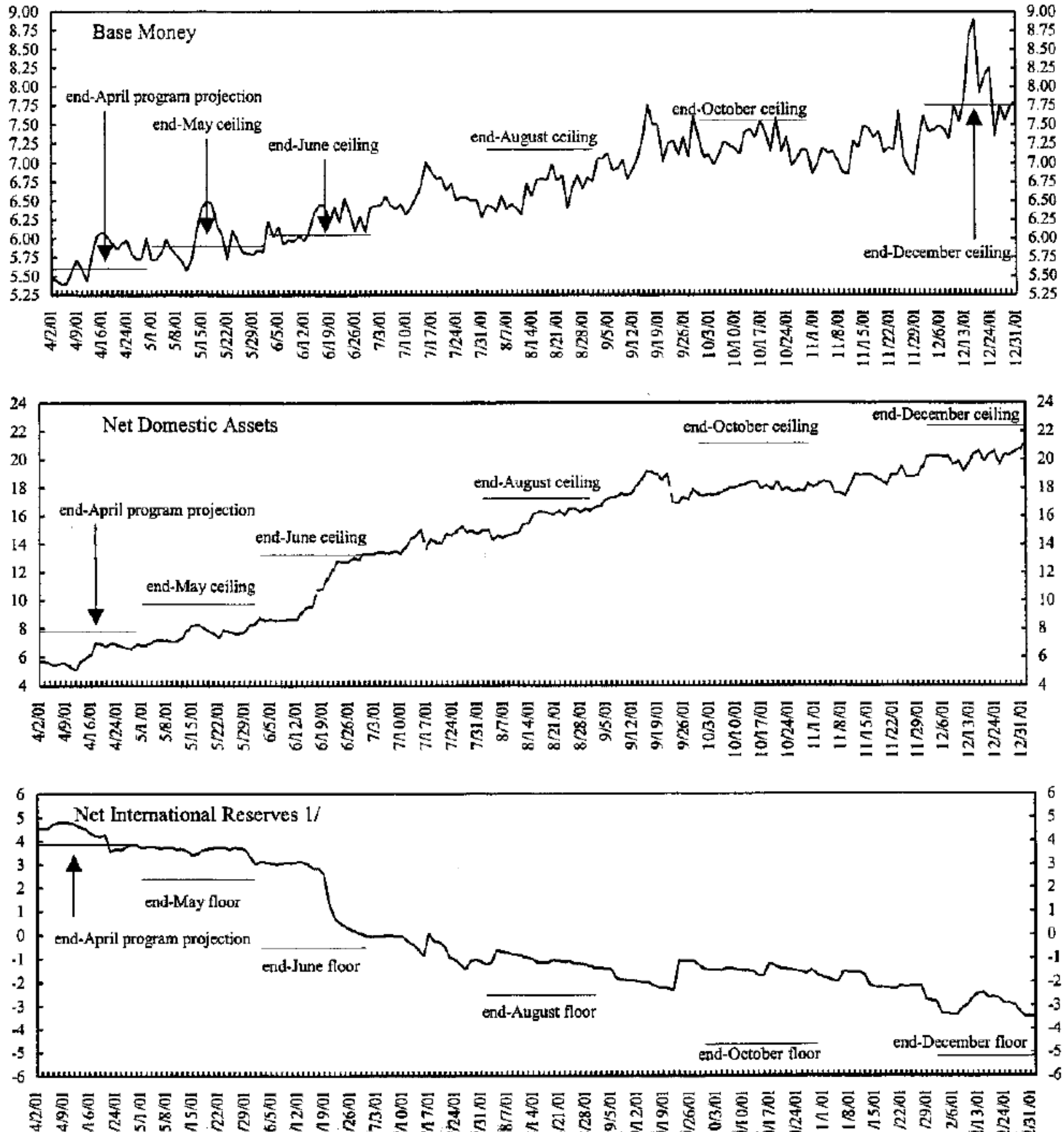
[3] The Treasury is the fiscal agency for Turkey, and as such is authorized to receive Fund resources. However, for operational reasons, the resources available under any Fund-supported program will be deposited with the CBT, in favor of the Treasury.

Figure 10. Turkey: Monetary Developments, 2001
(In quadrillions of TL)



Source: Data from the Turkish authorities.

1/ In billions of U.S. dollars.

23. **While confidence in the floating exchange rate regime had improved markedly, additional steps were still needed to improve the forward and futures markets** (¶24–25). The staff commended the authorities for refraining from discretionary intervention, and noted that the exchange rate had stabilized and even appreciated despite the CBT's decision to discontinue daily auctions in December. However, the staff urged the authorities to encourage the development of a successful interbank money market, a crucial ingredient in the development of forward markets. In this regard, the staff welcomed the CBT's decision to end its practice of borrowing on behalf of other banks, although this needed to be phased in with the strengthening of the financial system. Finally, the staff welcomed the authorities' initiative in creating a working group, with private and public sector representation, that would iron out the remaining impediments to the development of forward and futures markets.

24. **The authorities were also mindful that successful disinflation would require reducing indexation in the economy** (¶23). Reflecting a long history of high inflation, backward indexation is common in Turkey. Wages, salaries, pensions, taxes, social contributions, and administrative prices are all indexed to past inflation to a varying extent. The authorities and staff agreed that to reduce inflation inertia steps needed to be taken to limit backward indexation. Already in the previous program, the government had intended to set civil servant salaries and public sector wages according to projected inflation, but in the end had agreed to catch-up clauses that provided compensation for the gap between projected and actual inflation.[4] The staff urged decisive action to eliminate backward indexation during the program period. As a first step, the authorities indicated their commitment to seeking a significant reduction in the amount of catch-up allowed in the next wage and salary round in late 2002.

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[4] Civil servant salaries are adjusted twice a year (January and July). In 2002, they will be increased by 10 percent in January and 5 percent in July. Further adjustments, however, will be made for the difference between cumulative actual inflation during the first half of the year and 10 percent, and again for the difference between cumulative actual inflation during the second half of the year and 5 percent. An additional increase of 2 percent will be granted only once over the first half of 2002. Wages for public workers (blue-collar workers whose earnings are on average twice as high as those of civil servants) are also adjusted twice a year. The current two-year contract, which was negotiated in May 2001 (and was retroactive to the beginning of 2001), provided for a 15 percent increase for the first half of 2001—with that payment delayed until January 2002—and another 15 percent increase for the second half of 2001. Wages had also to be adjusted for 80 percent of the difference between cumulative actual inflation during the second half of 2001 and 15 percent. For 2002, wages will be increased by 10 percent both in January and July. In addition, they will be adjusted for 80 percent of the difference between cumulative actual inflation over the first half of 2002 and 10 percent. In the second half, this adjustment will be 100 percent.

Structural reforms

25. **Both sides readily agreed that structural efforts would need to focus on completing banking sector restructuring, intensifying public sector reform, and strengthening the private sector's role in the economy.** Over the past two years, Turkey had implemented a range of reforms in these areas. Nevertheless, a large agenda remained to remove structural obstacles to rapid sustained growth. The authorities had made substantial efforts to restructure the banking system, which had been at the core of recent crises, but the deeper-than-expected recession in 2001 had created additional difficulties that needed to be addressed. In the public sector, the authorities had achieved strong fiscal adjustment over the past two years in part through one-time measures. To sustain the large primary surpluses needed to ensure a viable debt position in the medium term, the authorities would need to put revenue collection and expenditure management on a firmer footing, with increased transparency. And although Turkey had a dynamic private sector, it continued to be hampered by extensive state ownership in key sectors, cumbersome bureaucratic procedures, and governance problems. Against this background, the authorities and the staff reached understandings on an ambitious structural reform package focused on these key areas, with conditionality covering measures central to the achievement of the program's macroeconomic objectives (Annex C in the attached Letter of Intent). World Bank staff provided key inputs to discussions on all structural issues.

***Banking sector reform*[5]**

26. **Given the critical importance of banks for financial stability and economic growth, the authorities and staff agreed on a policy package to accelerate the reforms and complete the restoration of soundness in the banking sector.** With state banks now financially restructured and the weakest private banks taken over by the Savings Deposit Insurance Fund (SDIF), the authorities' focus had turned to strengthening the core private banking system. To this end, the authorities adopted a two-pronged strategy of forcing banks to value their loan portfolios rigorously, while at the same time offering limited public support for private bank recapitalization efforts. The staff fully supported this new emphasis, while also insisting on the importance of establishing institutional capabilities for resolving the large amount of assets of banks taken over by the SDIF, and of maintaining momentum for strengthening the regulatory and supervisory frameworks.

27. **The staff agreed with the authorities that the financial restructuring of the state banks (Ziraat and Halk) had been successful, and that the next step would be to complete their operational restructuring** (¶28)**.** After their recapitalization in May 2001, the state banks had eliminated their overnight exposures, aligned their interest rates with

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[5] A forthcoming supplement to this staff report will provide a full discussion of banking sector developments.

those of private banks, and made provisions for their problem loans. Both banks were expected to return to normal lending on strictly commercial terms in 2002. Already in 2001, Ziraat had returned to profitability, and Halk seemed set to join it in 2002. To the extent profits remained high, the staff suggested that quarterly dividend payments be made to the Treasury. Emlak Bank had been absorbed into Ziraat in mid-2001, and the remaining state-controlled bank (Vakif) was in the process of privatization, with the exact form of its resolution to be decided by mid-2002. The state banks had developed an operational restructuring plan that included closure of at least 800 branches and reduction of some 16,000 excess staff by mid-2002. The staff urged the authorities to put in place the legal changes needed to support the restructuring, so that the Council of Ministers could deliver its formal endorsement in January.

28. **The SDIF had made significant progress in resolving the intervened private banks, the exceptions being in cases where liquidation had been halted by courts (¶33).** The SDIF had concluded the sale of 4 banks and had begun the liquidation of those that it was not able to sell. The authorities were confident that they would soon overcome the legal challenges raised by the former or minority owners of two small banks, and that liquidation would proceed shortly thereafter. The resolution strategy for a medium-size bank taken over in November 2001 would be determined in early 2002. In December 2001, deposits of the remaining SDIF banks were sold to other banks through a series of auctions, backed by matching government securities portfolios. Remaining assets and liabilities from banks being liquidated would be transferred to one of the intervened banks which will be converted into a bridge bank. The staff stressed the importance of limiting the activities of any such "bridge bank" strictly to asset management.

29. **The staff expressed more concern over the limited success of SDIF, and its Collections Department, in asset recovery (¶34).** Since intervening in banks, the SDIF had recovered over US$100 million through the sale of bank and nonbank subsidiaries, but a much smaller amount through sale of movables and real estate. Cash collections in the banks had amounted to close to US$900 million, with one third coming from former bank owners and their corporations, and the bulk of the remainder from other distressed assets. The staff stressed the importance of speeding up the process, which would also help maximize asset recoveries. The SDIF argued that the planned creation of a bridge bank would help asset recovery, and had hired an international consulting firm to provide assistance in this regard.

30. **For private banks, both sides agreed on the need to reinforce the earlier strategy, by requiring banks to more accurately value their loan portfolios, and then bring in new capital as needed, or be taken over by the SDIF if insolvent (¶29–32).** Since early 2000, when new loan valuation and provisioning rules were introduced, about half of the 40 private commercial banks operating in the late 1990s had been found insolvent and taken over by the SDIF. In 2001, a recapitalization program for weak banks introduced in midyear brought in some US$700 million in new capital from their owners. However, the adverse macroeconomic environment had further weakened the banking system, while at the same time severely limiting the scope for raising new capital from private investors at home and

abroad (Table 15). The staff therefore agreed with the authorities on the need to strengthen the current strategy by developing a public support scheme that would encourage private recapitalization in the core private banking system.

31. **Following extensive discussions, understandings were reached on a public support scheme to encourage private banks to recapitalize themselves, with strict criteria for participation and strong safeguards to protect public resources, backed up by the threat of SDIF takeover in the event of noncooperation** (¶30–32):

- **All banks would be subject to thorough targeted portfolio valuations by their external auditors**. Specific criteria and guidelines developed by the Banking Supervision and Regulation Agency (BRSA) would be applied, with auditors' findings verified by an independent third party. The authorities and staff agreed on the importance of ensuring high quality audits to determine the true net worth of the banks, and on the need to involve international accounting firms at all stages of the process.

- **Once the assessments have established the banks' accurate financial position, existing shareholders will be asked to provide any necessary additional capital to meet regulatory requirements.** Since new private capital may be scarce, for solvent banks under the public support scheme the SDIF would be prepared to match owners' contributions to Tier–1 capital (shareholder equity), provided that the Tier–1 capital adequacy ratio (CAR) can thus be raised to 5 percent. To encourage further consolidation of the banking system, Tier–1 capital from the SDIF would only be made available to banks with a market share (measured by banking system assets at end-September 2001) of at least 1 percent. At present, this covers about half of the remaining 20 banks. In addition, all banks with Tier–1 CAR of at least 5 percent can apply for convertible subordinated debt (Tier–2 capital) from the SDIF, to bring their total CAR to at least 9 percent.

- **The SDIF will make any Tier–1 capital contributions with seven-year government bonds that cannot be transferred to any third party without prior approval of the Banking Regulation and Supervision Agency.** The latter would produce a positive spread for the SDIF, as banks would be required to pay a premium over the rates on Treasury paper on their subordinated debt.

- **Under the scheme, if a bank's financial condition were to deteriorate further, the SDIF would rapidly obtain majority ownership control through the conversion into equity of its Tier–2 capital contribution.** This would enable it to pursue least cost resolution methods without having to rely on legal intervention.

- **For the scheme to work, a number of legal changes would be required.** In particular, fast-track procedures would be needed for writing down the value of existing shares, and for raising new capital. While the staff and authorities agreed on the operational details and legal framework of the scheme, both sides acknowledged that considerable implementation risks remained, especially in possible law suits that might seek to block the scheme on constitutional grounds (related to property rights). The authorities agreed to seek further legal advice to ensure that the scheme had a secure legal basis. In the event, parliament on January 10, 2002 passed the relevant legislation, which awaits the President's signature.

- **The public cost of the private bank recapitalization would be unlikely to derail public debt dynamics.** The staff estimated that under present assumptions the public portion of the cost would likely be covered by the contingency for 2001 already built into the existing program. This contingency of TL 5½ quadrillion (3 percent of GNP) was not used in 2001, and would with accrued interest amount to some TL 8 quadrillion in 2002, covering the presently estimated recapitalization needs.

32. **The authorities agreed to bring their supervisory framework closer to international standards, and to strengthen the BRSA's supervisory and regulatory powers through amendments to the Banking Act** (¶35). The authorities intended to make several new prudential regulations effective in 2002, including adoption of International Accounting Standards, introduction of capital charges for market risks, and introduction of risk management systems. In addition, the staff stressed the critical importance of amending the banking law to allow BRSA to intervene and take over banks before they become insolvent, thus reducing the eventual cost to the government. It was also essential for the authorities to introduce legal changes as soon as possible, to create fast track procedures to facilitate writing down registered capital to reflect market losses, and to allow for the potential participation of the SDIF in the recapitalization of banks that continue to operate. Additional institutional changes in the supervisory area were discussed, but it was agreed that these changes would be deferred so as not to interfere with the implementation of the public support scheme. Finally, the staff observed that in dealing with money laundering and financial crimes, appropriate rules and procedures were in place and were approved by the Financial Action Task Force in 1999. Banks in Turkey are required to know their customers, and since mid-2001 no banking transaction can be carried out without the use of a Tax Identification Number.

33. **The staff noted that experience from other crisis countries highlighted the importance of complementing the ongoing banking system reform with corporate debt restructuring** (¶36–38). Recapitalization was only a necessary condition for banks to be able to start extending credit. Unless corporate indebtedness was restructured to manageable levels, companies would be unable to obtain new loans, even for viable projects. The authorities had already taken the first steps toward promoting corporate debt restructuring, and would in January 2002 introduce a voluntary market-based framework known as the "Istanbul Approach." This would involve case-by-case restructuring of multicreditor exposures to large and medium-size borrowers. While welcoming this approach, the staff noted that responsibility for this had been devolved largely to the Turkish Bankers' Association. To improve the chances of success, a more concerted approach would likely be

needed, with inputs from the corporate sector, and with greater government leadership of the process. The staff also stressed the importance of improved bankruptcy and foreclosure frameworks, as well as of enhanced financial disclosure and corporate governance standards. The authorities indicated their commitment to reforming the bankruptcy law and execution procedures to reflect the findings of a Report on Standards and Codes on Turkey's insolvency regime which the World Bank would complete shortly. It was envisaged that a reform agenda and an action plan with specific measures would be developed in consultation with World Bank staff and that such measures would also be discussed with Fund staff in the context of program reviews. The authorities also indicated their intention to introduce from the beginning of 2003 international accounting standards for companies, including inflation accounting rules, and to start requiring corporate groups to report their consolidated financial position within months.

Public sector reform

34. **The authorities were determined to sustain the fiscal adjustment through reforms aimed at a lasting improvement of the fiscal position, and a significant enhancement of fiscal transparency** (¶39–42):

- **Retrenchment in public enterprises** would address high labor costs, preparing the ground for privatization, and creating a supporting environment for disinflation (by lessening the need for price increases to protect balance sheets). In total, SEEs presently employ 435,000 workers. The authorities agreed to undertake in January 2002 a comprehensive survey of redundancies in the public sector, followed by actions to eliminate the identified overstaffing (with tight controls to prevent re-entry) by mid-2003, with the bulk of the retrenchment to take place in 2002. The staff estimates that had such a labor force reduction been in place during 2001, SEE price increases could have been reduced by 5 percent with no impact on SEE primary surpluses. Alternatively, SEE primary surpluses would have been higher by 0.6 percent of GNP. Since cutting employment reduces the government's liabilities, the staff agreed to exclude net retrenchment costs (severance pay less wage savings) from the program's primary surplus calculation, up to a limit of TL 1.25 quadrillion (0.4 percent of GNP). The agreed cap allows for up to 80,000 redundancies eliminated by end-2002.

- **Tax system reform** would help make the revenue base broader and more sustainable, and reduce distortions in the economy. The authorities committed themselves to adopting as a prior action a medium-term tax reform plan which during 2002 would simplify indirect taxes, broaden the direct tax base while harmonizing the rates applied to it, and upgrade the tax administration. The discussion revolved around two points: how to upgrade the tax administration, and how to move the revenue base away from interest-related sources. On the latter, the authorities and staff agreed that high withholding taxes on nominal interest income had contributed to high interest rates, provided a strong tax incentive to hold foreign exchange, and paradoxically left the primary budget targets vulnerable to a sudden improvement in market confidence (as it would be unlikely that improved confidence would immediately translate into additional revenues to replace lost interest-related income taxes). The staff suggested a preemptive approach, focused on harmonizing the taxation of real interest income from various sources, but the authorities were concerned that they had too few options within the year to offset what could amount to large revenue losses. They concurred, however, that some effort would need to be made early in 2002, and that they would need to stand ready to respond in the event of weakness in interest-related revenues. The problem would be fully addressed in the context of a direct income taxation reform in October 2002. On tax administration, both sides agreed that the reform should aim to bring Turkey into line with OECD practices. This would involve, as a first step, reorganizing the tax administration to separate it from other Ministry of Finance operations.

- **Consolidating fiscal activities** into fewer institutions would enhance aggregate fiscal control and improve transparency. The staff suggested that in 2002 the work should focus on eliminating all remaining extrabudgetary funds (except the SDIF). The authorities were concerned that other budgetary reforms expected over the next few years first be put into place. Recognizing the general principle, however, they agreed to approve these funds' budgets in parliament, report their outturns monthly (on a consolidated basis with the central government's outturn), and subject them to scrutiny in the form of audits reported to parliament. This would leave executing their budgets through the Treasury system as the remaining step before their full elimination. The staff also welcomed the authorities' commitment to provide an appropriation in the 2003 budget for expenditures currently financed outside the budget by earmarked revenues, and urged further progress in reducing the number of revolving funds.

- The authorities were putting into place a significantly **enhanced legal foundation for fiscal policy**. Procurement and public liability management laws would both come into effect during the first year of the program, and the authorities had already begun to prepare a law covering budgeting, transparency, accounting, and internal and external control. This law was expected, among other things, to promote common accounting standards in general government. This should allow broader and more frequent monitoring of general government. Neither the staff nor the authorities wished to wait, however, for this new system to be in place, and thus the program's fiscal conditionality has been extended to cover additional elements of the public sector (¶15).

35. **Social protection would be enhanced in the new program.** In view of the retrenchment program in public enterprises, the safety net for retrenched workers was a key area of discussion. The authorities indicated that they would eliminate positions first through voluntary and then through forced retirements (in both cases accompanied by severance payments), and would utilize layoffs only when necessary. They also noted that

unemployment insurance would provide a safety net to those who would not be eligible for adequate severance. The other important area of discussion was the Direct Income Support program for farmers, where the staff supported World Bank efforts to enhance budgeted resources. The authorities agreed about the importance of this social program, and raised budgeted resources to levels consistent with verified lists of eligible farmers.

Enhancing the role of the private sector

36. **The authorities stressed their commitment to a wide range of reforms designed to increase the role of the private sector in the economy.** They recognized the need for profound changes to Turkey's economic structure and investment environment, and agreed with staff that such changes would be pivotal in unleashing the potential for private sector-led growth. The priorities would be to advance privatization, make Turkey a more attractive destination for foreign direct investment (FDI), and further improve transparency and governance.

37. **The authorities planned to take major steps to revitalize privatization in 2002, and to improve the private investment environment** (¶45–46). The staff noted the slow pace of privatization in 2001, which had in part reflected weak market conditions. For 2002, the privatization strategy would focus on the sale of companies for which the preparations for privatization had been completed (in particular, the oil refinery and petroleum distribution companies), the preparation of detailed action plans to bring other major companies (such as Türk Telekom) to the point of sale in a transparent manner, and the enactment of supporting legislation (including the Tobacco Law, to facilitate the privatization of the tobacco and alcohol monopoly, Turkey's largest company). As regards the investment environment, the staff noted the low level of FDI, which left Turkey vulnerable to sudden reversals in capital flows. Indeed, Turkey's FDI averaged 0.2 percent of GDP in the second half of the 1990s—well below the average of 2.7 percent of GDP for developing and transition economies. The authorities indicated their intention to act quickly on the recommendations of the recent Foreign Investment Advisory Service report on administrative barriers to investment.

38. **The authorities agreed that improving transparency and governance, and enhancing communication of the aims of the economic program, would be key to fostering a business-friendly environment** (¶48). Major initiatives would include the establishment of an investor relations office within the Treasury to facilitate two-way communication with investors, and an Investor Council consisting of prominent business representatives from Turkey and abroad.

IV. Design of the Proposed Program

A. Access and Capacity to Repay the Fund

39. **The proposed additional resources under the new program—to meet Turkey's external financing gap—would raise Fund exposure to Turkey to unprecedented levels, and would require invoking the exceptional circumstances clause** (Table 16). Access

would increase by almost 1,000 percent of quota, or US$12 billion (that is, the projected gap of US$10 billion in 2002, plus projected gaps of US$1 billion in each of the years 2003 and 2004) on top of the amounts outstanding under the current arrangement (US$4.3 billion). This exceptional access is being requested to address Turkey's very large balance of payments needs following the event of September 11, as discussed above. The first purchase will be in an amount equivalent to US$9.3 billion, comprising the amount needed to prepay the US$6.3 billion outstanding under the SRF, and the US$3.1 billion from the 11th review under the existing SBA. This frontloading also coincides with Turkey's financing needs, as discussed above. Even after SRF prepayment, outstanding Fund credit would exceed 1,800 percent of quota by end-2003—the highest ever recorded in the history of the Fund—and would remain at about this level through 2005.

40. **The authorities agreed to prepay the amounts outstanding under the SRF.** As Turkey's financing needs had become more medium term in nature following the September 11 shock, this prepayment would allow an appropriate lengthening of the maturity of Turkey's repayments to the Fund. Indeed, without the prepayment and the associated increase in access, the financing gaps in 2003–04 would have been significantly larger.

41. **Although the Fund would be highly exposed—with Turkey expected to account for around 30 percent of outstanding Fund credit next year—Turkey should still be in a position to discharge its obligations to the Fund in a timely manner** (Table 17). Turkey's unblemished record of payments to the Fund, the authorities' commitment to an intensified reform program, and the likely gradual resumption of access to the international capital markets provide assurances in this respect. Indeed, the recent turnaround in market sentiment, based on the prospect of additional Fund financing in the context of strengthened policies, is noteworthy in this regard. Turkey's obligations to the Fund will, however, continue to be substantial over the medium term. Based on current conservative balance of payments projections, peak payments to the Fund, including repurchases and charges, would reach US$10 billion (or 14 percent of exports of goods and nonfactor services, accounting for 29 percent of Turkey's overall external debt service) in 2006. The risks associated with unparalleled Fund exposure underscore the need for continued close monitoring of Turkey's capacity to repay the Fund over the medium term, and for corrective measures if medium-term projections turn out less favorable than expected.

42. **Alongside Turkey's unblemished payment record, its financing needs and the strength of the new economic program justify the proposed access to Fund resources.** Turkey's financing needs for 2002–04 are estimated at US$16.3 billion (of which US$4.3 billion would have been available in 2002 under the existing SBA). In response, the authorities have committed themselves to an intensified medium-term economic program, addressing the economy's deep-rooted problems, for which they deserve international financial support. In the absence of support from other sources, this financing is being provided by the Fund.

43. **Finally, both the Safeguards Assessment and the design of the program should provide further protection of Fund resources.** The comprehensive safeguards procedures of the CBT (described in Section V below) will help provide assurances regarding the accounting and control of Fund resources. Moreover, as already discussed, the new program is designed to address Turkey's key vulnerabilities to shocks. The authorities are also committed to taking strong policy actions should negative shocks be large and prolonged, and to increasing reserves or prepaying the Fund should the balance of payments and debt situation turn out to be better than expected. Together with the proposed close monitoring of the new program (see Section IV.C below), this should help further protect Fund resources.

B. Private Sector Involvement (PSI) in the Program

44. **The staff indicated that Fund-supported programs with high access carried with them an expectation of a significant PSI component.** Accordingly, in the discussions particular attention was devoted to this topic given the unprecedented level of Fund access.

45. **It was acknowledged by both sides that the existing program contained elements of PSI:**

- **On the external interbank side, the authorities had secured two voluntary agreements with foreign commercial banks to maintain their exposure to Turkey.** In meetings at Frankfurt and New York in December 2000 and June 2001, foreign banks had agreed to maintain (and seek to rebuild over time), in a voluntary fashion, the size of their overall interbank and trade credit to Turkey.

- **The authorities had also taken steps to enhance voluntary PSI in financing the public sector.** In June 2001, the authorities had engaged in a voluntary domestic debt swap to help lengthen maturities. More recently, they had pursued active and flexible debt management practices to widen the investor base and lengthen the maturity of government debt, as discussed above.

46. **Both sides agreed that the voluntary PSI approach to government debt had shown some results, but that efforts on the external interbank side had yielded little.** The increased demand generated by the voluntary debt management measures had contributed to lower interest rates on Turkish lira debt and narrower spreads on foreign currency debt. As a result, although domestic private banks had been constrained in their purchases of debt by the fall in their liability base in real terms, they had increased the share of government securities in their balance sheet from 22 percent at end-2000 to an estimated 33 percent at end-2001. Moreover, the authorities had been able to bring a wide range of international and domestic investors on board by tapping the Eurobond markets for US$1.5 billion in the fourth quarter of 2001, despite the difficult external environment. However, progress with external interbank loans had been less encouraging. Despite the two agreements with foreign banks, net interbank outflows amounted to some US$8 billion in 2001, representing a rollover of just 50 percent of the principal falling due in the year

(Figure 11). Exposure had remained broadly stable during the good to quiescent phases of the program, but declined sharply during unsettled periods, notably February–March and June–July 2001. However, the outflows did not result from lower supply alone. Much of the outflow in the third quarter of 2001 reflected syndicated loans which matured and were not fully rolled over as the recession and the currency depreciation reduced borrowing banks' demand.

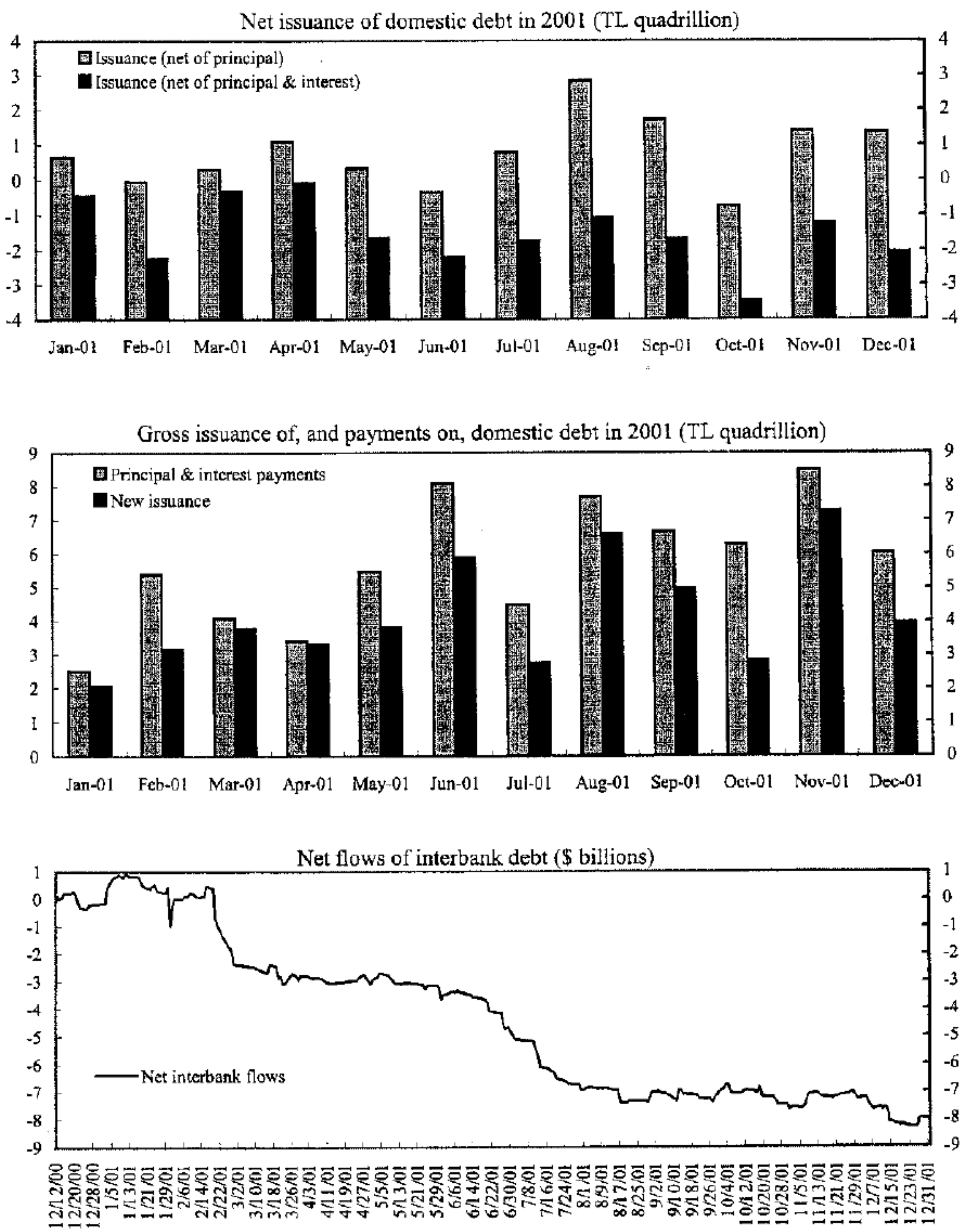
47. **It was acknowledged that the PSI elements of the new program would have to factor in this background of mixed success:**

- **On the external interbank side, while the authorities would continue their dialogue with international banks to encourage them to maintain their exposure, they concurred with the staff that a renewal of the interbank agreement would only be successful if proactively supported by the authorities of those countries whose banks are the major players.** Without such support, attempting to secure a further voluntary agreement with foreign banks along the existing lines would likely be ineffective, and could further undermine the concept of voluntary PSI. In the event, the existing voluntary agreement was not renewed when it expired at end-December 2001. However, the authorities agreed that daily monitoring of external interbank flows would continue, so that external private sector financing could be tracked closely. The authorities also underscored their commitment to explain their intensified program to international markets, to maintain a dialogue with borrowing and lending banks to encourage the rollover of interbank lending, and to embark on further roadshows. They agreed with staff that, whatever PSI measures were taken, strong policy performance was a prerequisite for resumed capital inflows.[6]

- **As for PSI on government debt, the authorities argued that perseverance with a voluntary approach, in the form of creative debt management practices, would work best.** They noted the strong catalytic effect which had already occurred in response to prospects of a new Fund arrangement. The authorities reiterated their strong commitment to strictly voluntary and market-friendly approaches, and argued that any departure from this approach could easily reverse the turnaround in market confidence recently achieved. Their planned measures to further lengthen maturities, widen the investor base, and deepen liquidity in the market would help secure the required private sector financing under the program, and make it less susceptible to fluctuations in market sentiment. The staff noted the continued risk that the

[6] Although the program conservatively projects that there would still be net external outflows by the private sector in 2002, the proportion of Turkey's external gross financing requirement financed by private sector inflows is projected to rise from 60 percent last year to over 70 percent this year, as portfolio outflows slow and a higher proportion of Turkey's short-term external debt is rolled over.

