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Turkey: Sixth and Seventh Reviews Under the Stand-By Arrangement; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of a discussion of the Sixth and Seventh Reviews under the Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Sixth and Seventh Reviews under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **April 23, 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 May 7, 2001.** 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 May 10, 2001 providing information on foreign exchange exposures in the banking sector.

- a Press Release **summarizing the views of the Executive Board as expressed during its May 15, 2001 discussion** of the staff report that completed the request.

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

Letter of Intent by the authorities of the member country*
Memorandum of Economic Policies by the authorities of the member country*

*May also be included in Staff Report.

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

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INTERNATIONAL MONETARY FUND

TURKEY

Sixth and Seventh Reviews Under the Stand-By Arrangement

Prepared by European I Department in consultation with other departments

Approved by Michael Deppler and Jesús Seade

May 7, 2001

- A staff mission—comprising Mr. Cottarelli (head), Mr. Kahkonen, Ms. Moalla-Fetini, Mr. Aitken (all EU1), Messrs. McGettigan and Thorne (PDR), and Mr. Mottu (FAD)—visited Ankara during April 8–23, 2001 to conduct discussions for the sixth and seventh reviews under the Stand-by Arrangement (SBA) with Turkey. The mission worked closely with an MAE team—headed by Mr. Lindgren and comprising Messrs. Coats and Josefsson, Ms. Cebotari (MAE), and Mr. Laryea (LEG)—which assisted the authorities in the area of banking reform. Mr. Brekk, senior resident representative, also participated in the discussions. The staff cooperated closely with the World Bank, which is assisting the authorities in the areas of structural reform, including telecommunication, energy, banking, and agriculture.

- The mission met with the State Minister for Economic Affairs, Mr. Derviş; the head of the Treasury, Mr. Öztrak; the Governor of the Central Bank, Mr. Serdengeçti; the Chairman of the Bank Regulation and Supervision Agency, Mr. Akçakoca; and other senior officials.

- Executive Board consideration is being proposed under the emergency procedures and the proposed access entails resort to exceptional circumstances.

- The Turkish authorities intend to publish the staff report.

I. Introduction

1. **On February 22, 2001 the Turkish government floated the lira, thus abandoning the nominal anchor of the disinflation program initiated at end-1999.** This decision was forced by a major speculative attack that was initially resisted through a freeze in domestic liquidity. The virtual paralysis of the payment system that followed, the rise of money market interest rates to over 2,000 percent (simple rate), and the markets' perception that the Turkish lira was overvalued, made it impossible to defend the crawling peg for more than a few days. In the aftermath of the crisis, a new economic team has been appointed—with Mr. Derviş as State Minister for Economic Affairs, Mr. Serdengeçti as new Governor of the Central Bank of Turkey (CBT), and Mr. Öztrak as head of Treasury—and has prepared a strengthened economic program aimed at financial stabilization, disinflation, fiscal adjustment, and improved governance and transparency. In support of this program, the authorities have asked for an augmentation of the SBA by the equivalent of SDR 6.3624 billion (660 percent of quota). The Turkish authorities have also asked the World Bank to raise lending to Turkey this year by US$2 billion with respect to the total originally envisaged under the Country Assistance Strategy.

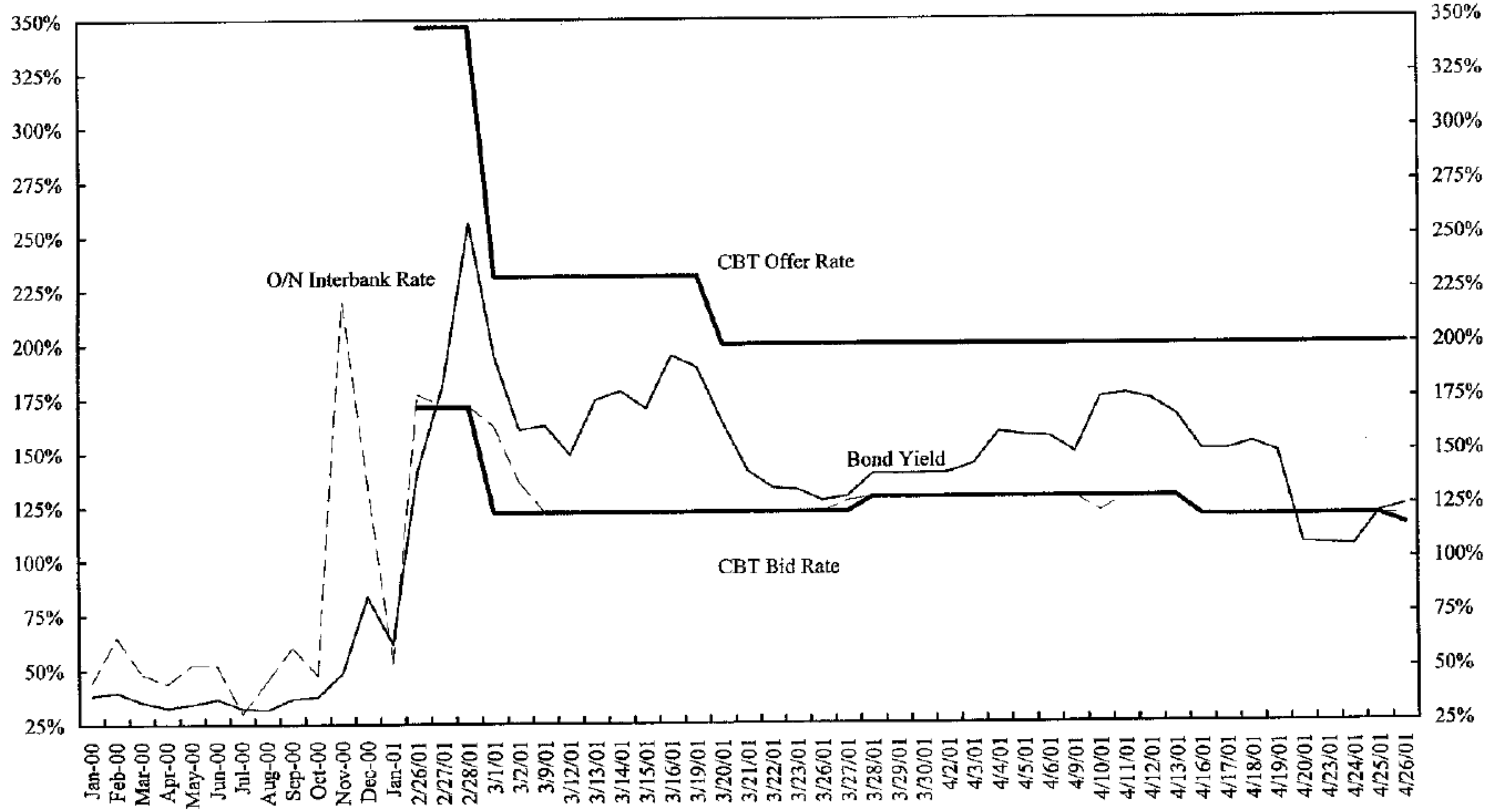
2. **The authorities' policies are presented in the attached Letter of Intent (LoI) and Memorandum on Economic Policies (MEP). These documents are prefaced by a letter of political support signed by the three leaders of the government's coalition** (also attached). The LoI requests waivers of the performance criteria that were not observed since the completion of the fifth review as a result of the crisis, as well as in relation to the approval of the electricity markets law and following a change in the privatization strategy for Turk Telekom (see below).

II. The Road to the Crisis and its Aftermath

3. **The speculative attack on the Turkish lira took place against the background of increased political uncertainty, policy slippages, and a weakening of economic fundamentals.** Following the November crisis, the strengthened policy package supported by additional Fund resources through the Supplementary Reserve Facility led to a reversal of capital outflows and a decline of money market interest rates to about 50 percent in mid-January (Figure 1). The situation, however, remained fragile, with the bulk of the external funds invested at extremely short maturity. The credibility of the program, including its nominal anchor, had been badly shaken by the November crisis, and only a virtually impeccable policy implementation could have restored it. Unfortunately, while many of the program actions (particularly on the fiscal side) were implemented, slippages in some key structural areas compounded with increased political uncertainty.

- As to **political risk**, financial markets increasingly focused on the possibility that the Constitutional Court might ban the *Fazilet* party, leading to the resignation of some 80 MPs and to by-elections. While the risk of by-elections may have been low in

Figure 1. Turkey: Nominal Interest Rates, 2000-2001 1/



Source: Data provided by the Turkish authorities.

1/ Annual compounded; monthly averages, up to end-Jan 2001; daily data thereafter.

2/ As of March 27, 2001, the overnight interbank rate has been consistently equal to the Central Bank of Turkey's bid rate.

practice, the failure to clarify this issue squarely and openly at the political level increased the perceived political risk.

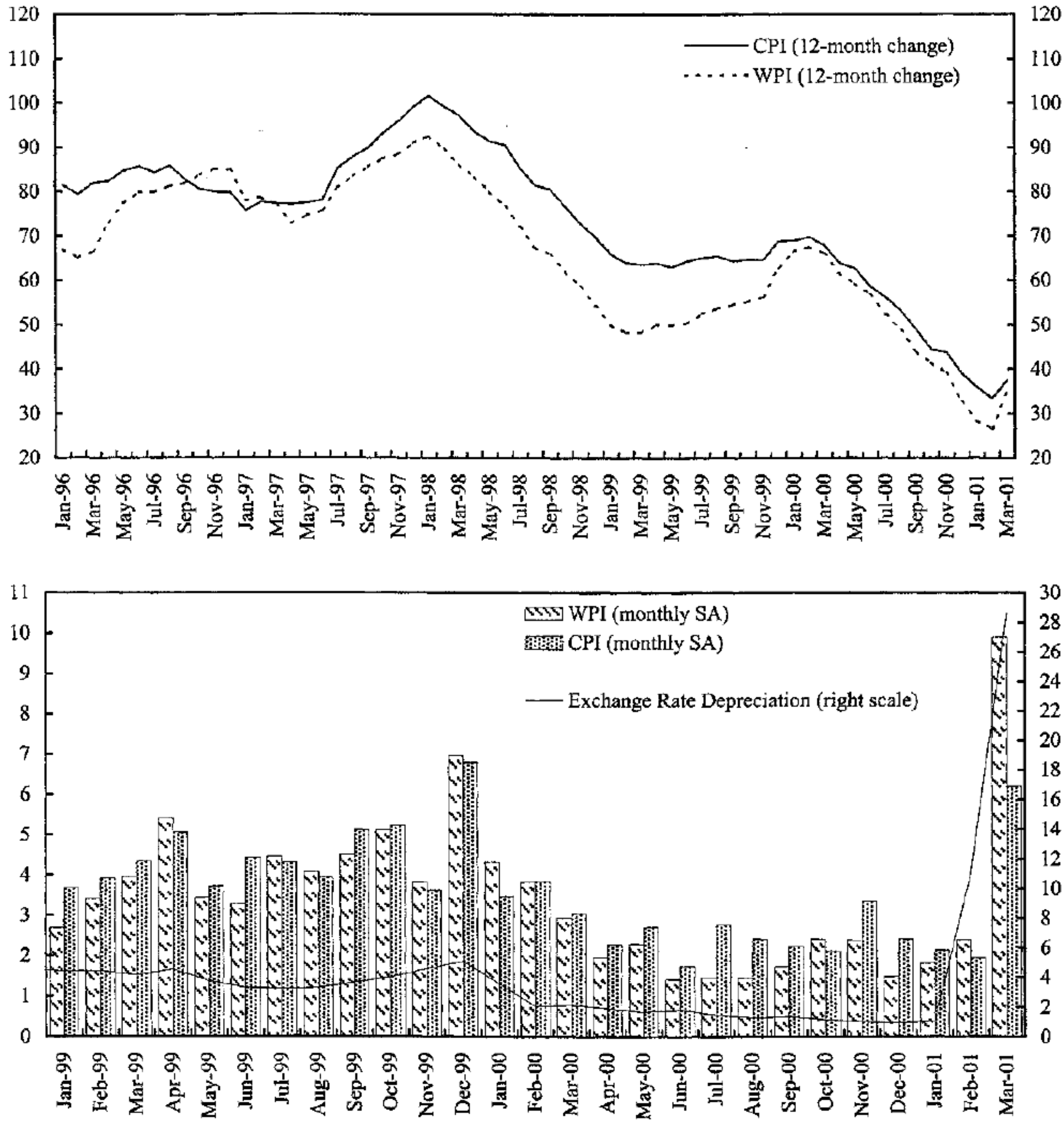
- Regarding **policy implementation**, the LoI for the fifth program review had rescheduled the implementation of some structural measures envisaged in the December 18, 2000 LoI. There were further difficulties in implementing these actions by the new deadline. The electricity market law, which was expected to be approved by mid-February, was approved only after the crisis (¶3 of the attached LoI). The tobacco market law, scheduled for approval by end-February, is now programmed to be approved in May. The new regulation on the application of limits on connected lending on a consolidated basis, scheduled for end-February, is now expected for early June (see below). There were also other slippages. In late January, the government approved measures to facilitate the payment of tax arrears outstanding at end-December 2000, a step that was perceived as signaling a lack of full commitment to enforce tax compliance. Finally, the government did not convincingly address some legal challenges to the sale of Turk Telecom, the key privatization operation envisaged by the 2001 government program.

- News on **economic fundamentals** was also not good. Inflation in January remained twice as large as the rate of crawl (Figure 2), and the rise in interest rates following the November crisis was weakening domestic demand. While this weakening was strengthening the external current account (imports sharply decelerated after November; Figure 3), it further increased the risk that policies might be relaxed to try to support the economy.

- All this was reflected in a new rise in interest rates, starting in late January, which cast a shadow on fiscal sustainability and further endangered the banks more exposed to interest rate risk. It was clear that unless interest rates declined rapidly to a level more consistent with the 12 percent inflation target for 2001 and the preannounced 11 percent exchange rate depreciation, the macroeconomic situation would become unsustainable. At mid-February 2001, interest rates had instead climbed to some 70 percent.

4. **Against this background, a short-lived but heated dispute between the Prime Minister and the President sent financial markets into a frenzy on Monday February 19**. Taking the opportunity of a bank holiday in the United States, which *de facto* postponed the settlement of purchases of foreign exchange by banks from the CBT to the following day, banks placed purchase orders amounting to over US$7 billion at the CBT. The following day the freeze in liquidity imposed by the CBT limited the actual loss of reserves to some US$1½ billion (with banks canceling the orders for the remaining US$5½ billion). The foreign exchange sales, however, continued on Wednesday, February 21, notwithstanding a rise of overnight interest rates to over 2,000 percent (simple rate), with peaks of 5,000 percent. At that point, the expectation that the peg would be abandoned had become overwhelming and impossible to resist through high interest rates. The government announced the float in the morning of Thursday, February 22.

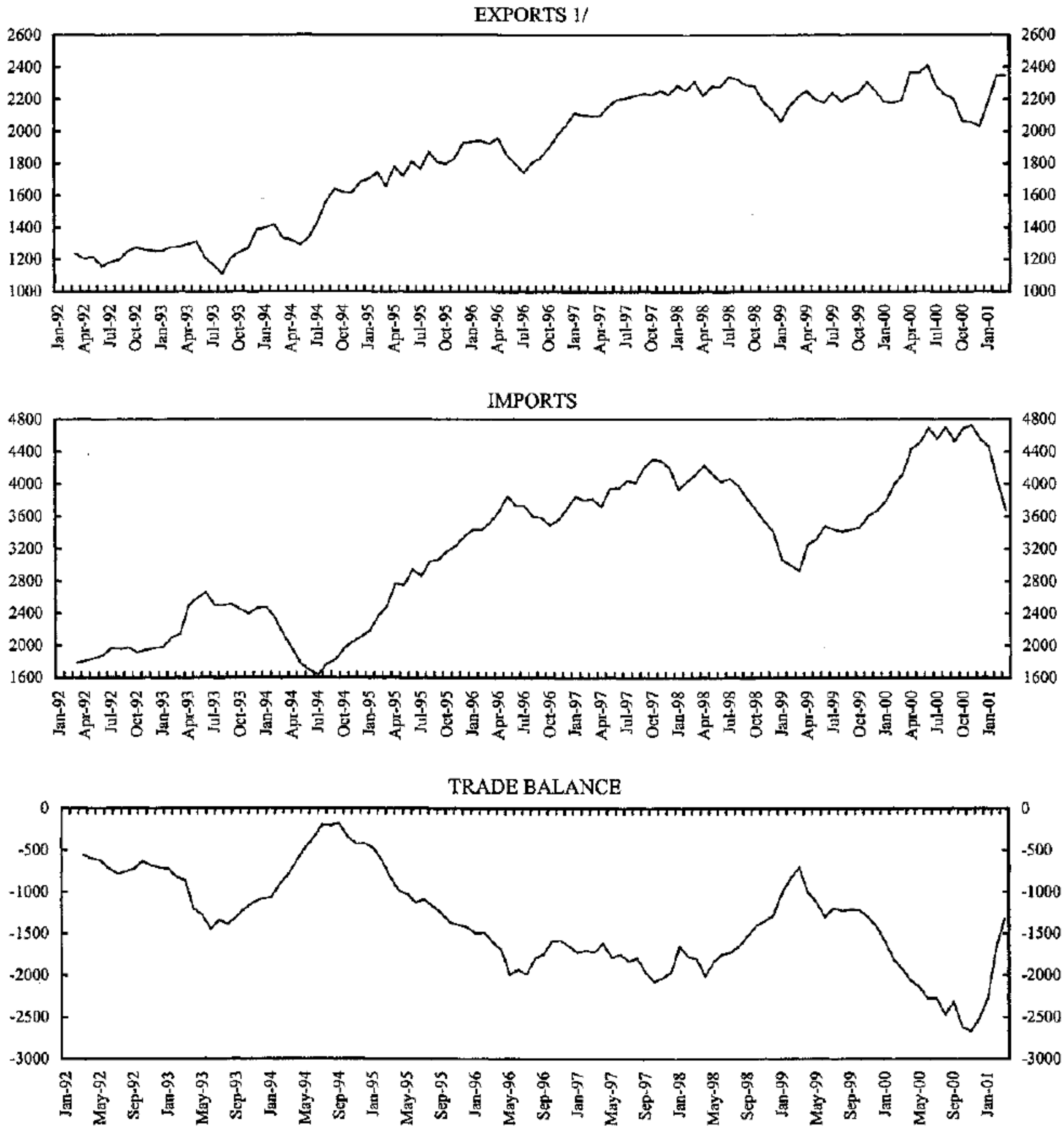
Figure 2. Turkey: Inflation, 1996-2001



Source: Data provided by the Turkish authorities.

Figure 3. Turkey: Trade Developments, 1992-2001

(In millions of U.S. dollars; seasonally adjusted three-month moving averages)



Source: Data provided by the Turkish authorities.

1/ Data for February and March are preliminary estimates based on data from the Union of Turkish Exporters.