Figure 11. Turkey: Private Sector Involvement, 2000-01



Source: Fund staff estimates and projections.

Treasury's ability to fund itself voluntarily from the private sector could be derailed by short-term market turbulence. However, they acknowledged the authorities' arguments, and encouraged them to explore all avenues under their voluntary approach.

C. Program Monitoring

48. **The program supported by the proposed SBA will run from January 2002 through December 2004, and will be subject to close monitoring.** By extending beyond the next scheduled election, due by spring 2004, the program should help to anchor medium-term economic policy expectations. As for monitoring, given the unprecedented access and considerable risks, the first three reviews will be bi-monthly (beginning with the first review in March 2002), followed by quarterly reviews thereafter for the duration of the program (Table 1).

49. **Given the deep-rooted problems facing Turkey, structural conditionality will be especially strong** (Box 3). Several prior actions and other program structural conditionality—concentrated in the important areas of banking, public sector and fiscal reform, and privatization—have been discussed at length in Section III above, and are summarized in Annex C of the attached Letter of Intent. The program also includes quantitative performance criteria on: (i) the cumulative primary balance of the consolidated government sector; (ii) the contracting or guaranteeing of new external public sector debt; (iii) the stock of short-term external public sector debt outstanding; (iv) net international reserves; and (v) base money. In addition, indicative targets have been set for: (i) net domestic assets; (ii) the cumulative overall balance of the consolidated government sector; and (iii) other subcomponents of the broader public sector primary surplus.

V. Safeguards Assessment

50. **Under the proposed arrangement, Turkey will be subject to a full safeguards assessment.** The safeguards assessment under the transitional procedures, which was limited to the CBT's external audit mechanism, was completed on August 21, 2001, and its recommendations presented in the tenth review staff report (EBS/01/192). Under the new arrangement, the CBT will be subject to a full safeguards assessment. This assessment has already begun, with TRE requesting a series of documents to allow the off-site assessment (Stage One). The CBT has provided most of these documents, which TRE is assessing with a view to determining whether an on-site (Stage Two) assessment is warranted. The staff will incorporate the specific recommendations of the safeguards assessment in program conditionality.

Box 3. Structural Conditionality

Coverage of structural conditionality in the proposed program

The proposed program aims at reinvigorating structural reforms, while incorporating those policy actions that were already agreed under the previous program (as set out in Table 2 of the November 20 Memorandum on Economic Policies and Annex B of the Letter of Intent attached to EBS/01/192). The areas covered by the program's structural conditionality continue to fall into two categories: (i) **measures with a direct and significant bearing on the attainment of macroeconomic stability**, which include extensive conditionality in the banking sector, the key source of weakness underlying the recent crises; and (ii) **measures that will improve medium-term growth prospects,** which, in addition to banking reforms, include measures to strengthen tax policy and expenditure management, and steps to enhance the role of the private sector in the economy. Since Turkey's problems largely reflect a lack of confidence stemming from structural weaknesses in the economy, the credibility of the program depends fundamentally on the strength of the structural effort.

Status of structural conditionality from earlier programs

Previous programs featured key structural conditions, many of which were prior actions for program reviews (see EBS/01/66). Comprehensive structural reforms have focused on banking sector restructuring, fiscal transparency, private sector development, and governance. While privatization has proceeded rather slowly, in part owing to weak market conditions, major progress has been made in other areas. The proposed program builds on these important results, with strong upfront conditionality. Over ten prior actions, including banking sector restructuring, privatization, and private sector development, are envisaged for Board approval of the proposed program.

Structural areas covered by World Bank Lending and conditionality

The key element of the World Bank's program lending in 2001 was the Public Sector and Financial Sector Adjustment Loan (PFPSAL) approved in July 2001. The PFPSAL program is focused on banking and public sector reforms to support the quality of fiscal adjustment and modernization of the public sector. A follow-up operation (PFPSAL II) is being prepared. The Bank's program lending also supports structural reform to promote private sector development and the strengthening of the social safety net. The Economic Reform Loan (ERL) covers reform of the energy, agricultural, and telecommunications sectors, as well as privatization and structural fiscal reforms. The Agricultural Reform Implementation Project (ARIP) supports implementation of the agriculture reform program, including the introduction of a direct income support program for farmers. The Social Risk Mitigation and Privatization Social Support projects help Turkey's efforts to improve its social protection system and alleviate the social costs of the crisis.

Other relevant structural conditions not included in the proposed program

An area that is not covered by program conditionality is trade regime and policy, given that Turkey's trade regime is only moderately restrictive. This area, however, will be kept under review, and specific policy actions will be included in program conditionality if warranted. On privatization, the program does not include upfront conditionality on actual sales of enterprises. The Fund and World Bank staffs regard this approach as appropriate at present, given the current unfavorable market conditions for many of the enterprises to be privatized. Instead, Fund and World Bank conditionality is aimed at preparing the ground for rapid privatization once market conditions improve as expected in 2002.

VI. Staff Appraisal

51. **Over the past two years, despite financial turmoil, the authorities have made considerable progress under their ambitious Fund-supported economic reform program, with positive results now becoming more apparent.** In particular, the authorities have moved ahead with fiscal consolidation, banking sector restructuring, pension reform, and preparations for privatization. While positive results have materialized more slowly than expected, signs of financial stabilization and economic recovery have increased over the past few months.

52. **Nevertheless, following September 11, which hit Turkey with a large exogenous shock, the country now faces a large external financing gap, which deserves the support of the international community in the form of a new Fund-supported program.** The September 11 shock is affecting the Turkish economy through several channels at a time when Turkey continues to face deep-rooted economic problems. The confluence of these factors calls for a new medium-term economic program supported by the Fund.

53. **Besides financing, the twin challenges facing Turkey are to protect the economy from future shocks and to lay the basis for sustained economic growth.** The new program addresses both these challenges. The program's strong initial focus on cleaning up the banking sector and consolidating the fiscal adjustment, coupled with the maintenance of a free float of the Turkish lira, should go a long way toward making the economy more robust in the face of future shocks. At the same time, the medium-term structural reform strategy aims directly at addressing the key impediments to growth, namely a weak banking system, inefficient management of public resources, and obstacles to a dynamic private sector.

54. **At the core of the program strategy is the maintenance of high primary budget surpluses over the medium term, underpinned by fundamental reforms of the tax system and spending policies.** The staff welcomes the government's recognition that a strict fiscal stance is needed over the medium term, coupled with improved public debt management to solidify government debt sustainability. Also, it is encouraging that the government has committed to policies designed to make the budget adjustment permanent, rather than relying on one-off measures. Especially important in this regard will be the reduction in public sector employment, which should be pursued vigorously, albeit in a manner that minimizes social costs. The government's renewed focus on strengthening social policies with the support of the World Bank is, therefore, especially welcome.

55. **The budget system itself will be overhauled, to improve transparency in the use of public funds and facilitate budgetary prioritization.** Building on the considerable progress in streamlining the budget system over the last couple of years, notably the closure of several budgetary and extra-budgetary funds, the program appropriately aims to take the process even further. The planned steps to improve public procurement, overhaul the tax system, reform public sector employment, and consolidate budget institutions will not only

improve spending decisions, but will also help build support for the economic program by enabling the public to better monitor the use of tax revenues.

56. **Lowering inflation on a lasting basis will be key to the success of the program.** Achieving the targeted reduction in inflation will be central to the success of the floating exchange rate regime and to the achievement of a stable macroeconomic environment conducive to economic growth. To achieve the targeted disinflation, the central bank should, in the first instance, adhere strictly to its base money targets, the key nominal anchor under the program. At the same time, the central bank should move ahead expeditiously with its preparations for formal inflation targeting. It is hoped that these moves, coupled with the planned progress toward putting the banking system on a sounder footing, strengthening the government finances, and moving toward a de-indexation of the economy, would allow an early transition to the new monetary framework. Finally, the development of the domestic money and foreign exchange futures market and the improvement of the foreign exchange management of major energy enterprises in the public sector should help to further bolster the workings of the foreign exchange market, and allow the floating exchange rate system to work even more effectively.

57. **A sound banking system will help protect the economy from future shocks and lay the basis for efficient financial intermediation in support of economic growth.** Progress in reforming state banks has been one of the main achievements under the existing program, and every effort must now be made to complete the operational restructuring of these banks, followed by their privatization. Regarding private banks, the banking supervision agency has established an impressive track record, although the deepest recession in Turkey for more than 50 years has taken its toll. Accordingly, a new private bank recapitalization scheme has been developed. It is imperative to ensure that a strong legal and regulatory framework for this scheme is put in place expeditiously, and that the scheme is implemented in a fully transparent manner that protects public resources. In particular, the scheme must not entail a bailout of existing owners. The planned steps to further strengthen the supervisory framework and institutions are welcome, and should leave Turkey with a modern and effective banking supervision system. However, to maximize its effectiveness, banking sector restructuring needs to be complemented with corporate debt restructuring. The authorities, working with the World Bank, should play a more active role in ensuring that an appropriate framework is put in place, including through instituting improved bankruptcy and foreclosure procedures.

58. **The program contains several measures to free up the growth potential of Turkey's private sector.** The program rightly addresses key obstacles to domestic and foreign private investment. Over the past year, while the legal basis for privatizing large enterprises has been improved, results have been few. For the new program to succeed in enhancing Turkey's growth prospects, it is imperative that the authorities convert the envisaged privatization plans rapidly into actual sales. Dealing with bureaucratic obstacles to investment and addressing governance concerns will also be important, and the adoption of concerted strategies to these ends is welcome. Finally, the renewed emphasis on better

communication, including through the establishment of an investor relations office and an Investor Council, is also welcome.

59. **Private sector involvement (PSI) under the new program is based on a voluntary approach.** This partly reflects the current rather favorable situation, which reduces the case for less voluntary measures. On external interbank PSI, the continued outflows during 2001 despite rollover agreements with international banks suggest that a renewal of that approach would not be successful without more active support from creditors' authorities. On PSI for government debt, the authorities' argument that a departure from a market-based approach at this point could reverse the recent turnaround in market confidence has merit. However, it should be recognized that the effect of short-term market turbulence on government financing remains a significant program risk. To counter this risk, and to encourage PSI more generally, strong policy performance is key.

60. **While the program faces real risks, Turkey's policy record under the May 2001 program increases the likelihood of the new program being implemented as planned and achieving its key objectives.** The proposed program faces many risks: the banking system remains fragile and the government debt situation is precarious; the external environment could take a turn for the worse, especially if the current international conflict were to spread; and, after two crises in less than one year, continued full political support for the program is essential. At the same time, several factors give confidence that the program could well succeed: the government has shown increasingly greater unity and impressive implementation of the May 2001 program in spite of the deep recession, and the three coalition leaders have renewed their commitment to economic reform, including through a soon-to-be issued joint public letter of support for the program; the proposed program contains an impressive reform agenda which, if implemented fully, will help insulate Turkey from adverse external developments; the government is committed to responding flexibly to unforeseen developments in consultation with the Fund staff; and the program calls for close monitoring, including frequent reviews. Full implementation of the program, coupled with demonstration of political unity, should help sustain the positive developments of the last few months, and underpin the success of the program.

61. **Against this background, the staff recommends the approval of the proposed stand-by arrangement.** Turkey has built a solid record of policy implementation with positive results now becoming increasingly evident. Moreover, Turkey has adopted an appropriate strategy in response to the fallout of the September 11 events, and to address the remaining long-standing problems in the economy. Nevertheless, following September 11, Turkey faces a balance of payments need, which deserves international support. On this basis, and mindful of the risks noted above, the staff recommends the approval of the proposed arrangement.

Table 1. Turkey: Proposed Schedule of Purchases Under the SBA, 2002-04

Date	Purchases			Conditions
	In millions of SDRs	In percent of quota (%)	In billions 1/ of U.S. dollars	(as indicated in Letter of Intent)
Scheduled Purchases	12,821.2	1,330.0	16.3	
2002	11,201.7	1,162.0	14.3	
January 14, 2002	7,326.4	760.0	9.3	Board approval of SBA
March 25, 2002	867.6	90.0	1.1	First review; end-January and end-February 2002 performance criteria
May 24, 2002	867.6	90.0	1.1	Second review; end-March and end-April 2002 performance criteria
July 25, 2002	867.6	90.0	1.1	Third review; end-May and end-June 2002 performance criteria
October 25, 2002	1,272.5	132.0	1.6	Fourth review; end-August and end-September 2002 performance criteria
2003	809.8	84.0	1.0	
January 24, 2003	202.4	21.0	0.3	Fifth review; end-November and end-December 2002 performance criteria
April 25, 2003	202.4	21.0	0.3	Sixth review; end-February and end-March 2003 performance criteria
July 25, 2003	202.4	21.0	0.3	Seventh review; end-May and end-June 2003 performance criteria
October 24, 2003	202.4	21.0	0.3	Eighth review; end-August and end-September 2003 performance criteria
2004	809.8	84.0	1.0	
January 23, 2004	202.4	21.0	0.3	Ninth review; end-November and end-December 2003 performance criteria
April 23, 2004	202.4	21.0	0.3	Tenth review; end-February and end-March 2004 performance criteria
July 23, 2004	202.4	21.0	0.3	Eleventh review; end-May and end-June 2004 performance criteria
October 25, 2004	202.4	21.0	0.3	Twelfth review; end-August and end-September 2004 performance criteria
Memorandum items:				
2002	11,201.7	1,162.0	14.3	
2003	809.8	84.0	1.0	
2004	809.8	84.0	1.0	
Quota (in millions)	964.0	100.0	1,229.1	
US$/SDR			1.275	

1/ For illustrative purposes only, SDR amounts have been converted into U.S. dollars at an SDR/U.S. dollar exchange rate of 1.275.

Table 2. Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In percent)			
Real sector						
Real GNP growth rate	-6.1	6.3	-8.5	3.0	5.0	5.0
GNP deflator	55.8	50.9	60.7	48.9	24.9	13.1
Nominal GNP growth rate	...	60.4	47.0	53.4	31.2	18.8
WPI (12-month, end-of-period)	62.9	32.7	88.6	31.0	16.2	12.0
CPI (12-month, end-of period)	68.8	39.0	68.5	35.0	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.7	69.6	46.0	32.4
Average ex-ante real interest rate 1/	32.0	-9.4	32.4	33.2	27.5	20.5
			(In percent of GNP)			
Central government budget						
Primary balance 2/	1.5	4.2	5.0	5.4	5.6	5.6
Net interest payments 3/	13.1	15.8	23.2	20.5	16.2	13.5
Overall balance	-11.6	-11.6	-18.2	-15.2	-10.6	-7.8
Consolidated public sector						
Primary balance	-2.0	2.3	5.7	6.5	6.5	6.5
Net interest payments 4/	22.1	21.9	24.7	18.4	15.8	13.3
PSBR (including CBT profits)	24.2	19.6	19.0	11.9	9.3	6.8
Net debt of public sector	61.0	57.4	92.2	81.3	73.3	69.4
Net external	20.1	18.3	38.0	35.1	30.6	28.5
Net domestic	40.9	39.1	54.2	46.2	42.7	40.9
Of which:						
Central government (gross)	42.5	40.9	70.3	54.2	...	...
Auctioned and other cash debt	25.8	23.4	25.3	23.1	...	...
Bank recapitalization	...	17.4	35.6	28.4	...	...
External sector						
Current account balance	-0.7	-4.9	1.3	-1.2	-1.2	-1.2
Gross external debt	55.0	56.6	75.4	71.7	66.7	63.3
Net external debt	34.0	37.0	51.6	48.1	44.4	40.8
Short-term external debt (by remaining maturity)	20.8	23.0	23.3	20.4	19.0	18.8
Monetary aggregates						
Seignorage 5/	3.2	1.8	1.0	1.0	0.7	...
Nominal growth of broad liquidity (in percent)	96.9	40.2	75.1	40.2	27.4	17.1
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	0.1	3.3	2.8	1.5	2.5	1.0
Net external financing of central government	1.4	4.1	-2.7	1.0	-1.0	-1.0
Amortization	6.0	6.2	8.2	6.5	8.4	8.0
Gross borrowing	7.4	10.3	5.5	7.4	7.5	7.0
Of which: Eurobond issues	5.0	7.5	2.2	2.5	4.5	4.7
GNP	187.4	201.3	150.3	165.6	183.0	201.3
GNP (in quadrillions of Turkish lira)	78.3	125.6	184.7	283.2	371.6	441.3

Sources: Data provided by Turkish authorities; and Fund 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/ Interest payments minus interest receipts plus profit transfers from the central bank.

4/ Interest payments minus interest receipts plus CBT profits before transfers to the government.

5/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

Table 3. Turkey: Quantitative Performance Criteria and Indicative Targets, 2001

	March 31, 2001		May 31, 2001		June 30, 2001		July 31, 2001			Sep. 30, 2001		Dec. 31, 2001
	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome		Ceiling/Floor	Outcome	Ceiling/Floor
I. Performance criteria												
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira)	1,850	3,557	3,250	6,292	...	...	4,250		7,330	6,200	10,316	9,250
2. Ceiling on contracting or guaranteeing of new external public debt (in millions of US$)	5,500	1,035	...	...	7,500	1,783	...	...	...	12,000	3,067	17,000
3. Ceiling on the stock of public short-term external debt outstanding (in millions of US$)	1,100	1,000	...	...	2,100	0	...	...	...	0	0	2,100
4. Ceiling on the cumulative primary expenditure of the central government (in trillions of Turkish lira)	5,830	5,480	11,400	10,950	...	...	17,450		16,890	24,150	22,961	36,050
							July-Aug., 2001			Sept.-Oct., 2001		Nov.-Dec., 2001
5. Floor on change in net international reserves (in millions of US$) 1/	...	...	-1,500	-838	-3,562	-3,059	-2,500		-1,370	-3,250	-304 2/	-3,546 3/
							Aug. 31, 2001			Oct. 31, 2001		Dec. 31, 2001 (indicative limit)
6. Ceiling on the stock of net domestic assets of the CBT 4/ 5/ (in trillions of Turkish lira)	0	5,117	9,750	7,942	13,250	12,943	17,250		16,437	21,150	17,933	22,400
II. Indicative targets												
1. Floor on the cumulative overall balance of the consolidated government sector (in trillions of Turkish lira)	-2,620	-734	-4,750	-4,400	...	...	-11,750		12,074	-18,150	-18,011	-27,800
							Aug. 31, 2001			Oct. 31, 2001		Dec. 31, 2001 (performance criterion)
2. Ceiling on base money (in trillions of Turkish lira) 5/	...	...	5,900	5,815	6,050	6,247	7,175		6,748	7,550	7,141	7,750

1/ Floors correspond to changes in NIR during the period specified in Annex F of the Memorandum on Economic Policies attached to the May 3, 2001 Letter of Intent. Excludes any carryover from previous period.
2/ Includes $650 million carryover from previous period.
3/ Includes $2946 million carryover from previous period.
4/ Net domestic assets are defined as base money less the net foreign assets of the CBT valued in Turkish lira at end-July 2001 actual exchange rates.
5/ For end-December, the ceiling on net domestic assets will be an indicative target; the ceiling on base money a performance criterion.

Table 4. Turkey: Indicators of External Vulnerability, 1997–2003 1/

	1997	1998	1999	2000	Projections 2001	2002	2003
CPI inflation (end year)	99.1	69.7	68.8	39.0	68.5	35.0	20.0
Public sector borrowing requirement (percent of GNP)	13.2	15.4	24.2	19.1	19.2	12.1	8.9
Net debt of the public sector (percent of GNP)	42.9	43.7	61.0	57.4	91.5	81.3	73.0
Export volume (percent change)	21.6	5.8	0.7	9.5	14.4	3.8	6.4
Import volume (percent change)	19.5	0.6	-13.3	31.4	-21.9	7.7	9.3
Current account balance, in percent of GNP	-1.4	1.0	-0.7	-4.9	1.3	-1.2	-1.2
Capital account balance (in billions of US$)	6.0	-1.5	6.6	6.8	-16.4	-2.9	3.2
Of which: Foreign direct investment	0.6	0.6	0.1	0.1	2.5	1.0	1.1
Foreign portfolio investment	-0.1	-6.1	0.2	-5.2	-4.0	-1.1	-0.5
Gross official reserves, in billions of US$ 2/	19.6	20.9	24.3	23.2	19.0	22.1	23.7
In months of imports of goods and NFS	3.8	4.1	5.3	4.0	4.2	4.5	4.3
In percent of broad money	37.6	32.3	32.5	27.8	27.2	28.9	26.7
Gross total external debt, in billions US$	84.9	97.2	103.1	119.6	113.3	118.7	122.0
In percent of GNP	43.7	47.1	55.0	56.6	75.4	71.7	66.7
In percent of merchandise exports	26.0	31.0	35.1	36.1	32.3	32.1	30.5
Gross short-term external debt, in billions US$ 3/	29.5	33.8	39.0	46.4	35.0	33.8	34.7
In percent of gross total external debt	34.7	34.9	37.9	40.5	30.9	28.5	28.5
In percent of gross official reserves	150.4	161.9	160.7	199.8	183.8	152.8	146.5
In percent of banking system gross reserves	74.7	88.4	88.7	106.2	...	...	...
Debt service 4/	21.2	26.0	34.1	37.0	44.3	41.3	41.9
REER appreciation (CPI based, period average) 5/	6.4	8.5	4.1	9.9	-23.5	...	...
REER appreciation (CPI based, end of period) 5/	13.5	3.9	5.6	13.7	-26.3	...	...
Capital adequacy ratio 6/	12.6	12.4	9.1	17.3	16.8	...	...
State and SDIF banks	12.6	8.6	8.2	7.9	27.6	...	...
Private banks	11.9	12.0	9.0	18.3	10.9	...	...
Foreign banks	13.7	21.0	20.3	29.4	29.5	...	...
Nonperforming loans (in percent of total) 6/	2.1	6.7	9.7	9.2	15.6	...	...
Real broad liquidity, percentage change (CPI deflated)	13.9	3.7	16.6	0.9	4.2	3.9	6.0
Real credit to the private sector, percentage change 7/	18.2	17.7	-7.4	28.3	-28.6	1.7	7.4
Banks' net foreign asset position, in millions of US$	-889	-3,018	-3,176	-5,883	...	...	...
Banks' net open exchange position, in millions of US$	-1,922	-2,898	-2,608	-5,437	...	...	...
Spread on Turkish dollar Eurobonds (in basis points) 8/	...	548	550	443	718	676	...

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

1/ For 2001-03, program projections.

2/ As of end-November 2001, reserves stood at US$18.3 billion.

3/ By residual maturity.

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

5/ As of August 2001.

6/ As of September 2001.

7/ Deflated by the WPI.

8/ As of January 4, 2002.

Table 5. Turkey: Macroeconomic Parameters, 2001-04

(Percentage change unless otherwise indicated)

	2001	2002	2003	2004
Real GNP	-8.5	3.0	5.0	5.0
Nominal GNP	47.0	53.4	31.2	18.8
GNP deflator (average)	60.7	48.9	24.9	13.1
CPI (average)	54.4	48.7	26.9	14.4
CPI (end-period)	68.5	35.0	20.0	12.0
WPI (average)	61.6	49.3	23.8	12.2
WPI (end-period)	88.6	31.0	16.2	12.0
Average interest rate on treasury bills (in percent)	99.7	69.6	46.0	32.4
Average ex-ante real interest rate 1/ (in percent)	32.4	33.2	27.5	20.5
External current account balance (in percent of GNP)	1.3	-1.2	-1.2	-1.2
Consolidated public sector primary balance (in percent of GNP	5.7	6.5	6.5	6.5
GNP (in quadrillions of Turkish liras)	184.7	283.2	371.6	441.3
GNP (in billions of US$)	150.3	165.6	183.0	201.3

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

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.

Table 6. Turkey: Balance of Payments, 1997-2005
(In billions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account balance	-2.6	2.0	-1.4	-9.8	2.0	-2.0	-2.2	-2.4	-2.1
Trade balance	-15.4	-14.2	-10.4	-22.4	-5.2	-6.2	-8.1	-8.8	-10.2
Exports (fob), *of which:*	32.6	31.2	29.3	31.7	35.1	37.0	39.9	43.4	46.8
Exports (fob) in trade returns	26.3	27.0	26.6	27.8	31.1	32.8	35.4	38.5	41.5
Shuttle trade	5.8	3.7	2.3	2.9	3.2	3.4	3.6	3.9	4.2
Imports (fob), *of which:*	-48.0	-45.4	-39.8	-54.1	-40.2	-43.3	-48.1	-52.2	-56.9
Imports (cif)	-48.6	-45.9	-40.7	-54.5	-41.1	-43.8	-48.7	-52.9	-57.0
Energy imports (cif)	-6.1	-4.5	-5.3	-9.3	-7.7	-6.3	-6.8	-7.1	-7.5
Services (net)	7.9	10.5	3.9	7.4	3.4	0.2	1.5	1.4	2.5
Services (credit), *of which:*	21.3	25.8	18.7	22.3	18.2	16.2	19.7	21.8	23.9
Interest	1.9	2.5	2.4	2.8	2.7	1.7	2.2	3.3	4.1
Tourism receipts	7.0	7.2	5.2	7.6	8.0	6.0	8.2	8.7	9.2
Other receipts 1/	7.7	10.5	7.1	7.9	3.6	4.4	4.9	5.3	5.8
Services (debit), *of which:*	-13.4	-15.3	-14.8	-15.0	-14.8	-16.0	-18.2	-20.5	-21.4
Interest	-4.6	-4.8	-5.5	-6.3	-7.7	-8.0	-9.2	-10.7	-10.8
Private transfers (net), *of which:*	4.5	5.6	4.8	5.0	3.6	3.9	4.3	4.8	5.3
Workers remittances	4.2	5.4	4.5	4.6	2.8	3.1	3.4	3.9	4.4
Official transfers (net)	0.3	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Capital account balance	8.7	0.4	4.7	9.4	-13.1	-2.9	3.2	7.2	8.5
(including errors and omissions)	6.0	-1.5	6.6	6.8	-16.4	-2.9	3.2	7.2	8.5
Direct investment 2/	0.6	0.6	0.1	0.1	2.5	1.0	1.1	1.4	1.7
Portfolio investment in securities	-0.1	-6.1	0.2	-5.2	-4.0	-1.1	-0.5	0.7	0.8
Public sector (central & local governments & EBFs)	-0.1	-1.9	1.2	6.2	-1.7	1.6	-0.5	1.1	1.5
Bonds (net)	1.4	-0.3	3.1	6.1	0.1	0.4	0.6	1.7	1.9
Eurobond drawings	2.9	2.7	5.0	7.5	2.2	2.5	4.5	4.7	5.0
Eurobond repayments	-1.5	-3.0	-1.9	-1.4	-2.1	-2.1	-3.9	-3.1	-3.1
Loans (net)	-1.5	-1.7	-1.9	0.1	-1.8	1.2	-1.1	-0.6	-0.3
Loan disbursements	1.1	1.2	1.0	3.7	2.9	4.7	2.7	2.8	2.9
Loan repayments	-2.5	-2.8	-2.9	-3.6	-4.7	-3.5	-3.8	-3.4	-3.2
Central Bank of Turkey, Dresdner (net)	1.2	0.7	-0.2	0.7	0.6	0.3	0.7	0.7	0.8
Domestic money banks (net)	1.7	1.9	0.5	2.1	-9.0	-5.0	0.9	1.6	1.4
Domestic money banks (FX deposits abroad, -: accumulation)	-0.7	-0.8	-1.8	-1.9	0.5	0.0	0.0	0.0	-0.1
Domestic money banks (other, net)	2.4	2.7	2.4	4.0	-9.5	-5.0	0.9	1.6	1.5
Domestic money banks (medium and long-term, net)	2.1	0.5	0.2	-0.2	-1.2	-0.7	0.3	0.8	0.5
Domestic money banks (short-term, net)	0.3	2.2	2.2	4.2	-8.3	-4.3	0.6	0.8	1.0
Interbank credit lines from foreign commercial banks	0.7	0.1	2.1	4.7	-6.3	-3.5	0.5	0.6	0.7
Other private sector (net)	5.6	5.3	2.8	5.6	-1.4	0.3	1.5	1.7	2.3
Other private sector (medium and long-term, net)	3.6	4.2	2.3	4.9	-0.5	-0.5	0.0	0.4	0.9
Other private sector (short-term, net)	2.0	1.1	0.5	0.6	-1.0	0.8	1.5	1.2	1.4
Errors and omissions	-2.8	-2.0	1.9	-2.7	-3.3	0.0	0.0	0.0	0.0
Overall balance	3.3	0.4	5.2	-3.1	-14.4	-4.9	1.0	4.7	6.4
Overall financing	-3.3	-0.4	-5.2	3.1	14.4	4.9	-1.0	-4.7	-6.4
Change in net international reserves (+ denotes decline)	-3.3	-0.4	-5.2	3.1	14.4	4.9	-1.0	-4.7	-6.4
Change in gross official reserves (+ denotes decline)	-3.3	-0.2	-5.9	-0.2	4.2	-3.1	-1.6	-4.0	1.6
Change in reserve liabilities (IMF)	0.0	-0.2	0.7	3.3	10.2	8.0	0.5	-0.8	-8.0
Purchases	0.0	0.0	0.8	3.4	11.4	14.3	1.0	1.0	0.0
Repurchases	0.0	-0.2	-0.1	-0.1	-1.1	-6.3	-0.5	-1.8	-8.0
Exceptional financing (gap)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Table 6. Turkey: Balance of Payments, 1997-2005
(In billions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Memorandum items:									
Trade in goods and services									
As percent of GNP									
Current account balance, incl. shuttle trade	-1.4	1.0	-0.7	-4.9	1.3	-1.2	-1.2	-1.2	-1.0
Trade account balance, incl. shuttle trade	-7.9	-6.9	-5.6	-11.1	-3.4	-3.8	-4.4	-4.4	-4.8
Exports of goods and non-factor services	26.8	26.5	24.4	25.3	33.6	31.1	31.4	31.0	31.3
Imports of goods and non-factor services	29.3	27.2	26.2	31.1	31.5	31.0	31.2	31.0	31.7
Percent change									
Value growth in exports of goods (incl. shuttle trade)	0.6	-4.4	-6.1	8.0	10.8	5.6	7.9	8.6	7.8
Value growth in exports of goods (excl. shuttle trade)	13.5	2.7	-1.7	6.1	11.0	5.6	7.9	8.6	7.8
Value growth in imports of goods	11.6	-5.3	-12.5	36.0	-25.6	7.5	11.1	8.5	9.1
Volume growth in exports of goods (excl. shuttle trade)	13.5	6.4	6.3	11.6	12.6	3.8	5.3	6.1	6.4
Volume growth in imports of goods	23.6	-2.5	-1.2	35.2	-20.2	9.1	7.4	7.7	6.8
Terms of trade	-0.2	3.3	-4.2	-6.4	1.4	2.7	-0.2	0.1	0.1
Reserve and debt indicators									
Gross foreign reserves (Central Bank of Turkey)									
US$ billion	19.6	20.9	24.3	23.2	19.0	22.1	23.7	27.7	26.1
Months of goods & NFS imports	3.8	4.1	5.3	4.0	4.2	4.5	4.3	4.6	4.0
External debt (end-of-period)									
US$ billion	84.9	97.2	103.1	119.6	113.3	118.7	122.0	126.5	124.8
Percent of GNP	43.7	47.2	55.0	59.2	75.4	71.7	66.7	63.3	58.7
Percent of exports of goods & NFS	163.2	178.2	225.5	233.8	224.1	230.8	212.6	204.3	187.6
Net external debt (end-of-period) 3/									
US$ billion	53.2	62.5	63.6	74.8	77.6	79.7	81.2	81.6	81.2
Percent of GNP	27.4	30.4	34.0	37.0	51.6	48.1	44.4	40.8	38.1
Short-term debt (end-of-period)									
US$ billion	18.0	21.2	23.5	28.9	19.4	16.3	18.6	20.9	23.5
Ratio to foreign reserves	91.9	101.6	96.7	124.6	102.1	73.6	78.4	75.4	90.0
Short-term debt plus MLT repayments									
US$ billion	29.5	33.8	39.0	46.4	35.0	33.8	34.7	37.5	40.3
Ratio to foreign reserves	150.4	161.9	160.7	199.8	183.8	152.8	146.5	135.7	154.4
Debt service ratio 4/	21.2	26.0	34.1	37.0	44.3	41.3	41.9	38.3	36.1

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

1/ The decline in other receipts between 1998 and 2000 partly reflects a methodological change in the compilation of this item.

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 7. Turkey: Net Debt of the Public Sector, 2000-02
(in percent of GNP)

	2000	2001	2002
Total (including CBT net assets)	57.4	92.2	81.3
CBT net assets	8.7	3.9	7.5
Central government 1/	57.5	88.0	84.7
External	18.8	27.1	33.1
Net domestic	38.7	60.9	51.6
Auction and other cash debt 2/	23.4	25.3	23.1
Bank recapitalization	17.4	35.6	28.4
Other	-2.1	0.1	0.0
Rest of the public sector	8.6	8.1	4.1
External	5.5	8.6	6.1
Net domestic 3/	3.1	-0.6	-2.0
Memorandum items:			
FX indexed net debt	20.9	61.5	55.2
Lira denominated net debt	36.4	30.7	26.1
Debt in percent of centered GNP 4/	51.3	74.2	71.8

1/ Excludes IMF onlending by CBT during 2001. IMF lending prior to 2002 is included as part of CBT net assets.
2/ Debt issued for budget financing.
3/ Includes assets of the Unemployment Insurance Fund.
4/ End-year debt stock divided by the sum of Q3-Q4 GNP of current year and Q1-Q2 GNP of following year.