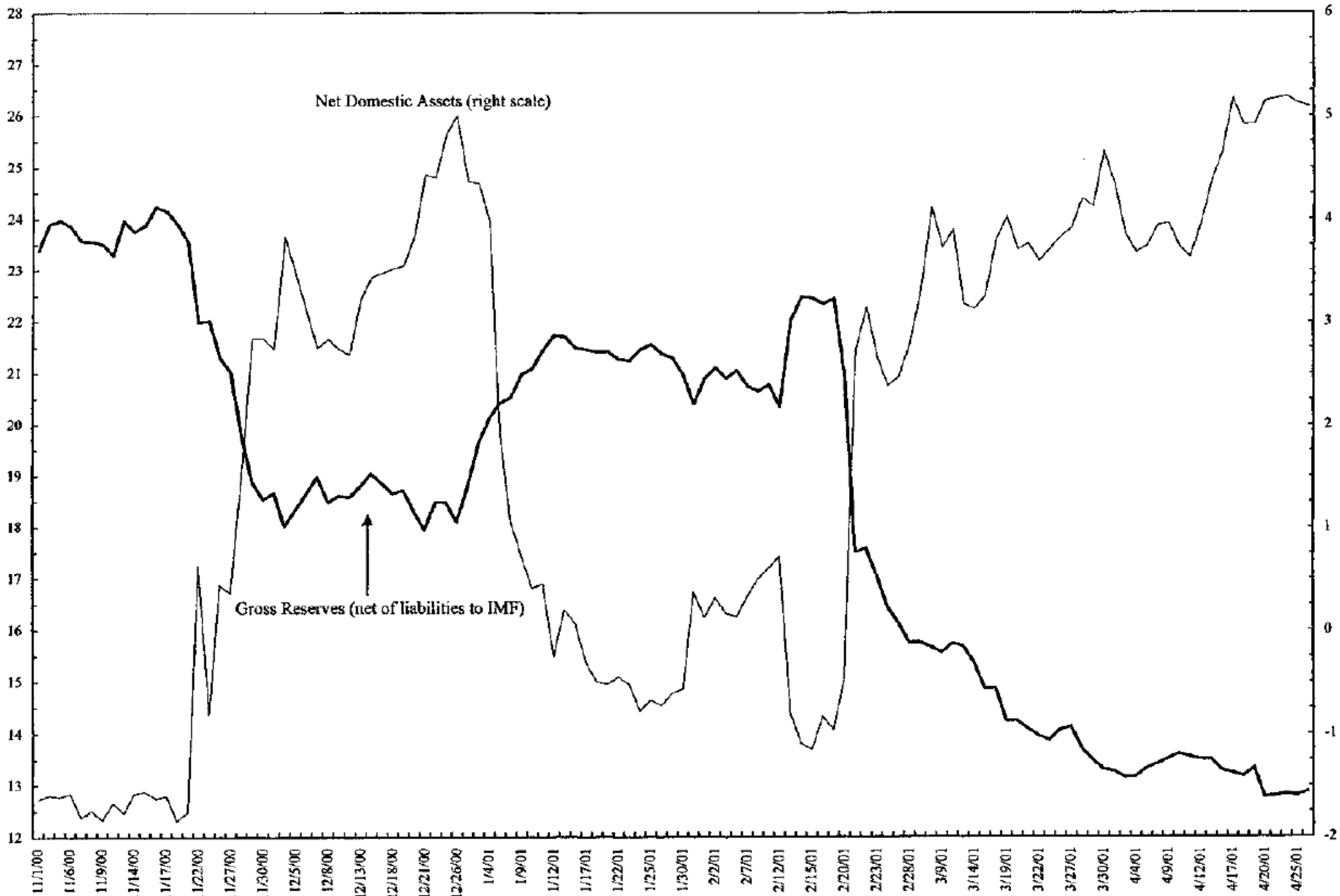
5. **In the immediate aftermath of the crisis, the authorities faced difficult choices.** On the one hand, there was the need to avoid a complete loss of monetary control, which would result into a spiraling exchange rate devaluation. On the other hand, there was the need to avoid a breakdown of the payment system and to honor the guarantee on domestic and external banks' liabilities issued by the government in early December. After a brief attempt to freeze domestic liquidity, the CBT announced in late February that it would provide liquidity at a maximum rate of 150 percent (simple rate); this move proved quite effective in jump-starting the payment system. Second, the authorities attempted to revive the foreign exchange market and avoid an overshooting of the exchange rate by selling foreign exchange. While this policy allowed Turkish banks and other residents to honor their external liabilities, it led to a further loss of foreign exchange reserves, which fell by US$4 billion between the date of the float and the beginning of April (Figure 4). A more flexible approach was introduced at end-March, when the CBT started selling foreign exchange by auction. As the amounts sold were quite small, the move succeeded both in reducing the loss of reserves and in increasing exchange rate flexibility. Thus, the exchange rate which, from a level of TL 0.68 million per U.S. dollar had moved to some TL 0.9–1 million per U.S. dollar in the immediate aftermath of the crisis, weakened by an additional 25 percent during the first half of April (Figure 5). This further devaluation took some pressure off interest rates, which declined somewhat during April. The government's shift to weekly (rather than monthly) government paper auctions helped the easing. In contrast to the failure of the February 21 treasury bill auctions, and the dramatic maturity shortening in March (to one month), the Treasury was able to sell securities of longer maturity (up to eight months) at a lower rate (some 120 percent) in April.

6. **The crisis put the banks for which the state is financially responsible (that is, the state banks, as well as the banks taken over by the Saving Deposit Insurance Fund (SDIF)), under severe pressure, with major implications for monetary and fiscal policies.**

- The large overnight exposure of state and SDIF banks implied that any attempt to tighten monetary conditions (to defend the peg before the float) or to limit the exchange rate fall (after the float) was bound to cause severe losses to these banks. This problem was further exacerbated by the poor liquidity management and weak governance in the state banks.

- With the state banks and SDIF banks being affected severely by the interest shocks, the fiscal costs of the interest rate hike before and after the crisis skyrocketed even if the Treasury's borrowing schedule in the first four months of 2001 was not prohibitive. In the week of the float the losses of the two main state banks alone amounted to some 2 percent of GNP. In addition, some private banks more exposed to interest rate risk had to be taken over by the SDIF, raising the fiscal costs further. A detailed analysis of the increase in public debt arising from the increase in interest rates and the takeover of banks is included in Box 1.

Figure 4. Turkey: Central Bank Gross International Reserves and Net Domestic Assets , 2000-2001
(In billions of U.S. dollars, at program cross exchange rates)



Source: Central Bank of Turkey.

Figure 5. Turkey: Lira Exchange Rate vis-à-vis the U.S. Dollar, 2001

Source: Data provided by the Turkish authorities.
1/ Since February 21, 2001.

Box 1. Increase in Public Sector Debt from Bank Recapitalization

Total public debt arising from state-owned banks and the takeover of private banks amounted to TL 44 quadrillion (24 percent of GNP) at end-April 2001 (Table 5 of the MEP). As about half of this debt was already included in the estimate of public debt at end-2000, the total increase during the first four months of 2001 amounts to TL 22 quadrillion.

Private banks taken over by the SDIF

In December 2000 some TL 3.8 quadrillion in treasury securities were issued to recapitalize private banks taken over by the SDIF. Even at the time, these bonds were less than needed given already incurred losses from increases in interest rates, additional losses in market value of the banks' securities portfolios, and additional bank takeovers. High real interest rates and the impact of the devaluation on these banks' open foreign position have added to these losses in 2001. By end-April 2001, the total public sector debt required to cover these losses and provision for additional nonperforming loans amounts to an estimated TL 13.7 quadrillion. This amount does not include the loss in market value of treasury bills currently held by SDIF banks, which is expected to be eliminated either through early redemptions by the treasury or through swapping these bills at face value for new treasury notes.[1] In addition, the projection of the stock of public sector debt at end-2001 includes a sizeable contingency for possible further costs of bank restructuring that may arise.

To prevent additional losses in the banks taken over so far, debt to recapitalize these banks takes the form of a combination of floating rate notes with quarterly coupons linked to borrowing costs (with part linked to the CBT repo rate and part to the average treasury bill rate), and foreign exchange-linked bonds sufficient to close these banks' open positions.

State-owned banks

At end-2000, the stock of government liabilities on account of the losses of state-owned banks exceeded TL 18 quadrillion. Although only TL 2.9 quadrillion had been securitized, the total including unsecuritized duty losses are included in the public debt at end-2000 (the program's figures have always included these duty losses as part of public debt). With these banks borrowing heavily in the overnight market, very high interest rates associated with the February crisis have led to a large increase in accumulated losses. By end-April 2001, the total public sector debt required to cover these losses and provision for additional nonperforming loans amounts to an estimated TL 30.1 quadrillion, including recapitalization costs for Emlak and allowing for some TL 700 trillion in securities required to bring the risk-weighted capital adequacy ratio of the state banks to 8 percent.

As with the SDIF-owned banks, additional losses in state banks are to be eliminated by recapitalizing them with floating rate notes bearing quarterly coupons linked to market interest rates. Also, most of the securities previously issued to these banks to cover past duty losses pay interest rates below current market rates, and will be replaced by floating rate notes.

Interest costs in 2001

Total interest on debt for bank recapitalization in 2001 is projected to amount to TL 14½ quadrillion (8 percent of GNP). This amount is to be paid in cash by the treasury.

[1] At end-March the total loss in market value of treasury bills held by SDIF banks, including the subsequent loss on recapitalization notes issued in December 2000 is estimated at TL 2.5 quadrillion.

- These fiscal costs are partly mirrored by the increase in interest receipts of the private banks that are net lenders in the interbank market, including the major private banks, the core of the private banking sector in Turkey. While these banks had to face an increase in their borrowing costs from domestic and external customers, their financial position was strengthened by the interest payments received from state and SDIF banks. At the same time, some small- and medium-sized banks were instead more severely hit by the crisis (Box 2).

III. The Challenges Ahead and the Authorities' Options

7. **The main challenge for the government is to restore confidence and, in this way, bring down interest rates rapidly and in a sustainable way**. At the mid-April level of interest rates, public debt would enter into an unsustainable spiral. The problem, however, goes beyond the public sector. The high level of nominal interest rates, coupled with extreme uncertainty about exchange rates and inflation, is paralyzing the economy, exacerbating the recession and increasing the likelihood of a surge in nonperforming loans and bank losses.

8. **What has kept interest rates high?** The most obvious reason is the weakness of public finances, the high level of indebtedness as a result of the crisis, and therefore the risk of monetization (or failure to roll over debt). The stock of public debt has increased rapidly in the last few months and the amount of securities to be rolled over every month has increased even more, on account of the maturity shortening. However, taking into account the measures implemented or soon to be implemented, the primary surplus is at a level that would be consistent with the sustainability of public debt, at low inflation (even were real interest rates remain quite high; more on this below). If financial markets can credibly be convinced that nominal and real interest rates will decline to more normal (even if still high) levels, fiscal sustainability will be guaranteed and interest rates will decline, as the risk of monetization would subside. But this is by no means a trivial task in an environment in which inflation and devaluation has been high and volatile for decades and confidence has just been shaken by two financial crises.[1]

9. **Faced with this situation, the authorities could have fulfilled markets' expectations and monetized the debt**. This is what Turkey had done in the past in similar

[1] The situation is similar to the one faced in late 1999, when nominal interest rates hovered at over 100 percent, making it impossible to proceed to a credible money-based disinflation, which would have resulted in unsustainably high real interest rates. The solution, at that time, had been to radically change the exchange rate regime, with the introduction of a pre-announced crawling peg, which helped reduce interest rates very rapidly. That solution is no longer viable.

Box 2. Private Banks

Sixty-three private banks, accounting for roughly 56 percent of total banking system assets, remain in Turkey.[1] Nearly 90 percent of those assets are held by 26 commercial banks, and more than half of that by 4 large banks (representing nearly 30 percent of total system assets). None of the largest banks have assets exceeding US$10 billion and 17 banks have assets below US$1 billion. Most banks in Turkey are owned by or closely associated with large industrial groups; the larger banks are listed on the stock exchange while most of the smaller banks are privately held. In addition, there are 18 branches or subsidiaries of foreign banks and 19 investment banks; all of them are small and, with a combined market share of about 7 percent of assets (1 percent of deposits), have no systemic importance.

Turkish banks have relatively small loan portfolios (averaging 35 percent of total assets) and relatively large holdings of securities (25 percent of assets). Total loans outstanding in private banks at end-year 2000 amounted to TL 19.2 quadrillion (US$28.6 billion) of which slightly less than one half was denominated in FX. At end-March 2001 exchange rate, the dollar value of these loans would be US$26 billion. Loan concentration is very high with only some 5,000 borrowers (0.1 percent of all borrowers) counting for nearly 40 percent of total loan value. This is a reflection of a traditional heavy concentration of lending to related group companies, a practice that the authorities are seeking to correct through legal and regulatory means, which will bring such exposures fully in line with EU standards by 2006. While this adjustment period is fairly long, it does not compare unfavorably with the experience of other countries that introduced similar regulations.

At year-end 2000, the four large banks had an average risk-weighted capital adequacy ratio (CAR) of 23 percent, while the remaining 23 commercial banks had a CAR of 13 percent. Since then, the financial condition of most of the largest and some small commercial banks, altogether representing nearly half of the commercial banking system, has been strengthened as a result of exceptionally high earnings during the recent crises episodes. At the same time, the remaining commercial banks have experienced substantial losses from high interest rates and the depreciation of the lira. In recent weeks banks have almost closed their net foreign liability positions, including off-balance sheet forward covers (see also supplement to the staff report of the foreign exchange position of Turkish banks) While nonperforming loans (NPLs) so far have remained low (below 4 percent of total loans) on average, the strict application of the loan classification and loan loss provisioning rules introduced in early 2000 are expected to reveal sharply increasing NPL numbers in the coming months.

Recognizing that the above CAR numbers have been seriously eroded and that the majority of banks have become undercapitalized and that the situation is bound to deteriorate further, the Banking Regulation and Supervisory Agency (BRSA) has held consultative meetings with all banks and has required all undercapitalized banks to present detailed and time-bound plans by end-April for raising additional capital. These plans are expressed in commitment letters, and the implementation of the banks' plans will be closely monitored by the BRSA. To support banks' strengthening of their capital base, dividend distributions have been suspended by the BRSA. In addition, bank mergers are being encouraged by making tax rules nonpunitive; this is initially expected to encourage mergers among banks with common owners.

BRSA has made it clear to the banks that their plans for raising new capital as expressed in their commitment letters will be followed very closely, and that banks will be taken over if the commitments are not honored. Early responses indicate that bank owners take the need to raise capital seriously and are prepared to sell assets and raise funds to provide the required additional capital. Information provided by the BRSA indicates that all undercapitalized banks have plans under way for strengthening their capital positions. The relatively small size of most banks, relative to the industrial groups that own them, makes the raising of the new capital feasible. In addition, the fact that many bank owners have unlimited liability for losses in their banks due to connected lending operations makes it more unlikely that they will walk away from their banks even if they were to become insolvent. The authorities' strategy is thus to apply strict rules on the banks to recognize their capital deficiencies and maximum pressure on bank owners to recapitalize them—together with a clear message that banks will be taken over by the SDIF and the owners lose their stakes, if it becomes obvious that their planned recapitalization will not take place or a bank becomes insolvent or illiquid.

[1] Since the late 1990s, 13 commercial banks representing some 10 percent of total system assets have been taken over by the SDIF, and 3 investment banks have been liquidated.

circumstances. This way out is, however, made more difficult now by the increased level of the debt and by its shorter duration (taking into account the share of floating rate notes in total debt). But, over and beyond this difficulty, the authorities believe that it is in Turkey's best interest to avoid a return to high inflation rates, which would ultimately undermine Turkey's long-term growth prospects.

10. **The authorities' strategy is strongly based on market-orientation and openness to the world economy; it aims to strengthen domestic policies and resume the adjustment process with support from the international community and private sector involvement sufficient to ensure that the program is financed, and thereby restore confidence.** The strengthening of domestic policies aims at putting on stronger grounds the progress made since 1999 in the fiscal accounts and in key structural areas, while at the same time assigning to monetary policy the task of driving down inflation. It consists of:

- A renewed effort to eliminate structural weaknesses that had not been fully tackled by the 2000 program, particularly by strengthening governance and good economic management through a number of steps: (i) in **banking**, a deep financial restructuring of state and SDIF banks, measures to facilitate the participation of private capital in the strengthening of the private banking system, and a further improvement of supervision; (ii) in **fiscal transparency**, the enhancement of which is a key condition to strengthen the medium-term evolution of public finances; and (iii) in **increasing the role of the private sector** in the Turkish economy, including foreign capital.

- Additional **fiscal measures** to strengthen the primary fiscal position of the public sector in spite of the cyclical decline in revenues, reduce the immediate borrowing requirement of the government, and ensure the long-term sustainability of public debt even under more unfavorable real interest rate assumptions.

- A **monetary policy** centered, in the short run, on the pursuit of monetary aggregates, but shifting to a full-fledged inflation-targeting regime managed by an independent central bank.

- An effort to involve the social partners in the support of the program, including through **incomes policies** aimed at supporting disinflation and removing some of the existing distortions in the wage structure in the public sector.

11. **The above policies aim at making sure that economic fundamentals are fully consistent with a decline in interest rates and inflation. However, in the short run, a key catalytic role to facilitate this decline is expected to be played by the voluntary rollover agreement with banks in place since last December and other forms of private sector involvement (PSI), as discussed below, as well as by the availability of official foreign financing.** All this is expected to ensure that sufficient financing resources are available in the short run in the economy.

IV. The Authorities' Policy Program

12. **The authorities' policies are presented in the attached MEP**. Section B relates to structural policies to enhance the strength of the economy and provide a better environment for macroeconomic policies to play their role. Section C presents the program's fiscal and monetary policies. Section D focuses on social dialogue and incomes policies. More emphasis, which is reflected in the whole MEP, is put on providing clearer information on the program to the public. More specifically, the authorities are committed to a "new communication and openness policy" and they have already started recruiting communication experts for this purpose (¶5 of the MEP).

Structural policies for a stronger economy

13. **The structural policy agenda focuses on three key areas**: banking, fiscal transparency, and policies to enhance the role of the private sector in the economy. The common thread of these policies is an effort to enhance the efficiency of the economy through greater transparency, better governance, and a stronger regulatory environment. These actions are to be seen as part of more long-term reform programs, which the authorities will be preparing with the assistance of the World Bank.

14. **The highlights of the structural section of the MEP relate to the banking sector, which has been at the center of the recent crisis**. There are four main areas related to: (i) the restructuring of state and SDIF banks; (ii) the resolution of SDIF banks; (iii) the strengthening of private banking; and (iv) the legislative and regulatory environment. The overall goal is to remove the structural weaknesses that have been highlighted during the recent crisis.

- The restructuring of state and SDIF banks is urgently needed for several reasons. First, the presence on the market of banks with a negative net worth casts doubts on the whole banking system. Second, the overnight exposure of these banks had surged to unprecedented proportions (almost 8 percent of GNP in mid-March). Third, governance in these banks has been weak. To address these problems, a number of radical steps are being taken. **First**, the state and SDIF banks will be fully recapitalized with the provision of government securities (mostly floating rate notes in Turkish lira but also securities in fx so as to close their open fx position) bearing quarterly coupons, so as to meet their liquidity needs (¶10). In practice, this means that the government will stop financing its deficit through the state (and SDIF) banks.[2] **Second**, part of the securities received by state and SDIF banks from Treasury will be sold to the CBT and the proceeds will be used to repay the overnight debt of these banks towards the private sector (¶8). Two-thirds of the overnight exposure of state and SDIF banks will be eliminated before the completion of the current review, with the balance following within the next month.[3] In essence, this operation shifts from the state and SDIF banks to the CBT the management of this very short-term borrowing (as the CBT will mop up through reverse repos the liquidity injection related to the purchase of securities from state and SDIF banks). The CBT is in a better position to manage this borrowing at lower rates and longer maturities (the CBT has been mopping up the liquidity with reverse repos of up to two weeks maturity). One key challenge for the CBT in the months ahead will be to roll over the short-term debt, not an ideal situation for a central bank. However, with all interest payment on the government securities received from state and SDIF banks paid in cash by the Treasury, and taking into account the strong CBT profits expected this year, the stock of short-term borrowing by the CBT should shrink rapidly (Table 1).[4] **Third**, in preparation for their eventual privatization, the larger state banks (Ziraat and Halk) will be managed by professional managers, and will no longer be controlled by line ministers.[5] The managers will have to follow strict guidelines issued by their governing board, in consultation with the CBT, regarding the maturity at which they borrow (so as to avoid a

[2] The negative net worth of the state banks (that is their net liability towards the private sector) was in the past covered by an unsecuritized credit towards the government (the so-called *duty losses*) that did not yield cash receipts. Thus, the state banks had to borrow on the market whatever was needed to service their debt (which was indirectly a public debt). While this reduced the pressure on the government securities market, it increased the pressure on the bank deposit and repo markets. After the restructuring, the government will service in cash its securitized debt towards the state banks. The securities given to state banks will be sufficient for them to reach a capital adequacy ratio of 8 percent (moving from 0 to 8 percent only involves an additional cost of some US$½ billion as, with most of the assets being zero-risk government securities, the capital required for prudential reasons is low), as these banks are expected to remain on the market until they are privatized. The SDIF banks will have their negative net worth covered but will not have a positive capital, as they are expected to be resolved soon.