Table 8. Turkey: Distribution of Debt by Instrument, 2000-01

	2000		2001	
	Percent of GNP	Share of debt	Percent of GNP	Share of debt
Total	66.1	100.0	96.1	100.0
(including CBT net assets)	57.4	87.0	92.2	96.0
External debt	24.3	36.8	35.8	37.3
Domestic Debt	41.8	63.2	60.3	62.7
Floating interest rate	20.1	30.4	34.0	35.4
Floating rate notes	8.0	12.1	34.0	35.4
Unsecuritzed state bank duty losses	12.1	18.3	0.0	0.0
Fx-indexed	2.5	3.8	18.2	18.9
CPI-indexed	2.3	3.5	0.0	0.0
Discount bills and other	16.9	25.6	8.1	8.4

Table 9. Turkey: Medium-Term Public Debt Sustainability, 2001-06

(in percent of GNP)

	2001	2002	2003	2004	2005	2006
			(In percent of GNP)			
Primary balance	5.7	6.5	6.5	6.5	6.5	6.3
Interest	24.7	18.4	15.8	13.0	11.8	10.3
Overall balance	-19.0	-11.9	-9.3	-6.5	-5.3	-4.0
Operational balance 1/	-3.0	-3.2	-3.8	-3.4	-3.2	-2.7
Privatization	0.8	0.4	0.9	0.5	0.5	0.5
Net debt	92.2	81.3	73.3	69.4	66.5	63.9
External debt	38.0	35.1	30.6	28.5	27.8	27.2
Domestic debt	54.2	46.2	42.7	40.9	38.8	36.7
			(In percent)			
Real GNP growth	-8.5	3.0	5.0	5.0	5.0	5.0
Inflation	68.5	35.0	20.0	12.0	8.0	5.0
Nominal interest rate on TL debt	99.7	69.6	46.0	32.4	27.4	23.9
Real interest rate on TL debt 2/	21.3	29.0	26.0	20.0	18.0	18.0

1/ Adjusts for the impact of inflation on the debt stock. Since interest payments are measured on a cash basis, the operational balance will adjust to changes in interest rates and the underlying fiscal position with a lag.

2/ Ex ante real interest rate using program inflation, assuming an average maturity of new debt issued of six months.

Table 10. Turkey: Central Government Primary Budget, 2000–02
(In trillions of Turkish liras)

	2000	2001			2002		
	Est.	Prog.	Est.	Diff.	Nov.	Prog.	Diff.
Total revenue	32,111	48,426	48,315	-111	71,658	72,740	1,082
Tax revenue	26,087	39,220	39,500	281	58,202	61,785	3,583
Direct	10,424	15,688	16,026	338	20,182	21,007	824
Personal income	6,212	11,664	11,581	-84	15,486	15,186	-300
Corporate income	2,357	3,229	3,646	417	3,940	5,022	1,083
Motor vehicle and wealth	214	415	416	2	724	766	42
Windfall gains tax	1,641	380	383	3	33	33	0
Indirect	15,663	23,532	23,474	-57	38,019	40,778	2,758
VAT	8,379	12,454	12,330	-124	19,484	20,553	1,069
Domestic transactions	4,487	7,142	7,292	149	11,114	12,007	894
Foreign transactions	3,892	5,312	5,038	-274	8,371	8,546	175
Foreign trade (excluding VAT)	399	386	390	4	603	681	78
Petroleum excises	3,268	5,577	5,602	26	10,533	11,147	614
Other indirect, incl. excises	3,617	5,115	5,152	37	7,400	8,397	997
Non-tax revenue	6,025	9,206	8,815	-391	13,456	10,955	-2,501
Budgetary funds	2,206	3,124	2,700	-424	5,000	2,195	-2,805
Education levies	513	828	662	-166	700	700	0
Revenue from state property 1/	1,104	1,844	1,987	143	3,094	3,044	-50
Other non-tax revenue	2,052	3,009	3,064	55	4,362	4,716	354
Of which:							
Interest receipts	332	415	445	30	650	650	0
CBT profits	229	472	472	0	750	750	0
Annexed budget	151	401	401	0	300	300	0
Non-interest expenditure	26,265	38,419	38,241	-178	54,525	56,043	1,518
Personnel	9,982	14,995	14,935	-60	22,101	22,514	413
Civil servants	8,274	12,525	12,465	-60	18,901	19,206	305
Public workers	1,708	2,470	2,470	0	3,200	3,308	108
Other current	3,635	4,800	4,800	0	7,292	7,283	-9
Transfers	10,002	14,854	14,736	-118	19,396	20,510	1,114
Social security, incl. unemployment fund	3,321	6,032	5,914	-118	7,589	8,519	930
Budgetary funds	1,995	866	866	0	300	300	0
Agricultural subsidies	359	938	938	0	2,335	2,525	190
State banks 2/	394	480	480	0	40	90	50
State enterprises	886	1,200	1,200	0	1,655	1,580	-75
Tax rebates	1,633	2,359	2,359	0	3,400	3,400	0
Other transfers	1,415	2,979	2,979	0	4,077	4,096	19
Investment	2,251	3,770	3,770	0	5,736	5,736	0
Unallocated earthquake expenditures	395	0	0	0	0	0	0
Primary balance (authorities' definition) 1/	5,847	10,007	10,074	67	17,133	16,697	-436
Primary balance (IMF staff definition) 3/	5,286	9,119	9,156	37	15,733	15,297	-436
Memorandum items:							
Monitorable earthquake costs	1,343	650	650	0	0	0	0
Primary expenditure excl. tax rebates	24,632	36,060	35,882	-178	51,125	52,643	1,518
Total revenue (IMF staff definition) 3/	31,550	47,538	47,397	-141	70,258	71,340	1,082
GNP	125,596	184,767	184,667	-100	280,551	283,241	2,690

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

1/ Excluding privatization proceeds.

2/ Excluding recapitalization of state banks.

3/ Excluding privatization proceeds, CBT profits, and interest receipts.

Table 11. Turkey: Central Government Primary Budget, 2000–02
(In percent of GNP)

	2000	2001			2002		
	Est.	Prog.	Est.	Diff.	Nov.	Prog.	Diff.
Total revenue	25.6	26.2	26.2	0.0	25.5	25.7	0.1
Tax revenue	20.8	21.2	21.4	0.2	20.7	21.8	1.1
Direct	8.3	8.5	8.7	0.2	7.2	7.4	0.2
Personal income	4.9	6.3	6.3	0.0	5.5	5.4	-0.2
Corporate income	1.9	1.7	2.0	0.2	1.4	1.8	0.4
Motor vehicle and wealth	0.2	0.2	0.2	0.0	0.3	0.3	0.0
Windfall gains tax	1.3	0.2	0.2	0.0	0.0	0.0	0.0
Indirect	12.5	12.7	12.7	0.0	13.6	14.4	0.8
VAT	6.7	6.7	6.7	-0.1	6.9	7.3	0.3
Domestic transactions	3.6	3.9	3.9	0.1	4.0	4.2	0.3
Foreign transactions	3.1	2.9	2.7	-0.1	3.0	3.0	0.0
Foreign trade (excluding VAT)	0.3	0.2	0.2	0.0	0.2	0.2	0.0
Petroleum excises	2.6	3.0	3.0	0.0	3.8	3.9	0.2
Other indirect, incl. excises	2.9	2.8	2.8	0.0	2.6	3.0	0.3
Non-tax revenue	4.8	5.0	4.8	-0.2	4.8	3.9	-0.9
Budgetary funds	1.8	1.7	1.5	-0.2	1.8	0.8	-1.0
Education levies	0.4	0.4	0.4	-0.1	0.2	0.2	0.0
Revenue from state property 1/	0.9	1.0	1.1	0.1	1.1	1.1	0.0
Other non-tax revenue	1.6	1.6	1.7	0.0	1.6	1.7	0.1
Of which:							
Interest receipts	0.3	0.2	0.2	0.0	0.2	0.2	0.0
CBT profits	0.2	0.3	0.3	0.0	0.3	0.3	0.0
Annexed budget	0.1	0.2	0.2	0.0	0.1	0.1	0.0
Non-interest expenditure	20.9	20.8	20.7	-0.1	19.4	19.8	0.4
Personnel	7.9	8.1	8.1	0.0	7.9	7.9	0.1
Civil servants	6.6	6.8	6.7	0.0	6.7	6.8	0.0
Public workers	1.4	1.3	1.3	0.0	1.1	1.2	0.0
Other current	2.9	2.6	2.6	0.0	2.6	2.6	0.0
Transfers	8.0	8.0	8.0	-0.1	6.9	7.2	0.3
Social security, incl. unemployment fund	2.6	3.3	3.2	-0.1	2.7	3.0	0.3
Budgetary funds	1.6	0.5	0.5	0.0	0.1	0.1	0.0
Agricultural subsidies	0.3	0.5	0.5	0.0	0.8	0.9	0.1
State banks 2/	0.3	0.3	0.3	0.0	0.0	0.0	0.0
State enterprises	0.7	0.6	0.6	0.0	0.6	0.6	0.0
Tax rebates	1.3	1.3	1.3	0.0	1.2	1.2	0.0
Other transfers	1.1	1.6	1.6	0.0	1.5	1.4	0.0
Investment	1.8	2.0	2.0	0.0	2.0	2.0	0.0
Unallocated earthquake expenditures	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance (authorities' definition) 1/	4.7	5.4	5.5	0.0	6.1	5.9	-0.2
Primary balance (IMF staff definition) 3/	4.2	4.9	5.0	0.0	5.6	5.4	-0.2
Memorandum items:							
Monitorable earthquake expenditures	1.1	0.4	0.4	0.0	0.0	0.0	0.0
Primary expenditure excl. tax rebates	19.6	19.5	19.4	-0.1	18.2	18.6	0.4
Total revenue (IMF staff definition) 3/	25.1	25.7	25.7	-0.1	25.0	25.2	0.1

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

1/ Excluding privatization proceeds.

2/ Excluding recapitalization of state banks.

3/ Excluding privatization proceeds, CBT profits, and interest receipts.

Table 12. Turkey: Public Sector Primary Balances, 2000–02

	2000	2001			2002		
	Est.	Prog.	Est.	Diff.	Nov.	Prog.	Diff.
	(In trillions of TL)						
Public sector	2,882	10,524	10,554	30	18,236	18,439	203
Central government 1/	5,286	9,119	9,156	37	15,733	15,297	-436
Total revenue	31,550	47,538	47,397	-141	70,258	71,340	1,082
Tax revenue	26,087	39,220	39,500	281	58,202	61,785	3,583
Nontax revenue 1/	5,463	8,319	7,897	-421	12,056	9,555	-2,501
Non-interest expenditure	26,265	38,419	38,241	-178	54,525	56,043	1,518
Personnel	9,982	14,995	14,935	-60	22,101	22,514	413
Other current	3,635	4,800	4,800	0	7,292	7,283	-9
Transfers 2/	10,397	14,854	14,736	-118	19,396	20,510	1,114
Investment	2,251	3,770	3,770	0	5,736	5,736	0
Rest of the public sector	-2,404	1,405	1,398	-7	2,503	3,142	639
EBFs	-225	-168	-161	7	-651	-677	-26
Unemployment insurance fund	334	1,134	1,120	-15	721	748	28
Local governments	-302	33	33	0	59	-82	-141
SEEs 3/	-2,211	405	405	0	2,274	3,061	787
Social insurance institutions	0	0	0	0	0	0	0
Revolving funds 4/	91	40	40	0	100	92	-8
	(In percent of GNP)						
Public sector	2.3	5.7	5.7	0.0	6.5	6.5	0.0
Central government 1/	4.2	4.9	5.0	0.0	5.6	5.4	-0.2
Total revenue	25.1	25.7	25.7	-0.1	25.0	25.2	0.1
Tax revenue	20.8	21.2	21.4	0.2	20.7	21.8	1.1
Nontax revenue 1/	4.4	4.5	4.3	-0.2	4.3	3.4	-0.9
Non-interest expenditure	20.9	20.8	20.7	-0.1	19.4	19.8	0.4
Personnel	7.9	8.1	8.1	0.0	7.9	7.9	0.1
Other current	2.9	2.6	2.6	0.0	2.6	2.6	0.0
Transfers 2/	8.3	8.0	8.0	-0.1	6.9	7.2	0.3
Investment	1.8	2.0	2.0	0.0	2.0	2.0	0.0
Rest of the public sector	-1.9	0.8	0.8	0.0	0.9	1.1	0.2
EBFs	-0.2	-0.1	-0.1	0.0	-0.2	-0.2	0.0
Unemployment insurance fund	0.3	0.6	0.6	0.0	0.3	0.3	0.0
Local governments	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
SEEs 3/	-1.8	0.2	0.2	0.0	0.8	1.1	0.3
Social insurance institutions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 4/	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
GNP (in trillions of TL)	125,596	184,767	184,667	-100	280,551	283,241	2,690
Real GNP growth	6.3	-8.5	-8.5	0.0	4.0	3.0	-1.0
CPI inflation (Dec-Dec)	39.0	65.0	68.0	3.0	35.0	35.0	0.0
Current account (in % GNP)	-4.9	1.5	1.2	-0.3	-1.2	-1.4	-0.2
Net public debt (in % GNP)	57.4	93.5	92.2	-1.3	73.6	81.3	7.7
PSBR (in % GNP)	19.1	19.5	19.2	-0.3	12.3	12.1	-0.2

Sources: Turkish authorities; and Fund staff estimates.

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

2/ Excluding recapitalization of state banks.

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.
primary surplus.

Table 13. Turkey: Monetary Aggregates, 1999-2002
(In quadrillions of Turkish Lira)

	1999	2000	2001		2002	Flow increase
	Dec.	Dec.	Sep. Actual	Dec. Proj.	Dec. Proj.	Dec 2001 to Dec 2002
Net foreign assets	6.0	2.8	-3.6	-5.7	17.3	23.0
(in billions of U.S. dollars)	11.1	4.1	-2.4	-3.8	9.0	12.8
CBT	7.5	6.6	-3.6	-5.7	10.6	16.3
(in billions of U.S. dollars)	14.0	9.9	-2.4	-3.8	5.5	9.3
Deposit money banks	-1.6	-3.9	0.0	0.0	6.7	6.7
(in billions of U.S. dollars)	-2.9	-5.8	0.0	0.0	3.5	3.5
Net domestic assets	34.2	53.3	103.3	110.8	130.1	19.3
Net claims on government	17.0	30.9	76.7	83.4	98.1	14.7
CBT	-1.9	-0.2	21.9	31.9	22.5	-9.5
Deposit money banks	18.8	31.1	54.8	51.4	75.6	24.2
Claims on business sector 1/	18.3	31.2	36.9	41.0	54.9	13.9
Turkish lira claims	11.2	21.8	20.2	22.4	31.6	9.2
Foreign exchange claims (est.) 2/	7.1	9.4	16.8	18.5	23.2	4.7
Other items (net)	-1.1	-8.8	-10.4	-13.6	-22.9	-9.3
Broad money (M2Y)	40.2	56.0	99.6	105.1	147.4	42.3
Lira broad money (M2)	22.0	31.1	40.6	44.2	62.0	17.8
Foreign exchange deposits 2/	18.2	24.9	59.1	60.9	85.4	24.5
Repos	4.1	6.0	4.0	3.5	4.9	1.4
Broad liquidity	44.2	62.0	103.7	108.6	152.3	43.7
Reserve money	3.9	5.8	7.6	7.8	10.9	3.1
Memorandum items:						
Annual percent change						
Broad money (M2Y)	98.7	39.6	91.5	87.6	40.2	...
Lira broad money (M2)	92.5	41.5	56.3	42.1	40.2	...
Foreign exchange deposits 2/	106.6	37.3	126.4	144.2	40.2	...
Claims on business sector 1/	50.8	70.3	25.0	31.5	33.9	...
Turkish lira claims	65.8	94.9	-3.4	2.8	41.0	...
Foreign exchange claims (est.) 2/	32.0	31.6	93.2	98.3	25.3	...
Net claims on government	134.2	81.7	271.7	170.0	17.7	...
CBT	...	...	...	...	-29.6	...
Deposit money banks	155.1	65.2	147.0	65.3	47.0	...
In billions of U.S. dollars						
Broad money (M2Y)	74.6	83.4	65.0	70.1	76.7	6.7
Lira broad money (M2)	40.9	46.3	26.5	29.5	32.3	2.8
Foreign exchange deposits	33.7	37.1	38.5	40.6	44.5	3.9
Foreign exchange claims (est.)	13.2	13.9	10.9	12.4	12.1	-0.3
Net claims on government	31.6	46.0	50.0	55.6	51.1	-4.5
Credit to the private sector	34.0	46.4	24.1	27.3	28.6	1.2
Base money/GNP 3/	5.0	4.6	4.1	4.2	3.8	...
Broad money (M2Y)/GNP 3/	51.3	44.6	54.0	56.9	52.0	...
Lira broad money (M2)/GNP 3/	28.1	24.8	22.0	23.9	21.9	...
Money multiplier						
Broad money (M2Y)	10.4	9.7	13.1	13.6	13.6	...
Lira broad money (M2)	5.7	5.4	5.3	5.7	5.7	...

1/ Includes credit to local governments and state economic enterprises.
2/ Evaluated at current exchange rates.
3/ Evaluated as percent of annual average GNP.

Table 14. Turkey: Central Bank Balance Sheet, 2000-02

	2000	2001				2002				
	Dec. Actual	March Actual	June Actual	Sept. Actual	Dec. Actual	Feb Prog.	Apr Prog.	Jun Prog.	Sep Prog.	Dec Prog.
Central Bank balance sheet	(In quadrillions of Turkish lira) 1/									
Net foreign assets	3.3	1.2	-5.5	-10.2	-12.8	-2.5	-1.9	-1.1	-0.6	0.0
Gross foreign assets	15.6	20.6	22.2	30.6	28.5	29.9	30.6	31.4	32.1	32.8
Gross foreign liabilities	12.3	19.4	27.7	40.8	41.2	32.4	32.5	32.5	32.7	32.8
International reserve liabilities	3.1	6.1	11.9	19.7	20.7	11.7	11.7	11.7	11.7	11.7
Other reserve liabilities 2/	4.9	5.4	6.9	10.5	10.1	10.1	10.1	10.1	10.1	10.1
Banks' foreign exchange deposits with CBT	4.3	7.9	8.9	10.6	10.4	10.6	10.7	10.7	10.9	11.0
Net domestic assets	2.5	4.4	11.9	17.8	20.6	10.7	10.8	10.4	11.2	10.9
Claims on central government (net)	0.4	-0.8	17.5	22.2	31.6	22.6	22.6	22.6	22.6	22.6
Claims on other public sector (net)	-0.3	-0.5	-0.7	-0.7	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Claims on banks	5.7	10.8	0.5	2.3	-2.0	-3.1	-3.3	-3.9	-3.5	-4.2
Other items (net)	-3.3	-5.0	-5.5	-5.9	-8.1	-7.8	-7.5	-7.3	-6.9	-6.5
Base money	5.8	5.6	6.4	7.6	7.8	8.3	8.9	9.2	10.6	10.9
Currency issued	3.8	3.6	4.4	5.1	5.3	5.6	6.0	6.3	7.4	7.3
Bank deposits in liras	2.0	2.0	2.0	2.5	2.5	2.7	2.9	3.0	3.2	3.6
Required reserves	1.4	1.2	1.3	1.4	1.6	1.8	1.9	2.0	2.1	2.3
Free reserves	0.6	0.8	0.7	1.1	0.9	0.9	1.0	1.0	1.1	1.2
Memorandum items:	(In billions of U.S. dollars)									
Gross international reserves	23.2	19.5	17.5	20.0	19.8	20.8	21.8	22.3	22.8	22.8
Gross international liabilities	18.3	18.4	21.9	26.6	28.6	22.5	22.6	22.6	22.7	22.8
Net foreign assets	4.9	1.1	-4.4	-6.7	-8.9	-1.7	-1.3	-0.8	-0.4	0.0
plus CBT forward position	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
plus other reserve liabilities	7.3	5.1	5.4	6.9	7.1	7.1	7.1	7.1	7.1	7.1
minus Dresdner one-year deposits	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7
minus defense fund	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net international reserves 3/	11.1	5.0	0.1	-0.9	-3.0	4.2	4.6	5.1	5.5	5.9
Net international reserves 4/	11.1	4.7	0.0	-1.3	-3.4	...	...	...	...	...
Definitions in the 2002 program (CBT plus Treasury)	(In billions of U.S. dollars)									
Net international reserves (Treasury) 5/ 6/	...	...	...	...	-1.3	-10.7	-11.8	-12.9	-14.0	-15.6
Net international reserves (Treasury plus CBT) 5/	...	...	...	...	-4.2	-6.5	-7.2	-7.8	-8.5	-9.7
	(In quadrillions of Turkish Lira, program exchange rate)									
Net foreign assets (Treasury)	...	...	...	...	-1.8	-15.4	-16.9	-18.5	-20.1	-22.4
Net foreign assets (Treasury plus CBT)	...	...	...	...	-14.6	-17.8	-18.8	-19.7	-20.7	-22.4
Net domestic assets (Treasury) 7/	...	...	...	...	1.8	15.4	16.9	18.5	20.1	22.4
Net domestic assets (Treasury plus CBT)	...	...	...	...	22.4	26.1	27.7	28.9	31.3	33.3
Base money (Treasury plus CBT)	...	...	...	...	7.8	8.3	8.9	9.2	10.6	10.9
Exchange rate (TL per U.S. dollar, in millions)	0.67	1.06	1.27	1.53	1.44	...	...	...	...	...

Sources: Central Bank of Turkey; and Fund staff projections.
1/ Consistent with program assumptions, all foreign currency aggregates are valued at current exchange rates through end-2001, and at the program exchange rate of TL 1.44 million per U.S. dollar thereafter.
2/ Mainly Dresdner deposit liabilities.
3/ At current cross exchange rates.
4/ At cross exchange rates used in the 2001 program.
5/ At end-December 2001 cross exchange rates (i.e. cross exchange rates for the 2002 program)
6/ Equals borrowing from IMF plus short-term foreign currency denominated liabilities.
7/ Since the Treasury cannot create base money, equals negative of Treasury net foreign assets.

Table 15. Turkey: Banking System—Selected Indicators, 1998–2001 1/
(In quadrillions of Turkish Liras)

	1998 Dec.	1999 Dec.	2000 Sept.	2000 Dec.	2001 March	2001 June	2001 Sept.
				Banking system			
Total assets	42.0	82.4	108.5	119.2	131.4	166.0	181.1
Cash and claims on CBT	2.7	5.1	6.2	6.2	7.7	8.8	10.9
Claims on other banks	4.4	9.1	12.4	14.4	14.6	18.8	17.8
Securities portfolio	10.2	23.3	27.2	32.0	34.4	63.0	68.8
Loans, net	14.7	22.6	34.6	35.8	40.6	44.8	51.5
Other assets	10.0	22.3	28.2	30.8	34.1	30.6	32.1
Total liabilities	42.0	82.4	108.5	119.2	131.4	166.0	181.1
Deposits	24.2	48.3	65.3	68.1	78.8	96.4	113.1
Borrowing from banks	4.7	10.1	14.6	16.0	20.8	23.4	24.1
Repos	4.6	8.9	12.0	13.6	11.1	13.5	11.2
Other liabilities	5.2	10.8	10.6	13.0	15.4	16.3	17.1
Shareholders' equity (incl. profits)	3.3	4.2	6.1	8.5	5.3	16.4	15.6
				(In percent)			
Memorandum items:							
Capital adequacy ratio	...	...	8.2	17.3	7.7	20.3	16.8
NPLs total loans	6.7	9.7	8.7	9.2	8.5	13.7	15.6
Provisions NPLs	44.2	53.7	9.4	59.8	53.2	66.5	65.4
ROA	1.8	-0.4	0.0	-0.7	-3.3	-3.0	-1.8
ROE	23.1	-7.2	0.0	-10.5	-83.0	-30.0	-20.8
Share in assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Share in deposits and repos	100.0	100.0	100.0	100.0	100.0	100.0	100.0
				Private banks 2/			
Total assets	23.6	42.2	60.2	56.2	68.4	80.9	94.0
Cash and claims on CBT	1.5	2.7	3.6	3.4	4.6	5.6	6.8
Claims on other banks	2.7	5.4	8.3	9.8	10.9	13.3	10.9
Securities portfolio	6.5	14.3	17.1	13.5	14.4	16.7	23.3
Loans, net	8.8	12.4	20.9	19.6	22.7	27.1	31.9
Other assets	4.1	7.3	10.3	10.0	15.8	18.2	21.1
Total liabilities	23.6	42.2	60.2	56.2	68.4	80.9	94.0
Deposits	13.7	23.2	32.7	30.8	40.5	51.2	63.7
Borrowing from banks	3.0	6.5	9.3	10.0	12.8	14.1	13.6
Repos	2.6	4.7	6.8	3.9	1.7	2.9	3.0
Other liabilities	1.9	3.0	3.7	3.5	5.7	4.8	5.2
Shareholders' equity (incl. profits)	2.4	4.8	7.7	7.9	7.7	7.8	8.6
				(In percent)			
Memorandum items:							
Capital adequacy ratio	...	...	16.7	18.3	14.6	10.6	10.9
NPLs total loans	6.9	3.5	3.4	3.5	3.8	4.8	4.4
Provisions NPLs	41.2	62.2	-69.3	63.0	52.5	42.2	45.2
ROA	2.8	3.8	1.0	2.3	0.3	0.1	0.6
ROE	27.4	33.7	8.2	16.2	2.3	0.8	7.1
Share in assets	56.2	51.2	55.5	47.1	52.0	48.7	51.9
Share in deposits and repos	56.5	48.6	51.1	42.5	46.9	49.3	53.6

Table 15. Turkey: Banking System--Selected Indicators, 1998–2001 1/

(In quadrillions of Turkish Liras)

	1998 Dec.	1999 Dec.	2000 Sept.	2000 Dec.	2001 March	2001 June	2001 Sept.
	Public (state and SDIF) banks 3/						
Total assets	14.8	32.6	41.4	53.6	53.0	73.9	74.1
Cash and claims on CBT	1.1	2.2	2.4	2.7	2.7	2.9	3.3
Claims on other banks	0.7	1.3	2.5	2.2	2.1	3.6	4.7
Securities portfolio	3.0	7.2	9.2	16.7	19.0	45.2	44.5
Loans, net	4.4	7.6	10.3	12.6	13.1	12.0	12.7
Other assets	5.6	14.3	17.0	19.4	16.1	10.2	8.9
Total liabilities	14.8	32.6	41.4	53.6	53.0	73.9	74.1
Deposits	10.3	24.6	31.9	36.4	37.1	43.8	47.6
Borrowing from banks	0.4	0.9	1.7	2.2	3.7	4.9	5.6
Repos	1.5	3.3	5.4	8.9	9.3	10.3	8.1
Other liabilities	2.2	5.3	5.4	7.0	7.1	8.3	8.1
Shareholders' equity (incl. profits)	0.4	-1.5	-3.0	-1.0	-4.2	6.5	4.7
	(In percent)						
Memorandum items:							
Capital adequacy ratio 4/	...	...	-13.7	7.9	-40.4	45.0	27.6
NPLs total loans	7.8	21.0	20.4	19.2	18.0	33.3	41.1
Provisions NPLs	48.7	61.9	54.4	59.1	58.9	73.2	69.9
ROA	-0.3	-6.9	-4.0	-4.7	-9.0	-7.4	-6.2
ROE	-11.2	...	...	...	...	-83.2	-97.3
Share in assets	35.3	39.6	38.2	44.9	40.4	44.5	40.9
Share in deposits and repos	40.9	48.8	48.3	55.5	51.6	49.3	44.8
	Foreign and investment banks						
Total assets	2.7	6.0	6.9	8.3	10.0	11.2	12.9
Cash and claims on CBT	0.1	0.1	0.2	0.2	0.3	0.4	0.8
Claims on other banks	0.6	1.6	1.6	1.9	1.6	1.9	2.2
Securities portfolio	0.2	1.0	0.9	1.3	1.0	1.1	1.0
Loans, net	1.5	2.6	3.3	3.6	4.9	5.7	6.8
Other assets	0.3	0.7	0.9	1.4	2.2	2.2	2.1
Total liabilities	2.7	6.0	6.9	8.3	10.0	11.2	12.9
Deposits	0.3	0.5	0.7	0.9	1.2	1.4	1.8
Borrowing from banks	1.3	2.7	3.5	3.8	4.3	4.3	4.9
Repos	0.1	0.1	-0.2	0.2	0.1	0.2	0.1
Other liabilities	0.7	1.7	1.5	1.9	2.6	3.2	3.8
Shareholders' equity (incl. profits)	0.4	0.9	1.5	1.5	1.8	2.0	2.3
Memorandum items:			(In percent)				
Capital adequacy ratio	...	...	28.7	29.4	29.8	31.3	29.5
NPLs total loans	2.1	2.1	2.2	1.8	2.1	2.8	2.9
Provisions NPLs	54.0	31.3	43.2	51.8	55.8	45.5	45.6
ROA	5.6	5.7	4.6	3.9	2.3	4.0	5.7
ROE	34.1	36.3	21.6	21.4	13.2	22.2	32.1
Share in assets	6.4	7.2	6.3	7.0	7.6	6.7	7.1
Share in deposits and repos	1.1	1.1	0.6	1.3	1.5	1.5	1.6

Source: Bank Regulation and Supervision Agency (BRSA).

1/ Includes off-balance sheet repos and reverse repos.

2/ Comprises the private (domestic) deposit-taking commercial banks.

3/ These include three state banks (Emlak Bank was closed and its assets and liabilities merged with Ziraat Bank) and SDIF banks. In March 2001, three SDIF banks did not report.

4/ CARs are reported on a quarterly basis. SDIF banks capital base was not reported in December 2000.

Table 16. Turkey: Indicators of Fund Credit, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
Outstanding Fund credit (end of period)								
In billions of SDRs	3.2	11.2	17.4	17.9	17.3	11.1	3.5	0.8
In percent of quota	333	1,165	1,810	1,852	1,791	1,150	368	81
In percent of exports of G&NFS	8	28	44	40	36	22	6	1
In percent of public sector external debt	7	20	28	28	27	19	7	2
In percent of overall external debt	4	13	19	19	18	11	4	1
In percent of foreign reserves	18	75	101	97	80	55	20	6
Debt service due to the Fund								
In billions of SDRs	0.1	1.2	6.0	1.3	1.9	6.3	7.5	2.7
In percent of quota	13	127.8	621.2	132.9	194.0	650.4	780.8	285.0
In percent of exports of G&NFS	0	3.2	15.1	2.9	3.9	12.2	13.7	4.9
In percent of public sector external debt service	0	4.1	26.8	6.4	9.0	29.3	33.3	25.7
In percent of overall external debt service	1	6.0	29.6	5.9	7.8	24.8	28.6	7.5
In percent of foreign reserves	1	8.4	35.2	7.0	8.8	31.3	41.7	23.1

Table 17. Turkey: External Financing Requirements and Sources, 1998-2005

(In billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Gross financing requirements	27.6	35.5	49.1	44.6	37.2	36.2	37.4	39.9
Current account deficit (excl. official transfers)	-1.8	1.7	10.1	-1.8	2.2	2.4	2.7	2.3
Amortization on debt securities	3.3	2.0	1.7	2.1	2.5	4.1	3.1	3.6
Of which:								
Public sector	3.0	1.9	1.4	2.1	2.1	3.9	3.1	3.1
Deposit money banks	0.3	0.1	0.4	0.0	0.4	0.2	0.0	0.4
Medium and long-term debt amortization	8.2	10.6	13.8	15.4	13.0	13.5	13.1	13.1
Of which:								
Public sector 1/	2.8	2.9	3.6	4.7	3.5	3.8	3.4	3.2
Private sector	3.0	5.2	7.9	8.8	8.5	8.8	8.8	8.8
Deposit money banks	2.3	2.4	2.3	1.8	1.0	1.0	1.0	1.2
Short-term debt amortization	18.0	21.2	23.5	28.9	19.4	16.3	18.6	20.9
Public sector 1/	0.9	0.9	0.7	1.7	0.7	0.7	0.7	0.8
Private sector	8.6	9.2	9.6	10.4	9.4	10.2	11.6	12.8
Deposit money banks	8.5	11.2	13.2	16.9	9.4	5.4	6.2	7.2
Available financing	27.6	35.5	49.1	44.6	37.2	36.2	37.4	39.9
Foreign direct investment (net)	0.6	0.1	0.1	2.5	1.0	1.1	1.4	1.7
Portfolio flows	-3.4	5.4	2.8	-1.8	1.4	4.2	5.6	6.1
Public sector	2.7	5.0	7.5	2.2	2.5	4.5	4.7	5.0
Deposit money banks	0.0	0.2	0.5	0.0	0.0	0.2	0.2	0.3
Private sector (net)	-6.1	0.2	-5.2	-4.0	-1.1	-0.5	0.7	0.8
Medium and long-term debt financing	12.2	10.9	19.1	12.4	13.7	13.3	14.2	15.1
Of which:								
Public sector 1/	1.8	0.9	4.4	3.4	5.0	3.3	3.4	3.6
Private sector	7.2	7.5	12.8	8.3	8.0	8.8	9.2	9.6
Deposit money banks	3.1	2.6	1.9	0.6	0.7	1.3	1.6	1.8
Short-term debt financing	21.6	24.2	28.3	20.4	16.3	18.6	20.9	23.5
Official transfers	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Other 2/	-3.0	-0.3	-4.5	-3.6	-0.3	-0.2	-0.2	-0.3
Accumulation of reserves net of IMF	-0.4	-5.2	3.1	14.4	4.9	-1.0	-4.7	-6.4
Accumulation of gross reserves	-0.2	-5.9	-0.2	4.2	-3.1	-1.6	-4.0	1.6
IMF (net)/exceptional CBT financing	-0.2	0.7	3.3	10.2	8.0	0.5	-0.8	-8.0
Purchases	0.0	0.8	3.4	11.4	14.3	1.0	1.0	0.0
Repurchases	0.2	0.1	0.1	1.1	6.3	0.5	1.8	8.0

Sources: Data provided by Turkish authorities; and Fund staff estimates.
1/ General government and Central Bank of Turkey.
2/ Errors and omissions.

Fund Relations

(As of December 31, 2001)

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	100.0
Fund holdings of currency	12,084.09	1,253.5
Reserve position in Fund	112.78	11.7

III. **SDR Department:**	**Millions of SDRs**	**Percent of Allocation**
Net cumulative allocation	112.31	100.0
Holdings	3.56	3.2

IV. **Outstanding Purchases and Loans:**	**Millions of SDRs**	**Percent of Quota**
Stand-by Arrangements	10,871.36	1,127.7
First credit tranche	361.50	37.5

V. **Financial Arrangements:**

Type	**Approval Date**	**Expiration Date**	**Amount Approved** (In millions of SDRs)	**Amount Drawn** (In millions of SDRs)
Stand-By	12/22/99	12/21/02	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
Stand-By	04/04/84	04/03/85	225.00	168.75

VI. **Projected Obligations to Fund:** (In millions of SDRs; based on existing use of resources and holdings of SDRs)

	Overdue	**Forthcoming**				
	12/31/01	2002	2003	2004	2005	2006
Principal		4,048.8	2,091.5	3,158.2	1,934.3	0.0
Charges/Interest		461.9	248.9	136.5	33.3	3.0
Total		4,510.7	2,340.4	3,294.7	1,967.6	3.0

VII. Safeguard Assessments:

Under the Fund's safeguards assessment policy, the Central Bank of Turkey was subject to the transitional procedures with respect to the SBA approved on December 22, 1999, which was scheduled to expire on December 21, 2002. The transitional procedures require a review of only the CBT's external audit mechanism. This assessment determines whether the CBT publishes annual financial statements that are independently audited in accordance with internationally accepted standards.

The External Audit assessment was completed on August 21, 2001. The assessment concluded that the Central Bank of Turkey's current external audit mechanism may not be adequate in certain respects and appropriate recommendations have been made to the authorities, as reported in EBS/01/192, 11/21/01.

Under the new SBA, the CBT is subject to a full safeguards assessment. Stage one of the assessment has begun, as reported in Section V of this report.

VIII. Exchange Rate Arrangement:

For the period January 1, 2000–June 30, 2001, the lira was to have depreciated against a basket comprising US$1 and € 0.77 along a daily path 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 1999 Article IV staff report (EBS/99/225) was issued on December 10, 1999, the accompanying Selected Issues and Statistical Appendix (SM/99/294) was issued on December 14, 1999. Board discussion took place on December 22, 1999 at EBM/99/137.

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	Under preparation	

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
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	September 2001	Inflation targeting

Relations with the World Bank Group

I. Lending Assistance

A. IBRD

1. **The World Bank Group's assistance program to Turkey is guided by the revised Country Assistance Strategy (CAS) discussed by the Bank's Board of Directors in July 2001.** The revised CAS includes additional IBRD support on Special Structural Adjustment Loan (SSAL) terms of up to US$1.2 billion, for a total possible lending of US$6.2 billion in the period FY2001–03, of which US$2.9 billion was committed as of November 2001. Delivery of this expanded assistance program is fully on track. Policy based lending in the revised CAS is centered around the Programmatic Financial and Public Sector Adjustment Lending (PFPSAL) program, which focuses on structural and institutional reforms in the banking and public sectors. The first PFPSAL of US$1.1 billion was approved by the Bank's Board and disbursed in a single tranche in July 2001. The second PFPSAL of US$1.35 billion is under preparation. Follow-up programmatic operations to support continuation of the Government's financial sector reform and public sector reform programs are envisaged during the remainder of the current CAS period. The World Bank Group is preparing a new CAS (for FY03-05), which will be completed in the Fall of 2002.

2. **The revised CAS also features increased support for social protection in response to the economic crisis.** It includes the US$250 million Privatization Social Support project approved in December 2000, the US$500 million Social Risk Mitigation project approved in September 2001, and additional lending for health, education, community development and watershed protection.

3. **The IBRD lending program also includes sustained support for structural reforms to promote private sector development.** It comprises the US$375 million second tranche of the Economic Reform Loan and the US$600 million Agriculture Reform Implementation project approved in July 2001.

B. IFC

4. **The IFC maintains a strong investment presence in Turkey.** It accounts for about 4.5 percent of the total IFC portfolio. The total IFC own-account held portfolio in Turkey is currently US$630 million and the outstanding balance of syndicated loans mobilized by IFC is US$391 million. IFC has also invested over US$150 million in Turkish companies outside of Turkey in neighboring countries of the CIS and the Balkans.

C. MIGA

5. **The activities of MIGA are a key element of the World Bank Group's assistance program.** Turkey's share of MIGA's portfolio is about US$165 million (gross), representing approximately 4 percent of the total portfolio. While MIGA's exposure is currently

concentrated in the financial sector, the agency continues efforts to extend coverage to infrastructure and services projects.

II. Non-lending Assistance

6. **The World Bank Group has a very active non-lending services program in Turkey.** Major economic and sector work recently undertaken include the Country Economic Memorandum on Structural Reform for Sustainable Growth completed in 2000, as well as the Public Expenditure and Institutional Review, the Country Procurement Assessment Report and the Country Financial Accountability Assessment, all completed during the Summer of 2001. The World Bank is currently finalizing a Corporate Assessment, which has contributed to the development of the authorities' strategy ("Istanbul approach") on corporate sector restructuring. A Non-Bank Financial Institutions study and a new Country Economic Memorandum are to be prepared in 2002. The World Bank sponsored an international conference on good governance and combating corruption in September 2001, and a second international conference on public expenditure management is scheduled for December. The Foreign Investment Advisory Service (FIAS) carried out a Diagnostic of the Foreign Investment Climate in Turkey and an Administrative Barriers Study during the course of 2001. The World Bank is assisting the Government in the creation of an Investor Council.

Structural Policies, 2001

Action	MEP Ref.	Timing	Type[1/]	Lead Institution	Status January 4, 2002
Communications strategy and real sector measures					
1. a. Develop strategy aimed at explaining major policies and actions to market participants	¶5			IMF/ WB	**Being implemented.** Publication of MEP, LOIs, and staff reports. Treasury has published information on the new program, hired new media staff and posted on the Treasury website fact sheets about elements of the program; BRSA has issued "strategy paper" on its website; CBT has posted information notices in its website.
b. Hold regular domestic press conferences	¶4 of July LOI				**Not done.** First press conference held by Undersecretary of Treasury in July. No follow-up since.
c. Hold additional road shows	¶4 of July LOI				Road shows in Europe/US in October
d. Explore the scope for setting up a more formal investor council (IC)	¶4 of July LOI; ¶29 of Nov LOI				Foreign Economic Relations Department of Treasury carrying out key functions of an IC. Plans being made for investor conference that would bring together major international business leaders.
2. Ensure that any measures to support the real sector are market based, transparent, and consistent with budget targets	¶9 of Nov LOI	Continuous		WB	Temporary VAT cuts, and plan to facilitate bank debt workouts ("Istanbul Approach") introduced
Banking sector reform					
3. Reduce the SDIF and state banks' overnight position by at least two thirds from the March 16, 2001 level (including the elimination of the position vis-à-vis commercial banks)	¶8	…	C; 6^{th}/ 7^{th}	IMF/ WB	**Done**
4. Eliminate the SDIF and state banks' overnight position	¶8	…	C; 8^{th}	IMF/ WB	**Done**

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
5. The stock of repurchase agreements of SDIF and state banks with the CBT not to exceed TL 7 quadrillion	¶8	End-May	C; 8th	IMF/ WB	**Done**
6. All SDIF and state banks to be subject to minimum maturity guidelines and uniform deposit rates	¶8; ¶25 of Nov LOI	Continuous		IMF	**Being implemented**. The CBT holds daily conference calls with the banks, instructing them about the maturities and interest rates. However, effective monitoring remains a problem.
7. a. Establish a common and politically independent board for Ziraat and Halk, reporting to the Treasury, and appoint new management who will apply commercial criteria to ensure profitability, and who will formulate privatization plans	¶10		C; 6th/7th	WB	**Done**
b. Work out criteria for branch closures and staff reductions in Ziraat and Halk, with rationalization to be completed in 18 months	¶17 of July LOI				Criteria for closures have been developed, and form the basis of conditionality under the new program
c. Hold shareholders' meeting for Emlak to appoint a liquidator	¶17 of July LOI				**Done**
d. Government to issue regulation that will allow the joint board to complete the rationalization of staffing and branches in state banks	¶26 of Nov LOI	mid-Dec. 2001			
8. Complete financial restructuring of state banks	¶10		C; 6th/7th	IMF/ WB	**Done**
9. The new governing board and managements of state banks to apply new risk management procedures and streamline operations as soon as possible	¶10			WB	**Done.**
10. State banks to comply fully with all BRSA regulations applicable to commercial banks. Treasury to monitor cash flow, profitability and liquidity position of state banks	¶10			IMF/ WB	**Done.**
11. Appoint independent outside auditors to oversee implementation of state bank reforms	¶10	May		WB	**Done**. Deloitte and Touche was appointed on June 15
12. Close Emlak Bank and transfer its liabilities and some of its assets to Ziraat Bank	¶11	end-May	C; 8th	WB	**Done**. License revoked with effect from July 9
13. a. Resume privatization process for Vakif Bank	¶11	As soon as market conditions allow		WB	**Underway**. Legislation to facilitate sale approved by parliament on June 21 and signed by President in August
b. Send letters to potential investors, requesting indication of interest by early 2002; bids to be requested by April/early May 2002, winning bid to be selected in late May	¶26 of Nov LOI				Privatization advisor appointed. Submission of bids to proceed soon. Letters sent in December.

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
14. The SDIF to recapitalize Sümerbank to cover the bank's negative net worth	¶12		C; $6^{th}/7^{th}$	IMF/ WB	**Done**
15. Transfer all NPLs of Sümerbank above TL 75 bln to the COD of the SDIF	¶12	end-July		IMF/ WB	**Done.** As of end-October, some 42,500 files had been transferred
16. Put Sümerbank up for sale, with bids to be received by end-September 2001; liquidate the bank if no viable bids are received by that date	¶12			IMF/ WB	**Done.** Sümerbank sale to OYAK group completed on August 10, 2001
17. Recapitalize the remaining seven SDIF banks to cover their negative net worth	¶13		C; $6^{th}/7^{th}$	IMF/ WB	**Done.**
18. Liquidate Demir/Ekspres/Iktisat if they cannot be sold by end-2001	¶13	end-2001		IMF/ WB	**Done. İktisat Bank was put into liquidation.**
19. a. Organize the remaining four SDIF banks into a second transition bank or put them into liquidation	¶13	end-May	C; 8^{th}	IMF/ WB	**Done**. Three banks merged as second transition bank under Etibank, effective July 2. BRSA Board decision to put Türk Ticaret into liquidation taken on June 15, but TT staff opened lawsuit against BRSA claiming that it lacks legal powers to close the bank.
b. Resolve Türk Ticaret Bank through voluntary liquidation once the legal process has been completed	¶17 of July LOI				BRSA has appealed lawsuit, and is awaiting the decision by the Constitutional Court
c. Put Etibank into voluntary liquidation if the cannot be sold by end-2001	¶17 of July LOI				
20. Sell, put into liquidation, or otherwise resolve the remaining SDIF banks	¶13	end-2001	C; 12^{th}	IMF/ WB	**Underway**. Completed for all banks except two for which court cases are pending (Taris and Türk Ticaret) and for Toprak (taken over in November 2001). Sale of Site concluded. Kent closed on December 14, 2001. EGS merged into Bayindir.
21. Finalize resolution strategies for Kent, EGS, Bayindir, Taris, and Site as soon as the SBAs have completed their assessment	¶17 of July LOI; ¶25 of Nov LOI	SBAs' assessment expected by end-Sept.		IMF/ WB	**Done**
22. Auction unsold deposits and matching assets of remaining SDIF banks to operating banks	¶25 of Nov LOI	end-2001		IMF/ WB	**Done**

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
23. The SDIF to decide whether to keep one of the intervened banks as a bridge bank	¶25 of Nov LOI	Nov. 2001		IMF/ WB	**Done.** Bayindir was kept as bridge bank for asset management purposes
24. a. Complete transfer to COD of NPLs of SDIF banks	¶14	end-October		IMF/ WB	**Done**
b. Transfer the files from Eti, Inter, Es, Demir, and Iktisat to the COD	¶17 of July LOI	end-Sept.			**Completed**
25. For the COD:					
a. Approve operating rules and procedures; appoint professional managers; initiate the recruitment of a substantial number of specialized professional staff	¶14	end-May		IMF/ WB	**Done.** Staffing being undertaken, and new operating rules have been approved by BRSA Board
b. Ensure that the COD is properly staffed	¶25 of Nov LOI	end-2001			**Done.**
c. Select consultant to advise on all aspects of asset management, including loan recoveries	¶24 of Nov LOI	end-Nov. 2001			**Done.**
26. a. Presentation by all capital-deficient banks of detailed capital strengthening plans (17 banks identified)	¶15	end-April	PA; $6^{th}/7^{th}$	IMF/ WB	**Done**
b. Finalization of commitment letters by the banks on recap plans	¶12 of June LOI		C; 8^{th}		**Done.** SDIF intervened 5 banks on July 10; one bank intervened in November
c. Promptly impose sanctions prescribed in the Banking Law on any bank that does not comply with its capital strengthening plan	¶16 of July LOI				**Being implemented**
d. Monitor private banks and require weak banks to agree with the BRSA on capital strengthening plans; resolve promptly banks for which plans cannot be agreed	¶16 of July LOI	Banks to be resolved by time of the following program review			**Being implemented**
e. Reassess agreed plans based on end-Sept. data and, if needed, request banks to further strengthen existing plans	¶24 of Nov LOI				Alternative strategy being developed
f. Assess the need to agree on recapitalization plans with additional banks	¶24 of Nov LOI				**Being implemented**
27. Further revise tax laws to make mergers of banks and their subsidiaries tax neutral	¶15			IMF/ WB	**Done.** Law adopted as part of omnibus law
28. SDIF to take over any insolvent bank	¶15	Continuous		IMF/ WB	**Done.** Five banks intervened in July and one bank in November
29. Strictly enforce loan-loss provisioning rules	¶15; ¶24 of Nov LOI	Continuous		IMF/ WB	**Foreseen in new program**

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
30. Finalize strategy for dealings with NPLs	¶24 of Nov LOI	January 2002		IMF/ WB	**Foreseen in new program**
31. Parliamentary approval of amendments to Banking Law	¶16		C; 6th/7th	IMF/ WB	**Done**
32. Adopt connected lending regulation, to take effect on July 1, 2001	¶17	One month after the amendment of the Banking Law	BM	IMF/ WB	**Done**. Regulation approved by BRSA Board
33. Bring accounting standards for banks in line with international standards	¶17	January 2002	BM	IMF/ WB	**Foreseen in new program**
34. Review legal and judicial frameworks to facilitate credit enforcement and corporate restructuring	¶18			WB	**Underway**. Ministry of Justice has sent draft new bankruptcy law for comments by relevant institutions.
35. Follow defined principles for the resolution of SDIF and undercapitalized private banks	¶19 of July LOI			IMF/ WB	**Done** in the case of Sümerbank
36. Ensure that the BRSA has the legal right and financial resources to maintain and recruit qualified staff, with employment conditions in line with the institutions under its supervision	¶20 of July LOI			IMF/ WB	**Not done**
37. Address any legal impediments to corporate restructuring, including submission of amended bankruptcy law	¶24 of Nov LOI	Law to be presented to parliament by Jan. 2002		IMF/ WB	**Foreseen in new program**
Fiscal transparency and management					
38. Close the remaining 15 BFs (except DFIF) and 2 EBFs (and create no new BFs or EBFs)	¶19	June	BM	IMF/ WB	**Done**. Law adopted as part of omnibus law. Decree needed for closure of three BFs; the decree was signed by the President on July 9.
39. Channel all revenues provided by Law No. 3418/39B into the budget	¶19	In 2002 budget		IMF/ WB	**Not done**
40. At least halve the number of revolving funds	¶19	end-2001	BM	IMF/ WB	**Not done**. Study being carried out, to be followed by merger of provincial funds through MOF directive (this is expected to effectively cut the number of funds in half)

Action	MEP Ref.	Timing	Type[1/]	Lead Institution	Status January 4, 2002
41. a. Submit to parliament a Law on Public Finance and Debt Management	¶19	end-June	BM	IMF/ WB	**Done**. Law submitted on July 2
b. Put in place new legal framework	¶10 of July LOI	end-November			**Not done**
42. Include in the monthly reports of the Treasury a "lending minus repayments" item following the GFS methodology	¶19	May		IMF	**Done**
43. Accompany the draft 2002 budget by accounts and financial outlook for EBFs and SSIs, revolving funds, contingent liabilities of the Treasury, SEEs, and local authorities	¶19	October 17, 2001	BM	IMF/ WB	**Done**. Accounts submitted at end-October
44. a. Complete implementation of computerized accounting system to allow better monitoring of spending and costs in government units	¶19	mid-2001		WB	**Preparations underway.** System to become operational with 2002 budget
b. Until new accounting system is operational, use quarterly surveys as a monitoring device for expenditure commitments	¶9 of July LOI	Starting at the end of the third quarter of 2001			**Foreseen under the program.** Survey expected by end-year
45. Complete a new budget classification in line with international standards, for initiation on a pilot basis for the 2002 budget	¶19	end-June		IMF/ WB	**Done**. Budget classification ready, and six pilot agencies have been identified
46. Initiate necessary studies to move towards accruals-based budget accounting	¶19			IMF/ WB	**Preparations underway**
47. Submit to parliament a Public Procurement Law in line with UN (UNCITRAL) standards	¶19	October 15	BM	WB	**Done**. Law presented to parliament in November
48 a. Inter-ministerial committee to design plan to identify areas where the government and civil society can work together to combat corruption and improve governance	¶19	end-Sept.		WB	**Underway.** Following workshop in mid-July, plan will be prepared, and will be finalized following conference on September 20-21 (see point 43.b. below)
b. Launch a series of international conferences on "Effective Government"		Before summer recess of parliament			**Underway**. First conference (On Promoting Good Governance and Anti-Corruption) held on September 20-21. Second conference (on the findings of the PEIR) held in December.
c. Submit to parliament relevant legislation to improve the code of conduct of government officials					**Done.** Legislation passed parliament in spring session but vetoed by President

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
Increasing the Role of Private Domestic and Foreign Capital in the Turkish Economy					
49. a. Parliamentary approval of legislation to facilitate Türk Telekom privatization	¶21		PA; $6^{th}/7^{th}$	WB	**Done**
b. Türk Telekom to contract advisors to develop corporatization plan acceptable to the Word Bank	¶21 of July LOI	By end-Oct.	BM		**Done.** Arthur Andersen appointed on October 31
c. The Board of Directors of Türk Telekom to adopt comprehensive corporatization plan for the company	¶21				**Not done**
d. The PA to complete a revised privatization plan for Türk Telekom (Tender Committee to be appointed)	¶21; ¶21 of July LOI	By end-2001	BM		**Not done**
e. Appoint new professional Board and management of Türk Telekom with relevant private sector experience	¶21		C; 8^{th}		**Done**
50. Initiate preparatory work for speeding up the sale of third generation mobile phone licenses	¶21			WB	**Not done** due to poor market conditions
51. PA to carry out further public offering of TUPRAS which will increase the private sector stake to 51 percent	¶21			IMF/ WB	**Not done** due to poor market conditions
52. PA to carry out public offering of POAS	¶21 of July LOI	Fourth quarter		IMF/ WB	**Not done** due to poor market conditions
53. a. Parliamentary approval of Tobacco Law	¶21	May	C; 8^{th}	WB	**Done.** Law adopted on June 21, but President returned the law to parliament citing constitutionality concerns
b. Re-submission of Tobacco Law	¶21 of July LOI				**Done.** Law was re-submitted in parliament's fall session and approved on January 3, 2002
c. The PA to prepare privatization plans for TEKEL and SEKER, consistent with the World Bank ERL	¶21 of July LOI	By end-2001			**Not done.** Preparation of plan for TEKEL awaiting passage of Tobacco Law; plan for SEKER being prepared
54. Privatization of ERDEMIR through merger with ISDEMIR and additional sale of shares on ISE	¶21			WB	**Underway**, including operational restructuring through reduction in staffing

Action	MEP Ref.	Timing	Type[1/]	Lead Institution	Status January 4, 2002
55. a. Privatize those thermal generation and electricity distribution assets that remain after the June 30, 2001 deadline for transfers of TOORs; PA to hire investment advisors for this purpose	¶21			WB	**Underway**. Pre-qualification tenders to be opened immediately after the deadline for TOOR contracts. Legislation to extend the deadline from June 30 to October 30 has, however, been adopted by parliament.
b. Resolve pending TOOR contracts before end-October and then proceed as in 49.a.	¶21 of July LOI				**Not done**. State Court (Danistay) has issued opinion that the Treasury cannot issue such guarantees
c. Immediately start preparations for privatization of electricity generation and distribution assets for which there are no pending TOOR contracts	¶21 of July LOI				**Underway**
56. Work with Ministry of Energy to prepare for the transfer of gas companies from BOTAS to the PA's portfolio	¶21 of July LOI			WB	**Underway**
57. Define program for sale of land owned by the state	¶21	May		IMF	**Done**. Legal amendments submitted to parliament on June 27 but vetoed by President
58. Passage by parliament of a law fully implementing the constitutional amendment on international arbitration	¶22	Before parliament summer recess	BM	IMF/ WB	**Done**. Law adopted by parliament on June 21
59. a. Complete study on administrative barriers to investment by June and submit action plan to Council of Ministers; identify specific actions to be taken under the program	¶22	Plan to be submitted by July; program actions to be identified during 10th program review		WB	**Done**. Action plan presented to the CoM in November
b. Workshop to be held in September	¶ 22 of July LOI				**Done**
60. Complete extensive review of the commercial law, the land development law, and other laws affecting the investment environment	¶22	September		IMF/ WB	**Not done**
61. Review tax laws and identify, if necessary, legal steps to improve investment environment (while safeguarding tax revenues)	¶22			IMF/ WB	**Not done**

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
62. Explore, with the main business organizations, further measures to facilitate FDI and improve business environment	¶23			IMF/ WB	**Not done**
63. To improve the quality of public sector data and public resource management, present to parliament a Public Finance Management and Internal Control Law	¶28 of Nov LOI	Mid-2002		IMF/ WB	**Foreseen in new program**
64. Submit to parliament a new draft Law on Foreign Direct Investment	¶28 of Nov LOI	January 15, 2002		WB	**Foreseen in new program**
65. Submit to parliament a draft law on work permits	¶28 of Nov LOI	End-December 2001		WB	**Foreseen in new program**
66. Complete draft legislation reducing the number of documents needed to obtain investment incentives	¶28 of Nov LOI	End-January 2002		WB	**Not done**
67. Raise the minimum amount in VAT rebates that can be made without submitting examination reports and posting financial bond guarantees.	¶28 of Nov LOI	End-January 2002		WB	**Not done**
Fiscal policy and public debt management					
68. Approval of tax measures: (a) increase petroleum consumption tax by 15 percent in early May 2001 (b) increase VAT rates (except the reduced 1 and 8 percent rates) by one percentage point; and (c) increase, as of April 2001, the minimum contribution base relevant for social security payments in line with the existing regulations	¶30		PA; $6^{th}/7^{th}$	IMF/ WB	**Done.** PCT increased by more than 20 percent; minimum contribution base increased by 40 percent, and contribution ceiling raised from 4 to 5 times the minimum
69. Raise the PCT every month by at least WPI inflation	¶30	As of June		IMF	**Done**
70. Increase health premia and co-payments	¶30	Before parliament summer recess		IMF/ WB	**Not done.** Foreseen in new program
71. Allow full deductibility of specific loan loss provisions that banks are mandated to make based on banking regulations; eliminate tax deductibility for general provisions	¶30			IMF/ WB	**Done.** Provided for in amended Banking Law
72. Approval of supplementary budget in line with the program following expenditure policies: ▪ adjust current expenditure, transfers, and investment by less than the revision in the inflation target ▪ cut "other current expenditure" covered by Article 53 of the budget law ▪ limit the temporary credit subsidies to 0.2 percent of GNP, covering the cost of financing loans outstanding before the February 2001 crisis (new lending will not be subsidized)	¶31		C; 8^{th}	IMF/ WB	**Done.** Budget approved by parliament on June 14

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
▪ wage and employment policy for civil servants that (a) maintain civil service wages in real terms and (b) do not increase the number of civil servants					
73. SEEs					
▪ increase SEE tariffs and prices in line with increased costs and revised inflation targets	¶32			WB	**Done**
▪ reduce operating expenses in real terms					Instruction issued by Treasury
▪ cut sugar beet quotas from 12½ tons to 11½ tons and increase the support price of sugar beets by no more than targeted inflation					Quota reduced as planned; price to be set in autumn
▪ limit the volume of support purchases of cereals and offload additional grain stocks					**Done**. The spread between TMO purchase and sales price increased to limit throughput
▪ in parallel to the introduction of direct income support to farmers, keep support price increases in 2001 at most at targeted inflation (the margin for the support price for wheat over world prices will be further reduced to at most 20 percent by June 2001 subject to the provision that the increase will not exceed targeted inflation; the tariff on grain imports will be lowered to at most 45 percent)					**Not Done**. Increase adopted in May exceeded targeted inflation
▪ maintain the average price of electricity sold by TEAS at 4.5 U.S. cents/kwh and increase accordingly fees and tariffs of TEDAS, allowing the latter to cover the cost of purchasing electricity from TEAS	¶7; June LOI				**Done**. Electricity price to increase by more than planned to 5.1US cents/kwh by end-2001 (with corresponding increase in TEDAS price)
▪ increase cigarette and alcohol prices charged by TEKEL by 16-22 percent					**Done**
▪ discontinue the policy of subsidizing LPG					**Done**
▪ eliminate all discounts and exemptions on SEE products and services by June 2001					**Foreseen in new program** (with several small exceptions)
continue policy of replacing up to a maximum of 15 percent of retiring personnel in the SEEs in the Treasury's portfolio, in the PA portfolio, in Turk Telekom, and in public banks.					**Being implemented**
74. Slow down new expenditure programs in EBFs	¶32			IMF/ WB	**Being implemented.** Through November, EBF expenditures have been restrained (excepting World Bank-financed social expenditures)

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
75. a. Enact tax regulation to extend the use of Tax Identification Numbers	¶34	End-May	C; 8th	IMF/ WB	**Done**. Regulation adopted on June 20
b. Commence the application of TINs to financial transactions	¶9 of July LOI	September 1, 2001			**Done**
76. Merge and reorganize the three data processing centers of the tax administration	¶34			IMF	**Underway**. Expected to be finalized during the first half of 2002
77. Reduce the stock of private sector tax arrears from the end-2000 level of 2 percent of GNP (including interest and penalties)	¶34; ¶23 of Nov LOI	End-2001	BM	IMF	**Underway**. Target unlikely to have been fully met
78. Adjust promptly the interest rate on late payment of tax and social security arrears to keep them sufficiently above market interest rates	¶34	Continuous		IMF	**Being implemented.** MOF is monitoring interest rate developments with a view to adjusting the rate as appropriate
79. Work jointly with the World Bank to adopt a medium-term strategy for improving the tax system	¶9 of July LOI	Strategy to be adopted by end-2001		WB	**Underway.** Likely to be adopted in January 2002
80. Transparently disclose to the public the government's total financing needs, including the securitization of its obligations to the SDIF and state banks	¶39			IMF	**Being implemented**
81. Enhance the primary dealer system and give consideration to introducing some additional methods of trading	¶39			IMF	**Underway**. Introducing a new primary dealer system by end-2002 is a structural benchmark under the new program. Discussions with candidate primary dealers are currently taking place.
82. Consider changes in the structure of the taxation of financial instruments that would facilitate the direct purchases of government securities by individuals	¶39			IMF	**Done** as part of July 26 package.
83. Ensure that all budgetary measures needed to reach the 6.5 percent of GNP public sector primary surplus target for 2002 are in place	¶22 and Annex G of Nov LOI	January 2002		IMF/ WB	**Foreseen as prior actions in new program** (with some exceptions for technical reasons)
84. Ensure that any liquidity of public banks in excess of that required to meet deposit outflows will be utilized to reduce the Treasury's borrowing requirement from the private sector.	¶10 of Nov LOI	Continuous		IMF/ WB	**Done**
85. To improve prospects for a smooth rollover of government debt:	¶11 of Nov LOI	Continuous		IMF	**Done**
• Make every effort to lower the domestic borrowing requirement *inter alia* by issuing eurobonds and pursuing privatization vigorously;					

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
▪ Issue a broad range of instruments aimed at lengthening maturities of domestic debt, including fx-denominated and fx-linked paper;					
▪ Supplement the regular program of auctions with continued direct public offerings of government instruments					
Monetary and exchange rate policy					
86. a. CBT to technical strengthen technical infrastructure needed to implement direct inflation targeting (DIT)	¶43			IMF	**Underway.** TA provided (including bilateral and MAE), communication on DIT with the public strengthened, and surveys of market expectations started in September 2001
b. Issue Inflation Report (with publication of a quarterly Monetary Policy Report in November as a forerunner)	¶12 of July LOI	By early October 2001			**Underway.** The first Monetary Policy Report was issued in November 2001
c. The Monetary Policy Council to start issuing press releases after its meetings	¶13 of Nov LOI				**Not done.** Issuance expected soon
d. Formally make inflation targeting the nominal anchor for monetary policy	¶12 of July LOI ¶13 of Nov LOI	Beginning in last quarter of 2001			**Not done.** Delayed to 2002
87. To enhance the development of forward and futures FX markets:	¶15 of Nov. LOI			IMF	**Not done.** Working group to announce concrete steps by end-January 2002 as part of the new program
▪ encourage introduction of Turkish Interbank Offer Rate					
▪ clarify the taxation and accounting procedures for futures contracts					
Social dialogue, incomes policy, and protection of the most vulnerable					
88. Negotiate public workers wages with the aim of reducing the ratio of average net salaries of public sector (blue-collar) workers and civil servants (white-collar) from 2.6 in 2000 to 2.0 during the contract period, with a decline in the ratio of about one fifth in the first contract year. The wage contracts for public sector workers will be adjusted for inflation exceeding the targets, but not before the end of each six-month period. The adjustment will not exceed 80 percent of the difference between actual and projected inflation, and there will be no adjustment for the first 6-months	¶45			IMF	Wage settlement for public workers reached on May 22 in excess of program. The ratio of average net salaries of public sector workers and civil servants was expected to decline to 2.2 in 2001 and rise to 2.3 in 2002.

Action	MEP Ref.	Timing	Type[1/]	Lead Insti-tution	Status January 4, 2002
89. a. Establish intensive dialogue with employers and trade unions, including frequent meetings of the ESC	¶46; ¶4 of June LOI			IMF	**Underway**. But outside the ESC framework
b. Hold first meeting of ESC under the new legal framework	¶25 of July LOI; ¶13 of Nov LOI	Before end-2001 (initially by end August 2001)			**Not done**
90. Strengthen social protection programs to help reduce the impact of the economic downturn on the most vulnerable sections of the population	¶47; ¶26 of July LOI			WB	**Underway**, with World Bank assistance. Social mitigation loan (US$100 million) as part of larger project loan (Social Risk Mitigation of US$500 million) approved by the World Bank Board in September

1/ C=condition for completion of review; PA=prior action; BM=structural benchmark.

REPORT ON EXTERNAL AND FINANCIAL VULNERABILITY

1. The recovery in the financial markets, which started in mid-October 2001, gained further momentum in December after the completion of the tenth review and the start of negotiations with the Fund on a new Stand-By Arrangement. By early January 2002, the interest rate on the benchmark bond had declined significantly, the stock market index had recovered strongly, and the exchange rate had appreciated substantially. Banking and external sector indicators had improved somewhat, although vulnerabilities remained.

Financial and monetary indicators

2. The improvement in financial markets in the period mid-October–early January was driven by expectations of additional financing from the IMF, but also by Standard and Poor's upgrade of its outlook on Turkey from negative to stable, a less likely enlargement of the military conflict to Iraq, and progress on Cyprus and European Security and Defense Policy issues. The compounded yield on the benchmark bond declined by almost 20 percentage points, to 68 percent. The exchange rate appreciated by 12 percent reaching some TL/US$1,400,000, and the stock market recovered by almost 66 percent.