[3] Initially the CBT will acquire the securities from state and SDIF banks through repurchase agreements, but the bulk of these repos will be converted into outright purchases before the completion of the eighth review.

[4] Reducing this stock is a key priority for the authorities; to the extent possible, the deficit may be overfunded to facilitate the decline of the short-term borrowing of the CBT.

[5] A third (smaller) state bank (Emlak) will be merged with the largest state bank. The fourth (and smallest) state bank (Vakif) will be privatized rapidly (¶11)

return to excessive overnight borrowing) and their deposit rates, which will be kept below the rate on the treasury securities (their main source of income), so as to guarantee their profitability (which will be monitored under the program (¶10)). It is hard to assess the extent to which this new deposit rate policy will lead to a loss of deposits. The financial flows behind the program assume that the balance sheet of these banks will remain constant in nominal terms, so that their size in real terms will shrink. If these banks lost deposit in nominal terms, these would be met by sales of their government securities, but, in the program baseline, this is not expected to happen, once their overnight position—the most interest-sensitive component of their liabilities—has been shifted to the CBT.

- The resolution of the SDIF banks will proceed rapidly, in spite of the difficult conditions of the banking market. Of the thirteen banks taken over by the SDIF since 1997, **four** have already been closed (and are being downsized as part of Sümerbank, a first transition bank; ¶12), and **four** more are expected to be closed by mid-May (including through a second transition bank; ¶13). **Three** more banks are in the process of being sold (¶3). The **two** transition banks are expected to be sold, put into liquidation, or otherwise resolved by end-2001. Arrangements to facilitate the collection of nonperforming loans of these banks—which are critical to minimize the cost to taxpayers of the restructuring of the banking system—are described in ¶14.

- Private banks are also expected to strengthen their capitalization, while the government guarantee on their liabilities, which has now been put on firmer legal grounds (¶15), is in place. Cash dividend distribution has been suspended and banks are agreeing with the BRSA on recapitalization plans. The tax deductibility of loan loss provisions will facilitate a proper provisioning by banks. Finally, tax laws are being modified to facilitate the restructuring of private banks through mergers.

- The banking law and bank supervision regulations will be further amended in a number of aspects (¶16–17), the most important of which are the gradual application of connected lending limits on a consolidated basis, the strengthening the debt recovery powers of the SDIF, and the introduction, as of 2002, of international accounting standards. The legal system is also being reviewed in order to identify improvements in foreclosure and bankruptcy laws (¶18)

15. **A second critical area is fiscal transparency**. The program included from its inception measures in this area and a fiscal ROSC was completed in the summer of 2000. Some of the commitments in the attached MEP simply reaffirm the commitments undertaken in the December LoI (such as the closure of budgetary and extrabudgetary funds). But there are also new commitments, including: the drastic reduction in the number of the so-called *revolving funds* (see definition in ¶19), a further improvement in the information made public on the fiscal accounts in their broader sense (so as to allow a better scrutiny by Parliament and the public opinion), a new procurement law, and steps to enhance governance and fight corruption.

16. **The third area relates to privatization and, more generally, an increased involvement of the private sector in the Turkish economy.** This is another area that had featured in the 2000 program, but slippages had emerged, partly because of poor market conditions, partly because of delays and less than full commitment to privatize. These delays had also reflected excessive political control of the enterprises to be privatized. A number of steps to remove obstacles to privatization are being taken. However, there is a change in emphasis. The new strategy envisages a stronger effort on the side of the authorities to put Turkey in the best position to privatize its public enterprises. However, acknowledging that market conditions may not be in the immediate future favorable to fast privatization, the expected privatization receipts for this year have been lowered from US$6 billion in the December 2000 program to US$3 billion (of which, US$2 billion have already been cashed, as they refer to 2000 privatization deals). Key steps in this area relate to:

- Turk Telekom, Turkey's headline privatization operation (¶21). The authorities have now decided on a series of legal and administrative steps to improve the management of Turk Telekom, including legally allowing the full privatization of the company,[6] and changing the composition of the privatization committee (which had not worked effectively). Moreover, the company will be corporatized ahead of its privatization, and competition in the telecommunication sector will be increased.

- Three laws to reform the sugar, tobacco, and natural gas markets and sell the state enterprises that now operate as monopolies.

- The electricity market, where the generation and electricity distribution companies that will not be handled through transfer of operating rights by end-June will be privatized.

- A number of steps, to be taken over the next few months, to facilitate FDI (¶22). While these are important—particularly the approval of the law fully implementing the constitutional amendment on international arbitration enacted in 1999—a recent study prepared by the Foreign Investment Advisory Service of the IFC/World Bank shows that there are no major legal or administrative impediments to FDI, and that the main obstacle is macroeconomic and political instability. Even assuming that the program is fully successful it may take some time before FDI responds to the improved macroeconomic environment, and conservative assumptions have been made in projecting FDI over 2001–02.

[6] It would be against the constitution to sell more than 50 percent of Turk Telekom to a foreign investor. However, foreign investors could hold the majority in a consortium that took control of Turk Telekom.

Macroeconomic policies

17. **Fiscal policy will be further tightened to help face the increased interest burden of the government and facilitate a decline in interest rates.** The extent of the fiscal adjustment is highlighted by the table below (see also Table 3 of the MEP).

Primary Surplus of the Public Sector
(In percent of GNP)

	1999	2000	2001			2002
			Original Program	Revised Baseline 1/	Target	Target
Central government	1½	4½	5½	2¾	5	5½
Other	-3½	-1¾	-½	-½	½	1
Total	-2	2¾	5	2½	5½	6½
Memorandum item:						
Real GNP growth rate	-6.1	6.1	3.7	-3.0	-3.0	5.0

1/ The revised baseline is based on the revised macroeconomic framework after the February 2001 crisis. It assumes that revenues and expenditures are adjusted in line with the revision in inflation. The new fiscal measures introduced as part of the strengthened program are not included.

The original 2001 program envisaged an increase in the primary surplus of the public sector from 2¾ percent of GNP to 5 percentage points of GNP, thus requiring the introduction of additional fiscal measures amounting to over 2 percentage points of GNP. Because of the weakening of economic activity (some 7 percentage points below the original baseline), the primary surplus would be projected to fall to 2½ percentage points of GNP. The new target for 2001 is 5½ percentage points of GNP, requiring the introduction of additional measures amounting to 3 percentage points of GNP. This is a massive fiscal effort. Altogether, between 2000 and 2001, the government will have introduced measures amounting to 5 percentage points of GNP (in addition to the almost 5 percentage points of GNP adjustment implemented between 1999 and 2000).

18. **Most of the increase in the primary surplus of the public sector targeted for 2001 (2¾ percentage points) is due to expenditure cuts.** While some revenue measures were implemented in December and are to be implemented ahead of the Board meeting (¶30), the revenue ratio for the central government is declining somewhat, reflecting inter alia the severe effect of the crisis on the profit taxes. However, this is more than offset by major cuts in primary expenditure, with the primary spending of the central government targeted to decline by 1 percentage point of GNP, or 8 percent in real terms (after adjusting for the expenditure of one extrabudgetary fund included in the 2001 budget). These cuts reflect

prudent wage and employment policies, and reductions in investment spending and in other current spending (including security outlays; ¶31 and Table 2).[7] Moreover, the primary deficit of the state enterprises is targeted to fall by 1½ percentage points of GNP, owing to draconian cuts in real wages of the workers in this sector (see below), and increases in public sector prices (including electricity) which had not covered production costs in 2000 (¶32).

19. **Finally, the fight against tax evasion will be strengthened**. While the program's projections do not include any revenue from increased collection efficiency, the rolling out of tax identification numbers (the base for any modern tax enforcement system) will be accelerated (¶34), together with the collection of tax arrears.

20. **The MEP also includes detailed discussions of debt management in 2001–02** (¶37–¶39). The forms through which public debt, in its broader definition, is managed in Turkey will undergo a dramatic change in this period. As noted, the management of public debt will be centralized, with the Treasury servicing the net debt of the state and SDIF banks to the private sector (consequently, the amount of securities that will have to be issued will increase significantly). The availability of external financing will reduce, *ceteris paribus*, the amount of government securities in circulation, so that the auctioned debt-to-GNP ratio is not expected to increase in 2001 (Table 3). However, it will rise significantly in 2002 and 2003, but this will be more than offset by the decline in percent of GNP of the value of the securities transferred to state and SDIF banks.[8] The immediate task of the Treasury will be to lengthen the maturities, including through possible voluntary debt swap operations. Additional possible steps in this area are discussed in ¶39.

21. **Monetary policy is to continue the task of reducing the rate of inflation within a flexible exchange rate framework**. The authorities intend to introduce, as early as possible, a formal inflation-targeting framework (¶42). As a first step, key amendments to the CBT law

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[7] These savings arise to a large extent from the fact that 2001 expenditure will not be raised in line with the revision in inflation, following the crisis. The new budget raising expenditure allocations has not yet been sent to Parliament, but expenditures continue to be capped by the tighter expenditure ceilings under the old budget. The authorities are committed to have the budget amendments approved before the completion of the eighth program review.

[8] The increase in the auctioned debt ratio over the medium term is simply a reflection of the progressive centralization of public debt, and should not be seen as an obstacle to the decline in interest rates. What matters, from this perspective, is the fact that the public debt ratio is expected to decline under the program. As explained above, the fact that all the government securities held by state and SDIF banks will be serviced in cash implies that these banks will no longer need to borrow on the market to service their debt, and this will free financial resources to buy government paper.

have been introduced to give independence to the CBT in pursuing its primary goal of maintaining price stability.

22. **The shift to inflation targeting, however, cannot be immediate**. While the preparatory work has been ongoing for a while, it will take some time for the CBT to improve its inflation forecasting techniques and set up the procedures for the implementation, transparency, and accountability of monetary policy that are a key component of this framework. Public opinion also needs to be prepared to understand the meaning of central bank independence and inflation targeting. Moreover, the CBT is understandably hesitant, in this phase of great uncertainty on short-term inflation movements and still unsettled financial market conditions, to take up the formal responsibility for achieving a specific inflation target.

23. **In the *interim*, the CBT will focus on the control of monetary aggregates.** The indicative target set for base money (47 percent December2001/December 2000) reflects some expected increase in the velocity of cash in circulation. There is a large margin of uncertainty around these projections, though, as money demand in Turkey has been difficult to predict. On this account, the indicative base money ceilings are expected to be closely scrutinized during the program reviews. Moreover, the CBT is also committed to follow other inflation indicators (one key feature of the forthcoming inflation targeting framework). In particular, it will stand ready to raise interest rates—even if base money is close to its target—in response to developments that jeopardize the disinflation process (¶43).

24. **The sources of base money creation will depend, at least in part, on how rapidly confidence is restored**. While an accumulation of some US$2½ billion during the balance of 2001 is projected, the program's NDA ceilings and the NIR floors give the CBT the possibility of using a large component of the foreign exchange resources available under the program to provide liquidity to the economy and support the government paper market (for example, by purchasing government paper from the secondary market and mopping up the Turkish lira liquidity through sales of foreign exchange) in case confidence is not immediately restored (¶43). A balance of payments scenario consistent with the use of external financing for this purpose is presented in Tables 4–5 (see also Section VII).[9] The MEP, however, contains a clear commitment to use the external financing for reserve accumulation, if confidence is rapidly restored and interest rates fall more rapidly than projected in the program. In this case, NDA would remain well below the program's ceilings.

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[9] Part of these capital outflows featuring in this scenario also reflect the need of the banking system to cover their on-balance sheet open position by increasing their holdings of high foreign exchange quality assets. This would allow banks to reduce their cover through forward contracts, which have a high counterpart risk.

25. **The foreign exchange resources will in no case be used to support any specific exchange rate target or target range** (last bullet of ¶43). The sale of foreign exchange to the market will occur primarily through auctions.[10] It is, however, likely that sales of foreign exchange under the program will, ceteris paribus, strengthen the Turkish lira, leading to a faster stabilization of inflation, and a decline in interest rates.

Incomes policies

26. **Incomes policies are also being strengthened**.

- The 2000 program used the wages of **civil servants** (the some two million "white collars" in the public sector) as one of the program's nominal anchors. Wages were set at the beginning of each semester in line with targeted inflation. However, a catch-up clause allowed an adjustment in wages, should inflation exceed the target. This policy—while breaking with the past practice of backward indexation[11]—provided only a short-term anchor. It would have been, however, difficult to follow a different approach as the level of civil servants' wages was very low, by historical standards, at end-1999, and it has remained low (currently below the 1990 level in real terms). The policy of ex ante increases in line with targeted inflation, coupled with ex post adjustments if the target is overshoot will continue in 2001 (¶ 31).

- There will be instead a major change for the wages of the so-called **"public sector workers"** (some one-half million blue collars in the state enterprises, but also in other components of the public sector). Reflecting generous contracts signed in the spring of 1999, their real wage has increased by a cumulative 40 percent in 1999–2000. Consequently, their relative wage with respect to that of civil servants has increased rapidly over the last two years (to 2.6 in 2000). The authorities intend to reduce this ratio to some 2.1 in 2001 and to 2.0 percent in 2002 (¶45). This will involve cuts in real terms by some 20 percent in the first year, with some further cuts in 2002. The indexation mechanism will also be innovative. No indexation, nor ex post catch-up, is expected for the first six months, while in the remaining 18 months of the contract, there will be an ex post catch-up, but only partial (¶45).

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[10] Part of the external support to the program (such as World Bank financing) will accrue directly to the Treasury. The Treasury cannot legally sell this foreign exchange directly to the domestic market, as it is constrained to sell any foreign exchange to the CBT. The latter, however, is expected to act as an agent, selling in its turn on the market the foreign exchange that the Treasury wishes to convert into domestic currency.

[11] If backward indexation had been applied since the beginning of the program, civil servants' salaries in March 2001 would be 24 percent above their actual level.

- The program also envisages a more active role of the government in incomes policy discussions with the **private sector**. This was a major implementation failure during 2000, and the authorities intend to be more active in this area. The new Minister of the Economy has already started more intense consultations with the social partners. Moreover, a law approved in April has given an institutional backing to the previously informal (and rarely convened) Economic and Social Council, which will become the main forum for incomes policy discussions (¶46).

- The authorities are also considering how the social safety net can be enhanced, in cooperation with the World Bank (¶47).

V. The Role of PSI

27. **The private sector is involved in many aspects of the resolution of Turkey's crisis**. In order to maintain their ownership and control of their banks, shareholders are being forced to raise additional capital. The recapitalization of the intervened banks, while intended to allow the banks to continue operations and to protect depositors, in no way sheltered the original shareholders from shouldering the losses. The sovereign guarantee on the on- and off-balance sheet liabilities of the banking system limited the risks borne by depositors and foreign commercial bank creditors. The rationale for the guarantee, however, was to stabilize confidence in the financial system at a moment of severe crisis, and thereby contain the risk of wholesale capital flight.

28. **More broadly, private investors have generally not been protected from the impact of the crisis**. The government has allowed the corporate sector to independently carry the burden of a depreciated exchange rate and high interest rates on their balance sheets.[12]

29. **It is also important that the macroeconomic vulnerabilities associated with private sector financing of government debt be managed carefully**. As interest rates decline and market conditions improve, the government should seek to lengthen the maturity of its debt both in terms of new debt issues in the auction market and through liability management. This will help to provide assurances that any temporary interruption in debt sales does not become a full-blown crisis.

30. **The involvement of foreign creditors has also generally been maintained.** Eurobond redemptions have not been excessive. On the contrary, the government was able to place a €0.7 billion bond with European retail investors in January. There has been a reduction in commercial interbank lines, as described in Box 3, mostly resulting from the

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[12] An exception is the limited extension of credit subsidies to small businesses discussed above.

Box 3: PSI—Maintenance of Interbank Exposures

A particular vulnerability of the Turkish banking system is its reliance on very short-term funding, including from foreign banks. During the November 2000 crisis the withdrawal of short-term interbank loans by foreign banks was a major contributor to the pressure on the exchange rate and the loss of foreign exchange reserves by the central bank, thus emphasizing the important role of a stable external funding base for Turkish banks in any future set of policies.

Accordingly, on December 11, 2000, following meetings in Frankfurt and New York between the Turkish authorities and major foreign bank creditors, foreign banks made a voluntary commitment to maintain aggregate exposure to the Turkish banking system in the form of interbank and trade related credit lines in existence at December 11. This commitment was intended to complement the catalytic effect of the revised Fund arrangement approved earlier that month, and the agreement of foreign banks was facilitated by the government's sovereign guarantee of the liabilities of Turkish banks. In order to monitor adherence to the agreement, the CBT has been collecting daily data from Turkish banks on changes in their liabilities to foreign banks, and this data is reported to the Fund and, via Executive Directors, to the central banks and supervisors of the foreign banks concerned. At the Frankfurt and New York meetings, foreign banks were also asked to maintain exposure on trade lines provided directly to the nonfinancial corporate sector (although this aspect has not been monitored.)

Until late January there were encouraging signs that this combination of a catalytic approach and accompanying maintenance of bank lines was bearing fruit. The Turkish government was able to place a €0.7 billion bond with European retail investors, and aggregate foreign bank exposure to the Turkish banking system was maintained. However, the foreign banks' commitment had been conditional on there not being a recurrence of macroeconomic and financial instability in Turkey and on continued maintenance of exposure by each other. When the February crisis developed, banks gradually withdrew $3 billion of exposure (which had amounted to around $18 billion at the time of the original commitment). Since early March the level of exposure has stabilized at around $15 billion, thus indicating that the continued loss of foreign exchange reserves during March was not caused by further withdrawals of interbank funding by foreign banks.

The authorities have initiated contact with the banks that are responsible for most of the outflows during the crisis. This information has also been provided to these banks' central banks and supervisors. More generally, the authorities plan to meet with foreign banks to obtain agreement to restore exposures to the December 11, 2000 level and to reinstate the commitment in stronger form, in order to complement the provision of additional Fund resources.

unwinding of positions based on carry trade. The authorities have recently consulted with the foreign commercial bank creditors, seeking a renewed commitment both to reconstitute exposure to the level of December 11, 2001 (the date of the earlier agreement with the banks) and to maintain that level.

31. **Looking to the future, it is critical that the operation of domestic financial markets should be put on a footing that promotes sound financial practices, including proper assessment of risk, and provide mechanisms to resolve individual problems that may arise**. To this end, the staff attaches great importance on measures to ensure the effective supervision of the Turkish financial system, as well as ensuring that difficulties that may arise in the corporate sector be resolved in an efficient and expeditious fashion (including through a possible revision of foreclosure and bankruptcy laws; ¶18).