3. These promising developments, which were supported by the passage by parliament of some key reform laws, were also underscored by the re-openings in December of Eurobond and Dollar Global Bond issues in the face of strong demand from international investors. The spread over the Treasury's 2010 bond in the U.S. Global Bond Market declined by 290 basis points in early January compared with end-October, underlining the improved international financial market sentiment for Turkish government securities despite the economic crisis in Argentina.

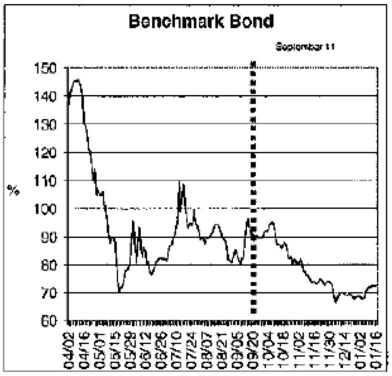
FINANCIAL AND MONEY MARKET INDICATORS (*)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec	Latest
1.Bond Yield (% Compound) (***)	53.6	157.6**	140.5	106.7	95.5	81.9	91.5	81.4	89.6	81.6	74.2	68.8	67.8
Volume (TL. Tr.)	41.8	0.4**	3.9	2.5	188.7	8.8	144.5	48.0	112.3	38.8	6.3	1.0	2.5
2. O/N Interest Rate (% simple)	54	121	83	77	63	63	67	61	59	59	59	59	59
3. Treasury Eurobond Spreads (2010 maturity) (basis pts.)													
Denominated in US$	736	1026	1130	902	873	888	1116	957	997	940	809	700	649
Denominated in Euro	477	553	577	522	488	477	676	568	695	685	584	514	474
4. ISE 100 Index (1986=1)													
TL Based	10685	8792	8023	12367	10880	11204	9814	9879	7626	8577	11634	13783	14273
US$ based	916	556	458	633	525	521	436	424	292	361	460	558	583
5. NDA of CBT (Tr. TL.)	236	3897	5802	6907	8357	13299	14703	16380	17902	18277	19439	20752	20415
6. Gross Reserves of CBT (US$ Mil.)	24518	21270	18822	18461	20621	17279	17606	18790	18882	18637	17610	19182	19064
7. Base Money (TL. Tr.)	4506	5071	5578	6022	5822	6412	6285	6752	7611	7157	7317	7803	7481

(*) End-month data, except for the latest

(**) Benchmark bond was not traded on the last day of the month. Figures are for Feb. 27th

(***) Figures reported are for the June 2001 paper up until end-April, for the March 2002 paper up until end-November, 2001, and for the April 2002 paper thereafter.



Real sector and government budget indicators

4. Real GNP figures for the third quarter were better than expected: GNP contracted by 8.3 percent with respect to the same period in 2000. The contraction in output was due mainly to a drop in private consumption and investment expenditures. Reflecting the sharp deterioration in market sentiment after the September 11 events, the CBT's Economic Tendency Survey and the SIS' Production Expectations Survey in September and October pointed to a reduction in both domestic demand and supply, although the former indicated a considerable improvement in November. Seasonally adjusted capacity utilization in private manufacturing industry, however, rose in October and November by 1.2 percent and 1.4 percent, respectively, after a drop of 2.7 percent in September. Seasonally adjusted industrial production rose in November by 1.8 percent after a flat September–October period. Underpinning the timid recovery in real activity, VAT revenues rose by 9 percent in October before declining by 2 percent in November, partly reflecting the temporary VAT reductions introduced over the November–December period. In November, WPI inflation was in line with market expectations, but was above them in December as the positive effect of nominal appreciation was counteracted by an increase in agricultural prices. CPI inflation in both November and December was somewhat lower than expected in the markets.

5. On the fiscal front, November posted another large primary surplus adding to a cumulative primary surplus of the consolidated budget that in October was higher than the 2001 end-year target. Financial market sentiment concerning the rollover of government debt in the rest of 2001 and in early 2002 improved with the completion of tenth review and the prospects for a new Stand-By Arrangement.

	REAL SECTOR AND GOVERNMENT BUDGET INDICATORS											
	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
1.CPI (monthly % change)	2.5	1.8	6.1	10.3	5.1	3.1	2.4	2.9	5.9	6.1	4.2	3.2
2.WPI (monthly % change)	2.3	2.6	10.1	14.4	6.3	2.9	3.3	3.5	5.4	6.7	4.2	4.1
3. Inflation Expectations***	25.0	35.0	55.0	59.6	56.5	55.8	56.7	57.6	60.7	62.9	61.5	..
4. Industrial Production Index (1997=100)	91.4	88.5	85.9	87.1	93.4	93.6	90.1	92.3	95.3	98.9	98.7	..
5. Capacity Utilization of Private Manuf. Ind. (%)	68.3	65.5	61.8	63.8	62.3	66.3	65.4	64.9	66.8	67.8	67.8	..
6. Production Expectation Survey (%)****	10.2	19.8	18.1	-5.6	37.5	34.5	23.7	33.2	39.3	10.3	-3.5	-28.9
7.Consolidated Gov.'t Primary Balance (Tr. TL.)	1292	2306	1122	1326	1084	509	670	1921	853	1020	1864	..
8. Gov't domestic debt service next month (TL. tr.)	..	..	..	..	..	5150	6400	7200	6700	7800	5645	..
9.Bid/cover ratio in TB auctions	1.64	1.61	2.5	1.25	1.61	1.26	2.08	1.17	2.14	1.59	1.25	1.27

(***) Percent change expected in WPI in the subsequent 12 months

(****) Difference between the percentage of respondents expecting a higher production vs lower production in the present month (data are collected in the previous month)

Banking and financial sector indicators

6. Capital adequacy for the banking sector excluding SDIF banks improved in the period June–September (mostly due to recapitalization of the state banks), but deteriorated for the banking sector as a whole. NPLs of the SDIF banks declined in absolute terms by almost 86 percent from end-October to December, helping the total NPLs in the banking sector to decline in absolute terms by almost 34 percent. The decline in NPLs of the SDIF banks was reportedly due to the transfer of NPLs of the liquidated SDIF banks to the Collection Department of the BRSA. However, when the SDIF banks are excluded, NPLs in absolute terms rose by almost 2 percent, owing to the rise in the NPLs of the state banks. These figures may understate the true extent of NPLs. Credit risk associated with the decline in economic activity remains a source of vulnerability in the banking sector.

7. Credit to private sector (excluding SDIF banks) declined in absolute terms by 4.8 percent from end-October to end-December, causing the ratio of credit to private sector to deposits to decline further. Although there was a sizable reduction in short open foreign exchange positions in absolute terms from end-October to mid-December, the improvement in the ratio of the short open foreign exchange positions to the banks' capital base remained limited as a result of the deterioration of the capital base in the same period. The maturity mismatch rose in October after a decline in September. With regard to currency substitution, although the FX deposit stock measured in U.S. dollars rose in late December compared with end-October, the share of foreign exchange deposits, measured in TL, as a share of total deposits declined over the same period owing to the appreciation of the TL and the rise in the TL deposit stock. Following a steep decline in October, banks' external loans due the following month rose in November.

8. With regard to banks resolutions, Toprak Bank was taken over by the SDIF on November 30, and Iktisat Bank entered into voluntary liquidation with its banking and deposit-taking license being revoked as of December 7. While the sale process of Sitebank is close to finalization, Kentbank and Etibank entered into voluntary liquidation and their banking and deposit-taking licenses was revoked as of December 28. EGS Bank was transferred to Bayindirbank, and its banking and deposit-taking license will be revoked as of January 18. The deposits of most SDIF banks have been auctioned to other banks, in preparation for the resolution of the SDIF banks. On January 10, parliament approved the law on recapitalization of banks. Standards and Poor's upgrade of the financial outlook of some leading Turkish banks (including Ziraat Bank) from negative to stable should help increase confidence in the banking sector.

BANKING AND FINANCIAL SYSTEM INDICATORS

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Latest
1. Capital Adequacy Ratio												
Total			3.2	..	..	19.7	..	..	15.9	..	..	..
Excl. SDIF			14.8	..	..	14.3	..	..	16.1	..	..	..
2. NPLs / Credit to Private Sector (%)												
Gross	11.0	11.3	11.9	13.1	14.4	15.7	14.4	19.4	19.2	18.8	16.0	13.9
Net (of Provisions)	4.0	4.3	4.5	4.9	4.5	4.5	3.3	6.9	6.6	6.8	7.2	7.5
3. Open FX Position / Capital Base												
Total												
Total Net FX Position (US$ Million)	-5324	-4310	-5149	-5336	-803	-242	-766	-724	-695	-880	-732	-563
Open FX Position/ Capital Base (%)	-66	-77	-88	-122	-20	-5	-12	-7	-7	-10	-10	-7
Excl. SDIF												
Total Net FX Position (US$ Million)	-1012	-765	-479	-517	-159	317	78	475	470	319	306	342
Open FX Position/ Capital Base (%)	-8	-10	-6	-8	-2	5	1	6	6	4	4	4
4. Proxy for Av. Maturity Gap (months) (*****)	3.5	2.8	3.0	3.0	3.5	3.4	3.6	4.0	3.7	4.5	..	..
5.Deposits (Tr. TL)	57,051	63,063	71,518	74,697	75,248	83,605	85,412	91,844	100,082	104,429	101,862	102,518
TL/Total (%)	55.0	50.8	51.5	48.0	48.6	45.7	42.0	41.6	39.2	38.4	40.6	43.2
FX/Total (%)	45.0	49.2	48.5	52.0	51.4	54.3	58.0	58.4	60.8	61.6	59.4	56.8
6. Credit to Private Sector (TL.tr.)	32,404	34,502	35,947	37,909	37,016	39,972	40,480	43,682	46,797	47,484	43,635	42,260
7. Credit to Private Sector / Deposits (%)	56.8	54.7	50.3	50.7	49.2	47.8	47.4	47.6	46.8	45.5	42.8	41.2
8.External Loans due next month (US$ Mil.)	6490	5765	5515	5591	4242	5291	1383	1520	2555	1073	1344	367

(*****) The difference between the average (weighted) maturities of assets and liabilities

External indicators

9. The current account surplus in January–September 2001 reached US$2.5 billion, compared with a deficit of US$6.9 billion over the same period in 2000. The improvement in the merchandise trade deficit, which was the main driving force behind the better-than-expected current account outcome, continued in October with better-than-expected export growth of 24.3 percent and a contraction in imports of 34.3 percent. In October–December, real appreciation reached 21 percent. Nevertheless, the preliminary figures from the Unions of Turkish Exporters suggested year-on-year export growth in November and December of 17.5 and 6.1 percent, respectively, pointing to a preliminary year-end export outcome of about US$31 billion. Although the Central Bank's Economic Tendency Survey indicated sharp deteriorations from August to October in the expectations for new orders from export markets and sales in the export markets for the next three months, both forward-looking indicators posted

considerable improvements in November. SIS data indicate that the number of foreign visitors to Turkey declined on year-on-year basis by 9.5 percent and 13.5 percent in October and November, respectively. In the period ahead, both export of goods and tourism receipts will continue to be affected by the fallout from the September 11 events.

10. Total capital outflows in January–September 2001 reached US$10.6 billion, although there were net capital inflows in September of US$381 million, for the first time since January. Although the bulk of the capital outflows in January–September 2001 was short-term flows (primarily due to repayments by banks) and portfolio investments (mainly due to sales of securities by nonresidents in Turkey), both items posted inflows in September: US$194 million and US$131 million, respectively. Nonrecorded capital flight registered in "net errors and omissions" reached US$3.1 billion in January–September 2001 compared with US$1.6 billion in the same period of 2000. Leading Turkish banks have returned to the international capital market for syndicated loans. The short-term debt-to-reserves ratio did not improve in September over the previous month, and stood at 110 percent.

	EXTERNAL INDICATORS												
	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec	Latest
1. REER (WPI) (1987=100)	109.8	102.7	87.5	81.1	92.5	90.6	86.6	82.7	82.0	81.3	90.1	98.3	..
2. Exports (US$ million)	2236	2516	2546	2607	2884	2561	2483	2578	2561	2790	..	..	..
3. Imports (US $ million)	3985	3513	3088	3013	3537	3267	3353	3385	3305	3299	..	..	..
4. Current Account (US $ million)	-674	-96	233	628	333	198	392	807	693	..	..	..	..
5. Change in foreign banks exposure (US $ million)	-280.6	-1525.2	-933.2	-172.2	-884.6	-1841.1	-2000.7	422.5	-285.0	-252.3	308.4	-411.1	52.3
6. Short-term external debt/reserves	1.18	1.29	1.42	1.43	1.19	1.32	1.18	1.10	1.10	..	..	..	..

ASSESSING BUDGETARY FINANCING NEEDS FOR 2002

1. **Estimating Turkey's budgetary financing needs for 2002 is not an easy task.** What is ultimately required is an assessment of whether the Treasury can be expected to meet its financing needs in 2002 under reasonable assumptions and without increasing market pressures. This depends in turn on the reliability of the funding base—in Turkey the banking sector has been the main source of government financing—which is determined by the size of the deposit base of the banking sector and the willingness of private banks to lend in the face of rollover risk. For the budget to be adequately financed, sufficient external resources are required both to bring the domestic borrowing need in line with absorptive capacity and to convince markets that the reliance on private sector gross borrowing is within the limits required to achieve a smooth debt rollover.

2. **The ability and willingness of private banks to absorb government debt— often proxied using the required rollover ratio—depend on highly uncertain factors, such as investor confidence, the rollover or growth of private banks' domestic and external liabilities, and the profitability and solvency of the banking sector.** The private sector rollover ratio (the government's borrowing from the private sector as a ratio to redemptions of government debt to the private sector, including interest payments) is widely viewed by markets as a benchmark for what private banks can absorb under difficult market conditions. As a rule of thumb, the rollover ratio provides some measure of demand for treasury bills; a rollover ratio of about 85 percent is consistent with banks maintaining their stock of treasury bills in real terms, depending on factors such as real interest rates and the maturity profile of domestic debt. If deposits and other liabilities grow in line with GNP, a rollover ratio greater than this level could be achieved consistent with a constant share of treasury bills in total assets. However, if liabilities remain constant in real terms, a higher rollover ratio would require banks shifting away from other assets such as private sector lending. For these reasons, markets often focus on the implied private sector rollover ratio when assessing the realism of the government's borrowing program, and hence the rollover risk.

3. **However, the rollover ratio is an incomplete indicator of domestic absorptive capacity, and a clear picture of the adequacy of budget financing requires a comprehensive view of projected balance sheet developments for the banking system.** As indicated above, Treasury's funding base comprises (i) public banks, holding about one-half of Treasury's domestic debt (excluding debt held by the CBT) and accounting for over 40 percent of total bank deposits; (ii) private banks, holding most of the domestic debt issued at auction; and (iii) nonbank entities (comprising mainly public funds, but including small foreign and direct retail holdings). About one-third of the domestic borrowing need is typically placed with public non-bank institutions, which as a rule roll over close to 100 percent of their Treasury bill holdings, leaving nearly all of the remainder to be financed from the banking sector.

4. **Within the banking sector, public banks have the capacity to contribute significantly to the domestic financing of the budget.** Aside from relatively small loan portfolios, most of the assets of public banks are concentrated in Treasury bills and bonds

issued during the recapitalization of state and SDIF banks in 2001. During 2001, most of the interest on deposits has been rolled over, giving the public banks the liquidity to reduce significantly their short-term liabilities. Stable growth in these banks' deposit base is expected to continue in 2002, which should allow for the elimination of any remaining short-term liabilities (mostly to the central bank), so as to allow the central bank to reduce its own short-term borrowing from the market. This should leave considerable scope for public banks to contribute toward meeting the domestic financing needs of the budget.

5. **The remaining domestic financing requirement would need to be met by private banks.** The capacity of private banks to hold government debt grows with their deposit base, which is assumed to stay roughly constant as a share of total banking system deposits. At the same time, the assumed continued decline in external interbank borrowing of US$3½ billion projected for 2002 will reduce private banks' capacity. This should be partly offset by an increase in central bank net lending to private banks during 2002, consistent with the monetary program and with the reduction in public banks' borrowing from the central bank. Lending from private banks to the private sector is projected to keep pace with nominal activity (with some small decline in percent of GNP owing to exchange rate effects). Altogether, these factors will determine the capacity of private banks to absorb government debt in 2002, and consequently, the need for additional external budgetary financing.

6. **The staff estimates that US$7 billion in external financing beyond that already identified would be adequate to meet the budgetary financing needs in 2002 without putting further upward pressure on interest rates.** The central government overall deficit (excluding interest accrued by the CBT) is projected to be 13 percent of GNP, of which less than ½ percent could be filled from identified net external financing and privatization proceeds (Appendix V, Table 1). With public banks and nonbank lenders expected to provide about 6 percent of GNP in financing, private banks would need to provide the remainder. However, if deposits and private sector lending were to grow in line with nominal activity, an expected decline in external interbank lending to private banks of US$3½ billion would imply only 2 percent could be filled from private banks at projected real interest rates, leaving some 4 percent of GNP (US$7 billion) as the budgetary financing gap. Other things being equal, if the gap is not closed by additional external financing, private banks could be induced to fill part of the gap only through an increase in real interest rates, leading to crowding out of lending to the private sector, slower output growth, and a larger budget deficit.

7. **With US$7 billion in additional external financing to the budget, the government's domestic borrowing requirement would appear consistent with the banking sector's capacity to absorb domestic debt.** An additional US$7 billion in external financing to the budget would imply a private sector rollover ratio of about 85 percent, a level markets would regard as manageable (especially given the lower projected net foreign commercial bank outflows and the net lending of the central bank, as discussed above), and reduce the domestic borrowing requirement from private sector banks to a level consistent with their absorptive capacity. Consistent with this, private bank lending could grow at the rate of 40 percent, in line with the projected recovery in output. The projected growth in the

deposit base of private banks, the slower reduction in external interbank liabilities, and the reduced borrowing needs of public banks in 2002 should provide sufficient room for private banks to maintain their stock of domestic debt in real terms and as a share of private bank assets, despite a fall in assets as a share of GNP (Appendix V, Table 2).

Table 1. Turkey: Central Government Budget Financing, 2001-02

(in percent of GNP)

	2001	2002
Overall balance	-18.2	-15.3
of which: accrued interest 1/	2.7	2.3
Overall balance excl. accrued interest	-15.4	-13.0
Financing	15.4	13.0
Net external financing	-2.4	-0.1
New borrowing	3.0	3.7
Amortization	5.4	3.7
Use of balance of payments support	7.0	4.2
Privatization	0.8	0.4
Net domestic financing	10.0	8.4
Non-bank institutions	2.7	2.5
Public banks	3.5	3.7
Private banks	3.8	2.2

1/ Interest costs financed by direct bond issues to CBT in 2001, and in 2002, by CBT profits.

Table 2. Turkey: Structure of Banking System, 1998-2001

(In percent of total assets for the system) 1/

	1998	1999	2000		2001	2002
	December	December	September	December	September	January 24
Total	100.0	100.0	100.0	100.0	100.0	...
Private Domestic	56.9	52.0	55.4	49.9	53.6	...
Largest six	32.0	32.1	34.2	34.4	39.3	...
Other	24.9	20.0	21.1	15.4	14.2	...
SDIF	1.2	5.6	3.2	8.5	11.7	...
State	34.9	34.9	34.1	34.1	27.2	...
Foreign	2.2	2.7	2.9	3.1	2.7	...
Investment	4.7	4.8	4.5	4.4	4.8	...
			(In number)			
Number of banks	75	81	80	80	68	59
Private Domestic	38	32	32	29	23	21
Largest six	6	6	6	6	6	5
Other	32	26	26	23	17	16
SDIF	2	8	8	11	9	4
State	4	4	4	4	3	3
Foreign	16	18	17	17	17	16
Investment	15	19	19	19	16	15

Source: Banking Regulation and Supervision Agency (BRSA).

1/ Excluding repos.

2/ From December 2000 to September 2001 five SDIF banks were merged into another SDIF bank, which was then privatized.

Ankara, January 18, 2002

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

Dear Mr. Köhler:

1. **From the outset, Turkey's economic reform program has had two main goals: conquering the chronic and persistent high inflation of the 1990s, and overcoming the associated macroeconomic instability which has constrained our economic growth.** Although the original three-year program initiated in December 1999 has had to be adapted and strengthened in the light of events, including the February 2001 crisis, we have made considerable progress. We have implemented a major fiscal adjustment to help bring about debt sustainability. We have reformed the banking sector through an operational and financial restructuring of public banks, and a strengthening of the regulation and supervision of private banks. We have also pursued disinflation both under the original crawling peg regime and following the float in February 2001. Finally, we have deepened the role of the private sector in the economy, including through reforms to facilitate privatization.

2. **Our revised program, adopted in May 2001, was beginning to achieve its aim of restoring investor confidence in the wake of the two crises, when the events of September 11 hit.** From early August onward, as confidence began to return, interest rates started to fall, and the Turkish lira stabilized. The events of September 11, however, hit Turkey particularly hard, given our debt situation and our location. This severe external shock is affecting the Turkish economy through several channels: weaker demand in industrial countries, lower tourism receipts, reduced access to international financial markets, and poorer privatization and foreign direct investment prospects. This has resulted in a projected external financing gap of US$10 billion in 2002, and weaker short-term economic growth prospects.

3. **We have responded to the fallout of September 11 and Turkey's ongoing economic problems by deepening and extending our economic program, building on our earlier reforms.** The Turkish economy is entering 2002 with greater strength thanks to the reforms carried out so far, but is still facing very important challenges. Chief among them is the reduction of inflation to the targeted 35 percent, the resumption of growth which should continue to be export led, and the more rapid extension of the benefits of growth to the lower-income groups. We are determined to build on the positive results that have emerged at the end of 2001 thanks to the success of our fiscal policies, the competitive exchange rate, and the enactment of many important structural reforms. Despite the progress made, Turkey continues to face difficult macroeconomic and structural policy challenges,

including a substantial public debt burden, high inflation, banking sector difficulties, and extensive state involvement in the economy. To tackle these problems, while addressing the repercussions of September 11, we have decided to adopt a strengthened medium-term economic program.

4. **This letter lays out in detail our economic program for 2002–04, and requests a new stand-by arrangement in its support.** Based on our balance of payments needs, and our strengthened policies described below, we request the approval of a new stand-by arrangement in an amount equivalent to SDR 12,821.2 million for the period January 2002 through December 2004. The current stand-by arrangement (2000–02) will be cancelled upon approval of the new arrangement. We will use the equivalent of SDR 4,916.4 million of what becomes available upon approval to repay outstanding resources under the Supplemental Reserve Facility. Annex A summarizes the main macroeconomic indicators under our program.

5. **The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks.** The reviews will be held bimonthly in March, May, and July 2002, and quarterly thereafter (starting in October 2002) for the duration of the arrangement. Annex B summarizes the quantitative performance criteria and indicative targets, while the structural conditions are listed in Annex C.

Objectives and strategy for 2002–04

6. **Our program aims to insure the economy against future crises and lay the basis for sustained noninflationary growth.** First, the program will improve the economy's resilience to shocks and reduce its vulnerability to future economic crises, by (i) maintaining the exchange rate float and using inflation targeting to deliver a significant reduction in inflation, (ii) pressing ahead with bank restructuring, and (iii) ensuring a viable government debt position. Second, the program will involve fundamental structural reforms aimed at raising Turkey's growth potential. Achieving these objectives will also help move Turkey closer to the goal of EU membership.

7. **For 2002, our priority will be to restore financial and macroeconomic stability, and to further progress in structural reforms.** To this end, we will ensure that our ambitious public sector primary surplus target of 6½ percent of GNP will be met. This, together with our active and flexible debt management strategy, should ease government debt rollover. We are also determined to deepen our structural reforms to build on the important results achieved so far. While in 2001 the sharp devaluation after the float of the Turkish lira in February and the September 11 shock raised CPI inflation to 68.5 percent, in 2002 monetary policy will be consistent with our 35 percent inflation target. Although real GNP is estimated to have declined by 8½ percent in 2001, a moderate economic recovery started in the third quarter, and is expected to continue in 2002. In light of the negative impact of the recent events on exports and tourism and our commitment to disinflation, we project real GNP growth in 2002 conservatively at 3 percent. We believe, however, that this projection

has upside potential. As regards the external current account, we expect the September 11 shock, the economic recovery, and a modest rebound in the real exchange rate to result in a deficit of about US$2 billion in 2002, following an estimated surplus of a similar size in 2001.

8. **For 2003–04 and beyond, our key objectives are sustainable growth, together with continued disinflation and a viable debt position.** Continued implementation of prudent financial policies and structural reforms will lay the basis for higher growth of at least 5 percent annually in 2003 and beyond. The move to an inflation targeting framework will underpin our disinflation efforts. Recovery in world demand and the impact of structural reform on the competitiveness of our economy will support the current account. In this context, we expect government debt to show a marked declining trend relative to GNP, and the external current account position to be fully financed, with foreign exchange reserves at safe levels.

9. **In support of these objectives, we will pursue a multi-pronged economic policy agenda in 2002–04:**

- **Continued sizeable public sector primary surpluses** to strengthen our debt position and rebuild market confidence. In 2003, we will maintain the primary surplus at the targeted 2002 level of 6½ percent of GNP, and will lower the target in subsequent years only if the debt-to-GNP ratio falls substantially faster than currently envisaged. To achieve these targets, we will introduce fundamental reforms of the expenditure and taxation systems, while ensuring that spending in social areas remains adequate.

- **Inflation targeting under a floating exchange rate regime**, featuring a pre-announced medium-term disinflation path. The Central Bank of Turkey (CBT) will direct monetary policy to keep inflation within 35 percent in 2002, 20 percent in 2003, and 12 percent in 2004. To facilitate the achievement of these targets, the government will make determined efforts to remove the widespread backward indexation of wages and prices during the program period.

- **Completion of banking sector restructuring**, to underpin financial stability and help orient credit flows to their most efficient uses. This will include a strengthening of the private banking sector, efficient resolution of intervened banks, continuation of the operational restructuring of state banks—with their privatization the ultimate objective—and further improvement of regulation and supervision.

- **Enhancing the role of the private sector in the economy** by accelerating privatization, facilitating corporate debt restructuring, improving the business climate (including through the creation of an Investor Council), and encouraging foreign direct and domestic investment. By the end of the program period, we expect all large state economic enterprises (SEEs) to have been restructured, and most of them privatized.

- **Public sector reform** aimed at a lasting improvement in public resource management and efficiency. Our main focus in this area will be on reforming the civil service, further consolidating the fiscal accounts, and improving fiscal reporting and transparency.

10. **Within this overall framework, economic policy will respond flexibly to unforeseen developments.** Economic prospects and the balance of payments will depend on the duration and effects of the September 11 shock, and on the restoration of investor confidence. If the balance of payments outturn were better than predicted, we would in the first instance allow a build-up of foreign exchange reserves and adjust monetary policy to safeguard the inflation target. Should the overperformance be large and persist, with the overall debt position better than expected, we would also be prepared to make repayments of Fund resources ahead of schedule, or refrain from drawing scheduled disbursements. In the event developments are less favorable than anticipated, the program's prudent fiscal and monetary stance and strong reform agenda should help reassure markets and thus insulate Turkey. Nevertheless, we would further strengthen fiscal policy as needed to ensure that the debt situation remains manageable should the circumstances deteriorate markedly and market confidence be slow to return. We believe that the policies and measures described in this letter are adequate to achieve the objectives of the program, but we stand ready to take additional measures if necessary to keep our program on track, in close consultation with the Fund. We will also consult with the Fund on its balance of payments policies after the expiration of the arrangement, in line with the Fund's policies on such consultations, while we have outstanding purchases in the upper credit tranches.

The program for 2002

Fiscal policy

11. **We are putting in place a fiscal framework to increase the public sector primary surplus from the targeted 5.5 percent of GNP in 2001 to 6.5 percent of GNP in 2002.** Even under the difficult economic conditions, we met all of our primary surplus targets through end-September with considerable margins, and expect to have met our full-year target as well. We will continue with this strong implementation in 2002, in view of our need to achieve a more sustainable debt situation. We have made some minor and neutral changes to our fiscal framework for 2002, due to changes in the macroframework. We expect much weaker-than-programmed oil prices and projections for a stronger-than-programmed currency to lift the primary surplus in our energy SEEs, which are large importers. The primary surplus, however, is now expected to be lower for the consolidated budget, since a higher price level will feed fully through to indexed wages and pensions, but in the case of revenues, be partially offset in impact by lower growth.

12. **In support of our fiscal target for 2002, we have specified about 2 percent of GNP in new measures (detailed in Annex G of our letter of November 20), and have already implemented many of them.** On the revenue side, we have passed a Finance Bill implementing changes in specific excises, raised the petroleum consumption tax (PCT) and

extended it to natural gas, doubled property tax rates in metropolitan areas, amended the Construction Law (to allow our electricity metering program to proceed), and raised prices and eliminated discounts and exemptions in key SEEs. We have also passed a budget law reflecting most central government expenditure measures, and issued circulars to implement tighter cost controls in the health sector. Finally, we have instructed SEEs in the Annual Investment and Financing Decree and in three circulars to implement all cost savings measures in their budgets. Treasury auditors will monitor SEEs' compliance with these measures on a quarterly basis.

13. **We will also implement as prior actions a number of additional measures to help achieve the 6.5 percent of GNP primary surplus target.** On the revenue side, the Council of Ministers will approve a reduction in the share of central government tax revenues accruing to metropolitan municipalities to 4.1 percent. On the expenditure side, we will issue a circular to implement our attrition rules, and the Minister of Finance will approve a reallocation of spending to ensure adequate funding for Direct Income Support (DIS) for small-scale farmers. The reallocation is needed, because the budget approved by parliament did not reduce agricultural premia and increase DIS to the extent intended, and it involves reducing transfers to the sugar and electricity companies to fund an increase in it.

14. **A few measures will be done later in the year, because they require more time.** In early February, we will increase the PCT (on items excluding natural gas) by 1 percent in real terms. By end-March 2002 (as a **structural benchmark**), the Minister of Finance will identify savings from closing regional administrations and other regional line agency offices, and block relevant budget appropriations in the budget, and SEEs will approve budgets in line with the cost reductions mandated. Throughout the year, to safeguard government revenues we will refrain from introducing any new tax exemptions or incentives, except those specified in our tax reform plan (discussed below). Moreover, to safeguard SEE revenues, we will refrain from introducing any new discounts or exemptions for SEEs, except those pursued for commercial reasons by enterprises' managements.

15. **We have expanded our monitoring to additional elements of the public sector for 2002.** In addition to a performance criterion on the primary surplus of the consolidated government sector (Annex D), the program will include a semiannual indicative target on the primary balance of other elements of the public sector (Annex E). For 2002, this new target covers the social aid and solidarity fund, 10 SEEs, all revolving funds in education and health, special provincial administrations, and a municipal development bank. For 2003, it will also cover 10 more SEEs, and municipalities with a population of over 50,000. The program will also include an indicative target on the overall balance of the consolidated government sector (Annex F). A baseline for net lending has been specified (Annex G), below which amounts will not be counted toward our primary balance performance criterion. In 2003, all net lending will be counted toward our target.

Public debt management

16. **In the last few months, the Treasury has been able to lengthen the maturity of domestic debt issuance and widen the range of investor participation, notwithstanding the turbulent conditions in world markets.** We lengthened the average maturity of Treasury bill issuance to nearly 6 months in November, the longest since May, which illustrates growing market confidence. Retail investors augmented their securities holdings, spurred by the recent increase in the tax exemption threshold and improving domestic market conditions. With demand from insurance companies and foreign investors also on the rise, this diversified the investor base. Meanwhile, the Treasury issued US$1.5 billion in international bonds during the final quarter of the year, exceeding expectations under difficult international market conditions.

17. **For 2002, we expect that additional external financing and the strong financial position of state banks will limit the domestic borrowing needs from the private sector to comfortable levels, facilitating a smooth rollover of the government's domestic debt.** With stable growth in the state banks' deposit base expected to continue in 2002, these banks will be able to eliminate any remaining short-term liabilities, and at the same time contribute toward meeting the domestic financing needs of the budget through the swapping into longer maturities of the bonds held by the state banks. Available external financing will further reduce domestic borrowing from the private sector. Our borrowing program is based on a conservative assumption of US$2½ billion in international bond issues in 2002, augmented by the use of some US$7 billion in external support from the Fund (prudent external debt limits will be monitored through the performance criteria outlined in Annexes H and I). The residual financing needs, while large, are expected to be well within the ability of the domestic private sector to absorb. Taking all the above into account, we estimate the required private sector rollover ratio in 2002 to be a manageable 85 percent.

18. **Beyond this, we will take several new debt management initiatives in 2002 to improve the robustness of the debt program to periods of market weakness, reduce remaining market concerns about the rollover, and diversify the investor base.** In Treasury bill auctions and public offerings, we will continue to lengthen average maturity to the extent demand allows and to encourage a diverse range of investors. This should further reduce the gross borrowing requirement from the market, and hence the private banks' rollover ratio. We will also provide instruments and a market structure which seek to ensure that banks continue to play a major role in the funding of government debt. Accordingly, in issuing new domestic debt we will pay particular attention to the need to allow banks to match their foreign exchange and interest rate exposures.

19. **Specifically, our new initiatives will include the following:**

- In January 2002, we will resume the program of **Floating Rate Note** (FRN) auctions which had halted in November 2000. By further increasing the maturity of the Treasury's debt, this program will allow a reduction in the Treasury's gross borrowing requirement, while providing an instrument which meets banks' needs concerning interest rate risk and liquidity. To improve the liquidity of the FRN market, before the first issue a revised standard method of price and yield calculations, in line with international practice, will be publicized by the Treasury for use in the primary and secondary markets, and by the CBT and the Istanbul Stock Exchange for use in their collateral valuation. For their part, the Treasury and the Banking Regulation and Supervision Agency (BRSA) will ensure that banks fully understand the appropriate interest rate risk treatment.

- To further enhance the liquidity of domestic debt, we will **reintroduce a primary dealer program** by end-September 2002 (**structural benchmark**). Discussions with candidate primary dealers are currently taking place. Under the program, primary dealers will commit to minimum levels of purchases at auctions, and to make markets in Treasury bills and domestic government bonds, both for outright transactions and for the lending of securities. The Treasury will also provide a facility to swap other bills into benchmark bills, at its own discretion, to relieve any securities settlement shortages which might occur.

- Liquidity in the government securities market will be helped by **liquidity in other financial instrument markets**. Therefore, the deepening of the interbank money market and creation of a Turkish Interbank Offer Rate described in paragraph 25 will be helpful for debt management.

- We will continue to issue, subject to market conditions, **domestic fx-denominated and fx-indexed bonds, as well as international bonds**, to further lower the gross domestic borrowing requirement while maintaining a diverse investor base and mix of instruments.

- The Treasury will conduct a study on its operational mechanism, procedures, and structure to improve its **risk and debt management**, including through closer coordination between domestic and international borrowing. The recommendations of this study will be implemented by mid-2002. This will allow joint decisions to be made on the borrowing approach in these two markets, to reflect the overall borrowing needs of the Treasury and the reality that international and domestic investors alike participate in these markets.

- The Treasury will also develop its **cash management operations**, acting in coordination with the CBT.

- The Treasury will intensify its **dialogue with the full range of investors**, including bilateral contacts and group discussions with institutional investors and intermediaries, and enhanced retail outreach.

Monetary policy

20. **The main goal of monetary policy will be to reduce inflation to 35 percent by end-2002.** The CBT will achieve this goal by initially using base money targets and later, as the preconditions are met, through the introduction of formal inflation targeting. To achieve this goal, we have developed a monetary program that sets performance criteria on the level of base money. Through 2002, we will target base money growth of 40 percent, in line with projected 3 percent real output growth and our target of 35 percent inflation. However, as the experience in 2001 has shown, the demand for base money is difficult to predict. Thus, during program reviews an assessment of base money demand will be a focus area, with targets for base money adjusted should money demand show signs of deviating markedly from program projections. In such assessments, indicators such as dollarization of deposits, velocity and currency movements, and yield curve indicators will be monitored closely.

21. **In May 2001, we took the first crucial step toward inflation targeting, by granting the CBT full operational independence to pursue the goal of price stability.** Throughout the turbulence in financial markets of the past year, we believe that CBT independence has helped stabilize monetary policy, keeping inflation from spiraling out of control. Looking ahead, we will ensure that any new laws or regulations do not undermine the independence enshrined in the CBT law. With confidence now showing signs of improving, the CBT's independence will play a crucial role in delivering a significant and sustained reduction in inflation.

22. **We are taking important steps to fulfill the remaining conditions for the successful launch of inflation targeting.** First, we have sustained our efforts to raise the public sector primary surplus and to improve debt management. This has put the public finances in significantly better shape which, in time, will give monetary policy greater freedom to reduce inflation. Second, we will continue to strengthen the banking system which, as a side benefit, will considerably ease the pressures facing monetary policy. Third, we believe that our strengthened economic program will sustain the recent improvement in financial market conditions, increased confidence in the Turkish lira, and exchange rate stability. Together with our adherence to the program's money supply targets, monthly inflation should soon fall quite sharply and, with it, expectations of inflation for the remainder of the year. Fourth, we will continue our technical preparations for the introduction of inflation targeting, including improved modeling and forecasting of inflation, highlighted in the CBT's inaugural Monetary Policy Report of November 2001—the forerunner to a quarterly Inflation Report. We believe that these four steps will play an important role in meeting all of the pre-conditions for successful inflation targeting by mid-year.

23. **In support of the early introduction of inflation targeting, we are strengthening incomes policy and taking steps to reduce backward indexation in the economy.** We recognize the need to move to a system of wage and salary determination that focuses increasingly on productivity and profitability rather than inflation. To this end, we will seek a significant reduction of the ex-post indexation element contained in current contracts during

the next public worker collective bargaining round and civil service salary adjustment, and will use the Economic and Social Council as a forum for incomes policy discussions with the private sector. We will also consider the possibility of reducing backward indexation of administered prices, without compromising SEEs' financial conditions.

24. **We will maintain the floating exchange rate regime, which is central to our monetary policy and the sustained reduction of inflation.** Since the beginning of August, the CBT has almost completely refrained from discretionary foreign exchange intervention, limiting itself to pre-announced auctions, which in recent months have been daily. We will continue to strictly limit discretionary intervention outside the pre-announced auctions. In December, reflecting the lack of need for sales in that month, the CBT discontinued these auctions, a move well received by markets. However, significant external assistance to the budget will continue in 2002, and we will still need at times to make foreign exchange sales to convert this assistance into Turkish lira as needed for domestic payments. As in 2001, any such sales (or any purchases which may be needed to build up reserves) will be conducted in an orderly and predictable way, and not used to defend a particular level of the exchange rate. Specifically, any such sales will be effected through pre-announced auctions.

25. **We are also introducing reforms to improve the working of the money and foreign exchange markets:**

- **Developing the money market.** Under the floating exchange rate, interest rate volatility has decreased significantly. As a result, conditions are now in place for deepening the interbank money market, and for creating a Turkish Interbank Offer Rate (TIBOR). This can play a key role in the pricing of credit, as well as for other financial instruments (including forwards and swaps). We will encourage a successful conclusion by end-February 2002 of banks' discussions to establish interbank borrowing reference rates in Turkish lira out to at least three-month maturity to enhance money market liquidity and transparency, and to provide accurate reference rates for financial instruments. In addition, with most SDIF banks resolved and the measures taken to strengthen the private banking system, the CBT has already announced that during 2002 it will gradually end its practice of acting as a blind broker (for example, borrowing on behalf of banks).

- **Developing forward and futures markets.** By reducing uncertainty, forward and futures markets are an essential part of a successful floating exchange rate regime. We have established a working group, chaired by the CBT and with representatives from the Treasury, Ministry of Finance, BRSA, Capital Markets Board, Istanbul Stock Exchange, and the Turkish Bankers' Association, charged with facilitating the development of these markets, as well as the creation of an interest rate futures market. The working group will identify concrete actions by end-January 2002 in the areas of taxation (including exemption of daily revaluations of open positions from transaction taxes), accounting, and regulation. The first measures will be put in place by end-February 2002. In addition, banks will be allowed to deal in these markets electronically, rather than being required to be physically present at the futures exchange. Progress toward establishing and deepening these forward and futures markets will be monitored closely in program reviews.

- **Currency transactions of state economic enterprises.** Consistent with the change to floating exchange rates, in January 2002 the Privatization Agency will authorize companies in its portfolio to transact their foreign exchange business not at the CBT official rate, but at the market rate. The oil and gas companies (TÜPRAŞ and BOTAŞ) will work with state banks to improve their foreign exchange practices, to minimize lumpy transactions in the foreign exchange market. In this connection, the Treasury has already issued BOTAŞ this instruction, and has ended the practice of requiring this company to seek market quotations (and, in so doing, revealing its foreign exchange needs) from major market participants.

26. **Implementation of the monetary program will be monitored through performance criteria on the monetary base and net international reserves (NIR), and indicative limits on net domestic assets (NDA).** As outlined above, until the introduction of inflation targeting the main anchor of the monetary program will be the monetary base. Performance criteria on base money and indicative targets for NDA are presented in Annex J. In addition, performance criteria for NIR are designed to allow the use of US$7 billion out of the US$10 billion external financing under the program to ease pressures in financial markets (Annex K). Developments in this area, including the behavior of interest rates, NDA and NIR, will be monitored in close cooperation with the Fund, between and during the reviews, to ensure that program objectives are achieved.

Banking reform

27. **The program aims to continue the strengthening of the banking system and oversight framework that has been underway since 1999.** The focus is on measures to strengthen private banks, resolve intervened banks (those under the control of the Saving Deposit Insurance Fund, or SDIF), further improve the efficiency of state banks (with privatization the final goal), put in place frameworks for dealing with nonperforming bank loans, and further improve prudential regulation and supervision.

28. **In 2001 we completed the financial restructuring of state banks, and for 2002 our objective is to conclude their operational restructuring.** We have recapitalized Ziraat and Halk banks and reorganized them under new professional management. We expect them both to resume normal lending to the real sector and to be profitable in 2002. We will also pass the necessary legal amendments and issue a Council of Ministers' decree for staff reductions to continue the operational restructuring that is already underway (**prior actions**). By end-June 2002, we will reduce the number of branches by 800 (**structural performance criterion**). In this context, we will also reduce staffing correspondingly. For Vakif Bank, a privatization advisor is doing due diligence analysis, and we have invited potential investors to indicate their interest in the bank and submit bids in May.

29. **We are introducing a comprehensive plan to further strengthen the private banking system so that it can perform its crucial role of financial intermediation to the real sector.** In the first stage, we took over the weakest banks in the system. However, continued financial market turbulence has caused market losses and weakening economic conditions are causing loan losses, worsening the financial position of many banks. The capital-strengthening program implemented in 2001 brought in substantial amounts of private capital, but will not be sufficient. We have therefore initiated a strategy to ensure the soundness of the Turkish banking system, which we see as a precondition for banks to resume normal lending to the economy. The strategy will start with a rigorous and targeted evaluation of banks' loan portfolios and other counterparty risks. This will be accompanied by a public support scheme, which allows the SDIF to make equity and subordinated debt investments in viable private banks, provided that their owners meet certain capitalization targets. The scheme seeks to maximize private capital contributions, minimize the cost to the government, and bring about further rationalization of the banking sector. Once banking sector soundness has been restored, the general guarantee can be lifted with due prior notice.

30. **The rigorous evaluation of banks' loan portfolios is an essential element of the new support scheme, providing a clear basis for investors and the government to inject necessary new capital into the banking system.** In January 2002, the BRSA will issue guidelines to be applied in the evaluation, including the use of uniform criteria (**prior action**). The targeted evaluation of loan portfolios, collaterals, and certain other exposures will be performed by banks' existing external auditors, and will be completed by end-March 2002. Third-party auditing firms will be appointed by the BRSA by end-March 2002 to verify that the guidelines have been followed, and to ensure the integrity of the process (**structural benchmark**). The BRSA will complete the final interpretation of the evaluations by end-April 2002, and by May 15, 2002 will send letters to banks stipulating required actions on the basis of this interpretation (the latter is a **prior action for the second review**). Any losses identified in the evaluation will be fully absorbed by writing down existing shares. The evaluation results will be incorporated into banks' end-June 2002 financial statements.

31. **Public capital support will be provided to solvent private banks whose owners are prepared to raise equity to certain thresholds.** The support will be provided on a one-time basis. Owners of solvent banks can have their Tier-1 equity contributions matched by equity provided by the SDIF. Capital contributions in cash in 2001 will be counted as owners' contributions, except for amounts needed to cover negative net worth. SDIF equity contributions will be against a pledge of shares from banks' majority shareholders. In addition, banks that participate in the scheme will give the SDIF board representation and selective veto rights, and will adhere to restrictions on the distribution of profits as long as the SDIF remains an owner. To qualify for SDIF support, a bank or group of banks to be merged must have a market share of at least 1 percent of total banking system assets. In case there are banks that are insolvent or severely undercapitalized and unable to raise sufficient capital to participate in the scheme, they will be taken over and resolved by the BRSA and the SDIF. In addition to equity support, banks with a Tier-1 capital adequacy ratio (CAR) of at least 5 percent may qualify for convertible subordinated debt (Tier-2 capital) contributions

from the SDIF, up to a CAR of 9 percent. The scheme will be administered by BRSA jointly with SDIF, which must receive applications for participation in the scheme before end-May 2002. Banks will make preparations for their participation in the scheme while the valuation assessments are going on, and the scheme will be completed before end-June 2002.

32. **We expect that the legal framework for the scheme described above and related regulations will become effective in January 2002 (prior actions).** On January 10, 2002, parliament passed the relevant legal amendments. Once effective, the amendments will create fast track procedures for calling shareholders' general assemblies, writing down existing capital, and raising new capital; assign a special commercial court to deal with all issues related to the support scheme; and limit the scope for shareholders and other parties from interfering in the implementation of the scheme. The amendments will also make more precise the conditions for the BRSA to intervene in, and SDIF take control of, chronically and severely undercapitalized banks before they become insolvent, to facilitate least cost solutions for the government. Details of the scheme, including the SDIF's rights as shareholder as well as the terms for the SDIF's exit from the scheme, will be regulated by the BRSA and announced in January 2002. Given the complexity of the legal issues involved, the BRSA will undertake legal consultations, as necessary, to ensure implementation of the public capital support scheme as planned.

33. **We remain committed to the speedy resolution of banks taken over by the SDIF.** With the exception of two banks, whose resolution has been halted by courts, all SDIF banks taken over before November 2001 were resolved by end-2001 (meeting a **prior action**). Their deposits, together with matching government securities, were successfully auctioned off to other banks. Most interbank liabilities with matching government securities were transferred to Ziraat. The SDIF will, however, retain one small bank with a small staff and branch network as a bridge bank with its operations strictly limited to asset management purposes; this bank will not accept deposits. The bank will be funded through the SDIF. Remaining assets and liabilities have been transferred to the Collection Department of the SDIF. The medium-size bank taken over in November 2001 is for sale; its final resolution method will be determined and initiated by February 2002.

34. **The SDIF will make strong efforts to deal with nonperforming loans and collaterals.** The SDIF is developing a strategy and procedures for dealing with these assets with the assistance of a consulting firm, and is recruiting additional staff to deal with the large volume of problem assets. Transparency of SDIF's operations is essential, given the complexity of its transactions and the large funding it receives from the Treasury. Accordingly, the SDIF will prepare a monthly balance sheet starting end-March 2002 and become subject to annual external audits. The external audit for 2001 will be completed by end-April 2002 (**structural benchmark**).

35. **We will take a number of measures to further strengthen the legal and regulatory framework:**

- Laws and regulations regarding loan classification, loan loss provisioning, and collateral valuation will be amended as necessary following the portfolio reviews by end-June 2002. As a first step, we will pass as a **prior action** a legal amendment in January 2002 to eliminate with immediate effect the existing four-year transition rule for loan loss provisioning.

- As of January 1, 2002, two important regulations became effective: including in CAR calculations capital charges for market risks on a solo basis; and monitoring of internal control and risk management systems. Moreover, trial implementation of a new accounting system in line with International Accounting Standards (IAS) will begin in January 2002 (**prior action**). The inclusion of off-balance sheet repos in banks' balance sheets was announced in December 2001, and will take effect as of February 1, 2002. Effective July 1, 2002, capital charges for market risks will be included on a consolidated basis when calculating the CAR. Moreover, following the trial implementation the BRSA will evaluate the experience and issue by end-June 2002 a revised regulation on the new accounting standards to ensure that banks' end-2002 balance sheets comply with IAS (**structural performance criterion** for end-June 2002).

- Reporting requirements will be improved based on the findings of the independent assessments, and the quality and timeliness of the reporting will be strictly enforced as of end-June 2002.

Corporate debt restructuring

36. **We are strengthening the framework for corporate debt restructuring to complement the restructuring of the banking sector.** The existing legal, judicial, and institutional frameworks are inadequate for the scale of restructuring that is needed. As a first step, in January 2002 we will introduce a voluntary market-based framework (the "Istanbul Approach") for dealing case-by-case with multicreditor exposures to large and medium-size borrowers. A Technical Secretariat has been established under the Bankers' Association to monitor progress and an Arbitration Panel to resolve disputes. For its part, Halk Bank is renegotiating with and extending credit to small and medium-size enterprises, both at market terms. Given the need to accelerate the debt restructuring process, we will in early 2002 create a multiagency Coordination Committee with private sector participation under the Treasury. This Committee will be responsible for facilitating and monitoring the corporate debt restructuring process, as well as identifying and proposing the removal of impediments that may exist.

37. **To facilitate corporate debt restructuring, we are also undertaking a major review of the bankruptcy and foreclosure frameworks, which will be overhauled as needed.** This will complement our ongoing work of modernizing our Civil and Commercial Codes to conform with EU rules and directives. A World Bank Report on Standards and Codes (ROSC) on Turkey's insolvency regime is expected to be completed in January 2002. The Ministry of Justice will prepare an action plan based on the findings of that report and

existing reform proposals, and form a Commission to prepare necessary amendments to the Bankruptcy Law. We will also support the upgrading administrative procedures in the judiciary to improve the capacity of the courts.

38. **Financial disclosure of companies and especially of large corporate groups will be improved, and corporate governance standards strengthened.** The Capital Markets Board (CMB) will introduce international accounting standards, including inflation accounting provisions, by January 1, 2003. Starting end-March 2002, the CMB will require corporate groups to provide consolidated financial statements, and will set up a dedicated group to monitor their finances. As of the same date, the CMB will also require corporate groups with financial affiliates to provide consolidated group statements and share those statements with the BRSA.

Public sector reform

39. **We will significantly strengthen the central government's underlying fiscal position by implementing our ambitious public sector reform program.** In particular, we will aim to increase expenditure efficiency (allowing more to be done with less), and reform the tax system (to broaden the base and make it more sustainable), and the civil service (to increase efficiency and improve the quality of the public service). To alleviate the impacts of these actions on the most vulnerable members of society, we will enhance and better target our social spending (paragraph 43 below).

40. **Our key reform initiatives for the central government include the following:**

- To strengthen **expenditure efficiency**, we will improve procurement methods and rationalize the public investment program. The Public Procurement Law in line with UN standards (UNCITRAL) was adopted by parliament on January 4, 2002 (meeting a **prior action**). Following its adoption, we will immediately begin the work necessary to allow it to take effect by January 1, 2003, including establishing an independent procurement agency by end-March 2002 (**structural benchmark**), and changing laws and regulations to make them consistent with the new framework. To further improve the transparency and competitiveness of public procurement, we expect parliament to amend the Public Procurement Law by end-May 2002, to (i) bring the real value of the thresholds toward those in line with international best practice and (ii) extend the minimum time period for procurement applicable for cases below the thresholds (**prior actions for the second review**). Public investment has already been rationalized in the 2002 fiscal framework, with 353 (of 5,047) main projects and 649 sub-projects removed from the roster, and a 20 percent reduction in both total costs and the estimated time to completion. Building on this, we will compile a comprehensive list of projects to be phased out in time to make decisions for the 2003 budget.

- We will specify an ambitious three-year plan to **reform the tax system**, which the Council of Ministers will approve in January 2002 (**prior action**). The plan will establish two phases of tax reform to be implemented in 2002. The first phase, to be enacted in a revenue-neutral manner by end-April 2002 (**structural benchmark**), will focus on simplifying the system of indirect taxation and lessening distortions associated with the taxation of nominal interest income. The second phase will deal with reform of direct taxation (to take effect on January 1, 2003). Legislation for the second phase of this reform will be submitted to parliament by end-October 2002 (**structural benchmark**). Our direct tax priorities will be to: (i) harmonize taxes on investment income; (ii) rationalize ad hoc inflation adjustments in the tax system; (iii) rationalize the system of investment incentives; and (iv) reform the system of credits against income tax. The plan will also address tax administration reform (including technical assistance needs). To achieve greater efficiency, we will reorganize the tax administration in line with the study that we have carried out with the World Bank. Conditionality on implementation will be set at the time of the first program review.

- To **reform the civil service**, the Council of Ministers will adopt a civil service reform strategy by end-2002. As part of the preparatory work, by end-March 2002 we will establish a ministerial committee to carry out a functional review of government, which will be completed by end-September 2002. By this time, we will also have in place an integrated system to monitor total general government and SEE employment levels on a quarterly basis (**structural benchmark**).

41. **We expect the biggest improvements in public resource use and the underlying fiscal position to arise from reductions in overstaffing, especially in inefficient SEEs.** This will reduce the necessity for aggressive public sector price increases, thereby supporting disinflation, improve the efficiency of enterprises, and in many cases help to prepare the ground for privatization. Supported by a Prime Minister's circular issued on December 3, 2001, we have already initiated a voluntary retirement scheme for public sector workers. 15,000 individuals will have been retired or notified of their retirement by mid-January 2002 (**prior action**). We have also recently identified (with World Bank assistance) redundant workers in Türk Telekom and in the Privatization Agency portfolio of companies, and we will extend voluntary retirement offers to the individuals occupying them. For those who accept, we will provide payments, and allow them to retire, no later than end-March 2002. Also by end-January 2002, we will (i) identify all redundant workers and positions in SEEs (updating and expanding our earlier analysis); and (ii) eliminate all open, unfilled redundant positions (**prior actions for the first review**). Through voluntary retirement offers, and layoffs only when necessary, we will reduce the number of redundant workers by one-third by end-June, and cumulatively two-thirds by end-October 2002 (the latter being a **structural performance criterion**). By end-June 2003, we will phase out the remaining redundancies. For this well-targeted attrition, we will allow no replacement hiring, and the resulting unfilled positions will be immediately eliminated. We will audit SEE compliance with this program on a quarterly basis. Progress toward meeting the above targets will also be a focus of earlier program reviews. Since we are making long-term financial savings from this action, the net cost of this initiative (severance payments less wage savings) will not be counted toward our primary surplus target, up to a limit of TL 1.25 quadrillion in 2002.

42. **We will enhance aggregate fiscal control, by strengthening the legal framework for fiscal policy, consolidating fiscal institutions, and deepening fiscal transparency reforms:**

- To strengthen the legal framework for fiscal policy, we will (i) pass the Law on Public Debt Management and issue two supporting communiqués (**prior actions for the first review**), and (ii) by end-June 2002, submit to parliament a Law on Financial Management and Internal Control consistent with best international practices (**structural benchmark**). The latter law will cover budgeting, accounting, transparency, and internal and external control.

- To continue the process of consolidating fiscal institutions, we will by end-March 2002, close 548 additional revolving funds (out of 1,981 remaining), to achieve the target we originally set for end-2001 (**structural benchmark**). We will also, in the draft budget for 2003 to be submitted to parliament, incorporate the revenue and expenditures under Law 3418 (**structural benchmark** for October 17, 2002). The earmarking of these revenues, and those under Law 4306 would also be eliminated. We will also improve the transparency of the operations of the remaining extra-budgetary funds (the Social Aid and Solidarity Fund, the Defense Industry Support Fund, the Privatization Fund, and the Promotion Fund). By July 2002, we will amend their governing legislation to require passage of their budgets by parliament, external audit of their accounts (reported to parliament), and monthly reporting of their accounts, on a consolidated basis, with the central government's accounts (**structural benchmark**). Looking forward, we will eliminate the one remaining budgetary fund (the Support Price and Stabilization Fund) in three years, when the World Bank's Agricultural Reform Implementation Project ends.

- To enhance fiscal transparency, in the draft 2003 budget to be submitted to parliament we will (i) include net lending as an appropriation, and (ii) extend accounting and coding reforms to all consolidated budget agencies, and to general government units on a pilot basis (**structural benchmarks** for October 17, 2002). Moreover, by end-March 2002, we will complete a survey of end-2001 commitments in excess of appropriations (**structural benchmark**).

43. **We will enhance and better target our social spending.** Already in 2002, we are increasing social spending substantially in real terms. In addition, we will address the impact of public sector retrenchment through the labor redeployment and reinsertion program (supported under the World Bank's Privatization Social Support Project), and through unemployment insurance, for which benefit payments are set to commence in 2002 (this would protect those workers who are not eligible for adequate severance). Other key priorities will be (i) to increase resources allocated to direct income support for farmers (in support of this, we will eliminate all agricultural premia in the 2003 budget), and (ii) to fully implement the World Bank supported Social Risk Mitigation Project, which seeks to enhance safety net resources available to the poorest households.

Enhancing the role of the private sector

44. **Our program places a special emphasis on fostering private sector development.** The key elements—which have been developed in close consultation with the World Bank—include privatizing companies, encouraging domestic and foreign investment, and improving governance and transparency. We will also improve our communications policy, to underline both to the public and to investors that a genuine economic transformation is underway.

45. **Our privatization strategy aims to complete in 2002 the preparatory work for the divestiture of all major companies slated for sale.** Besides selling enterprises for which the technical preparations have already been completed—notably TÜPRAŞ (petroleum refinery) and POAŞ (petroleum distribution)—we are committed to completing in 2002 all preparatory work for the privatization of Türk Telekom, TEKEL (tobacco and spirits), ŞEKER (sugar), THY (airlines), ERDEMIR (steel), EUAŞ (electricity generation), TEDAŞ (electricity distribution), BOTAŞ (natural gas), and state-owned land. Specifically:

- While the specific timing will depend on market conditions, we expect the Privatization Administration (PA) to proceed with the public offerings of POAŞ by end-March 2002 and the public offering of TÜPRAŞ by end-June 2002. This will lower the government's stake in TÜPRAŞ to less than 50 percent. The PA is also ready to launch the initial public offering for THY as soon as market conditions allow.

- The government has in December 2001 appointed a Privatization Tender Committee for Türk Telekom. While it was not possible for the Committee to prepare a revised privatization plan by end-2001, as originally intended, we will ensure that such a plan is adopted by the Council of Ministers in April 2002 (**prior action for the second review**). The corporatization plan now under preparation with the help of international consultants will provide input to the privatization plan.

- On January 3, 2002, parliament passed the Tobacco Law (meeting a **prior action**). As the next step, a privatization plan for TEKEL will be prepared and adopted by the Council of Ministers by end-September (**prior action for the fourth review**).

- We also will proceed with the privatization of ŞEKER, with the first step being the adoption of a privatization plan by May 2002. For both TEKEL and ŞEKER, we recognize that successful privatization needs to be preceded by major operational restructuring, which we are determined to undertake in close cooperation with the World Bank.

- In the electricity sector, in January 2002, subject to legal clarification, we expect the Council of Ministers to adopt a government decree annulling with immediate effect all the projects for which transfer of operating rights (TOOR) contracts are pending. By March 2002, the Ministry of Energy will inform the PA which electricity assets will be privatized, and by April 2002 the prequalification tenders for the distribution companies will be launched.

- We expect to complete the transfer of gas distribution companies to the PA by March 2002.

- The PA is ready to go forward with the divesting of ETI Krom AŞ, ETI Elektrometalurji AŞ, ETI Gümüs AŞ, which are in the PA portfolio, as soon as licenses are transferred from ETI Holdings.

- The PA will continue its divestment of ERDEMIR, and of tourism and fertilizer assets in its portfolio. The PA will also continue divesting its portfolio of small and medium-size companies.

- Finally, we will build on efforts made in 2001 (including legal amendments and simplified procedures) to increase the sale of government land. As constitutional problems made the legal amendments less effective than envisaged, we have initiated a study to evaluate how the remaining obstacles to government land sales could best be removed.

46. **We aim to make Turkey substantially more attractive for domestic and foreign investors.** A list of follow-up actions to a Foreign Investment Advisory Service (FIAS) report finalized in mid-2001 has been sent to the Council of Ministers, and is expected to be adopted in January 2002 (**prior action**). As envisaged under that action plan, we will:

- submit to the parliament by end-May 2002 a new draft Law on Foreign Direct Investment in line with the findings of the FIAS study (**structural benchmark**);

- submit to the parliament by end-March 2002 a draft law on work permits prepared by Ministry of Labor and Social Security, and issue a communiqué by end-April 2002 on the implementation procedures for employing foreign personnel employed by foreign capital companies as soon as the new law is approved by parliament;

- complete by end-February 2002 legislation reducing the number of documents needed to obtain investment incentives;

- establish and implement by end-February 2002 an employee code of ethical conduct for proceedings at customs; and

- submit to the Council of Ministers by end-January 2002 legal amendments to strengthen the Turkish Patent Institute.

47. **We attach the highest importance to improving governance and transparency.** To this end, the Council of Ministers will adopt a strategy for increasing transparency and combating rent-seeking activities by end-January 2002 (**structural benchmark**). Concrete

follow-up actions for the remainder of the 2002–04 program period based on this plan will be defined and included as program conditionality in subsequent program reviews.

48. **Finally, we will further improve our strategy for explaining the goals and policies of the program.** To this end, we will establish an Investor Relations Office by February. This Office will serve as the focal point for two-way communication between the Turkish authorities and the domestic and international investor communities, and will be set up as a permanent structure within the Treasury. Furthermore, we will establish an Investor Council consisting of prominent business representatives from Turkey and abroad. This Council, which is expected to have its first meeting by mid-2002, will advise on issues relevant for the attractiveness of Turkey as an investment destination and will meet with regular intervals. In addition, the recently intensified efforts of the of the Treasury, the CBT, and the BRSA to explain policies under the economic program in their respective areas will be further strengthened, including through the arrangement of regular (bimonthly) press conferences by the Treasury.

Very truly yours,

/s/	/s/
Kemal Derviş	Süreyya Serdengeçti
Minister of State for Economic Affairs	Governor of the Central Bank of Turkey

Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In percent)			
Real sector						
Real GNP growth rate	-6.1	6.3	-8.5	3.0	5.0	5.0
GNP deflator	55.8	50.9	60.7	48.9	24.9	13.1
Nominal GNP growth rate	...	60.4	47.0	53.4	31.2	18.8
WPI (12-month, end-of-period)	62.9	32.7	86.0	31.0	16.2	12.0
CPI (12-month, end-of period)	68.8	39.0	68.0	35.0	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.7	69.6	46.0	32.4
Average ex-ante real interest rate 1/	32.0	-9.4	32.4	33.2	27.5	20.5
			(In percent of GNP)			
Central government budget						
Primary balance 2/	1.5	4.2	5.0	5.4	5.6	5.6
Net interest payments 3/	13.1	15.8	23.2	20.5	16.2	13.5
Overall balance	-11.6	-11.6	-18.2	-15.2	-10.6	-7.8
Consolidated public sector						
Primary balance	-2.0	2.3	5.7	6.5	6.5	6.5
Net interest payments 4/	22.1	21.9	24.7	18.4	15.8	13.3
PSBR (including CBT profits)	24.2	19.6	19.0	11.9	9.3	6.8
Net debt of public sector	61.0	57.4	92.2	81.3	73.3	69.4
Net external	20.1	18.3	38.0	35.1	30.6	28.5
Net domestic	40.9	39.1	54.2	46.2	42.7	40.9
Of which:						
Central government (gross)	42.5	40.9	70.3	54.2	...	...
Auctioned and other cash debt	25.8	23.4	25.3	23.1	...	...
Bank recapitalization	...	17.4	35.6	28.4	...	...
External sector						
Current account balance	-0.7	-4.9	1.3	-1.2	-1.2	-1.2
Gross external debt	55.0	56.6	75.4	71.7	66.7	63.3
Net external debt	34.0	37.0	51.6	48.1	44.4	40.8
Short-term external debt (by remaining maturity)	20.8	23.0	23.3	20.4	19.0	18.8
Monetary aggregates						
Seignorage 5/	3.2	1.8	1.0	1.0	0.7	...
Nominal growth of broad liquidity (in percent)	96.9	40.2	75.1	40.2	27.4	17.1
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	0.1	3.3	2.8	1.5	2.5	1.0
Net external financing of central government	1.4	4.1	-2.7	1.0	-1.0	-1.0
Amortization	6.0	6.2	8.2	6.5	8.4	8.0
Gross borrowing	7.4	10.3	5.5	7.4	7.5	7.0
Of which : Eurobond issues	5.0	7.5	2.2	2.5	4.5	4.7
GNP	187.4	201.3	150.3	165.6	183.0	201.3
GNP (in quadrillions of Turkish lira)	78.3	125.6	184.7	283.2	371.6	441.3

Sources: Data provided by Turkish authorities; and Fund 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/ Interest payments minus interest receipts plus profit transfers from the central bank.

4/ Interest payments minus interest receipts plus CBT profits before transfers to the government.

5/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

Turkey: Quantitative Performance Criteria and Indicative Targets for 2002

	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome
	January 31, 2002		March 31, 2002		May 31, 2002		August 31, 2002		November 30, 2002	
I. Performance criteria 1/										
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira) 2/	9,600		2,800		4,700		9,600		14,900	
	February 28, 2002		April 30, 2002		June 30, 2002		September 30, 2002		December 31, 2002	
2. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$)	6,500		10,000		11,100		14,300		17,500	
3. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000		1,000		1,000		1,000		1,000	
4. Floor on level of net international reserves of CBT and Treasury combined (in millions of US$)	-6,500		-7,200		-7,800		-8,500		-9,700	
5. Ceiling on base money (in trillions of Turkish lira)	8,250		8,900		9,250		10,600		10,850	
II. Indicative targets										
	January 31, 2002		March 31, 2002		May 31, 2002		August 31, 2002		November 30, 2002	
1. Floor on the cumulative overall balance of the consolidated government sector (in trillions of Turkish lira)	-32,500		-12,500		-17,500		-28,250		-39,750	
	February 28, 2002		April 30, 2002		June 30, 2002		September 30, 2002		December 31, 2002	
2. Floor on the Cumulative Primary Balance of Other Public Entities sector (in trillions of Turkish lira)	...		...		550		...		1,100	
3. Ceiling on the stock of net domestic assets of the CBT and Treasury combined (in trillions of Turkish lira)	26,100		27,700		28,900		31,300		33,300	

1/ The figures through June 30, 2002 are performance criteria. The remaining figures are indicative targets.
2/ For January 31, 2002, the ceiling applies to the cumulative primary balance of the consolidated government sector since January 1, 2001. For the other test dates, the starting date is January 1, 2002.