VI. The Program's Macroeconomic Baseline and Risks

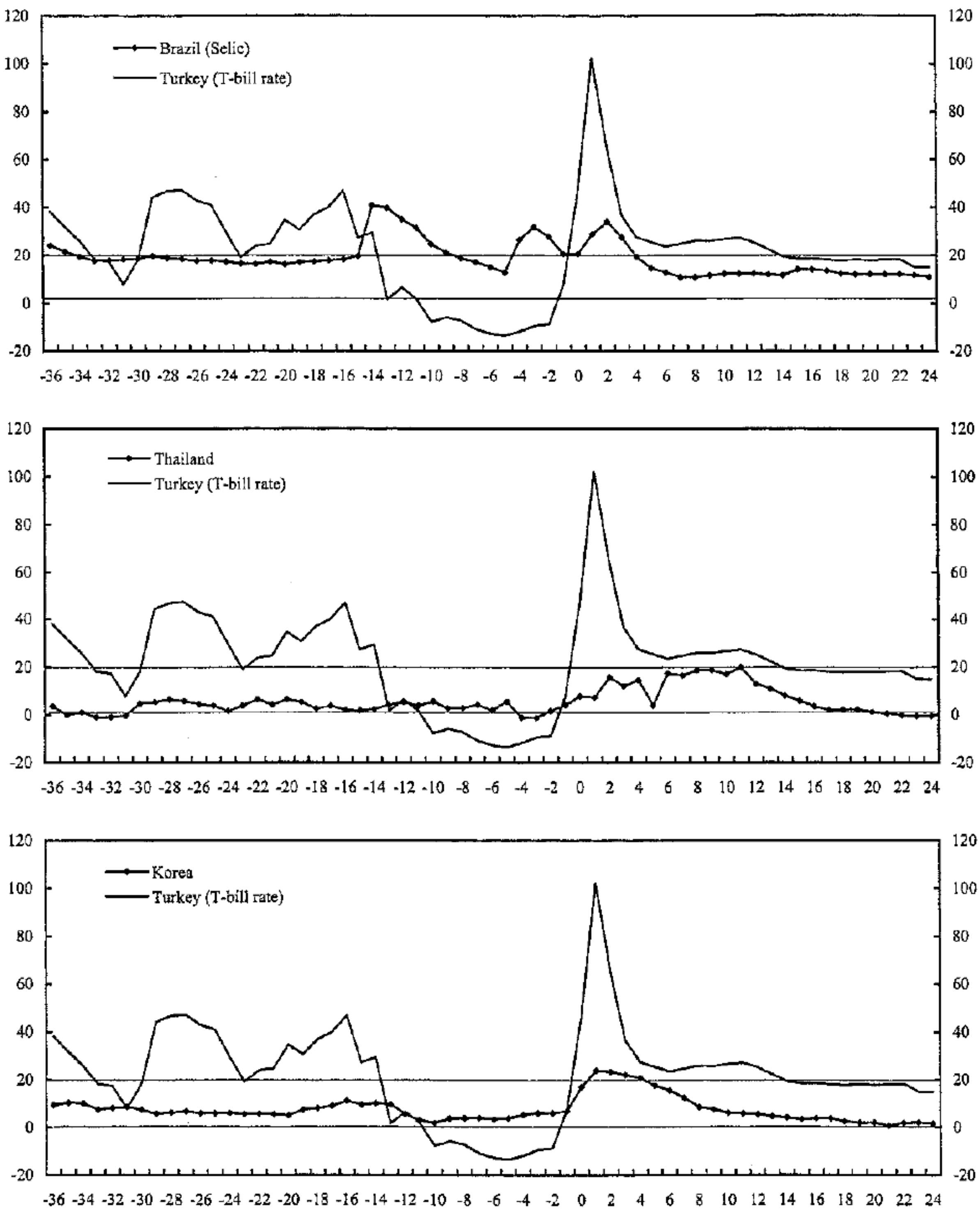
32. **The program baseline envisages a gradual but steady improvement in economic conditions as a result of the program's policies and the availability of foreign financing**.

- **Real interest rates**, deflated by targeted CPI inflation, are expected to fall from some 65 percent in mid-April to some 25 percent in December, edging down further in 2002 (to some 20 percent on average). These real interest rates projections are based on the experience of other countries (e.g., Brazil) plus a sizable margin to reflect differences in the starting situation, notably as regards inflation and the strength of the banking system (8–10 percentage points; Figure 6).

- **GNP growth** (-3 percent for 2001; ¶3 and Table 3) is expected to be negative in the first two quarters of 2001, but a turnaround is projected for the third quarter, reflecting the recovery of exports (as the effects of the devaluation take hold), in tourism (there are strong indications that the tourism season will be a record one), and the projected decline in interest rates. The recovery is expected to continue in 2002 and 2003 with annual growth rates of 5–6 percent. While estimates of potential growth and the output gap for Turkey are not very reliable, these growth rates seem to be consistent with a gradual absorption of the existing output gap, and are indeed lower than those experienced by Turkey following the 1994 crisis.

- The program projects CPI **inflation** at 52½ percent in 2001 (December/December). While the inflation rate over the next few months is very uncertain, the authorities intend to bring inflation to 2 percent per month by the last quarter of this year, and to lower inflation to 20 percent in 2002 (¶3). This decline should reflect the combined effect of: (i) a monetary policy focused on limiting the growth of base money; (ii) some appreciation of the nominal exchange rate, following the initial overshooting, as confidence is restored and external support flows in; (iii) the overall effect on inflation expectations of the policy strengthening; and (iv) wage and price moderation as a result of more active consultations with the social partners.

Figure 6. Turkey: Real Interest Rates (Deflated by 12-month ahead CPI inflation) 1/



Source: International Financial Statistics; and Fund staff projections.

1/ Month 0 corresponds to March 2001 for Turkey, January 1999 for Brazil when the Real was floated, July 1997 for Thailand, and December 1997 for Korea.

- The **external current account balance** is projected to improve markedly, as a result of the recession, and, to a lesser extent, of increased competitiveness and an acceleration of exports (it will take some time before the effect on the latter of the real devaluation if fully felt).[13]

33. **The above developments crucially hinge on the return of confidence ensuring the sustainability of public debt dynamics, which developments in early 2001 have put in question**. Even assuming a decline in interest rates over the balance of 2001, the public debt-to-GNP ratio is projected to rise by 20 percentage points of GNP in 2001 (17 percentage points using centered GNP[14]). However, this rise was due, to a considerable extent, to temporary factors. Indeed, looking ahead, fiscal sustainability would be ensured, even at relatively high interest rates.

- The rise in the debt ratio in 2001 is in part due to temporary factors—the real devaluation (the effect of which is equal to some 3 percentage points of GNP), the inclusion in the public debt figures of debt components previously not included (amounting to some 6 percentage points of GNP),[15] the decline in GNP (about 2 percentage points) and the exceptionally high level of real interest rates in the first quarter of 2001, which inflated the losses of state and SDIF banks.

- Taking also into account privatization revenues, the public debt ratio (using centered GNP) is actually projected to decline by a cumulative 8 percent by end-2003 (see Box 4 for an analysis of the factors behind the decline in the debt ratio).

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[13] The projections assume a real depreciation of some 16 percent in 2001, using the CPI-based real exchange rate.

[14] In countries with high inflation the conventional measurement of the debt-to-GNP ratio is distorted by the fact that the stock of debt is measured at end-year, while GNP is measured as a flow, and therefore reflects the average price level. Thus, the standard measure tends to overestimate the rise in the debt ratio when inflation accelerates (as the denominator of the ratio lags behind the numerator), and vice versa. One simple way to correct for this bias is to use measures of GNP that is centered around the end of the year.

[15] While the public debt figures included fully the negative net worth of the state banks at end-2000, the SDIF banks, after the injection of securities in November, still had a negative net worth. Moreover, the negative net worth of one state bank (*Emlak*) was not included. Finally, the end-December public debt data did not include the negative net worth of the private banks taken over in early 2001 (nor the contingency for the possible additional bank recapitalization costs during rest of 2001).

Box 4. Why the Public Sector Debt Ratio Declines in 2002

The net public debt-to-GNP ratio is projected to drop by about 8 percentage points in 2002 (Table 3) in spite of very high real interest rates on treasury bills in 2001 (36 ½ percent) and 2002 (20 percent).[1] Based on the debt sustainability analysis referred to in the text of the staff report, real interest rates at this level should involve an increase in the debt ratio, given the targeted primary surplus. Why does the public debt ratio fall instead of rising?

There are several reasons for this. **First**, half of the decline is accounted for by a well-known statistical bias that occurs in high inflation cases. Conventional debt-to-GNP ratios (based on end-year debt stock over annual GNP) tend to overstate the rise in debt when inflation accelerates following a devaluation (as in 2001), and thus overstate the fall when inflation decelerates. The reason is that the end-period debt stock fully reflects the jump in inflation and the exchange rate, while the annual GNP figures "lag behind." One simple way to correct for this bias and provide a better indicator of the dynamics of public debt is to use a measure of GNP that is centered around the end of the year. According to this measure, the debt ratio drops by 4¼ percentage points, from 68 percent in 2001 to 63¾ percent in 2002 (Table 3). **Second**, part of the decline in the debt ratio is accounted for by privatization proceeds (some 1¾ percent of GNP). **Third**, seignorage projected for 2002 is high relative to that expected over the medium term. **Fourth**, the real effective interest rate on public sector debt in 2001-02 will be well below the real rate for treasury bills.

There are three reasons why the real effective interest rate in 2001-2002 is lower than the treasury bill rate. **First**, a large portion of public debt is denominated in foreign exchange and thus has to be serviced at fx dollar interest rates, which are well below the domestic real interest rates in 2001-02. The share of net public sector debt linked to foreign exchange will be about 45 percent at end-2001. The average interest rate in U.S. dollar terms in 2002 on the total stock of external and fx-linked domestic debt is projected at about 8½ percent (taking into account official lending). **Second**, the share of floating rate notes in TL-denominated domestic debt of the central government will reach about 75 percent by end-2001. This component of debt reacts rapidly to the decline in interest rates projected under the program, thus reducing the expected effect on interest payments in 2002 of higher interest rates in 2001. **Third**, borrowing at fixed interest rates in 2001 year will be disproportionately concentrated in the post-crisis period when interest rates are expected to be below the annual average. **Fourth**, all borrowing during February–April, when crisis interest rates prevailed, took place at short maturities to be repaid before end-2001, which are expected to be rolled over into debt-paying lower interest rates.

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[1] The level of interest rates in 2001 affects the deficit and debt figures in 2002 because of the lag between interest rates and interest payments for fixed coupon bonds.

- Leaving aside the specific developments in 2002-03, with a primary surplus of some 6 percent of GNP the debt dynamics would be unstable only for extremely high levels of real interest rates. Standard debt sustainability formulae (focusing on the trend behavior of the debt-to-GNP ratio) show that the debt ratio would not increase even for real interest rates on domestic debt as high as 20½ percent.[16]

- Maintaining a primary surplus at 6 percent over the medium term may be demanding. On the other hand, there is no reason why real interest rates on domestic debt should remain at 20 percent over the medium term once the economy has stabilized (high inflation and exchange rate volatility have been regarded as the main reasons for high real interest rates in Turkey). To illustrate this, Table 6 presents a long-term scenario in which a gradual decline in real domestic interest rates is accompanied by a gradual decline in the primary surplus, while at the same maintaining the public debt ratio on a slightly downward sloping path.

34. **While the program is strong, there are some risks**:

- *There may be additional costs for bank restructuring*: This is indeed possible, taking into account the recession corporate risks, and the likely rise of nonperforming loans. However, the fiscal projection includes a sizable contingency that can be used to cover these costs if necessary.

- *Implementation risks are significant*: several critical actions have been or will be implemented before the completion of the current review—including the financial and operational restructuring of public banks, amendments in the banking law, a new CBT law, a new Turk Telekom law, and increases in tax rates and public sector prices. Nevertheless, the list of structural measures to be implemented during the rest of 2001 is

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[16] The following table shows the primary surplus that is needed to service stock of debt of about 60 percent for various real interest rate levels.

Primary Surplus Needed to Stabilize the Debt to GNP Ratio for Various Levels of Real Interest Rate

Real Domestic Interest Rate (In percent)	Primary Surplus (In percent of GNP)
11.8	3.0
13.3	3.5
14.7	4.0
16.2	4.5
17.6	5.0
19.0	5.5
20.5	6.0

Assumptions: Real growth: 5 percent; seignorage: 0.5 percent of GNP; privatization proceeds: none; share of net foreign debt: 40 percent; and real interest rate on net foreign debt: 10 percent.

not a short one (Table 2 of the MEP). Moreover, the attainment of the ambitious fiscal targets for 2001 depends on strict program implementation. Two aspects are particularly important: first, the contract for public sector workers; second, the expenditure cuts envisaged in the post-crisis period. The new budget to be approved before the completion of the eighth review must be in line with the program's expenditure ceilings. At a more general level, the coalition government stands behind the economic program, as highlighted by the letter addressed to the Managing Director from the three coalition leaders. Finally, the high frequency of the program reviews (four more before end-2001) will allow a close monitoring of developments.

- *Inflation may not decelerate*: Inflation inertia has proved very strong in Turkey. Surveys of inflation expectations suggest that the government's inflation target is not regarded as unrealistic. Nevertheless, the risk of an inflation overshooting is not trivial. A relatively small overshooting is unlikely to be problematic in the context of a floating exchange rate. Problems may arise if there were a major overshooting (say, an inflation rate of 80–100 percent) as this would likely be associated with increased exchange rate and price uncertainty and, thus, in increased risk premia and high real interest rates. Such a large inflation slippage could, however, happen only in case of major deviations from program policies.

- *Interest rates may not decline as expected*: the decline in interest rates is critical to the success of the program. Problems in this area may arise not only as a result of domestic shocks but also of contagion from other emerging markets. There are some built-in safety margins, though. The interest rate path is cautious, based on the experience of other countries in successful post-crisis periods (see above). Moreover, the public debt ratio would continue declining in 2002 even if interest rates were some 15 percentage points higher (although this would largely reflect one-off privatization receipts).

- *Growth may fall short of expectations*: this is not a trivial risk, particularly if interest rates do not decline rapidly. The Turkish economy has, however, shown much resiliency in the past and the removal of the exchange rate overvaluation which had accumulated before the crisis (perhaps some 15 percent) should help in this respect.

VII. Augmentation of Access Under the SBA, Financing Needs, and Monitoring Issues

35. **Despite the sharp projected decline in its external current account deficit in 2001, the impact of the recent crises on Turkey's access to international capital markets will lead to an overall balance of payments deficit and an external financing gap that warrants Fund support in the form of augmentation of access under the SBA (Table 7).** Given Turkey's recession and the improvement in its international competitiveness following the float, a sharp turnaround in the current account deficit is expected—to just US$1 billion in 2001 from almost US$10 billion in 2000. However, the projected current account improvement is dwarfed by the projected worsening of Turkey's capital account given the

negative impact of the recent crises on Turkey's access to international capital markets. Portfolio flows and private sector bank and corporate sector financing from international sources are all expected to fall sharply this year. Also, private banks need to build up their foreign assets to close their open on balance sheet foreign exchange positions, which will further add to pressures on the capital account. With a projected capital account deficit of US$14.4 billion, the overall projected balance of payments for 2001 is expected to reach US$15.4 billion. Without strong international support, Turkey's reserves would plummet to dangerously low levels—already Turkey's reserves are just half of its short-term debt by remaining maturity. These payment difficulties generate an external financing gap estimated at $10 billion. The collapse of the Turkish lira unveiled severe structural weaknesses especially in the banking system. The ensuing balance of payments need is more of a medium-term nature and justifies Fund support on SBA terms. Moreover, Turkey is facing a demanding repayment schedule that would be exacerbated by providing resources of a much shorter-term nature. Relatedly, the ratio of reserves to short-term debt by remaining maturity is not set to begin increasing significantly until 2004—therefore favoring augmentation under the SBA rather than the SRF.

36. **Proposed augmentation of access under the program supported by the SBA is 660 percent of quota, equivalent to SDR 6,362.4 million, or about US$8 billion (Table 7).** This is substantially in excess of the normal access limit and is front-loaded in light of the exceptional circumstances surrounding Turkey's external crisis and the need to quickly regain market confidence and support. The financing gap is expected to be covered with resources from the Fund (US$8 billion) and the World Bank (US$2 billion). The purchase related to the sixth and seventh reviews (upon Board approval on May 15, 2001) under the new SBA/SRF-supported program amounts to 311 percent of quota, the two subsequent purchases in June 2001, and July 2001, are each equivalent to about 125 percent of quota, the September and November bi-monthly purchases are each equivalent to about 250 percent of quota, with the remaining purchases, beginning in 2002, and not affected by the augmentation request, each equivalent to about 23 percent of quota. While proposed Fund support is large and access is frontloaded, the strength of the program, the size of the financing needs, and the need to quickly restore market confidence argue for strong upfront support from the Fund.

37. **Notwithstanding the large Fund support, it is expected that Turkey will be in a position to discharge its obligations to the Fund in a timely manner**. Turkey's satisfactory record of payments to the Fund, the authorities' renewed commitment to a stronger reform program, and the likely gradual resumption of access to the international capital markets once confidence is restored, also provide assurances in this respect. Nevertheless, Turkey's obligations to the Fund will continue to be significant over the medium term, and the staff will pay particular attention to Turkey's continued capacity to repay the Fund in forthcoming reviews. Based on current projections, total Fund credit outstanding will peak at some SDR 13.6 billion at end-2001, or about 23 percent of public sector external debt (Table 8). It will also remain at high levels over the remainder of the program period—SDR 10.2 billion, or 18 percent of projected external public debt by end-2002—before declining to SDR 3.4

billion by end-2005. In terms of debt service capacity, peak projected payments to the Fund, including repurchases and charges, are projected to reach SDR 5.2 billion, or 12 percent of exports of goods and nonfactor services, in 2002. And, while projected obligations to the Fund are set to decline in 2003 and 2004, in 2005 and 2006 obligations again are set to increase to SDR 4.5 billion and SDR 3.3 billion respectively, or about 8 percent and 6 percent of projected exports.

38. Given the ongoing need to evaluate risks to the program at a high frequency, **performance under the program will be monitored through monthly reviews until July, with bi-monthly reviews until November and quarterly reviews thereafter**.

VIII. Safeguards Assessment

39. **Under its SBA with the Fund, Turkey is subject to the transitional procedures governing safeguards assessments.** These procedures require the CBT to publish annual financial statements that are independently audited in accordance with internationally accepted standards (the "external audit"). In July 2000, as part of the safeguards assessment process, the authorities formally committed to publish externally audited financial statements of the central bank for the fiscal year ended December 31, 2000. In a letter dated October 5, 2000, the authorities advised that a member firm of *Deloitte Touche & Tohmatsu* has been appointed to audit the central bank's financial statements for the first time. The audited financial statements are expected to be published no later than June 30, 2001. Pursuant to the safeguards framework, staff will undertake an assessment of the quality and effectiveness of the external audit to ascertain that it meets internationally accepted standards.

IX. Staff Appraisal

40. **In February 2001, Turkey suffered the second major financial crisis in a short time.** The legacy of the recent crises has been a sharp rise in real interest rates and a massive increase in Turkey's indebtedness. The very high real interest rates observed so far in 2001 imply totally unsustainable debt dynamics. To restore confidence, the authorities need to bring real interest rates down to convince markets that the fiscal outlook is sustainable.

41. **Turkey's new economic team has put together a strengthened program to address the root causes of the country's problems.** The revised program aims at cushioning the short-term macroeconomic impact of the recent turmoil, while laying the foundation for the resumption of disinflation and growth. To achieve these goals, the authorities have adopted a three-pronged strategy: (i) structural policies to correct the distortions underlying the crises, enhance transparency in economic management, and improve governance in both the public and private sectors; (ii) fiscal and monetary policies to restore financial stability and facilitate disinflation; and (iii) a strengthened social dialogue to promote wage moderation and social protection.

42. **The program's structural policies are geared toward a fundamental change in the way business is done in Turkey.** A major bank restructuring will be implemented. To ensure that past problems do not recur, the recapitalization to erase the negative net worth of banks under government control will be accompanied by measures to enhance governance in both public and private banks. Fundamental improvements are also needed in other sectors of the economy. Fiscal transparency will be increased, and the role of the private sector in the economy will be strengthened through the removal of obstacles to privatization and promotion of foreign direct investment.

43. **The program includes a major fiscal adjustment effort**, necessary to help finance the additional interest costs arising from the increase in debt. The fact that the authorities are ready to implement such a tightening at a moment of declining economic activity shows their full commitment to restoring fiscal sustainability and thereby confidence as the only way to support a steady economic recovery. While a significant part of the adjustment is implemented upfront, vigilance is required throughout the program period to meet the fiscal targets.

44. **Monetary policy will pursue disinflation under a floating exchange rate framework.** While the float removes a powerful anchor, monetary policy will be anchored by the program's quantitative ceilings and, over the medium term, by a full-fledged inflation-targeting framework. A strict implementation of the program policies over the coming period will be critical in enhancing the credibility of the independent CBT and, in this way, in facilitating the shift to inflation targeting.

45. **The authorities' commitment to a strengthened social dialogue is welcome.** The Economic and Social Council is being revitalized to promote this dialogue, which should be aimed at facilitating moderation in wage and price increases.

46. **While the program envisages very strong domestic measures, its success also requires adequate external financing and PSI.** In the staff's judgment, the additional financing from the Fund and the World Bank that the authorities have requested is necessary not only to fulfill financial requirements but also to reassure markets. To further boost confidence, the program includes several elements of voluntary PSI, in line with the authorities' strong preference for market solutions. The authorities need to pursue these elements vigorously, as doing so could reduce reliance on external official financing in the period ahead.

47. **The strength of the program notwithstanding, risks remain.** In the aftermath of a major crisis, estimating the impact of a thorough-going change in policies is bound to be subject to large margins of error. Thus, interest rates could decline more slowly than expected, inflation inertia could prove strong, the recession could be deeper than envisaged, and the costs of bank restructuring could still rise. The main risk, however, relates to implementation. The two recent crises have severely weakened confidence. To restore it, it is imperative for the authorities to implement program commitments fully and on schedule.

48. The staff recommends that the Board approve the authorities' request for the completion of the sixth and seventh program reviews, the augmentation of access to Fund resources under the SBA, and the waivers of the relevant performance criteria. The proposed arrangement with the Fund is being submitted to Executive Directors under the emergency financing procedures, with access under the exceptional circumstance clause. The staff believes that the strength of the proposed policy program and the size of the financing requirement justify the requested access. Turkey's new economic team is strongly committed, and Turkey's political leaders have expressed their full backing to the strengthened program. A large number of key measures have already been implemented. With continued strict implementation, the program has a good chance of restoring confidence and lowering real interest rates quickly.

Table 1. Turkey: Central Bank Balance Sheet, 1999-2003
(End-of-period stocks, in trillions of Turkish liras) 1/

	1999	2000	2001				2002	2003
			Q1	Q2	Q3	Q4		
	Act.	Act.	Act.	Prog.	Prog.	Prog.	Prog.	Prog.
Net foreign assets	**7,803**	**7,598**	**9,014**	**3,393**	**425**	**-2,679**	**3,752**	**9,900**
Net international reserves	12,349	12,480	14,454	9,686	6,781	3,928	11,495	18,595
Other foreign liabilities (net)	4,546	4,882	5,441	6,293	6,356	6,607	7,743	8,695
							30.3	17.5
Banks deposits in foreign currency	**2,992**	**4,295**	**7,858**	**9,069**	**9,160**	**9,522**	**12,407**	**14,578**
Required reserves	2,039	2,530	3,647	3,904	3,943	4,099	5,341	6,276
Free reserves	952	1,766	4,212	5,165	5,217	5,423	7,066	8,302
			4,422					
Net domestic assets	-932	**2,485**	**4,422**	**11,704**	**15,272**	19,483	**17,488**	**14,795**
Net domestic assets (excluding devaluation account)		*3,360*	*5,803*	*13,248*	*16,809*	*20,994*	*19,293*	*17,471*
Claims on central government (net)	**-835**	**368**	**-748**	**19,173**	**22,225**	**25,665**	**27,645**	**29,306**
Of which: for the O/N operation		...	...	**14,700**	**14,700**	**14,700**	**14,700**	**14,700**
Claims on other public sector (net)	**-39**	**-333**	**-542**	**-542**	**-542**	**-542**	**-542**	**-542**
Claims on banks	**2,414**	**5,719**	**10,777**	**101**	2,161	**4,565**	**8,008**	**11,521**
Claims on SDIF and State Banks		4,583	12,567	7,000	7,000	7,000	7,000	7,000
Claims on other banks		1,136	-2,844	-6,899	-4,839	-2,435	1,008	4,521
FX lending		0	1,054	0	0	0	0	0
Other items (net)	-2,473	**-3,269**	**-5,065**	**-7,027**	**-8,572**	**-10,205**	**-17,622**	**-25,489**
Other	-1,143	-2,393	-3,684	-5,483	-7,035	-8,694	-15,817	-22,813
Devaluation account	-1,329	-875	-1,380	-1,544	-1,537	-1,511	-1,805	-2,676
Base money	**3,879**	**5,788**	5,578	**6,029**	6,537	7,282	**8,833**	**10,117**
Currency issued	2,391	3,772	3,587	3,898	4,190	4,715	5,489	6,187
Bank deposits in liras	1,488	2,015	1,991	2,130	2,347	2,567	3,345	3,930
Required reserves	1,023	1,404	1,162	1,318	1,452	1,588	2,070	2,432
Free reserves	466	611	829	812	895	979	1,275	1,499
Memorandum items:								
Base money growth rate (unadjusted)	84.0	49.2				25.8	21.3	14.5
Base money growth rate (adjusted) 2/	84.0	35.8				47.0	21.3	14.5
NFA (in *millions* of US$)	14,499	11,311	8,531	2,968	368	-2,232	2,668	6,268
Of which:								
Gross reserves	24,274	23,206	19,478	19,712	21,798	21,093	21,593	23,993
International reserve liabilities	1,329	4,627	5,798	11,239	15,925	17,820	13,420	12,220
Of which: IMF	891	4,175	5,431	10,893	15,579	17,475	13,075	11,875
Other liabilities	8,446	7,268	5,149	5,505	5,505	5,505	5,505	5,505

Sources: Central Bank of Turkey; and Fund staff projections.

1/ All foreign currency aggregates are valued at current exchange rates.
2/ Adjusted for the Bayram effect at end-2000 and the lowering of the reserve requirements in 2001.

Table 2. Turkey: Central Government Budget, 1997-2001
(In percent of GNP)

	1997	1998	1999	2000	2001	
				Est.	Orig. Prog. 3/	Program
Total revenue 1/	**19.3**	**21.0**	**23.2**	**25.4**	**26.0**	**25.0**
Tax revenue	**16.1**	**17.3**	**18.9**	**21.0**	**21.4**	**20.4**
Direct taxes	**6.6**	8.0	**8.6**	**8.6**	**8.3**	**7.1**
Personal income	5.1	6.5	6.3	5.0	6.0	5.4
Corporate income	1.3	1.4	2.0	2.0	1.7	1.2
Motor vehicle and wealth	0.1	0.1	0.2	0.3	0.3	0.2
Windfall gains tax	...	...	...	1.3	0.3	0.2
Indirect	**9.6**	9.2	**10.3**	**12.4**	**13.1**	**13.3**
VAT	5.3	5.1	5.3	6.7	7.5	7.2
Petroleum excises	2.2	2.0	2.9	2.6	1.9	3.0
Foreign trade (excl. VAT)	0.4	0.3	0.3	0.3	0.3	0.3
Other indirect (incl. excises)	1.7	1.8	1.8	2.9	3.3	2.8
Nontax revenue 1/	**3.1**	**3.8**	**4.3**	**4.3**	**4.6**	**4.6**
Budgetary and non-budgetary funds	1.9	1.7	2.0	1.8	1.9	1.7
Education levies	...	0.4	0.5	0.4	0.5	0.4
Revenue from state property 1/	0.7	1.1	1.2	0.9	1.0	1.0
Other non-tax revenue 1/	0.3	0.4	0.6	1.2	1.1	1.2
Annexed budget	0.2	0.1	0.1	0.1	0.2	0.3
Expenditure	**26.9**	**28.4**	**34.8**	**36.5**	**31.0**	**40.0**
Non-interest expenditure	**19.4**	**17.2**	**21.8**	**20.8**	**20.4**	**19.9**
Personnel	7.1	7.2	8.8	7.9	7.9	7.8
Other current	2.4	2.4	2.8	2.8	2.7	2.6
Transfers	8.0	6.0	8.4	7.9	7.5	7.4
Social security	2.6	2.6	3.5	2.6	2.8	2.8
Extrabudgetary funds	1.3	0.8	1.3	1.6	0.6	0.5
Agricultural subsidies	0.9	0.3	0.3	0.3	0.6	0.6
State participation (capital transfers)	0.6	0.1	0.2	0.2	0.1	0.0
Transfers to SEEs	0.4	0.3	0.5	0.7	0.5	0.5
Banks' duty losses / Credit subsidies	0.2	0.0	0.0	0.1	0.0	0.2
Tax rebates	0.0	1.0	1.5	1.3	1.0	1.1
Other transfers	1.2	0.8	1.1	1.1	1.8	1.6
Investment	2.0	1.7	1.8	1.8	2.2	2.1
Other unallocated earthquake expenditure	...	...	...	0.3	...	...
Primary balance 1/	**-0.2**	**3.8**	**1.5**	**4.6**	**5.6**	**5.1**
Net interest payments 2/	**7.4**	**11.2**	**13.1**	**15.8**	**10.6**	**20.1**
Overall balance	**-7.6**	**-7.4**	**-11.6**	**-11.2**	**-5.0**	**-15.0**

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

1/ Excluding privatization proceeds, interest receipts, and CBT profits.
2/ Excluding interest receipts and CBT profits.
3/ In percent of the original program's GNP.

Table 3. Turkey: Selected Indicators, 1999-2003

	1999	Prel. 2000	Proj. 2001	2002	2003
Real Sector					
GNP growth rate	-6.1	6.1	-3.0	5.0	6.0
GNP deflator growth (in percent)	55.8	51.6	49.4	28.3	16.5
WPI inflation (12-month, end-of-period)	62.9	32.7	57.6	16.6	12.4
CPI inflation (12-month, end-of period)	68.8	39.0	52.5	20.0	15.0
Average nominal T-bill interest rate	106.2	38.0	81.1	40.6	32.6
Average backward-looking T-bill real interest rate 1/	25.2	-11.4	23.7	6.9	13.2
Average forward-looking T-bill real interest rate 2/	32.0	-6.5	36.4	20.0	18.0
Central Government's Budget (in percent of GNP)					
Primary balance 3/	**1.5**	**4.6**	**5.1**	**5.6**	**5.6**
Net interest payments 4/	**13.1**	**15.8**	**20.1**	**19.2**	**16.1**
Budget balance	**-11.6**	**-11.2**	**-15.0**	**-13.6**	**-10.5**
Operational balance 5/	-4.0	-2.0	-0.6	-4.8	-2.5
Consolidated Public Sector (in percent of GNP)					
Primary balance of public sector	**-2.0**	**2.8**	**5.5**	**6.5**	**6.5**
Net interest payments 6/	22.1	21.9	22.6	16.2	13.5
PSBR (incl. CBT profits)	**24.2**	**19.1**	**17.1**	**9.7**	**6.9**
Operational balance 5/	**-12.4**	**-6.6**	**-3.2**	**-2.3**	**-0.1**
Net Debt of the Public Sector (in percent of GNP) 7/	61.0	**58.4**	**78.5**	**70.4**	**64.9**
Net external	20.1	19.7	34.2	28.3	23.5
Net domestic	40.9	38.8	44.3	42.1	41.5
Of which: Gross domestic debt of the central government	42.5	41.0	60.9	57.8	57.3
Of which: Auctioned debt	25.8	23.4	23.2	28.3	32.3
Net Debt of the Public Sector (In percent of centered GNP) 8/	48.6	**50.6**	67.9	**63.8**	**60.5**
External Sector					
Current account balance (in percent of GNP)	**-0.7**	**-4.8**	**-0.6**	**-0.9**	**-0.6**
Gross external debt (in percent of GNP)	55.0	56.6	66.2	59.6	56.8
Net external debt (in percent of GNP)	34.0	37.0	44.3	39.4	36.2
Monetary Aggregates					
Seignorage 9/	3.2	1.8	1.5	1.0	0.7
Nominal growth rate of broad liquidity	100.0	39.9	59.5	29.7	17.3
Privatization Proceeds (in millions of US$)	139	3,273	3,109	3,500	3,500
Net External Financing of Public Sector (in millions of US$)	1,417	4,134	-291	1,773	-938
Amortization	5,971	6,199	8,535	6,927	8,438
Gross borrowing	7,388	10,333	8,244	8,700	7,500
Of which: Eurobond issues	5,000	7,500	2,500	4,700	4,500
GNP (in trillions of lira)	78,283	125,971	182,439	245,814	303,626

1/ Average of monthly nominal T-bill interest rate divided by 12-month past CPI inflation.
2/ Average of monthly nominal T-bill interest rate divided by 12-month ahead CPI inflation.
3/ Excluding profit transfers from the CBT, interest receipts, and privatization proceeds.
4/ Interest payments minus interest receipts plus profit transfers from the central bank.
5/ Overall balance netted out of the difference between nominal interest payments and real interest payments.
6/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
7/ Gross public debt net of the net assets of the CBT.
8/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.
9/ Change in reserve money (currency issued plus reserve requirements) in percent of GNP.

Table 4. Turkey: Balance of Payments, 1998-2003
(In billions of U.S. dollars)

	1998	1999	2000	2001			2002	2003
				Q1	Q2-Q4	Total		
CURRENT ACCOUNT BALANCE	**2.0**	**-1.4**	**-9.8**	-0.6	-0.4	**-1.0**	**-1.7**	**-1.2**
Trade balance	-14.2	-10.4	-22.3	-2.2	-10.6	-12.8	-13.4	-14.2
Exports (fob)	31.2	29.3	31.2	8.0	26.1	34.1	36.5	39.3
Exports (fob) in trade returns	27.0	26.6	27.3	7.0	22.9	29.9	31.9	34.4
Shuttle trade	3.7	2.3	2.9	0.7	2.5	3.2	3.4	3.7
Imports (fob)	-45.4	-39.8	-53.6	-10.2	-36.8	-47.0	-49.9	-53.6
Of which: Energy imports (cif)	-4.5	-5.3	-9.3	-2.0	-6.1	-8.1	-7.5	-7.1
Services (net)	10.5	3.9	7.4	0.3	6.2	6.5	6.2	7.2
Services (credit)	25.8	18.7	22.3	4.1	19.1	23.2	24.4	26.0
Of which: Interest	2.5	2.4	2.8	0.7	2.2	2.9	3.1	3.2
Tourism receipts	7.2	5.2	7.6	0.9	7.5	8.3	8.6	9.1
Other receipts 1/	10.5	7.1	7.9	1.6	5.9	7.5	8.1	8.7
Services (debit)	-15.3	-14.8	-15.0	-3.8	-12.9	-16.7	-18.2	-18.8
Of which: Interest	-4.8	-5.5	-6.3	-1.9	-6.4	-8.3	-8.8	-8.6
Private transfers (net)	5.6	4.8	5.0	1.1	3.9	5.0	5.2	5.5
Of which: Workers remittances	5.4	4.5	4.6	1.0	3.6	4.6	4.8	5.0
Official transfers (net)	0.2	0.4	0.2	0.1	0.2	0.3	0.3	0.3
CAPITAL ACCOUNT BALANCE	**0.4**	**4.7**	**9.4**	**-4.4**	-10.0	**-14.4**	**6.6**	**4.9**
(including errors and omissions)	-1.5	6.6	6.8	-4.4	-10.0	-14.4	6.6	4.9
Direct investment 2/	0.6	0.1	0.1	1.0	-0.2	0.8	1.6	1.6
Portfolio investment in securities 2/	-6.1	0.2	-5.2	-2.0	-1.4	-3.3	1.5	1.5
Public sector (central & local governments & EBFs)	-1.9	1.2	6.2	0.2	-0.9	-0.7	2.6	-0.1
Bonds (net)	-0.3	3.1	6.1	0.4	-0.1	0.3	2.3	0.6
Disbursements	2.7	5.0	7.5	0.7	1.8	2.5	4.7	4.5
Repayments	-3.0	-1.9	-1.4	-0.2	-1.9	-2.2	-2.4	-3.9
Loans (net)	-1.7	-1.9	0.1	-0.3	-0.8	-1.1	0.2	-0.7
Disbursements	1.2	1.0	3.7	0.6	3.9	4.4	4.0	3.0
Repayments	-2.8	-2.9	-3.6	-0.8	-4.7	-5.5	-3.8	-3.7
Central Bank of Turkey (net)	0.7	-0.2	0.7	-0.2	0.2	0.0	0.9	1.0
Domestic money banks (net)	1.9	0.5	2.1	-1.9	-3.9	-5.8	0.1	0.5
Domestic money banks (FX deposits abroad, - accumulation)	-0.8	-1.8	-1.9	2.5	-3.3	-0.8	-0.5	-0.5
Domestic money banks (other, net)	2.7	2.4	4.0	-4.4	-0.6	-5.0	0.6	1.0
Domestic money banks (medium and long term, net)	0.5	0.2	-0.2	-0.7	-0.4	-1.1	0.1	0.3
Domestic money banks (short term, net)	2.2	2.2	4.2	-3.8	-0.2	-4.0	0.5	0.7
Other private sector (net)	5.3	2.8	5.6	-1.4	-3.9	-5.3	0.0	0.5
Other private sector (medium and long term, net)	4.2	2.3	4.9	-0.1	-3.2	-3.3	-0.8	-0.5
Other private sector (short term, net)	1.1	0.5	0.6	-1.3	-0.7	-2.0	0.8	1.0
Errors and omissions	-2.0	1.9	-2.7	0.0	0.0	0.0	0.0	0.0
OVERALL BALANCE	**0.4**	**5.2**	**-3.0**	**-5.1**	-10.4	**-15.4**	**5.0**	**3.6**
Change in central bank's gross reserves	0.2	5.9	0.3	-3.6	1.7	-2.0	0.5	2.4
IMF (net)	-0.2	0.7	3.3	1.4	12.1	13.5	-4.5	-1.2
Purchases	0.0	0.8	3.4	1.4	13.2	14.6	1.2	0.0
Repurchases	-0.2	-0.1	-0.1	0.0	-1.1	-1.1	-5.6	-1.2

Table 4. Turkey: Balance of Payments, 1998-2003
(continued)