STRUCTURAL CONDITIONALITY

Action	Paragraph	Type
Fiscal policy		
1. Implement all further measures to reach the 6.5 percent primary surplus target that are technically feasible to put in place in January	13	Prior action for SBA approval
2. Complete by end-March 2002 the remaining measures to reach the public sector primary surplus target of 6.5 percent of GNP for 2002: the Minister of Finance to identify savings from closing regional administrations and other regional line agency offices, and block relevant budget appropriations in the budget, and SEEs to approve budgets in line with cost reductions mandated	14	Benchmark
Public debt management		
3. Reintroduce a primary dealer program by end-September 2002	19	Benchmark
Banking reform		
4. Pass necessary legal amendments, and issue a Council of Ministers Decree for staff reductions in state banks	28	Prior actions for SBA approval
5. Reduce the number of branches at Ziraat and Halk banks by 800 by end-June 2002	28	Performance criterion
6. BRSA to issue guidelines for targeted evaluations of private banks in preparation for the public support scheme for private banks	30	Prior action for SBA approval
7. BRSA to appoint by end-March 2002 third-party auditing firms to verify that the guidelines have been followed	30	Benchmark
8. BRSA to send letters to banks by May 15, 2002 stipulating required actions on the basis of the BRSA's final interpretation of the evaluations	30	Prior action for second review
9. The legal framework and related regulations for the public support scheme for private banks to become effective in January 2002	32	Prior action for SBA approval
10. Resolve by end-2001 all banks taken over by the SDIF before November 2001, with the exception of two banks whose resolution has been halted by courts	33	Prior action for SBA approval
11. Complete external audit of SDIF for 2001 by end-April 2002	34	Benchmark
12. Pass legal amendment in January 2002 to eliminate with immediate effect the existing four-year transition rule for loan loss provisioning	35	Prior action for SBA approval
13. Start trial implementation of new accounting system in line with IAS in January 2002	35	Prior action for SBA approval
14. BRSA to issue by end-June 2002 an implementing regulation to ensure that banks' end-2002 balance sheets comply with IAS	35	Performance criterion
Public sector reform		
15. Parliament to approve Public Procurement Law in line with UN (UNCITRAL) standards in January 2002	40	Prior action for SBA approval
16. Parliament to amend the Public Procurement Law by end-May 2002 to (i) bring the real value of thresholds toward those in line with international best practice and (ii) extend the minimum time period for procurement applicable for cases below thresholds	40	Prior actions for second review

Action	Paragraph	Type
17. Establish an independent procurement agency by end-March 2002	40	Benchmark
18. Approval by Council of Ministers in January 2002 of plan to reform the tax system	40	Prior action for SBA approval
19. Enact first phase of tax reform plan by end-April 2002	40	Benchmark
20. Submit to parliament legislation for the second phase (direct tax component) of the tax reform plan by end-October 2002	40	Benchmark
21. Have in place by end-September 2002 an integrated system to monitor total general government and SEE employment levels on a quarterly basis	40	Benchmark
22. 15,000 individuals to have been retired or notified of their retirement by mid-January 2002	41	Prior action for SBA approval
23. By end-January 2002: (i) identify all redundant workers and positions in SEEs; and (ii) eliminate all open, unfilled, redundant positions	41	Prior actions for first review
24. Reduce the number of redundant workers by two-thirds by end-October 2002	41	Performance criterion
25. Pass the Law on Public Debt Management and issue two supporting communiqués	42	Prior actions for first review
26. Submit to parliament Law on Financial Management and Internal Control consistent with best international practice by end-June 2002	42	Benchmark
27. Close 548 additional revolving funds by end-March 2002	42	Benchmark
28. Incorporate revenues and expenditures under Law 3418 in the draft budget for 2003 to be submitted to parliament by October 17, 2002	42	Benchmark
29. Amend by end-July 2002 governing legislation of the remaining extra-budgetary funds to require passage of their budgets by parliament, external audit of their accounts (reported to parliament), and monthly reporting of their accounts, on a consolidated basis, with the central government's accounts	42	Benchmark
30. In the draft 2003 budget to be submitted to parliament by October 17, 2002, (i) include net lending as an appropriation and (ii) extend accounting and coding reforms to all consolidated budget agencies, and to general government units on a pilot basis	42	Benchmarks
31. Complete by end-March 2002 a survey of end-2001 commitments in excess of appropriations	42	Benchmark
Enhancing the role of the private sector		
32. Council of Ministers to adopt in April 2002 a privatization plan for Turk Telekom	45	Prior action for second review
33. Parliamentary approval of Tobacco Law	45	Prior action for SBA approval
34. Council of Ministers to adopt privatization plan for TEKEL by end-September 2002	45	Prior action for fourth review
35. The Council of Ministers to adopt in January 2002 follow-up actions to FIAS study to make Turkey more attractive for domestic and foreign investors	46	Prior action for SBA approval
36. Submit to Parliament by end-May 2002 a new draft Law on Foreign Direct Investment in line with the findings of the FIAS study	46	Benchmark
37. The Council of Ministers to adopt by end-January 2002 a strategy for increasing transparency and combating rent-seeking activities	47	Benchmark

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, 2001, to:	
January 31, 2002	9,600
Cumulative primary balance from January 1, 2002, to:	
March 31, 2002	2,800
May 31, 2002	4,700
August 31, 2002 (indicative target)	9,600
November 30, 2002 (indicative target)	14,900

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the extrabudgetary funds (EBFs) identified below, the ten state economic enterprises (SEEs) identified below, the social security institutions (SSIs), the unemployment insurance fund, and any new government funds and institutions established after January 1, 2002. The floors on the primary balance of the CGS will be monitored:

- For the central government from above the line on a modified cash basis (the so-called consolidated budget-adjusted balance)
- 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 and the unemployment insurance fund, profit transfers of the Central Bank of Turkey (CBT) and proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof). Interest receipts of EBFs, SEEs, and SSIs will not be excluded. As well, the floor on the primary balance will be adjusted upwards for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. 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 CGS after March 31, 2001.

3. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments. As well, net lending of any component of the CGS will be considered as a noninterest expenditure item. Payment of guaranteed debt by treasury on behalf of other components of the public sector will not be regarded as net lending up to the baseline reported in Annex G.

4. For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. It will also exclude severance payments made to retire or retrench public workers, and pension payments to them (net of projected wage savings during 2001 from this retrenchment), up to a cap of TL 1,250 trillion (above which they would count towards the target).

Extra budgetary funds

5. The two EBFs included in the definition of the performance criterion for 2002 are: the defense fund and the privatization fund. The balances of the social aid and solidarity fund and the promotion fund—which do not have the legal authority to borrow, and will not be given such authority during the duration of the stand-by arrangement—are excluded from the definition of the performance criterion.

State economic enterprises

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

7. 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 September 30, 2001 the stock of net banking claims on SEEs as defined above stood at TL 254 trillion, valued at the exchange rates on that day.

8. 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 September 30, 2001 the stock of external loans stood at TL 6,186 trillion, valued at the exchange rates on that day.

Social security institutions

9. 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 2002. The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as those payments overdue by more than one month, and in the case of Bag Kur exclude arrears to the common retirement fund. The stock of arrears of Bag Kur stood at TL 120 trillion on September 30, 2001, while ES and SSK had no expenditure arrears.

Adjusters

10. 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. They will also be adjusted upward for any off-balance sheet expenditure of any component of the CGS.

PRIMARY BALANCE OF OTHER PUBLIC ENTITIES

Table 1. Turkey: Indicative Target on the Cumulative
Primary Balance of Other Public Entities

	Floor (In trillions of Turkish lira)
Cumulative primary balance from January 1, 2002, to:	
June 30, 2002	550
December 31, 2002	1,100

11. The primary balance of *other public entities* (OPE), Table 1, comprises the primary balances (primary revenue minus non-interest expenditures) of the social aid and solidarity fund, the ten state economic enterprises (SEEs) identified below, the local governments and local government institutions defined below (LGs), and the revolving funds defined below (RFs). The floors on the primary balance of the OPE will be monitored:

- For the social aid and solidarity fund from above the line on a cash basis;
- For the SEEs, from below the line as described in paragraph 5;
- For the LGs, as described below in paragraph 8;
- For the RFs, from below the line, as described in paragraph 9.

12. For the purposes of the program, the primary revenues will exclude interest receipts of LGs and RFs and proceeds from the sale of assets of the OPE (privatization proceeds or transfers thereof). Interest receipts of the social aid and solidarity fund and SEEs will not be excluded.

13. For the purposes of the program, revenues of the OPE will exclude payments-in-kind and other non-monetary forms of payments. As well, net lending of any component of the OPE will be considered as a non-interest expenditure item.

State economic enterprises

14. The 10 SEEs whose primary balances will be included in the definition of the indicative target are Telekom (telecommunications); THY (airline); PETKIM (petrochemicals); MKEK (machinery and chemicals); ETI holdings (mining); TKI (coal mining); TPAO (petroleum extraction); PTT (postal services); DHMI (airports); and Caykur (tea).

15. The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing

from the banking system (excluding pre-export financing from the Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

16. 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 September 30, 2001 the stock of net banking claims on SEEs as defined above stood at TL 333 trillion, valued at the exchange rates on that day.

17. 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 September 30, 2001 the stock of external loans stood at TL 9,451 trillion, valued at the exchange rates on that day.

Local governments

18. The LG entities whose primary balances will be included in the definition of the indicative target are all 81 special provincial administrations, and Iler Bank (a development bank serving the municipal sector). Special administrations' primary surplus will be measured from above the line on a modified cash basis. For Iler Bank, the primary surplus will be measured by its expenditures less its revenues (excluding, in both cases) interest.

Revolving funds

19. The RFs whose primary balances will be included in the definition of the indicative target are all of those which exist in the health and education sectors (1,627 at present, with consolidation expected to reduce this number to 664 by end-March). Net financing for RFs will be monitored as: the change in cash holdings, plus net domestic borrowing, plus net foreign borrowing.

20. Net domestic borrowing is defined as the change in deposits in banks, as reported by the RFs. 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.

21. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction.

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, 2001 to:	
January 31, 2002	-32,500
Cumulative overall balance from January 1, 2002 to:	
March 31, 2002	-12,500
May 31, 2002	-17,500
August 31, 2002	-28,250
November 30, 2002	-39,750

1. The overall balance of the consolidated government sector (CGS), Table 1, comprises the primary balance of the CGS as defined in Annex D, the net interest payments of the consolidated central government and the unemployment insurance fund and gross interest payments of the EBFs, SEEs, and SSIs, and the overall balance of any new government funds and institutions established after January 1, 2002. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of Annex D. Revenues of the CGS will be as defined in paragraph 2 of Annex D; i.e., excluding privatization proceeds.

2. All definitions and adjusters specified in Annex D to apply to the primary balance of the CGS will also apply to the overall balance of the CGS.

PROGRAM BASELINE FOR TREASURY NET LENDING

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US$)	Baseline (In trillions of TL)
Cumulative guarantee payments from January 1, 2001, to:		
January 31, 2002 1/	1,662	1,794
Cumulative net lending from January 1, 2002 to:		
March 31, 2002	216	336
May 31, 2002	409	653
August 31, 2002	690	1,136
November 30, 2002	1,056	1,802

3. Net lending is defined as the sum of guarantee payments made by treasury minus repayments obtained by treasury. Repayments include those obtained in cash directly from municipalities, or those obtained through clawback mechanisms, either directly, by withholding of transfers of tax shares from the MoF, or indirectly, via withholding of transfers to be made by Iler Bank. Proceeds from privatization, direct or indirect, are not included as repayments.

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

SHORT-TERM EXTERNAL DEBT CEILINGS

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

	Ceilings (In millions of US$)
Outstanding stock as of December 31, 2001:	0
February 28, 2002 (performance criterion)	1,000
April 30, 2002 (performance criterion)	1,000
June 30, 2002 (performance criterion)	1,000
September 30, 2002 (indicative ceiling)	1,000
December 31, 2002 (indicative ceiling)	1,000

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

MEDIUM- AND LONG-TERM DEBT CEILINGS

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

	Limits (In millions of US$)
Cumulative flows from end-December 2001	
February 28, 2002 (performance criterion)	6,500
April 30, 2002 (performance criterion)	10,000
June 30, 2002 (performance criterion)	11,100
September 30, 2002 (indicative ceiling)	14,300
December 31, 2002 (indicative ceiling)	17,500

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

MONETARY TARGETS

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

(In quadrillions of Turkish lira)

	Ceilings	Actual
Outstanding base money as of December 31, 2001	7.75 2/	7.64
February 28, 2002 (performance criterion) 1/	8.25	...
April 30, 2002 (performance criterion)	8.90	...
June 30, 2002 (performance criterion)	9.25	...
September 30, 2002 (indicative ceiling)	10.60	...
December 31, 2002 (indicative ceiling)	10.85	...

1/ These ceilings are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates. The February 28, 2002 performance criterion will be calculated using the four working day average of February 11–12 and March 11–12, to take account of the transitory impact of the Bayram religious holiday on currency demand.

2/ Ceiling applicable in the previous program.

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

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

3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex K), medium- and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange). As of December 31, 2001, net foreign assets of the CBT amounted to TL –12.75 quadrillion.

4. Net domestic assets of the Treasury are equal to Treasury liabilities to the International Monetary Fund and Treasury foreign exchange denominated borrowing with an original maturity of less than one year.

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

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

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

where: R denotes the 4 percent reserve requirement plus the 2 percent liquidity requirement coefficient and ΔB denotes the change in base generated by a change in the definition of the reserve aggregate, or due to any change in the averaging period.

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

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

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

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

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

(In quadrillions of Turkish lira) 1/

	Ceilings	Actual
Outstanding NDA as of December 31, 2001: 2/	...	22.4
February 28, 2002 (indicative target) 1/	26.1	...
April 30, 2002 (indicative target)	27.7	...
June 30, 2002 (indicative target)	28.9	...
September 31, 2002 (indicative target)	31.3	...
December 31, 2002 (indicative target)	33.3	...

1/ These targets are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates. The February 28, 2002 target will be calculated using the four working day average of February 11–12 and March 11–12, to take account of the transitory impact of the Bayram religious holiday on currency demand.

2/ Net domestic assets of the CBT alone (the target under the previous program) amounted to TL 19.5 quadrillion, below the TL 22.4 quadrillion indicative target.

Targets for Net International Reserves

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

(In billions of U.S. dollars)

	Floor on level of NIR	Actual	Memo item: NIR of the CBT
Outstanding stock as of December 31, 2001:	-4.2	-4.2	-3.0
February 28, 2002 (performance criterion)	-6.5	...	4.2
April 30, 2002 (performance criterion)	-7.2	...	4.6
June 30, 2002 (performance criterion)	-7.8	...	5.1
September 30, 2002 (indicative floor)	-8.5	...	5.5
December 31, 2002 (indicative floor)	-9.7	...	5.9

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

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

3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the December 31, 2001 average London fixing market price of US$276.5 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US$0.426 billion on December 31, 2001). The special Dresdner portfolio (amounting to US$0.808 billion on December 31, 2001) is also encumbered, but is not subtracted from foreign reserves given the overlap with one-year foreign currency denominated liabilities (see below). Reserve assets as of December 31, 2001 amounted to US$19.363 billion.

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

overdraft obligations of the central bank, and central bank liabilities arising from balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On December 31, 2001 reserve liabilities thus defined amounted to US$22.342 billion.

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of December 31, 2001 these amounts were zero.

6. As of December 31, 2001 the sum of: (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year amounted to US$1.264 billion.

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

PROGRAM EXCHANGE RATES

Table 1. Cross Exchange Rates for Program Purposes

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

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period December 31, 2001–December 31, 2002. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of December 31, 2001.

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

INTERNATIONAL MONETARY FUND

TURKEY

Banking System Developments and Reforms

Prepared by the Monetary and Exchange Affairs Department

(In Consultation with Other Departments)

Approved by Susan Schadler and Stefan Ingves

January 25, 2002

I. Introduction

1. **Turkey's banking problems have many causes:** poor governance and excessive risk taking by banks, abuse by owners, weak regulatory and supervisory frameworks for banking, lack of market discipline to drive weak banks into mergers or out of the market, and extreme macroeconomic volatility. The Turkish adjustment programs since 1999 have sought to correct these deficiencies through macroeconomic stabilization, deep structural reforms seeking to bring the operating rules and environment for Turkish banks up to EU and international standards, and a concerted strategy to deal with system weaknesses and a strengthening of the core of the banking system. The latter has included deep restructuring of the state banks, takeover by the Savings Deposit Insurance Fund (SDIF) and resolution of insolvent banks, and efforts to strengthen the capital position of the core private banking system. The worsening economic environment and prospects of larger loan losses for banks than what had been envisaged, has led to a new and strengthened strategy to shore up the capital base and operations of the core private banking system.

2. **This report summarizes the main causes of the banking problems, reviews the measures already implemented to reform the regulatory and operating frameworks for banks, and describes the measures contemplated under Turkey's new program supported by the Fund.** Following the February 2001 crisis, the authorities redoubled their efforts to deal with existing problems and strengthen the banking system. The strategy aimed at eliminating existing distortions in the money market, while strengthening the capital position of all banks and reducing the system's vulnerability to market shocks. The sections below describe developments under the program to date and especially the additional measures to be introduced in early 2002 aimed at safeguarding the private banking system.

II. Background

A. Structure of the Banking System

3. **The Turkish banking system has total assets amounting to some US$119 billion** (including repos) as of end-September 2001, roughly 80 percent of 2001 GNP. Credit to the private sector accounts for 28 percent of total assets, while holdings of government securities account for some 38 percent of assets (Table 1). Deposits amounted to 63 percent and interbank borrowing from abroad to 13 percent of banks' total liabilities. More than half of banks' assets and liabilities are either denominated or linked to foreign exchange (FX).[1]

4. **The banking system is becoming more concentrated, with seven banking groups counting for two-thirds of banking system assets (Table 2).** Three large state banks represent about 27 percent of total assets (excluding repos), while the 5 largest private banks account for 39 percent of system assets. While the number of banks is still large, it has shrunk from 81 at end-1999 to 61 at end-2001. Most of the banks have no systemic importance as they are branches of foreign banks (17 banks) or nondeposit taking investment banks (16 banks) that together count for only 8 percent of total system assets.[2] The remaining 28 banks are domestic commercial banks, of which eight are the large state and private banks mentioned above, and 20 (including five owned by the SDIF) are small- and medium-sized.

5. **From 1997 to January 24, 2002, the number of small- and medium-sized commercial banks has declined from 34 to 20.** 14 banks have remained in private hands throughout, one has merged with another private bank, while 19 banks have been taken over by the SDIF. Of these 19 banks (representing some 14 percent of total system assets), 11 have exited the market, 5 remain under SDIF control,[3] while 3 banks (representing 2 percent of assets) have been sold to new owners (one to another domestic bank, one to a foreign bank operating in Turkey, and one sold on a stand-alone basis). As a result, 15 small- and medium-sized commercial banks are left in private hands, which represent about 15 percent of total system assets.[4]

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[1] For more information on foreign exchange exposure see paragraph 12.

[2] Three investment banks have closed since late 1999 and are being liquidated.

[3] Of the five banks left under SDIF control, two remain in operation under court injunctions, one is in the process of being sold to a foreign bank group, one will be converted into an asset management vehicle, while one taken over in November 2001 is still being prepared for sale.

[4] Banks with a market share of 1–5 percent of total system assets are considered medium-sized, those with less than 1 percent are considered small.

6. **The ownership of private banks is highly concentrated and insider lending is prevalent.** Most private banks have a tradition of being closely held and only ten banks, including the largest ones, are listed on the Istanbul Stock Exchange; typically 25–30 percent of their shares are listed. Many banks are run as treasuries of their respective corporate groups. Until 2000, banks were relatively free to lend to their owners and to related companies (due to lax definitions of related parties and ample limits in relation to capital), which has made related party transactions prevalent. Traditionally, weak prudential rules allowed excessive risk-taking. Relaxed accounting rules in general and loan valuation rules in particular have allowed banks to inflate asset values and to operate with overstated capital numbers with impunity. As a result, many banks have failed and most of the 19 banks taken over by the SDIF since 1997 failed largely due to defaults on loans to related parties; some also have failed because of high exposures to volatile government securities and maturity mismatches. Since late 1999, a wide range of regulatory and supervisory reforms has sought to bring the framework for bank ownership and operations up to EU and international standards as explained below.

7. **Until recently, the operations of state banks led to huge market distortions.** The accumulation of "duty losses" without regard to the banks' escalating liquidity needs and the lack of incentives to minimize the cost of their borrowing (due to yield formulae that were not linked to market rates), made these banks the source of massive distortions in the market and extremely vulnerable to liquidity and interest rate shocks. Chronic under-capitalization added to the distortions. These shortcomings now have all been dealt with as explained below. A third state-owned bank, Vakif, is in the process of privatization. One insolvent state bank, Emlak, was closed in 2001 and part of its balance sheet absorbed by Ziraat.

B. Prudential Regulation and Supervision

8. **The legal and regulatory framework for banking has undergone major reforms since 1999, and is expected to fully conform to EU and international standards by 2002.** In the past, inadequate prudential rules allowed private banks to take excessive risks, and undercapitalized or clearly unviable private banks were allowed to operate and distort the market (an operational legal definition of insolvency was lacking). Different prudential rules applied to state banks. Accounting and reporting rules for banks were lax, and loan valuation and loan loss provisioning rules were particularly inadequate. Since early 2000 a new banking law and several new regulations have corrected these shortcomings: new loan classification, loan loss provisioning and collateral valuation rules were put in place, loan concentration exposure limits were tightened, connected lending rules were defined (with a schedule for gradual compliance by 2006, given the extreme concentration to start with), FX exposure rules were tightened, new rules regulated FX exposure and capital adequacy ratios based on consolidated statements were established, as well as for risk management by banks, fitness and propriety of owners and managers, and new accounting standards. Particularly important were new rules for the exit of banks that were insolvent or illiquid. Prudential rules applicable to private banks were also extended to cover the state banks. Finally, tax rules were changed to promote adequate loan loss provisioning, facilitate bank and corporate

mergers and transfers of distressed assets, and promote deposits of longer maturities through differentiated withholding taxes.

9. **An independent Banking Regulation and Supervision Agency (BRSA) was established** in September 2000, and the SDIF, which was previously managed by the Central Bank of Turkey (CBT) was transferred under the BRSA. Before, banking supervision was performed by a department in the Treasury, including by a semi-autonomous group of bank examiners (the so called Sworn Bank Auditors). Although it was known in the past that certain banks were facing difficulties and were paying increasingly high premia for deposits to maintain their liquidity, little corrective action was taken until the Banking Law was changed and the supervision and enforcement functions were transferred to the BRSA. Initially, the new agency was run by a board that was more political than professional, and started to function as intended only after the board had been largely replaced in June 2001. The BRSA has steadily improved its performance as supervisor and is in the process of implementing plans for its institutional strengthening, including through strengthening banks' regulatory reporting, better integrating its on-site examination, off-site monitoring and enforcement functions, and new recruitment.

C. Recent Banking System Developments

10. **The banking system experienced large market and credit losses as banks' various structural weaknesses were exposed to extreme market turbulence in late 2000 and early 2001 and the economic slowdown thereafter.** Early in the year, the state banks' exposure to overnight borrowing caused them to incur massive losses when interest rates spiked in February. Following their financial restructuring, state banks have been performing well, especially as their loan portfolios are very small, making them less vulnerable to the slowdown in economic activity.

11. **The performance of private banks deteriorated substantially in 2001, even before considering that their profits are likely to be overstated due to inadequate loan loss provisioning.** The financial crises of late 2000 and early 2001 seriously affected private banks' profitability. In the case of some banks, interest rate gains, mainly at the expense of state banks, offset exchange rate losses. Direct exchange and interest rate gains and losses are largely reflected in their financial statements already; so is the loss of profitable overnight lending to state banks. For the first nine months of 2001, the private banks reported net profits (Table 3) of about TL 721 trillion (roughly US$500 million), compared to net profits of TL1,387 trillion or some US$2 billion during the same period in 2000 (and a return on assets of 0.8 percent and a return on equity of 8.8 percent). The average risk weighted capital adequacy ratio (CAR) of private banks declined from 19 percent at end-2000 to 11 percent by end-September 2001. However, the full force of credit losses are yet to be reflected in banks'

profitability and capital. Private banks still show NPLs of only some 4 percent of total loans.[5] Undoubtedly, inadequate loan classification and loan loss provisioning is overstating banks' capital.

12. **Private banks have traditionally kept large short FX exposures** to reap profits from very high real returns on domestic debt instruments (Table 4). During most of 2000, the on-balance sheet short foreign exchange position of the private banking system (excluding SDIF banks) grew steadily to reach about US$13 billion in September 2000. However, after netting out forward cover and FX-indexed loans, as allowed under prudential rules, the short position remained consistently at about US$1 billion, or well within the regulatory limit of 20 percent of capital. Market analysts' concerns about the creditworthiness of the institutions providing the forward cover, turned out to have had some basis. The February devaluation of the TL led to substantial valuation losses for banks, as a significant amount of forward cover contracts, in particular contracts with related counterparties, were not honored.[6] However, after the debt swap of June 2001, in which some US$5 billion equivalent of TL-denominated securities were exchanged for FX-indexed papers, the banking system appears protected from further direct exchange rate risks.

13. **Interest rate risk** in the banking sector increased in 2000 and early 2001 as there was a marked shortening of deposit maturities, while the average maturity of government securities increased. In addition, in 2000, consumer lending grew very rapidly with longer maturities and in TL at fixed interest rates. This widening of the maturity gap exposed banks to a significant interest rate risk. State banks, which by early 2001 had become largely dependent on overnight liabilities, were the most vulnerable. When short-term interest rates skyrocketed during the exchange rate crisis of February 2001, these banks took enormous losses and became massively insolvent overnight. Private banks that held government securities suffered market losses when their portfolios had to be marked to market. The exposure of the system to interest rate risks has diminished in recent months as the Treasury increasingly has issued securities at floating rates and with shorter maturities, the overnight exposure of state and SDIF banks was eliminated, and these banks aligned their interest rates closer to those of private banks.

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[5] Several factors contribute to the underestimation of NPLs: (a) in mid-1999 banks were given four years to provision for existing loans; (b) loan classification is still more affected by the type of collateral than by the borrower repayment capacity; (c) many banks have not yet properly classified and provided for nonperforming related party loans; and (d) the typical lag in the recognition of credit losses in an economic downturn.

[6] The authorities will pursue claims on these owners with the full force of the law (unlimited liability) to the extent their banks are taken over by the SDIF.

14. **Lending to the private sector** (except for lending to related parties) traditionally has been relatively modest and usually short-term and heavily collateralized. This has been due in large part to the ownership structure of private banks but also to very high real interest rates that have made few credits bankable. Bank lending in Turkey is extremely concentrated, with some 100 borrowers accounting for about 50 percent of total credit outstanding (based on data in the largest banks). This includes credit to related group companies, which traditionally has been very high, especially in smaller banks. The authorities have sought to reduce such related exposures through legal and regulatory means but it will take some time before that can be achieved—in fact, there are indications that related party exposures, many of which are denominated in FX, have grown relative to capital as a result of the depreciation of the TL. Although the books of the banks (except for SDIF and state banks, which have been through rigorous valuation exercises) do not yet show any significant deterioration in asset quality, there are reports that the number of loans on banks' watch lists is increasing. Partial data also indicate that banks' NPLs are highly concentrated: in the six largest banks some 50 borrowers count for nearly half of all recorded NPLs. As mentioned above, NPLs are undoubtedly underestimated (Table 5) and it is expected that the upcoming targeted valuation of loan portfolios (as explained below) will provide a better basis for estimating loan losses and determining banks capital adequacy ratios (CARs).

III. The Restructuring of the Banking Sector

15. **Following the February 2001 crisis, the authorities redoubled their efforts to deal with existing problems and strengthen the banking system.** The strategy aimed at eliminating existing distortions in the money market, while strengthening all banks' capital positions and reducing the system's vulnerability to market shocks. The program centered on a complete revamping of the operations of the state banks, an accelerated strategy to resolve the banks under SDIF ownership, and a program to strengthen the capital position of private banks. The worsening economic environment and prospects of larger loan losses than envisaged before, has led the authorities to revise and strengthen their strategy to deal with the core private banking system, which up until now had been considered sound. The sections below describe developments under the program to date and especially the additional measures to be introduced in early 2002 aimed at safeguarding the private banking system.

A. The Restructuring of State Banks

16. **The overnight exposure of public banks (state and SDIF owned banks) had become a major source of vulnerability in the banking system.** The rollover of these liabilities at very high interest rates resulted in sharply growing losses and liquidity problems in those banks. In the week starting February 19, 2001 the withdrawal of TL liquidity by private banks to buy FX resulted in extreme pressures on the state banks and overnight TL market rates above 5,000 percent p.a. (on an uncompounded basis). This resulted in losses in that week alone of around TL 4 quadrillion. As of mid-March, the total amount of overnight liabilities had reached close to TL 20 quadrillion (close to TL 8 quadrillion were owed to nonbank customers) or equivalent to over 300 percent of base money. The need to fund the

rapidly growing losses of the state and SDIF banks became a vicious circle and led the CBT to lose monetary control.

17. **The removal of the overnight positions of the public banks became the highest priority.** The overnight debt of the banks was converted into term claims on the Treasury and CBT, where it could be managed much more effectively, at lower cost and longer maturities. This conversion consisted of the Treasury transferring securities to the banks to regularize all receivables from the government ("duty losses") in the books of Halk and Ziraat, and to recapitalize those two banks and the SDIF banks.[7] The CBT provided repos and subsequently bought securities from the banks, which allowed them to pay off their overnight borrowing from other banks and customers. By June 2001 the entire overnight position of the state banks had been eliminated and since then those banks have engaged in no further overnight borrowing.

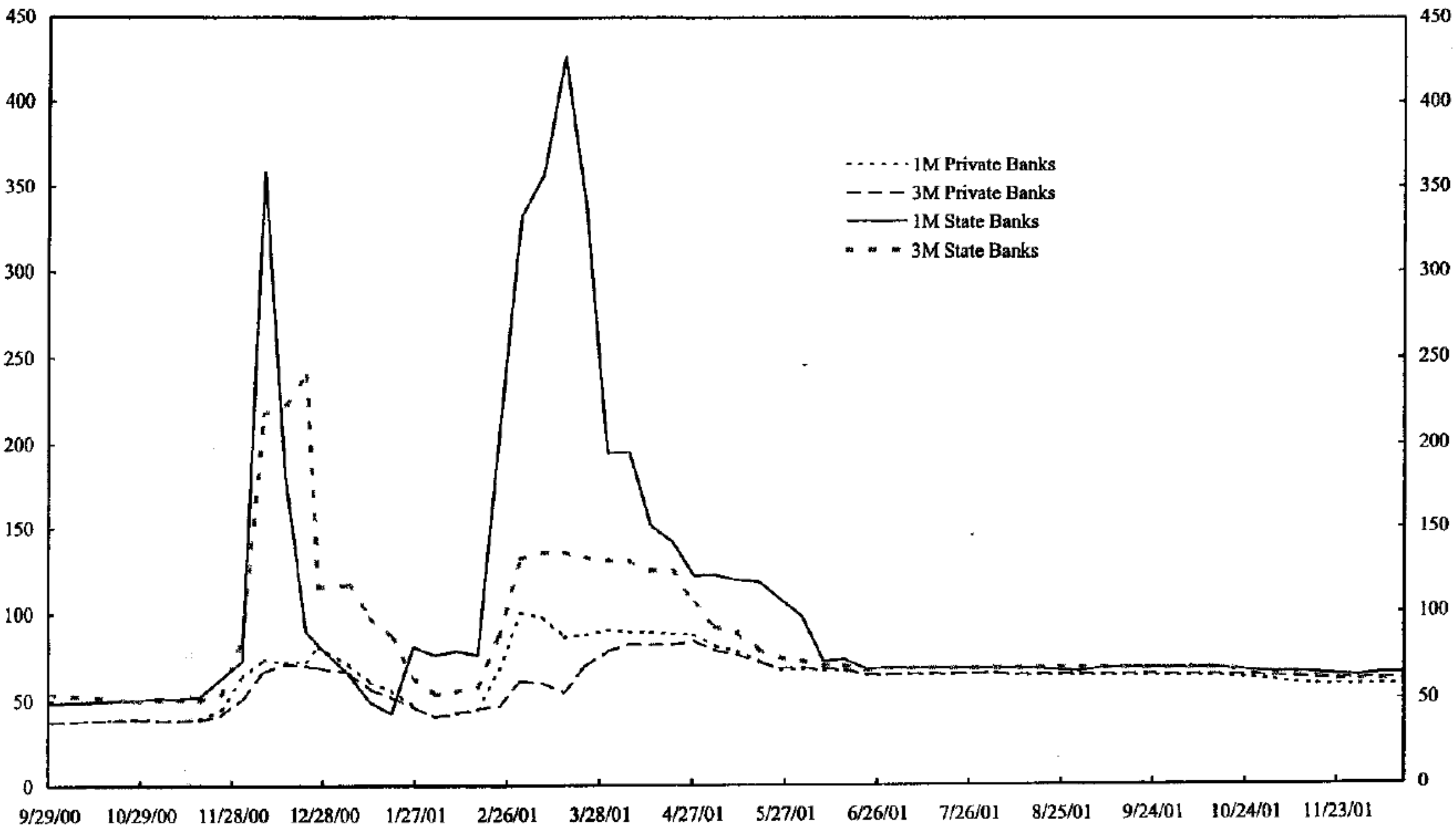
18. **The public banks were also recapitalized and one insolvent state bank (Emlak) was closed.** The capital adequacy ratios (CARs) of Ziraat and Halk were brought up above the regulatory requirement of 8 percent. Emlak (the housing state bank) has had its license revoked and its banking assets and liabilities transferred to Ziraat (the latter received from the Government TL 1.7 quadrillion to cover the net difference in liabilities and assets transferred).