	1998	1999	2000	2001	2002	2003
Memorandum items						
Trade in goods and services						
As percent of GNP						
Current account balance, incl. shuttle trade	1.0	-0.7	-4.8	-0.6	-0.9	-0.6
Trade account balance, incl. shuttle trade	-6.9	-5.6	-11.1	-7.3	-6.9	-6.9
Exports of goods and nonfactor services	26.5	24.4	25.1	30.8	29.6	30.0
Imports of goods and nonfactor services	27.2	26.2	30.8	31.3	30.3	30.8
Percent change						
Value growth in exports of goods (incl. shuttle trade)	-4.4	-6.1	6.4	9.4	6.8	7.8
Value growth in exports of goods (excl. shuttle trade)	2.7	-1.7	4.4	9.4	6.8	7.8
Value growth in imports of goods	-5.3	-12.5	34.7	-12.3	6.3	7.4
Volume growth in exports of goods (excl. shuttle trade)	6.4	6.3	11.6	10.4	6.1	6.8
Volume growth in imports of goods	41.3	41.8	35.2	-10.4	9.0	7.4
Terms of trade	6.1	-6.6	-8.9	2.6	2.0	0.0
Reserve and debt indicators						
Gross foreign reserves (CBT)						
US$ billion	20.9	24.3	23.2	21.2	21.8	24.2
Months of goods & NFS imports	4.1	5.3	4.1	4.0	3.8	4.0
External debt (end-of-period)						
US$ billion	96.9	103.0	114.3	117.0	116.7	117.8
Percent of GNP	47.1	55.0	56.6	66.3	59.7	56.8
Percent of exports of goods & NFS	177.7	225.3	225.5	215.1	201.8	189.6
Net external debt (end-of-period) 3/						
US$ billion	62.5	63.6	74.7	78.2	76.8	75.0
Percent of GNP	30.4	34.0	37.0	44.3	39.3	36.2
Short-term debt (end-of-period)						
US$ billion	21.2	23.5	28.9	22.2	23.6	25.4
Ratio to foreign reserves	101.6	96.7	124.6	104.5	108.3	105.0
Short-term debt plus MLT repayments						
US$ billion	32.7	36.1	44.5	41.6	39.6	42.8
Ratio to foreign reserves	156.5	148.5	191.6	196.0	182.1	177.3
Debt service ratio 4/	26.0	34.1	37.3	44.6	37.7	36.8
Other (US$ billion)						
Change in NFA of CBT	-0.2	5.4	-3.7	-15.4	4.1	2.7
Change in NFA of DMBs	-1.9	-0.5	-2.1	5.8	-0.1	-0.5
Change in NFA of the banking system	-2.2	4.9	-5.8	-9.6	4.0	2.2

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 5. Turkey: External Financing Requirements and Sources, 1997-2003
(In billions of U.S. dollars)

	1997	1998	1999	2000	2001			2002	2003
					Q1	Q2-4	Total		
Gross financing requirements	**28.1**	**27.6**	**35.5**	**49.0**	**11.9**	**37.8**	**49.7**	**40.2**	**42.6**
Current account deficit (excl. official transfers)	3.0	-1.8	1.7	10.0	0.7	0.6	1.3	2.0	1.5
Amortization on debt securities	1.7	3.3	2.0	1.7	0.2	1.9	2.2	2.5	4.1
Of which: Public sector	1.5	3.0	1.9	1.4	0.2	1.9	2.2	2.4	3.9
Deposit money banks	0.2	0.3	0.1	0.4	0.0	0.0	0.0	0.1	0.2
Medium and long-term debt amortization	6.1	8.2	10.6	13.8	3.7	13.6	17.3	13.5	13.4
Of which: Public sector 1/	2.5	2.8	2.9	3.6	0.8	4.7	5.5	3.8	3.7
Private sector	2.8	3.0	5.2	7.9	2.2	7.8	10.0	8.0	8.0
Deposit money banks	0.8	2.3	2.4	2.3	0.7	1.1	1.8	1.8	1.7
Short-term debt amortization	17.3	18.0	21.2	23.5	7.2	21.7	28.9	22.2	23.6
Public sector 1/	1.0	0.9	0.9	0.7	0.4	1.2	1.7	0.7	0.7
Private sector	7.9	8.6	9.2	9.6	2.6	7.8	10.4	8.3	9.1
Deposit money banks	8.4	8.5	11.2	13.2	4.2	12.7	16.9	13.2	13.8
Available financing	**28.1**	**27.6**	**35.5**	**49.0**	**11.9**	**37.8**	**49.7**	**40.2**	**42.6**
Foreign direct investment (net)	0.6	0.6	0.1	0.1	1.0	-0.2	0.8	1.6	1.6
Portfolio flows	3.3	-3.4	5.4	2.8	-1.3	0.5	-0.8	6.7	6.5
Public sector	2.9	2.7	5.0	7.5	0.7	1.8	2.5	4.7	4.5
Deposit money banks	0.6	0.0	0.2	0.5	0.0	0.0	0.0	0.5	0.5
Private sector (net)	-0.1	-6.1	0.2	-5.2	-2.0	-1.4	-3.3	1.5	1.5
Medium and long-term debt financing	10.9	12.2	10.9	19.1	2.5	9.4	11.8	13.7	13.1
Of which: Public sector 1/	2.0	1.8	0.9	4.4	0.4	4.1	4.4	4.8	3.9
Private sector	6.4	7.2	7.5	12.8	2.1	4.6	6.7	7.3	7.5
Deposit money banks	2.5	3.1	2.6	1.9	0.0	0.7	0.7	1.6	1.7
Short-term debt financing	19.0	20.6	22.0	26.5	4.6	17.5	22.1	23.0	24.8
Official transfers	0.3	0.2	0.4	0.2	0.1	0.2	0.3	0.3	0.3
Accumulation of gross reserves (-)	-3.3	-0.2	-5.9	-0.3	3.6	-1.7	2.0	-0.5	-2.4
IMF (net)	0.0	-0.2	0.7	3.3	1.4	12.1	13.5	-4.5	-1.2
Purchases	0.0	0.0	0.8	3.4	1.4	13.2	14.6	1.2	0.0
Repurchases	0.0	0.2	0.1	0.1	0.0	1.1	1.1	5.6	1.2
Other 2/	-2.8	-2.0	1.9	-2.7	0.0	0.0	0.0	0.0	0.0

1/ General government and Central Bank of Turkey.

2/ Errors and omissions.

Table 6. Turkey: Medium-Term Fiscal Projections For the Consolidated Public Sector, 2000-10
(In percent of GNP, unless otherwise specified)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Primary balance	2.8	5.5	6.5	6.5	4.6	4.6	4.5	4.5	4.5	4.0	4.0
Net interest payments	21.9	22.6	16.2	13.5	13.8	13.0	12.2	10.1	10.1	9.7	9.8
PSBR (incl. CBT profits)	19.1	17.1	9.7	6.9	9.2	8.4	7.7	5.6	5.6	5.7	5.8
Privatization proceeds	1.6	1.8	1.9	1.7	0.5	0.3	0.0	0.0	0.0	0.0	0.0
Net debt of the public sector 1/	50.6	67.9	63.8	60.5	59.9	59.6	59.5	59.4	59.3	59.4	59.5
Memorandum items:											
GNP growth (in percent)	6.1	-3.0	5.0	6.0	5.5	5.0	5.0	4.5	4.5	4.5	4.5
GNP deflator (in percent)	51.6	49.4	28.3	16.5	10.7	9.4	8.6	5.0	5.0	5.0	5.0
Real T-bill interest rate	-6.5	36.4	20.0	18.0	18.0	17.0	16.0	15.0	15.0	14.0	14.0
Seignorage	1.8	1.5	1.0	0.6	0.6	0.6	0.5	0.4	0.4	0.4	0.4
Share of dollar debt 2/	36.1	50.4	46.7	44.7	40.0	40.0	40.0	40.0	40.0	40.0	40.0

1/ In percent of centered GNP.
2/ In making the projection for 2003 and beyond, a dollar real interest rate of 10 percent was assumed.

Table 7. Turkey: Schedule of Purchases Under the SBA/SRF, 1999-2002
(SBA augmentation at 660 percent of quota)

Date	Purchases under SBA		Purchases under SRF		Purchases under the Augmentation to SBA		Combined Purchases under SBA/ SRF		Conditions
	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	
Actual Purchases	**1,330.3**	**138.0**	**2,602.8**	**270.0**	-	-	3,933.1	**408.0**	
1999	221.7	23.0	-	-	-	-	221.7	23.0	
December 22, 1999	221.7	23.0	-	-	-	-	221.7	23.0	Board approval of SBA
2000	886.9	92.0	1,735.2	180.0	-	-	2,622.1	272.0	
April 29, 2000	221.7	23.0	0.00	-	-	-	221.7	23.0	First review; and end-Dec. 1999 performance criteria
July 6, 2000	221.7	23.0	0.00	-	-	-	221.7	23.0	Second review; and end-Mar. 2000 performance criteria
December 22, 2000	443.4	46.0	1,735.2	180.0	-	-	2,178.6	226.0	Third and fourth reviews; and end-Sept. 2000 performance criteria
2001 (Jan-Mar)	221.7	23.0	867.6	90.0	-	-	1,089.3	113.0	
February 5, 2001	221.7	23.0	867.6	90.0	-	-	1,089.3	113.0	Fifth review; and end-Dec. 2000 performance criteria
Scheduled Purchases	**1,561.7**	**162.0**	**3,181.2**	**330.0**	**6,362.4**	**660.0**	**11,105.3**	**1,152.0**	
2001 (Apr-Dec)	665.2	69.0	3,181.2	330.0	6,362.4	660.0	10,208.8	1,059.0	
May 10, 2001	-	-	1,446.0	150.0	1,554.0	161.2	3,000.0	311.2	Sixth and seventh reviews; end-Mar. 2001 performance criteria
June 25, 2001	221.7	23.0	578.4	60.0	401.3	41.6	1201.5	124.6	Eighth review; and relevant performance criteria 1/
July 25, 2001	221.7	23.0	578.4	60.0	401.3	41.6	1201.5	124.6	Ninth review; and relevant performance criteria 2/
September 20, 2001	-	-	578.4	60.0	1,824.5	189.3	2,402.9	249.3	Tenth review; and relevant performance criteria 3/
November 15, 2001	221.7	23.0	-	-	2,181.2	226.3	2,402.9	249.3	Eleventh review; and relevant performance criteria 4/
2002	896.5	93.0	-	-	-	-	896.5	93.0	
February 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Twelfth review; and end-Dec. 2001 performance criteria
May 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Thirteenth review; and end-Mar. 2002 performance criteria
August 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Fourteenth review; and end-June 2002 performance criteria
November 15, 2002	231.4	24.0	-	-	-	-	231.4	24.0	End-Sept. 2002 performance criteria
Total	**2,892.0**	**300.0**	**5,784.0**	**600.0**	**6,362.4**	**660.0**	**15,038.4**	**1,560.0**	
Memorandum items:									
2001	886.9	92.0	4,048.8	420.0	6,362.4	660.0	11,298.1	1,172.0	
Quota	964.0	100.0							

1/ End-May performance criteria on NDA and NIR.

2/ End-June performance criteria on NDA and NIR; and end-May performance criteria on consolidated government sector primary balance and central government primary expenditure.

3/ End-August performance criteria on NDA and NIR; end-July performance criteria on consolidated government sector primary balance and central government primary expenditure; and end-June performance criteria on external debt.

4/ End-October performance criteria on NDA and NIR; end-September for all other performance criteria.

Table 8. Turkey: Indicators of Fund Credit, 2001-08

	2001	2002	2003	2004	2005	2006	2007	2008
Outstanding Fund Credit (end of period)								
In millions of SDRs	13,636	10,194	9,241	7,573	3,421	282	0	0
In percent of quota	1,415	1,058	959	786	355	29	0	0
In percent of exports of G&NFS	32.4	22.8	19.3	14.8	6.3	0.5	0	0
In percent of public sector external debt	23.5	17.8	16.3	13.4	6.3	0.5	0	0
In percent of foreign reserves	82.9	60.6	49.6	36.3	15.4	1.1	0	0
Debt Service due to the Fund								
In millions of SDRs	1,263	5,166	1,539	2,205	4,522	3,256	294	4
In percent of quota	131	536	160	229	469	338	31	0
In percent of exports of G&NFS	3.0	11.6	3.2	4.3	8.3	5.8	0.5	0.0
In percent of public sector external debt	2.2	9.0	2.7	3.9	8.3	6.0	0.5	0.0
In percent of foreign reserves	7.7	30.7	8.3	10.6	20.3	13.0	1.0	0.0

Source: Fund staff projections.

Table 9. Turkey: Indicators of External Vulnerability, 1997–2003 1/

	1997	1998	1999	2000	Projections 2001	2002	2003
CPI inflation (Dec-on-Dec)	99.1	69.7	68.8	39.0	52.5	20.0	15.0
Public sector borrowing requirement	13.2	15.4	24.2	19.1	17.1	9.7	6.9
Operational balance	-3.0	-4.6	-12.4	-6.6	-3.2	-2.3	-0.1
Net debt of the public sector	42.9	43.7	61.0	58.4	78.5	70.4	64.9
Export volume (excl. shuttle trade, percent change)	13.5	6.4	6.3	11.6	10.4	6.1	6.8
Import volume (percent change)	23.6	-2.5	-1.2	35.2	-10.4	9.0	7.4
Current account balance, in percent of GNP	-1.4	1.0	-0.7	-4.8	-0.6	-0.9	-0.6
Capital account balance (in millions of US$)	8,736	448	4,671	9,448	-14,396	6,642	4,853
Of which: Foreign direct investment	554	573	138	112	800	1,570	1,588
Foreign portfolio investment	-140	-6,132	209	-5,230	-3,320	1,500	1,500
Gross official reserves, in millions of US$ 2/	19,575	20,874	24,274	23,206	21,241	21,768	24,158
In months of imports of goods and NFS	3.8	4.1	5.3	4.1	4.0	3.8	4.0
In percent of broad money	32.3	28.1	30.0	25.5	26.2	24.3	25.8
Gross total external debt, in millions US$	84,891	96,907	103,026	114,326	116,966	116,662	117,767
In percent of GNP	43.4	47.2	55.0	56.6	66.2	59.6	56.8
In percent of merchandise exports	260.0	310.4	351.3	366.3	342.6	319.9	299.5
Gross short-term external debt, in millions US$ 3/	25,794	32,673	36,050	44,459	41,637	39,631	42,829
In percent of gross total external debt	30.4	33.7	35.0	38.9	35.6	34.0	36.4
In percent of gross official reserves	131.8	156.5	148.5	191.6	196.0	182.1	177.3
In percent of banking system gross reserves	74.7	88.4	88.7	106.2	102.4	95.1	96.1
Debt service 4/	21.2	26.0	34.1	37.3	44.6	37.7	36.8
REER appreciation (CPI based, period average)	6.4	8.5	4.1	9.9	...	...	...
REER appreciation (CPI based, end of period)	13.5	3.9	5.6	13.7	...	...	...
Capital adequacy ratio 5/	12.6	12.4	9.1	16.3	...	...	...
State banks	12.6	8.6	8.2	7.9	...	...	...
Private banks	11.9	12.0	9.0	17.4	...	...	...
Foreign banks	13.7	21.0	20.3	20.0	...	...	...
Nonperforming loans (in percent of total)	2.1	6.7	9.7	9.2	...	...	...
Real broad liquidity, percentage change (CPI deflated)	13.9	3.7	18.2	0.6	4.6	8.1	2.0
Real credit to the private sector, percentage change 6/	18.2	17.7	-11.5	29.7	...	...	...
Domestic cash debt to broad liquidity, in percent	37.4	43.5	46.3	48.3	43.4	55.0	66.2
Banks' net foreign asset position, in millions of US$	-889	-3,018	-3,176	-5883	-83	-183	-683.2
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) 7/	...	548	550	443	818	...	...

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

1/ For 2001-03, program projections.

2/ As of end-April 2001, reserves stood at US$18.4 billion.

3/ By residual maturity.

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

5/ For 2000, it represents the level as of end-September; it excludes the banks owned by the Deposit Insurance Fund.

6/ WPI deflated

7/ For 2001, average during the first four months.

Table 10. Turkey: Banking System-Selected Indicators, 1997-2000 1/
(In trillions of Turkish liras)

	1997	1998	1999	2000
		Banking System		
Total Assets	**22,759**	**41,969**	**82,371**	**119,202**
Cash and claims on CBT	1,495	2,665	5,097	6,235
Claims on other banks	2,679	4,414	9,070	14,376
Securities portfolio	5,857	10,179	23,344	32,027
Treasury bills and bonds	5,163	8,864	18,314	22,327
Other securities	694	1,314	5,030	9,700
Loans, net	8,873	14,689	22,601	35,789
Other assets	3,855	10,024	22,258	30,775
Total Liabilities	**22,759**	**41,969**	**82,371**	**119,202**
Deposits	12,571	24,194	48,272	68,143
Borrowing from banks	2,556	4,663	10,070	15,996
Repos	3,139	4,644	8,950	13,620
Other liabilities	2,743	5,179	10,844	12,983
Shareholders' equity (incl. profits)	1,749	3,290	4,235	8,461
Memorandum Items:				
NPLs (%) total loans	2.1	6.7	9.7	9.2
Net profit (loss) before tax	673	1,283	829	-160
Net profit (loss) after tax	480	760	-305	-888
		Private Domestic Banks		
Total Assets	**10,361**	**18,826**	**37,170**	**54,978**
Cash and claims on CBT	708	1,248	2,445	3,247
Claims on other banks	1,346	2,714	5,882	10,181
Securities portfolio	3,000	4,688	11,138	12,854
Treasury bills and bonds	2,635	3,768	7,613	6,414
Other securities	366	920	3,525	6,439
Loans, net	3,884	7,009	11,408	19,199
Other assets	1,422	3,167	6,297	9,498
Total Liabilities	**10,361**	**18,826**	**37,170**	**54,978**
Deposits	5,331	10,489	20,694	29,865
Borrowing from banks	1,421	2,492	5,716	9,708
Repos	1,600	1,646	2,761	3,581
Other liabilities	983	1,940	3,585	3,930
Shareholders' equity (incl. profits)	1,025	2,259	4,414	7,894
Memorandum Items:				
NPLs (%) total loans	1.3	2.2	3.6	3.5
Net profit (loss) before tax	514	1,160	2,127	1,907
Net profit (loss) after tax	395	810	1,462	1,421
Share in assets (%)	45.5	44.9	45.1	46.1
Share in deposits and repos (%)	44.1	42.1	41.0	40.9

Table 10. Turkey: Banking System-Selected Indicators, 1997-2000 1/
(In trillions of Turkish liras)

	1997	1998	1999	2000
	Public (State and SDIF) Banks 2/			
Total Assets	**10,733**	**20,472**	**39,250**	**55,877**
Cash and claims on CBT	751	1,341	2,510	2,806
Claims on other banks	948	1,116	1,638	2,316
Securities portfolio	2,673	5,244	11,214	17,903
Treasury bills and bonds	2,374	4,873	9,960	15,048
Other securities	299	371	1,255	2,855
Loans, net	4,126	6,209	8,610	12,946
Other assets	2,236	6,562	15,278	19,907
Total Liabilities	**10,733**	**20,472**	**39,250**	**55,877**
Deposits	7,042	13,447	27,033	37,396
Borrowing from banks	416	911	1,685	2,495
Repos	1,469	2,940	6,077	9,834
Other liabilities	1,299	2,582	5,572	7,115
Shareholders' equity (incl. profits)	507	592	-1,116	-963
Memorandum Items:				
NPLs (%) total loans	2.9	12.6	19.0	18.8
Net profit (loss) before tax	80	-89	-1,795	-2,555
Net profit (loss) after tax	30	-200	-2,106	-2,637
Share in assets (%)	47.2	48.8	47.7	46.9
Share in deposits and repos (%)	54.2	56.8	57.9	57.8
	Foreign and Investment Banks			
Total Assets	**1,665**	**2,672**	**5,951**	**8,346**
Cash and claims on CBT	36	75	143	182
Claims on other banks	385	584	1,550	1,878
Securities portfolio	183	247	992	1,271
Treasury bills and bonds	154	223	741	865
Other securities	29	24	251	406
Loans, net	864	1,471	2,583	3,645
Other assets	197	295	683	1,370
Total Liabilities	**1,665**	**2,672**	**5,951**	**8,346**
Deposits	197	258	546	882
Borrowing from banks	719	1,259	2,670	3,792
Repos	70	58	111	205
Other liabilities	462	657	1,687	1,938
Shareholders' equity (incl. profits)	217	439	937	1,529
Memorandum Items:				
NPLs (%) total loans	1.8	2.1	2.1	1.8
Net profit (loss) before tax	79	212	496	489
Net profit (loss) after tax	54	150	340	328
Share in assets (%)	7.3	6.4	7.2	7.0
Share in deposits and repos (%)	1.7	1.1	1.1	1.3

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

2/ These include 4 state banks and 13 SDIF banks through the entire period.

TURKEY: FUND RELATIONS
(As of March 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:**	**SDR Million**	**% Quota**
Quota	964.00	100.0
Fund holdings of currency	5,145.83	533.8
Reserve position in Fund	112.77	11.7

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	112.31	100.0
Holdings	1.69	1.5

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**% Quota**
Stand-by Arrangements	3,933.10	408.0
First credit tranche	361.50	37.5

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	12/22/99	12/21/02	8,676.00	3,933.10
Stand-by	7/08/94	3/07/96	610.50	460.50
Stand-by	4/04/84	4/03/85	225.00	168.75

VI. **Projected Obligations to Fund:** (SDR Million; based on the use of resources and holdings of SDRs at end-March 2001)

	Overdue		Forthcoming			
	3/31/01	2001	2002	2003	2004	2005
Principal		867.6	1,735.2	679.6	845.9	166.3
Charges/Interest		213.4	175.8	74.8	38.8	8.0
Total		1,081.0	1,911.0	754.4	884.7	174.3

VII. 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 euros 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. On February 22, 2001, the government decided to float the currency.

VIII. 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.

IX. 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-supported public Financial Management project; eight FAD missions since 1994, assignment of five 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	BOP statistics
MAE	Sept. 2000-April 2001	Banking sector reform

Ankara, May 3, 2001

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

Dear Mr. Köhler,

The letter of intent sent to you by Minister Derviş and Central Bank Governor Serdengeçti sets out the polices, programs and measures that Turkey's government will implement to overcome the financial and economic crisis affecting Turkey today and to steer the country to a strong economic recovery within a macroeconomic framework that aims at reducing inflation to less than 20 percent next year. In our program, growth, stability and structural reform are mutually reinforcing goals. The government is fully committed to pursue these goals and stands behind all the measures and polices detailed in the letter. As you know, we already have made impressive progress in the legislative agenda that constitutes the basis of very deep structural reforms, including in enhancing governance and transparency in both the public and the private sectors.

A key dimension of our national effort is a strong primary surplus in the budget. The fiscal adjustment, which will be of the order of 9 percentage points of GNP over 2000–2002 period, requires very tough measures. But we want to establish debt dynamics for Turkey that will reduce both domestic and foreign debt, free resources for private sector investment and allow us to channel public resources as much as possible into activities that crowd-in that investment and that protect the poorest and most vulnerable sectors of our population.

The program needs strong and timely financial support from the international community. We are grateful for the cooperation you are offering to our economic team and we trust that the positive evaluation of our program by the Board of the International Monetary Fund will help stabilize markets, restore confidence, and allow us to implement the structural reforms that will permit Turkey to achieve growth with stability and social justice.

Very truly yours,

/s/
Dr. Devlet Bahçeli
Deputy Prime Minister

/s/
Bülent Ecevit
Prime Minister

/s/
A. Mesut Yilmaz
Deputy Prime Minister

Ankara, May 3, 2001

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

Dear Mr. Köhler,

1. The attached Memorandum on Economic Policies (MEP) sets forth the economic program of the Turkish government for the balance of 2001 and for 2002. This program is a continuation of the one initiated in late 1999, with the support of a stand-by arrangement with the International Monetary Fund. It shares the same strategy: disinflate the Turkish economy, strengthen the fiscal accounts, and reform the structure of the Turkish economy as a condition for setting economic growth on a sustainable basis and moving Turkey closer to its goal of joining the European Union. However, the program's policies have been significantly strengthened, in response to the recent crisis that led to the float of the Turkish lira on February 22, 2001, including through increased emphasis on transparency, accountability, and good governance in both the private and public sectors. In support of our strengthened program, we request that the arrangement be augmented by the equivalent of SDR 6.3624 billion and that the purchases scheduled through end-2001 be rephased and would consequently be subject to reviews which are expected to be completed during May, June, July, September, and November 2001.

2. We believe that the policies and measures described in the attached memorandum are adequate to achieve the objectives of the program, but we stand ready to take additional measures, if necessary, to keep the program on track, consulting regularly with the Fund. Purchases under the arrangement will be subject to reviews in June, July, September, November 2001, and quarterly reviews thereafter for the duration of the arrangement.

3. With this letter we also request the completion of the sixth and seventh program reviews under the stand-by arrangement. Because of the severe financial distress in the run up to and immediately after the float of the Turkish lira on February 22, 2001, as well as some revisions in our policies we request the following waivers in the program's performance criteria:

- the end-March 2001 performance criteria on net domestic assets (NDA) and on net international reserves (NIR) were not observed (Annex A of the attached Memorandum). We are hereby requesting waivers of these performance criteria.

- We are also requesting a waiver of the structural performance criterion related to the approval of the Electricity Market Law. This waiver is needed because the law was enacted some two weeks after the program's revised deadline of February 15, and because in that law the deadline for reaching financial closure for the contracts involving the transfer-of-operating rights (TOORs) for generation and distribution electricity companies was set at end-June 2001 (against the envisaged end-March 2001 deadline). These small deviations do not diminish the scope of this important structural reform.

- We request a waiver of the performance criterion related to the issue by end-March 2001 of final tender documents and invitation of bids for Turk Telekom. As discussed in the attached Memorandum, we have decided to improve the terms at which Turk Telekom will be privatized, including through legislative amendments allowing the divestiture of up to 100 percent of the company (excluding a golden share). However, the timing of the privatization will also depend on the conditions of the international telecommunication market, which are at present not conducive to a successful privatization operation.

Very truly yours,

/s/
Mr. Kemal Derviş
Minister of State for Economic Affairs

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

Memorandum on Economic Policies

1. This memorandum lays out our new economic policy framework following the float of the Turkish lira on February 22, 2001. The float requires a recalibration of economic policies and of short term policy goals. However, it does not alter our overall economic strategy, which remains anchored to our firm commitment to eradicate inflation, strengthen the fiscal accounts, and remove the structural distortions that have constrained for years Turkey's growth. To these ends, we will build on the considerable results that, in spite of the crisis, have been achieved since the beginning of the program: before the crisis inflation was brought down to about 30 percent, the primary position of the public sector was shifted to a level consistent with long term fiscal solvency, and major structural reforms were undertaken in banking, social security, and agricultural support. These results have considerably enhanced the underlying strength of the Turkish economy.

A. The Decision to Float and its Implications for the New Policy Framework

2. While our program envisaged from the beginning an exit strategy from the crawling peg system, unanticipated financial and macroeconomic developments led us to float the Turkish lira earlier than planned. Financial conditions had improved significantly after the November crisis, as highlighted by a decline in interest rates in the secondary government paper market to some 50 percent by mid-January. However, the situation remained fragile, owing to persistent concerns about the health of the banking system, an inflation rate still twice as large as the rate of crawl, and some slippages in policy implementation. Against this background, the perception by financial markets that the political situation was deteriorating led to a major attack against the Turkish lira on February 19-21. This attack was initially resisted through a tight liquidity policy. However, overnight interest rates skyrocketed to over 2000 percent, a level clearly unsustainable even for a few days. Thus, the government decided on February 22 to float the Turkish lira and to revise the macroeconomic and structural policy framework in light of that decision.

3. **Our economic policies aim at minimizing the short-term macroeconomic impact of the recent crisis, while setting the stage for a resumption of disinflation and growth.** While considerable uncertainty remains about short-term developments, the program's baseline scenario (Table 1) envisages the following macroeconomic targets:

- We expect real GNP to fall by 3 percent in 2001. However, after a decline in the first half, growth is expected to resume in the second half of the year, reflecting the rebound of exports and the expected good performance of tourism. This recovery is projected to lead to a growth of GNP of 5 percent in 2002.

- Owing to the depreciation of the lira after the float, inflation is expected to increase in the second quarter. However, reflecting the effect of the program policies, CPI inflation is expected to decline in the third quarter, and is targeted to fall to about 2 percent per month (on a seasonally adjusted basis) in the last quarter. For the whole year, we expect

CPI inflation (December/December) to be 52 percent. CPI inflation is targeted to fall to 20 percent by December 2002.

- The external current account balance is projected to improve significantly as a result of stronger competitiveness of Turkish products and the deceleration in economic activity. We expect the external current account to be close to balance in 2001 and 2002, after a deficit of almost 5 percent of GNP in 2000.

4. **These goals will be achieved through a three-pronged approach based on: (i) structural policies aimed at correcting the distortions directly underlying the recent crisis, including in banking, and at enhancing the transparency of economic management and the role of the private sector in the restructuring of the economy; (ii) fiscal and monetary policies geared towards restoring financial stability and resuming the disinflation process; and (iii) an enhanced social dialogue aimed at price and wage policies consistent with macroeconomic stability, growth, and the protection of the most vulnerable parts of the society.**

5. **Policies will be explained and implemented in a transparent manner.** A new communication and openness policy will be an integral and important part of our reform strategy, particularly in critical areas such as banking. We will develop a strategy aimed at explaining major policies and actions to market participants through regular press conferences, newsletters, seminars, and other events.

B. Structural Policies for a Stronger Economy

6. **The recent developments have highlighted the difficulty of implementing tight monetary and fiscal policies aimed at disinflation while widespread structural weaknesses persist.** The vulnerability of the banking sector, including the state banks, has involved sizable fiscal costs and distorted the functioning of monetary policy. These problems have resulted from underlying weaknesses, but also from insufficient transparency, particularly in the accounts of state banks, which have impeded public scrutiny and delayed the needed policy adjustment. Enhancing transparency in policy making is thus a priority. This will be achieved through administrative and regulatory steps and by improving the reporting required by public and private institutions. More generally, it will be achieved by increasing the role of the private sector in the economy, within the context of a proper regulatory framework. Our structural policy agenda, detailed below, in banking, public accounting, privatization and foreign direct investment is indeed unified by a common thread: that of improving the economic environment through enhanced transparency, better governance, and a strengthened regulatory environment. In implementing our structural agenda, we expect continued support from the World Bank.

Banking sector reform

7. **There is a need for far-reaching and decisive actions in the banking area.** The structural weaknesses in the banking sector, especially in state-owned banks but also a steady

erosion of solvency in private banks that has led to a growing number of takeovers by the Savings Deposit Insurance Fund (SDIF), have caused an accumulation of large losses to be borne by the government. The increasing funding needs to cover these losses have forced the state- and SDIF-owned banks into large-scale overnight funding, which has made them particularly susceptible to liquidity and interest rate shocks. This in turn has undermined monetary control. Exceptionally high overnight interest rates have made losses and funding needs grow exponentially in recent months.

8. **Fundamental reforms of the state- and SDIF-owned banks are of the highest priority for systemic stability, monetary control, and a lowering of interest rates.** Excluding liabilities to the CBT, three state banks (Halk, Ziraat, and Emlak) and the SDIF banks on March 16 had overnight liabilities (repurchase agreements and deposits of commercial bank and nonbank customers) of some TL 13¾ quadrillion. In order to reduce the systemic vulnerability of these banks, their threat to monetary policy effectiveness, and shrink their balance sheets, our strategy is to eliminate fully this overnight position. More specifically, state- and SDIF-owned banks will receive government securities as part of their recapitalization (see below). These securities will be sold directly or through repurchase agreements to the CBT and the proceeds will be used to eliminate the overnight borrowing. SDIF and state banks' overnight position outstanding on March 16, 2001 will be reduced by at least two thirds (including the elimination of overnight positions vis-à-vis commercial banks) as **a condition for the completion of the sixth and seventh reviews (Table 2)**. The remaining overnight position will be eliminated as **a condition for the completion of the eighth review**. The resultant excess liquidity in the financial system will be absorbed by the CBT through monetary instruments in close coordination with Treasury's debt management. Moreover, the stock of repurchase agreements of SDIF and state banks with the CBT will not exceed TL 7 quadrillion by end-May 2001 as **a condition for completing the eighth review**.

9. **In addition, all state and SDIF banks will be subject to maturity guidelines and uniform deposit rates for different maturity ranges.** The maturity guidelines will be determined by the governing boards of the state and SDIF banks in consultation with CBT. These guidelines will include limits on the overnight borrowing from commercial banks and other market sources (these limits will be further discussed during the eighth review). Uniform deposit rates for all state and SDIF banks will be determined on a daily basis by the managements and treasuries of the state and SDIF banks in consultation with the CBT. These deposit rates will be kept below market rates for treasury securities to allow the state and SDIF banks to be profitable. Special arrangements have been set up for continuous coordination between the CBT, Treasury, the Bank Regulation and Supervision Agency (BRSA), and the treasurers of the state and SDIF banks.

10. **The two largest state banks (Ziraat and Halk) will undergo financial and operational restructuring to ensure their future profitability.** More specifically:

- Governance of Ziraat and Halk will be strengthened through the establishment of a common and politically independent governing board, reporting to the Treasury, and the appointment of new management (**a condition for the completion of the sixth and seventh reviews**) who will apply commercial criteria to operations and pricing policies that ensure profitability. The governing board will also formulate plans for the privatization of these banks.

- The financial restructuring will entail the elimination of remaining "duty losses," a recapitalization to cover any negative net worth, the replacement of existing government papers bearing below-market yields (where needed to improve the structure of their balance sheet), and an increase in the banks' risk-weighted capital adequacy ratio (CAR) to 8 percent (implementation of this financial restructuring is **a condition for the completion of the sixth and seventh reviews**). The instruments used for these purposes will be transferable government securities at market terms in a mix of maturities and currency denominations with interest paid quarterly to ensure that the banks have sufficient liquidity to operate and honor any deposit withdrawals. These securities will be held to generate income and liquidated only to cover the net withdrawal of deposits or other liabilities.

- These actions will be accompanied by new risk management procedures to be applied by the governing board and the managements of the banks. To reduce operating costs, the operations of these banks will be streamlined as rapidly as possible.

- After the above financial restructuring is completed, these banks will be required to fully comply with all BRSA regulations applicable to commercial banks. Treasury will immediately start monitoring more closely their cash flow, profitability and liquidity. The specific indicators for program monitoring of the state banks will be defined during the eighth program review.

- The implementation of these reforms will be overseen by independent outside auditors in each bank, to be appointed in May.

11. **Among the remaining two smaller state banks, one is insolvent and unviable while the other one is in the process of privatization.** The banking license of the insolvent bank (Emlak) will be withdrawn (the bank will be closed) and its liabilities and some assets transferred to Ziraat (**implementation of this action by end-May 2001 will be a condition for the completion of the eighth review**). Ziraat will be provided with additional capital to facilitate the absorption of Emlak. The launching by the other bank (Vakif) of an initial public offering in the Istanbul Stock Exchange has been delayed by the recent crises, but the privatization process will be resumed as soon as market conditions allow.

12. **The sharp increase in the losses of the SDIF banks, due to excessive recourse to the overnight market, has made a speeding up of their resolution a high priority.** Thirteen banks have been taken over since 1997, of which 10 in the last two years. The operations of the five banks combined into the transition bank (Sümerbank) are being scaled down rapidly, with half of the branches already closed and half of the personnel already laid off. Another small bank (Ulusal) has already been scaled down to a shell and will be merged

into Sümerbank in May. It should be noted, however, that the overall administrative costs count for less than 2 percent of total losses and that financial restructuring is what is called for with utmost urgency. Accordingly, Sümerbank will be recapitalized by the SDIF to cover the bank's negative net worth **(a condition for the completion of the sixth and seventh reviews)** using transferable securities similar to those used in the state banks and with a currency composition to provide cover for its FX deposit liabilities. Its nonperforming loans (NPLs) will be transferred to the Collection Department of the SDIF (COD) by end-July. Sümerbank will be put up for sale with bids to be received by end-September 2001. If no viable bids are received at that time, the bank will be liquidated. A liquidation plan involving transfers of deposits to other banks, together with matching portfolios of government paper, will be developed for the event that the bank has not been sold.

13. **At the same time, SDIF is stepping up its efforts to resolve the remaining seven SDIF banks—a difficult task in view of weakening investor interest and the deterioration in the economic environment.** Banks in this group will also be recapitalized to cover their negative net worth **(a condition for the completion of the sixth and seventh reviews).** So far, bids have been received for only 2 banks offered for sale, the medium-sized Demirbank and a small bank (Ekspres). A third recently intervened bank (Iktisat) will be offered for sale in May. We consider these 3 banks to be the most attractive ones to sell and are making every effort to conclude an early deal. In the case of Demirbank, negotiations are under way with one domestic and two foreign bidders. In case these banks cannot be sold by end-2001, they will be liquidated. The remaining 4 banks will be organized into a second transition bank by end-May or put into liquidation (**a condition for the completion of the eighth review**). In sum, out of the 13 banks taken over by SDIF since 1997, 8 will be closed by end-May. The remaining banks will be sold, put into liquidation, or otherwise resolved by end-2001 **(a condition for the completion of the twelfth review).** In the future, in the privatization of any of the banks that have been taken over by the SDIF, we will disqualify all previous owners from participating in the bidding, directly or indirectly, including for a minority stake.

14. **The build-up of capacity in the Collection Department of the SDIF (COD) to deal with distressed assets has become a high priority.** COD has experienced a very slow start and no NPLs have yet been transferred. We realize that capacity for loan and other asset sales, recovery and workouts has become essential for the bank resolution process. We intend to rapidly hire additional staff to make the COD ready to start receiving NPLs and other assets from the SDIF. Legal amendments to facilitate the operation of the COD (establishment of special commercial courts and special powers to SDIF for debt recovery) have been submitted to Parliament. As mentioned above, Sümerbank will transfer all its NPLs above TL 75 billion to COD by end-July, and other SDIF banks will have started their transfers by that time as well. These transfers will be completed by end-October this year. The COD will report on its performance to the public and markets. Operating rules and procedures for the COD will be approved, professional managers appointed, and recruitment of a substantial number of specialized professional staff initiated by end-May.

15. **In private banks, recapitalization is needed to counter the effects of high interest rates, the depreciation of the lira, and the slowing economy.** Banks need to raise capital and several banks have already done so. All cash dividend distributions have been suspended until the capital adequacy ratios have been restored. The BRSA is requiring all capital deficient banks to present detailed capital strengthening plans by end-April **(prior action for the completion of the sixth and seventh reviews)** and will actively follow up on the implementation of such plans through time-bound commitment letters. Banks, especially those with common owners, are encouraged to merge. Tax laws will be further revised to make mergers of banks and their subsidiaries tax neutral. Any insolvent bank will be taken over by the SDIF. Loan loss provisioning rules will be strictly enforced. An enhanced monitoring system for the liquidity position and interest rates in all banks has been introduced to make sure that unviable banks are not allowed to engage in unsound practices and that corrective actions are taken early. While we feel confident that the full guarantee of depositors and creditors will continue to give the BRSA the protection it needs for resolving banks without concern for bank runs, we have strengthened it further by making its funding by the government legally explicit.

16. **The Banking Law will be amended in several respects to facilitate the resolution process and support the upgrading of the regulatory framework, including:** (a) establishing special commercial courts and giving SDIF special debt recovery powers; (b) strengthening the protection of staff and management of the BRSA and SDIF against law suits arising from carrying out their official duties; (c) defining the concept of "own funds" to permit the application of new connected lending limits on a consolidated basis; (d) broadening the definition of credit exposure to include derivatives; and (e) providing for the full tax deductibility of specific loan loss provisions (see below). **Parliamentary approval of these amendments will be a condition for the completion of the sixth and seventh reviews**.