19. **Operational restructuring complemented the financial restructuring.** The boards of the state banks were replaced by a joint board consisting of professional bankers with instructions to restructure their operations so as to bring them back to profitability and prepare them for eventual privatization. Direct political influences in the operations of the banks was thus dramatically reduced. In order not to distort market interest rates, a committee with observer representatives of the CBT was established to set deposit rates of public banks in a coordinated manner. As a result, deposit rates of state banks have converged to those paid by the main private banks (Figures 1 and 2). In May 2001, the state banks started reporting on their financial performance to the Treasury, which in turn started to control them more closely.

20. **Ziraat and Halk have been restored to financial soundness and their operations are now being streamlined with a view to their eventual privatization**. The banks have fully provisioned or set aside capital for all problem loans and now have positive cash

[7] Although most of the accumulated "duty losses" up until then were not formalized in the form of regular government securities and not included in government debt statistics, most of them had been included IMF's presentation of debt numbers.

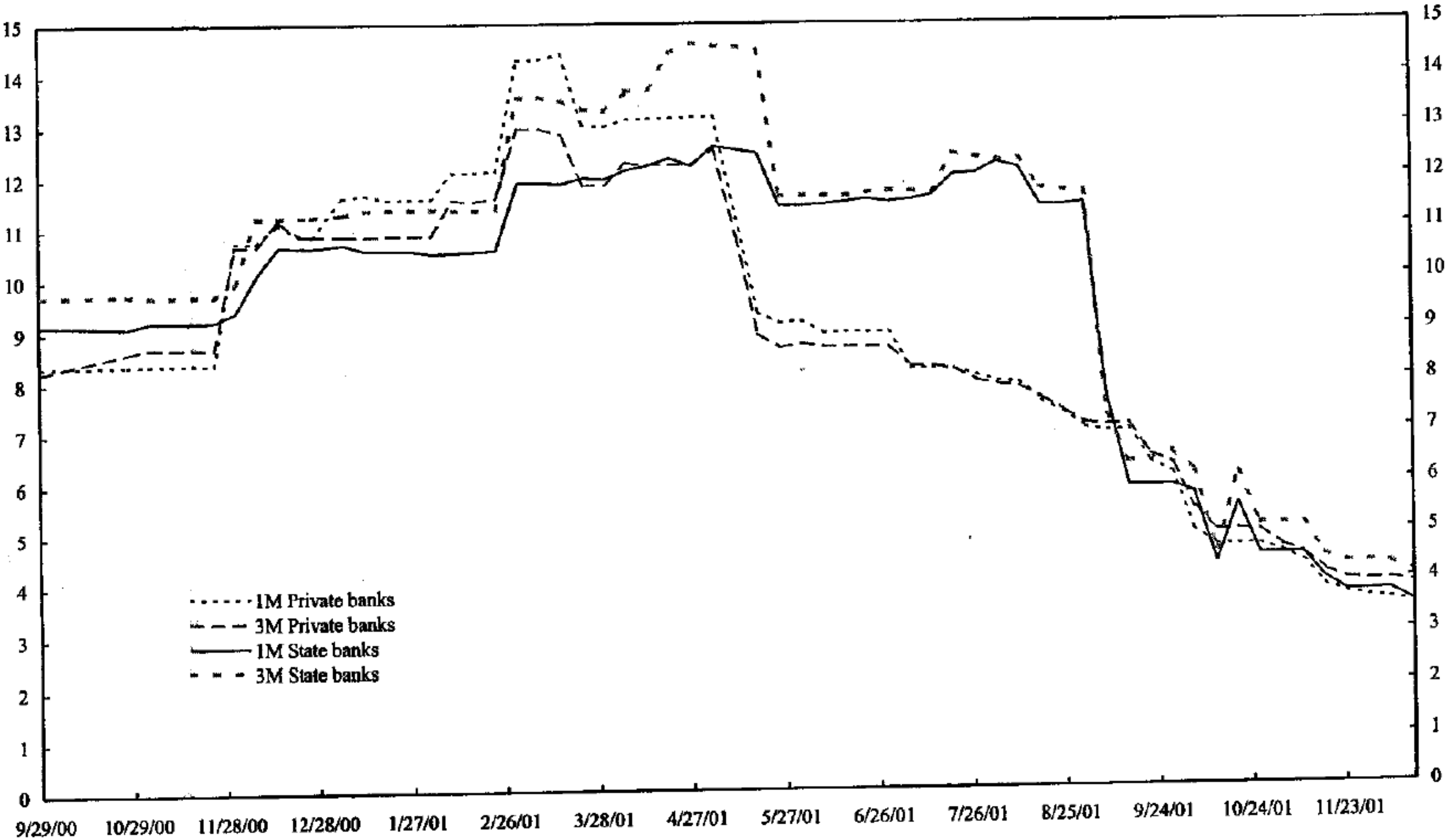
Figure 1. Turkey: Turkish Lira Deposit Interest Rates, 2000-2001 1/
(In percent; weighted average interest rate)



Source: Central Bank of Turkey.

1/ Weighted average interest rate of 5 private banks: T.İş Bankası, Yapı ve Kredi Bankası, Akbank, T. Garanti.

Figure 2. Turkey: US Dollar Deposit Interest Rates, 2000-2001 1/
(In percent; weighted average interest rate)



Source: Central Bank of Turkey.

1/ Weighted average interest rate of 5 private banks: T.İş Bankası, Yapı ve Kredi Bankası, Akbank, T. Garanti.

flows.[8] These banks are no longer seen as causing distortions in the deposit and money markets and are now seen by the public as being sound, and have even benefited from flight to quality in recent months despite much lower deposit rates relative to private banks than earlier in 2001. Legal changes are being proposed to allow the planned downsizing of the staffing and branch networks of these banks (Table 6). Both banks are expected to be highly profitable in 2002 and can be expected to transfer dividends to the Treasury. After their extensive financial and operational restructuring they can also be expected to become valuable franchises for privatization.[9] No specific measures have been introduced for the third state-controlled bank, Vakif, for which privatization bids are presently being solicited and final decisions regarding the privatization are expected to be made in mid-2002.

B. The Resolution of SDIF Banks

21. **Since 1997, 19 private banks have been taken over by the SDIF, of which 16 since December 1999.** Bank runs have been avoided and the stability of the system maintained, first by keeping all banks in operation, and later by introducing in January 18, 2001 an explicit general guarantee of all bank depositors and creditors. Five banks were taken over in late 1999, three banks in 2000, two in early 2001, five banks in mid-2001, and one in late November 2001 (Table 7). While most of the banks were relatively small, some were also medium-sized. Altogether, these banks represented some 14 percent of total banking system assets. Initial efforts to sell intervened banks were less successful than the authorities expected. After a slow start, the resolution of SDIF banks started in earnest in late 2000 with the introduction of new fit-and-proper criteria for bank ownership and a more proactive sales effort in the form of public auctions. However, the auctions failed to attract much interest in the wake of the November 2000 crisis. As a result, in early 2001 six banks were merged and a part of the merged bank eventually sold.[10] Three banks merged in mid-2001 did not find a buyer and the merged bank was closed in late 2001. Three other banks were closed in late 2001 with part of their assets and liabilities transferred to the "bridge" bank and their remaining balance sheet transferred to SDIF for liquidation. In December 2001, SDIF successfully auctioned off to private banks most of the deposits of the banks in liquidation; this was done without any market distress and at no additional cost to the government.

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[8] In some cases capital has been set aside but, because of tax considerations, has not yet been used to provide for the loan loss.

[9] In privatization, Ziraat's special role in the government payment system (i.e., in revenue collections, expenditure disbursements and cash management) will need to be considered.

[10] In January 2001, five banks were merged with Sumerbank; one third of the balance sheet of this bank was sold to another bank in August 2001, and the remainder transferred to the SDIF for liquidation.

22. **Considerable momentum has been reached in the resolution of SDIF banks.** Despite a deteriorating environment, four banks (including one representing the merger of six) have been sold (even if only a part of their balance sheet was purchased by new investors); two of the banks have been bought by foreign and two by domestic investors. Of the remaining ten SDIF banks, 6 have been closed and put into liquidation. Four SDIF banks remain in operation: one small bank that is being kept by the SDIF as a bridge bank for asset management purposes (see below), a recently intervened bank for which a buyer is still being sought, and two banks that SDIF has tried to close but has been forced to keep in operation under court injunctions. All the banks taken over by SDIF through mid-2001 have thus been dealt with. The authorities are expecting to have their resolution strategy for the recently intervened bank finalized in February 2002.

23. **The SDIF is strengthening its capacity to deal with nonperforming assets.** The authorities are contracting additional staff, have sought the advice of an international consulting firm and have started to outsource loans for workouts. SDIF will use one small bank as a bridge bank to assist it in the asset management process; this bank will not be allowed to accept deposits. While SDIF has legal "superpowers" for loan recovery exceeding those of other creditors, it is quite restricted by public sector operating rules in what it can do in the case of loan workouts and corporate debt renegotiations; here the use of the publicly incorporated bridge bank with its different legal status, small branch network and established IT system would give SDIF much needed flexibility.

C. Strengthening the Private Banking Sector

24. **Since the start of the program supported by the Fund in December 1999, the authorities' strategy for dealing with private banks has been to bring about a proper valuation of their assets and then force undercapitalized banks to bring in new capital or have insolvent banks taken over by the SDIF.** In mid-2001, undercapitalized banks were required to bring in new capital. Six banks were unable to do so and were taken over by the SDIF. Some other undercapitalized banks were required to strengthen their capital base and improve their financial condition through outright increases in paid-in capital, mergers tied to operational restructuring efforts, or participation of foreign investors. They were given until end-2001 to reach the committed targets or face takeover by the SDIF. About US$700 million of new capital was raised this way. Another US$400 million was raised by other banks on a voluntary basis in 2001.

25. **The adverse macroeconomic environment and likelihood of increasing future credit losses has led the authorities to adopt a new strategy designed to support and protect the core private banking system.** The authorities expect banks to incur credit losses as a result of corporate distress in the face of falling demand and high real interest rates. The efforts in 2001 to raise private capital were important but insufficient to deal with the likely further deterioration in banks' financial condition. Planned mergers with strategic foreign partners appear to have stalled after the events of September 11.

26. **A solvency support scheme for private banks therefore has become the priority of the authorities in order to safeguard the core private banking system.** This is needed in addition to the general guarantee of all depositors and creditors already in place. Given the likelihood of larger additional credit losses in banks, and that additional capital from existing owners or new investors can be expected to be scarce, the authorities have designed a scheme that would provide public capital support. The scheme would safeguard the solvency, profitability and continued confidence in the banking system. The scheme will require that all existing losses be identified by independent external audits and borne by existing owners. It is designed to show strong government support of the banking system, and create the conditions for renewed lending to the real sector, while minimizing up-front cash outlays for the SDIF and overall public sector costs. The scheme will be introduced in January 2002 and will be implemented by end-June 2002. It is expected to lead to a more efficient and profitable banking system with more risk-aware banks engaged in more lending to a less volatile corporate sector.

27. **The scheme will be based on a rigorous targeted valuation exercise of banks' loan portfolios and certain other exposures, especially exposures to connected parties.** This is the only way to get a reliable valuation of banks' net worth. This up-front valuation exercise is crucial and the authorities are taking measures to make sure that it is thorough and viewed by markets and investors as being technically of the highest quality and honest. Accordingly, the BRSA will establish clear guidelines with criteria, templates and detailed instructions for the assessment exercise and have asked for Bank-Fund technical assistance in that regard. The BRSA will ask banks' existing external auditors (typically local affiliates of the big-five auditing firms) to do the assessments. Once asset values and capitalization needs have been established by the auditors, banks will hire auditing firms for a third party assessment of the integrity of the exercise. The BRSA will then establish the possible need for additional capital. These numbers would then feed into recapitalization plans that banks would be required to comply with and would also feed into banks' balance sheets for end-June 2002. This would coincide with the introduction of new international accounting standards starting July 1, 2002.

28. **Once a bank's capital shortfall has been established, the BRSA will require banks to write down their capital and ask existing owners or new investors to raise capital.** Banks' shareholders and private investors would be asked to provide necessary capital to bring up banks Tier-1 capital to 4 percent and overall CAR to 8 percent as called for under existing regulations. Legal amendments will provide new fast-track procedures for these operations. Banks that meet their CARs or can raise capital on their own would only be required to show a business plan to ensure their continued solvency.

29. **For banks that would not be able to raise the full amount of new capital on their own, the SDIF would stand ready to provide support to banks that meet certain capital adequacy thresholds.** Insolvent banks or banks unable to raise the necessary capital would be taken over by the SDIF (legal changes will be introduced to increase SDIF's powers to take over chronically undercapitalized banks) and/or otherwise resolved. In any bank in

which SDIF would hold equity, it would have board representation with veto rights. In addition, majority shareholders would be required to pledge theirshares to guarantee that SDIF could sell its shares in the future and recoup its investment, including carrying costs. A bank would adhere to restrictions on the distributions of dividends, while SDIF remains a shareholder. The detailed regulations regarding the scheme will be issued by the BRSA as soon as the recapitalization scheme has been enacted into law.

30. **Under the proposed support scheme the SDIF is authorized to put in Tier-1 equity capital in private banks** (on behalf of the government) provided that: (i) SDIF's Tier-1 equity contribution does not exceed the new private contribution and (ii) the bank's Tier-1 capital is raised to 5 percent CAR, and (iii) the bank, or banks to be merged, represent a market share of at least 1 percent of total banking system assets.[11] Banks' capital contributions in cash in 2001 would count as new capital, after a bank's CAR has been brought to zero. The SDIF will make any Tier-1 capital contributions with government securities issued at market terms.

31. **SDIF is also authorized to contribute Tier-2 capital in the form of convertible subordinated debt.** Such capital would be available to all banks with a Tier-1 CAR of at least 5 percent (regardless of market share). SDIF will make any Tier-2 contribution with seven-year government bonds that cannot be transferred to any third party without prior approval of the BRSA. If a bank were to make further losses and its Tier-1 CAR were to decline below 5 percent, Tier-2 capital would convert to equity in order to bring the Tier-1 CAR back up to 5 percent on a quarterly basis. This would give private owners incentives to rehabilitate their bank and prevent the SDIF from becoming the majority owner. If SDIF were to become the majority owner of a bank, this would allow it to pursue "least-cost" early resolution options. The regulations for the scheme will spell out the precise conditions under which the SDIF can sell its shares, for bank owners to purchase shares held by SDIF, and for SDIF to convert Tier-2 capital into equity.

D. Public Sector Gross Cost of Restructuring

32. **The regularization of the "duty losses" in state banks and the recapitalization of the state and SDIF banks in May 2001 required the issuance of TL 45 quadrillion in new government FRNs (24 percent of 2001 GNP).**[12] For Ziraat and Halk, the Treasury injected TL 27.3 quadrillion, the bulk of which was used to regularize unsecuritized "duty losses" with floating rate Treasury securities. In addition, the Treasury provided

[11] This measure is designed to encourage mergers—nearly one half of the remaining 20 private commercial banks have a market share below 1 percent.

[12] As some of the new issues replaced earlier heavily discounted issues, the increase in the stock of public debt was somewhat less than this amount.

TL 1.7 quadrillion in securities to cover the transfer of net liabilities from Emlak to Ziraat. For SDIF banks, the Treasury issued about TL 16 quadrillion of FRNs and FX denominated securities to replace some earlier issues and cover the accumulated losses in the banks taken over prior to mid-May.

33. **The contingency of TL 5.5 quadrillion (3 percent of 2001 GNP) "set aside" in the public debt projections in mid-2001 to cover potential future resolution and takeover costs of the SDIF is expected to be sufficient to cover the additional costs of the public support scheme and additional SDIF resolution costs.** The contingency will grow to some TL 8 quadrillion in the 2002 debt projections due to accumulated interest. There are two types of claims on this contingency: first, the public support scheme and, second, the resolution of the remaining SDIF banks. There may also be costs of additional bank takeovers and resolutions, the magnitude of which are not likely to be known until mid-2002, when the results of the valuation exercise and the uses of the public support scheme are known. For now, including subordinated bank debt to the government, it is expected that the additional costs will remain within the contingency.

Statement by the IMF Staff Representative
February 4, 2002

1. This statement provides an update on economic and policy developments since the staff report (EBS/02/8, 1/18/02) was issued. The new information does not warrant changes in the thrust of the staff appraisal.

2. **Financial indicators have continued to reflect a positive market sentiment.** In January, the Turkish lira appreciated by 11 percent relative to the U.S. dollar, bringing the cumulative appreciation since mid-October 2001 to 22 percent. The interest rate on the benchmark bond (maturing in July 2002) declined by a further 1 percentage point during the month, to 69 percent. Stock prices remain more than 80 percent above the post-September 11 low, despite a modest decline of 4 percent in January.

3. **The prior actions for approval of the SBA have been completed.** As already mentioned in the staff report, three prior actions were met before the Letter of Intent was signed. Parliament passed the Tobacco Law on January 3, 2002 and the Procurement Law on January 4, 2002 (both have since been signed into law by the President), and all banks taken over by the SDIF by November 2001, with the exception of two whose resolution has been halted by courts, were resolved by end-2001. The other prior actions have been implemented as follows:

- **Fiscal policy.** The Council of Ministers' decree implementing the reduction in the share of central government tax revenues accruing to metropolitan municipalities was issued on January 29. The circular to implement attrition rules was issued on January 28. The Minister of Finance signed the letter approving the reallocation of spending to ensure adequate funding for direct income support for small-scale farmers on January 11.

- **Banking reform.** Many of the banking reform prior actions were linked to passage of the amended Banking Law. Although the Law originally approved by parliament on January 10, the President vetoed three articles in it on January 25. They related to the auditing and reporting of independent supervisory and regulatory boards (not directly relevant for banking reform), changing the status of state bank employees, and providing legal protection for state bank management (the latter two articles were aimed at facilitating the restructuring of state banks and state banks' participation in corporate debt restructuring under the Istanbul approach). On January 30, parliament passed the Law for a second time, without amendment, after which the President was required to sign the Law, which he did on January 31. The Law took effect on February 1, when it was published in the official gazette. Although the disputed articles can be challenged in the Constitutional Court, this does not affect the remainder of the Law. Moreover, the authorities have indicated that until the Constitutional Court makes its ruling, the disputed articles remain in effect, and any actions taken on the basis of these articles will stand even if they are ruled unconstitutional. With the amended Banking Law passed and signed into law, the following prior actions were met: (i) the legal framework for the public support scheme for private banks became effective, (ii) the legal amendment to eliminate the existing four-year transition rule for loan-loss provisioning was passed, and (iii) the necessary legal amendments for staff reductions in state banks were put in place. The remaining prior actions in banking were completed through a Council of Ministers' decree on staff reductions in state banks signed on January 29; through the circulation on January 30 by the BRSA to the Turkish banking community of rules (effective July 1, 2002) to begin the trial implementation of accounting standards in line with the IAS; and through approval by the BRSA on January 31 of regulations related to the private bank recapitalization scheme and of guidelines for the targeted evaluation of banks' loan portfolios.

- **Public sector reform.** (i) On January 29, the Council of Ministers approved a plan to reform the tax system. A matrix that spells out the reform in further detail was approved by the Ministers of Finance and Economy on January 31. (ii) Between December 3 (the issuance of the Prime Minister's circular) and mid-January, 12,657 public sector workers were retired or notified of retirement. In addition, in the context of the merger of the state-owned steel company Isdemir with Erdemir on January 31, 2,606 workers at Isdemir were laid off on that day, bringing the reduction in the number of public sector workers above the targeted 15,000. Erdemir is a steel company classified as private under the commercial code, with the state's present share at 50.4 percent. The authorities have agreed to reduce the state's share in Erdemir to below 50 percent by mid-February. While the inclusion of the laid-off workers in meeting the targeted reduction does not meet the letter of the envisaged action (retirement), the staff considers that satisfactory progress has been made toward completing this prior action.

- **Enhancing the role of the private sector.** The Council of Ministers approved an action plan to foster domestic and foreign investment on January 28.

4. Although not prior actions for the approval of the SBA, progress has also been made with two program actions envisaged for completion by end-January. First, the review of redundancies in state economic enterprises has been initiated (with World Bank assistance) and the Treasury has issued an instruction to eliminate 90 percent of existing open positions in state economic enterprises, paving the way for completing the related prior action for the first program review in due course. Second, the strategy for increasing transparency and combating rent-seeking activities has been opened for signature by the Council of Ministers (adoption of this strategy is a structural benchmark).

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 02/7
FOR IMMEDIATE RELEASE
February 4, 2002

International Monetary Fund
Washington, D.C. 20431 USA

IMF Managing Director Sees Impressive Commitment by Turkey to Economic Reforms; Executive Board Approves US$16 Billion Stand-By Credit

The Executive Board of the International Monetary Fund (IMF) today approved a three-year, SDR 12.8 billion (about US$16 billion) stand-by credit for Turkey to support the government's economic program for 2002-2004. This decision will enable Turkey to draw SDR 7.3 billion (about US$9 billion) from the IMF immediately.

The arrangement with Turkey replaces the previous stand-by credit, which was approved in December 1999 (see Press Release No. 99/66) and amounted to a total of SDR 15 billion (about US$19 billion). Total disbursements to Turkey under the previous stand-by credit came to SDR 11.7 billion (about US$14 billion). The remaining undisbursed SDR 3.3 billion (about US$4 billion) were folded into the new arrangement and are included in the total amount.

After the Executive Board discussion on Turkey, IMF Managing Director Horst Köhler issued the following statement:

"Today's decision is a recognition by the international community of Turkey's success in developing and implementing a bold and comprehensive economic reform program. Progress is impressive, and the authorities are committed to doing what is necessary for the country's economic and financial recovery through continued steadfast policy implementation. The IMF continues to support Turkey in its truly "owned" program.

"Executive Directors commended the Turkish authorities on the considerable progress they have made in implementing their ambitious economic reform program. They have moved successfully to a floating exchange rate regime, set a clear course toward debt sustainability through a greatly improved fiscal position, and achieved important progress in banking sector restructuring, public sector reform, and preparations for privatization. In tandem with the associated strengthening in the perceptions of markets, these policies have laid the basis for a resumption of growth.

"Achieving a lasting improvement in Turkey's economic conditions will require the authorities' strong perseverance in the flawless implementation of their reform agenda to further improve prospects for economic recovery, disinflation, and debt sustainability.

"The authorities have appropriately responded to the exogenous shock that Turkey suffered following the September 11 events with a strengthened medium-term program. The new program aims at cleaning up the banking sector, consolidating fiscal adjustment, and achieving disinflation within a floating exchange rate framework, and, if consistently implemented, will go a long way toward making the economy more robust in the face of possible future shocks.

"The recent improvement in Turkey's growth performance, and prospects for continued recovery, underpinned by improved market stability and confidence, are encouraging. The authorities should now act with determination to sustain this recovery into the medium term by removing the basic impediments to growth. This will imply rehabilitating the banking system, introducing an efficient management of public resources, and creating an environment supportive to private investment and the growth of a dynamic private sector.

"Achieving sustained reductions in public indebtedness will require high primary budget surpluses over the medium term, underpinned by fundamental reforms of the tax and spending policies. The planned reduction in public sector employment is key to achieving a permanent budget adjustment and a more efficient public administration. It must be pursued vigorously but in a manner which minimizes social costs. Building on the considerable progress in streamlining the budget system over the last several years, the authorities will also further improve public procurement, overhaul the tax system, reform public sector employment, and consolidate budget institutions.

"Lowering inflation on a lasting basis will be central to the achievement of a stable macroeconomic environment conducive to economic growth, and to the success of the floating exchange rate regime. To achieve the targeted disinflation, the central bank will adhere strictly to its base money targets, while finalizing preparations for a successful transition to formal inflation targeting.

"The reforming of the state banks has been one of the main achievements under the program, and every effort must now be made to complete the operational restructuring of these banks, followed by their privatization. The authorities' strong efforts to put in place the legal and regulatory framework supporting the new recapitalization scheme for the private banks are commendable.

"The authorities' continued strong implementation of a challenging economic program, and the renewed demonstration of political unity behind the program justify the Fund's exceptional support to Turkey's reform agenda," Mr. Köhler said.

ANNEX

Recent Developments

In late summer 2001, Turkey's revised economic program was beginning to show positive results, when the events of September 11 struck. The September 11 shock has affected the Turkish economy through lower export demand, loss of tourism receipts, reduced access to international financial markets, and weaker privatization and foreign direct investment prospects. These losses in foreign exchange strained domestic financial markets in September-October and led to large increases in domestic interest rates, the opposite of the program's goal.

By November 2001, Turkey was estimated to face an external financing gap of US$10 billion for 2002, with gaps of US$1 billion in each of the following two years. Although the program, which was strengthened in May, addressed many of Turkey's deep-rooted macroeconomic and structural problems, including the heavy debt burden, entrenched high inflation, banking sector difficulties, and pervasive state involvement in the economy, Turkey now needed to follow an intensified medium-term approach in order to fulfill its growth potential with disinflation and falling debt ratios.

In recent months, the prospects of a strengthened economic program, to be supported by additional external financing in the context of a Fund arrangement, has helped to improve market sentiment. In January, the Turkish lira appreciated by more than 10 percent against the U.S. dollar, bringing the cumulative appreciation since mid-October 2001 to more than 20 percent. In addition, the interest rate on the benchmark bond has fallen by more than 20 percentage points (to around 70 percent at end-January), while the stock market has risen more than 80 percent from its post-September 11 low.

Program Summary

Turkey's economic program for 2002-2004 deepens and extends the efforts that were made under the previous program. The program aims at protecting the economy against future crises, while laying the basis for sustained economic growth. Three key elements of the program are designed to reduce the risk of future crises. First, continuation of the floating exchange rate regime will limit the potential for speculative attacks, allowing greater interest rate stability. Second, efforts to reform and strengthen the financial system will make banks less vulnerable to withdrawal of funds, and boost confidence in domestic financial assets. Third, expenditure and tax reforms will help sustain the fiscal adjustment needed in the medium term to ensure debt sustainability.

The program aims to generate sustained economic growth through macro stability, to be achieved by fiscal adjustment, disinflation under the planned inflation targeting framework, and structural reforms. Structural reform efforts will focus on completing banking sector restructuring, intensifying public sector reform, and strengthening the private sector's role in the economy.

The medium-term macroeconomic framework envisages gradual economic recovery, continued disinflation, improved external accounts, and government debt sustainability. For 2002, GNP is projected to grow by 3 percent with an upside potential given the depth of the 2001 recession. The authorities have reaffirmed their commitment to reach the CPI inflation target of 35 percent in 2002, from 68.5 percent in December 2001. The government intends to support a viable debt position by maintaining the public sector primary surplus in 2002 at the level of 6.5 percent of GNP. The current account is still expected to move from a surplus of about US$2 billion in 2001 to a deficit of a similar magnitude in 2002. The capital account deficit is projected at US$3 billion in 2002, compared with US$13 billion in 2001, reflecting mainly the expected improvement in portfolio and banking sector flows as a result of a gradual restoration of confidence. Provided interest rates converge to program levels and the primary surplus remains strong, Turkey's public debt would be sustainable in the medium term—that is, it would shift to a declining trend relative to GNP.

On fiscal policy, the authorities intend to continue their strong fiscal efforts begun in 2001, which had allowed for a public sector primary surplus of more than 5.5 percent of GNP despite the deep recession. For 2002, Parliament has passed a central government budget consistent with the objective of achieving a public sector primary surplus of 6.5 percent of GNP, and the authorities have already started to implement supporting measures to enhance revenues and rationalize expenditures. On debt management, the authorities plan to take further steps to build on the recent achievements, including offering securities that are matched by investors' needs; widening the investor base to make it more stable; and lengthening the maturity of government debt and deepening the liquidity of benchmark issues.

The authorities reaffirmed that the goal of monetary policy will be to lower inflation, and they are making additional efforts to put in place the preconditions for successful inflation targeting. Improving financial market conditions and a stabilizing exchange rate will rebuild confidence in the financial system and free monetary policy to target inflation.

Structural priorities under the program are threefold: in the banking sector to restore credit flows to the real sector; in the public sector, greater transparency of government operations, and state enterprise restructuring; and in the private sector, intensifying privatization and fostering greater foreign direct investment. The authorities will implement a policy package to accelerate banking sector reforms and complete the restoration of the sector's soundness. Their two-pronged strategy will force banks to value their loan portfolios rigorously, while at the same time offer limited public support for private bank recapitalization efforts. Furthermore, institutional capabilities need to be established to resolve the large amount of assets of banks taken over by the Savings Deposit Insurance Fund (SDIF), and the momentum for strengthening the regulatory and supervisory frameworks needs to be maintained.

In the public sector, the authorities are determined to sustain the fiscal adjustment through reforms aimed at a lasting improvement of the fiscal position, and a significant enhancement of fiscal transparency. Tax system reform will make the revenue base broader and more sustainable, and reduce distortions in the economy. Consolidating fiscal activities into fewer institutions will enhance aggregate fiscal control and improve transparency. Social protection in the new program will be enhanced to cushion the impact of the necessary retrenchment program in public enterprises. At the same time, the authorities plan to take major steps to revitalize privatization in 2002 and to improve the private investment environment. Key to fostering a business-friendly environment will be to improve transparency and governance, and enhance communication of the aims of the economic program.

Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In percent)			
Real sector						
Real GNP growth rate	-6.1	6.3	-8.5	3.0	5.0	5.0
GNP deflator	55.8	50.9	60.7	48.9	24.9	13.1
Nominal GNP growth rate	...	60.4	47.0	53.4	31.2	18.8
WPI (12-month, end-of-period)	62.9	32.7	88.6	31.0	16.2	12.0
CPI (12-month, end-of period)	68.8	39.0	68.5	35.0	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.7	69.6	46.0	32.4
Average ex-ante real interest rate 1/	32.0	-9.4	32.4	33.2	27.5	20.5
			(In percent of GNP)			
Central government budget						
Primary balance 2/	1.5	4.2	5.0	5.4	5.6	5.6
Net interest payments 3/	13.1	15.8	23.2	20.5	16.2	13.5
Overall balance	-11.6	-11.6	-18.2	-15.2	-10.6	-7.8
Consolidated public sector						
Primary balance	-2.0	2.3	5.7	6.5	6.5	6.5
Net interest payments 4/	22.1	21.9	24.7	18.4	15.8	13.3
PSBR (including CBT profits)	24.2	19.6	19.0	11.9	9.3	6.8
Net debt of public sector	61.0	57.4	92.2	81.3	73.3	69.4
Net external	20.1	18.3	38.0	35.1	30.6	28.5
Net domestic	40.9	39.1	54.2	46.2	42.7	40.9
Of which:						
Central government (gross)	42.5	40.9	70.3	54.2	...	...
Auctioned and other cash debt	25.8	23.4	25.3	23.1	...	...
Bank recapitalization	...	17.4	35.6	28.4	...	...
External sector						
Current account balance	-0.7	-4.9	1.3	-1.2	-1.2	-1.2
Gross external debt	55.0	56.6	75.4	71.7	66.7	63.3
Net external debt	34.0	37.0	51.6	48.1	44.4	40.8
Short-term external debt (by remaining maturity)	20.8	23.0	23.3	20.4	19.0	18.8
Monetary aggregates						
Seignorage 5/	3.2	1.8	1.0	1.0	0.7	...
Nominal growth of broad liquidity (in percent)	96.9	40.2	75.1	40.2	27.4	17.1
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	0.1	3.3	2.8	1.5	2.5	1.0
Net external financing of central government	1.4	4.1	-2.7	1.0	-1.0	-1.0
Amortization	6.0	6.2	8.2	6.5	8.4	8.0
Gross borrowing	7.4	10.3	5.5	7.4	7.5	7.0
Of which: Eurobond issues	5.0	7.5	2.2	2.5	4.5	4.7
GNP	187.4	201.3	150.3	165.6	183.0	201.3
GNP (in quadrillions of Turkish lira)	78.3	125.6	184.7	283.2	371.6	441.3

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/ Interest payments minus interest receipts plus profit transfers from the central bank.

4/ Interest payments minus interest receipts plus CBT profits before transfers to the government.

5/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.