17. **The ongoing strengthening of the regulatory framework will include the following measures:**

- To address the problem of connected lending, we have prepared a regulation defining related parties for purposes of limits on banks' exposures to owners and other parties. The legal amendment defining "own funds" mentioned above will allow consolidation and thus make the regulation fully consistent with EU standards. It will be adopted within one month after the amendment of the Banking Law **(a structural benchmark)**. The new regulation will take effect on July 1, 2001. The BRSA will allow banks that initially exceed the limit a timetable for gradual convergence toward full compliance with the law.

- Foreign exchange exposures will carry a capital charge under the recently issued market risk regulation that becomes effective on January 1, 2002. However, banks that cover foreign currency liabilities with forward purchases of foreign exchange face a counterparty exposure. To cover such credit risk, the Banking Law will be amended as mentioned above to include derivatives in the definition of "credit" to limit the overall exposure to individual (and related) counterparties.

- Accounting standards for banks are being brought in line with international standards from the beginning of 2002 (**a structural benchmark**). This will include bringing all repurchase agreements on banks' balance sheets.

18. **The broader legal and judicial frameworks are being reviewed to facilitate the enforcement of credit payments and corporate restructuring.** The government is reviewing foreclosure and bankruptcy laws, as well as judicial and administrative procedures, with the aim of ensuring that an efficient and speedy collection and restructuring of debt can take place. This review is being conducted in the context of broader reforms in the judicial framework, including the creation of intermediate regional civil courts of appeal, establishment of a Justice Academy to improve the specialized training of judges and lawyers and authorization of the Supreme Court judges to assign cases on subject matters, such as foreclosure and bankruptcy, to specific lower courts. Furthermore, the government is continuing to review taxation laws with the aim of removing impediments for debt and corporate restructuring.

Fiscal transparency and management

19. **Progress has been made under the program in improving fiscal transparency and management, but more is needed**. The implications for the fiscal accounts of developments outside the central budget, particularly in financial and nonfinancial state enterprises, are highlighted by developments in 2000 and in early 2001, when increasing deficits have emerged in these sectors. While the program figures for the public sector included most of these fiscal costs, the reporting to the public and to Parliament needs to be improved, so as to enhance the accountability of fiscal management in its broader definition. Thus, in order to streamline further the fiscal accounts, and in addition to the steps described above regarding state banks, our program involves the following steps:

- After closing 25 budgetary funds and two extra-budgetary funds (EBFs) in 2000, we have closed another 21 budgetary funds and four EBFs in March 2001, with effect in 2002. We remain committed to closing the 15 remaining budgetary funds (with the exception of the Support Price Stabilization Fund (DFIF), needed to channel the proceeds from World Bank loans) and two EBFs by June 2001 (**a structural benchmark**). As a result, all budgetary funds (with the exception of DFIF) will be eliminated in the 2002 budget, and the number of EBFs will be limited to five (the Social Aid and Solidarity Fund, the Defense Fund, the Promotion and Publicity Fund, the Savings Deposit Insurance Fund, and the Privatization Fund). No new budgetary fund or EBF will be created.

- In addition, in order to improve budget control and transparency, we will channel all revenues provided by law no. 3418/39B (mostly from motor vehicle taxation), which are currently channeled directly to special accounts of spending ministries, into the budget (as provided by article 39A of the same law), with implementation in the 2002 budget.

- We intend to at least halve by end-2001 the number of revolving funds (2,650 special accounts or institutions recording expenditures against revenues from the sale of public services amounting to some 1 percent of GNP) **(a structural benchmark).** After this sizeable scaling down, we will carry out a comprehensive financial and economic audit of their operations by end-May 2002. Based on the findings of the report, further steps will be identified by the end of June 2002.

- We intend to submit to parliament by end-June 2001 a law on public finance and debt management that defines clear borrowing rules and limits for the public sector, and incorporates into the budget on-lending and debt guarantee operations of the treasury **(a structural benchmark).** As of May 2001, we will include in the monthly reports of the Treasury a "lending minus repayments" item following the IMF's *Government Finance Statistics* standards, thus expanding the coverage of the budget balance to include net treasury payments of guaranteed debt. This item will be included in the 2002 budget.

- We will improve the transparency of budget documentation. The government agencies involved in fiscal management will enhance the contents of the Annual Program (the document to be submitted to parliament in October 2001 together with the budget to explain the government's fiscal policies and commitments and provide background information on the fiscal accounts). This document will be preceded by a mid-year Economic and Fiscal Update published in July 2001. The draft budget submitted to parliament for 2002 will be accompanied by the accounts and financial outlook for: (i) all EBFs and social security institutions (including a report on social security contribution arrears); (ii) revolving funds; (iii) contingent liabilities of the treasury; (iv) all SEEs, including state-owned banks; and (v) local authorities **(a structural benchmark).** Moreover, as of 2003, the budget will include the implications for projected medium-term current spending of public investment programs.

- To improve expenditure management, we will complete by mid-2001 the implementation of a computerized accounting system that will allow a better monitoring of spending and costs in government units. Moreover, a new budget classification in line with international standards will be completed by end-June 2001 for initiation on a pilot basis for the 2002 budget. We also intend to initiate in 2001 the necessary studies to move toward accrual-based accounting.

- A public procurement law in line with UN standards (UNCITRAL) will be submitted to Parliament by October 15, 2001 **(a structural benchmark).**

- We will adopt a more systematic approach to enhance governance in the public sector, with a view to defining and implementing any needed legal and ethical measures. To this end, we have formed a steering committee consisting of representatives of Treasury, the Prime Minister's Inspection Board, the Anti-Money Laundering Unit at the Ministry of Finance, the Ministry of Justice, and the Ministry of Interior. This committee, in collaboration with the World Bank, will design a plan to identify areas where the Government and civil society can work together to combat corruption and improve governance. We expect the committee to complete this plan by end-September. The plan, together with the findings of Public Expenditure and Institutional Review (PEIR) could form a basis for a Public Sector Adjustment Loan (PSAL) from the World Bank to address structural issues related to governance in the medium term. To increase the public awareness of our efforts, we are planning to launch a series of international conferences on "Effective Government" in the months ahead. In the short run, we are concentrating our work on improving the code of conduct of government officials, including relevant legislation which we will submit to Parliament before the summer recess.

Increasing the role of private domestic and foreign capital in the Turkish economy

20. **Policies aimed at increasing the role of private capital in managing the Turkish economy, including through privatization, have been part of our program from its outset**. While the ambitious privatization agenda of 2000 has been only partially implemented, privatization policies are especially needed now to reduce the stock of public debt and improve the efficiency of the economy. Moreover, it is imperative, over the medium term, to attract more foreign direct investment so as to reduce the stock of external debt, which is sizeable, and to further modernize the economy. As discussed above, private capital is expected to participate in restructuring the banking sector. In addition, the following steps are envisaged.

21. **While the timing of privatization operations will depend on market conditions, our goal is to remove all obstacles to a successful privatization policy, so as to be in the best position to act quickly as soon as market conditions allow**. Actions for the remainder of 2001 will focus on completing all preparatory work for privatization of majority stakes in key state-owned enterprises including Turk Telekom, TUPRAS (petroleum refineries), Turkish Airlines (THY), ERDEMIR (steel), TEKEL (tobacco and spirits), SEKER (sugar), and electricity generation (TEAS) and electricity distribution (TEDAS). The Privatization Administration (PA) will also continue to divest its portfolio of small- and medium-sized companies. These operations could bring very high cash receipts to the budget, but their specific timing will depend on market conditions. Thus, we have lowered the expected yield from privatization receipts to US$1 billion for the balance of 2001 (in addition to the US$2 billion already cashed from operations concluded in 2000). In 2002, privatization proceeds are expected to rise to US$3½ billion. More specifically:

- In the telecommunication sector, the government intends to adopt legislation to: (i) authorize divestiture of up to 100 percent of Turk Telekom, excluding a golden share which will remain with the government (as in similar privatization operations in other countries, the golden share will cover security and protection of national interests); (ii) reserve 5 percent of the shares of Turk Telekom to employees and small investors; (iii) allow foreign ownership of the shares of Turk Telekom of up to 45 percent , while not excluding majority foreign participation in a strategic investor consortium that could acquire a majority share; (iv) revise the composition of the tender committee, which takes decisions by simple majority, as follows: two representatives from the Privatization Agency, two from the Ministry of Transportation, and one from the Treasury; (v) remove the monopoly of Turk Telekom on fixed lines and other telecommunication services effective from the date the government shareholding falls below 50 percent; (vi) transfer all licensing authority for telecommunication services and infrastructure to the Telecommunication Regulatory Authority; and (vii) give Treasury, as owner, the authority to amend Turk Telekom's Articles of Agreement without the approval of the Ministry of Transportation and to appoint the board and management team of Turk Telekom. Parliamentary approval of this legislation will be a **prior action for completion of the sixth and seventh program reviews.** In accordance with the new law, the PA will submit a revised privatization plan for Turk Telekom to the Council of Ministers for approval. In order to ensure full commercialization of the company, the members of the new professional board and management team appointed by the general assembly of Turk Telekom will have recognized qualifications and experience. The board and management team will have members with relevant private sector experience **(appointment of such a board and management team will be a condition for the completion of the eighth review).** Moreover, the board of directors of Turk Telekom will adopt a comprehensive corporatization plan. The corporatization plan will: (i) introduce international standards, financial controls, and management procedures, adequate to ensure unqualified audit opinions; (ii) bring staffing levels in line with the real operational requirements of the company; and (iii) address the need to expand both internet and rural access. Preparatory work will also be initiated for speeding up the sale of third generation mobile phone licenses.

- To further deregulate the civil aviation industry and attract foreign investment, Parliament has passed a law liberalizing domestic airline fares.

- With regard to TUPRAS, the PA intends to carry out a further public offering which will increase the private sector stake in the company to 51 percent.

- The law to reform the sugar market was approved in April. The Tobacco Law—which liberalizes the tobacco sector, phases out the support purchases of tobacco, and allows for the sale of TEKEL assets—is expected to be approved by Parliament in May (**a condition for completing the eighth review**). Following the approval of this law, the privatization of TEKEL and SEKER, which is expected to be completed by end-2002, will be coordinated with other components of the agriculture reform program that we expect to be supported by a loan from the World Bank.

- ERDEMIR will be privatized through a merger with ISDEMIR and additional sale of shares on the Istanbul Stock Exchange.

- The government intends to privatize those thermal electricity generation and electricity distribution assets remaining in state hands after the June 30, 2001 deadline for the transfer of operating rights stipulated in the electricity market law. The PA will engage investment advisors to conduct these transactions under a timetable consistent with the market reform strategy set forth in the law.

- Parliament has approved a law to reform the gas sector. This legislation includes a framework for privatization of the gas distribution assets of BOTAS (the natural gas company).

- We intend to initiate a program for the sale of land owned by the state. This program will be defined in May 2001 and may potentially yield, over the medium term, sizable receipts.

22. **Foreign direct investment (FDI) can play a critical role in the years ahead.** FDI in Turkey has remained low despite Turkey's advantageous location, large domestic economy, and skilled and cost-effective labor force. In this regard, success in achieving the program's goals of attaining macroeconomic stability, advancing the privatization program, and establishing a continuous and predictable policy reform process should greatly increase the attractiveness of Turkey to foreign investors. In addition, while there are no major legal impediments to FDI, the government is taking steps which should improve the investment environment for all investors. Among these steps:

- A law fully implementing the constitutional amendment on international arbitration will be passed before the Parliament's summer recess (**a structural benchmark**).

- A comprehensive study on administrative barriers to investment will be completed by end-June 2001 with the assistance of the Foreign Investment Advisory Service of the International Finance Corporation/World Bank. Based on this study, an action plan—containing deadlines and institutional responsibilities—to streamline procedures that a company must undertake to establish and operate a business legally in Turkey, will be submitted to the Council of Ministers by end-July 2001. Specific actions to be taken under the program from this plan will be identified during the tenth program review.

- An extensive review of the commercial law, the land development law, and other laws affecting the investment environment will be completed by September 2001. In addition, the government will review the tax laws, and will identify, if necessary, legal steps to rationalize investment tax allowances, improve the structure of incentives, and streamline statutory rates, while safeguarding tax revenues.

23. **The above steps are expected to facilitate not only FDI, but also the business environment more generally.** To the same end, we will maintain close contacts with the main business organizations and we will explore with them further measures that the government could undertake over the next few months.

C. Macroeconomic Policies for Financial Stability and Growth

24. **The structural steps described above will provide challenges for macroeconomic policies aimed at financial stability and growth.** In the immediate future, the major costs shifted to the budget and the related need to increase the supply of treasury paper will make financial management more difficult in 2001. In response to this, we have intensified the

pace of adjustment in the primary fiscal balance, in spite of the decline in economic activity observed recently. This was necessary to contribute to the financing of the additional burden of public debt arising from the crisis. The availability of international support, together with the strengthening of our macroeconomic and structural policies, should restore confidence and facilitate the decline in interest rates. This, together with a rebound in exports and continued good performance of tourism, should counter the contractionary effects of the fiscal tightening and make possible a recovery of output in the second half of 2001.

25. **There will also be key opportunities**. First, the strengthening of the banking system will allow more flexibility in monetary policy. Second, the medium-term developments of fiscal accounts will eventually benefit from the program's structural policies, including privatization. This will enhance the credibility of the fiscal adjustment and facilitate sustainable interest rates.

Fiscal policy and public debt management

26. **Fiscal policy will remain focused on the process of fiscal adjustment initiated in 2000, a precondition for the resumption of growth on a sustainable basis.** The floating of the Turkish lira requires a reassessment of the fiscal targets for 2001 and 2002. The revision in the GNP growth rate in 2001 from about 4 percent indicated in the December LoI to the current –3 percent involves a sizable fiscal loss of some 2½ percentage points of GNP. However, because of the high borrowing requirement of the government this year, as well as the need to service over the medium term the additional public debt arising from the crisis, we intend not only to fully offset this loss, but also to increase the primary surplus of the public sector to a level higher than in the program formulated in December 2000. We have enacted in April a supplementary 2001 budget law authorizing the issue of the securities needed to recapitalize the banking system, reflecting the additional interest costs, and allocating resources for some temporary credit subsidies (see below). Other expenditures continue to be limited, for the moment, to the appropriations of the original budget.

27. **The main fiscal targets for the public sector in 2001 and 2002 are the following (Tables 3 and 4):**

- The primary surplus of the public sector (including the consolidated central government, extrabudgetary funds (EBFs), nonfinancial state enterprises, social security funds, the unemployment insurance fund, and local governments), which was close to 3 percent of GNP in 2000 and which the December 2000 LoI targeted at 5 percent of GNP in 2001, is now targeted to reach 5½ percent of GNP this year and 6½ percent of GNP in 2002.

- The net public debt-to-GNP ratio including the net asset position of the CBT (Tables 1 and 4) will rise sharply this year, from 58.4 percent at end-2000 to 78.5 percent at end-2001. However, this increase reflects one-off factors: first, the effect of the devaluation on the value of external debt expressed in domestic currency; second, the exceptionally high level of interest rates during the crisis, which led to an explosion of the borrowing costs of the public sector, particularly state and SDIF banks; third, the taking over and the cover of the losses of insolvent private banks; fourth, the fall in GDP. Moreover, the above figures include a contingency for possible additional costs of bank restructuring that may eventually arise. The fiscal costs arising from the need to recapitalize state banks and the take-over of private banks are estimated to amount to TL 44 quadrillion (24 percent of GNP) at end-April 2001 (Table 5). As a sizeable portion of these costs was already included in the estimate of public debt at end-2000, the total increase in public debt from bank restructuring amounts to TL 22 quadrillion.

28. **In spite of the large increase in public debt registered in 2001, the dynamics of public finances remain inherently stable, given the level of the primary surplus, and the expectations that real interest rates will decline from their current abnormally high level.** Indeed, the public debt ratio is expected to fall sharply already in 2002 (Tables 1 and 4), and to edge down further in 2003 (although this partly reflects privatization receipts).

29. **The primary surplus of the consolidated central government (excluding privatization proceeds, transfers of profits from the CBT, and interest receipts) is targeted at 5.1 percent of GNP in 2001 (against 4.6 percent of GNP in 2000) and at 5.6 percent of GNP in 2002.** The primary revenue ratio will decline slightly (from 25.4 percent of GNP to 25.0 percent of GNP) but the primary expenditure ratio will decline more rapidly (from 20.8 percent of GNP to 19.9 percent of GNP), in spite of the inclusion of the Public Participation Fund in the budget as of 2001.

30. **To achieve these goals, we have, along with the approval of the 2001 budget, implemented significant tax and nontax revenue measures. In addition, we will:**

- Increase the petroleum consumption tax (PCT) by 15 percent in early May (after a 20 percent increase in April).
- Increase VAT rates, excluding the reduced 1 and 8 percent rates, by one percentage point.
- Increase, as of April, the minimum contribution base relevant for social security payments in line with the existing regulations.

Approval of the above revenue measures will be **a prior action for the completion of the sixth and seventh reviews**. Furthermore, as of June 2001, we will raise the PCT every month by at least WPI inflation; this, together with the increases in the PCT mentioned above, will raise the yield of this tax by 0.4 percent of GNP with respect to 2000. We will also increase health premia and co-payments as part of the reform of social security institutions now in parliament, before the summer parliamentary recess. Finally, as part of the amendments to the Banking Law (see above), we will allow, effective as of the second quarter of 2001, the full deductibility of the specific loan loss provisions that banks are mandated to make based on bank supervision regulations. At the same time the tax deductibility of general provisioning will be eliminated.

31. **On the expenditure side, we will aim at keeping the growth rate of primary expenditure well below that of GNP.** Real spending, adjusted for the transfer of the Public Participation Fund to the central government, will be cut by about 8 percent between 2000 and 2001. To this end, the following policies will be implemented:

- We will save some 1½ percentage points of GNP by adjusting current expenditure, transfers, and investment by less than the revision in the inflation target. While the savings in the area of investment spending this year will arise from slowing down investment projects, we intend to rationalize our public investment policies through a more structured approach in the 2002 budget. More specifically, the number of projects will be decreased gradually to a sustainable level, in accordance with sectoral targets and available financial resources. The State Planning Organization (SPO) and the line ministries will take the necessary measures to optimize the existing project stock in the preparation of the 2002 budget. For this purpose, they will prioritize their investment plans and will not propose new investment projects, except emergency projects based on sound feasibility reports.

- In addition, savings of 0.3 percent of GNP will be generated during the implementation of the budget by cuts in "other current expenditure," covered by Article 53 of the budget law, as already envisaged in the December 2000 LoI.

- We have allocated 0.2 percent of GNP to finance—in a transparent manner—the temporary credit subsidies extended by state banks in 2001 as a result of the crisis. These subsidies will cover the cost for the state banks of financing the loans outstanding before the February crisis at a rate of 55 percent (simple interest). New lending will be charged interest rates in line with the borrowing costs of banks. Credit subsidies will be eliminated as of January 2002.

- As the level of civil servants' wages was low by historical standards at end-2000, our goal is, in spite of the recession, to maintain civil servants' wages constant in real terms during 2001 with respect to end-2000. Civil servants' salaries were raised by 10 percent in January, and will be adjusted further during the first half of 2001 by the difference between the CPI inflation rate and 10 percent. As stated in the Budget Law, a 2 percent adjustment has been granted during the first half of the year to compensate for the one month lag in salary adjustments existing under this system. Salaries will be raised in July 2001 by 5 percent. However, should cumulative CPI inflation exceed the salary increases granted up to July, salaries will be adjusted by that difference before end-2001. Halting the trend registered during the 1990s, the number of civil servants will not increase in 2001 in spite of the need to raise employment in key social sectors (mostly health and education).

Approval of a supplementary budget in line with the above expenditure figures will be **a condition for the completion of the eighth review**.

32. **A major improvement is expected in the primary position of the state enterprises, which is projected to move from a deficit of 1½ percent of GNP in 2000 to a broad balance in 2001**. To this end, we will, in addition to implementing prudent wage policies, take the following measures: (i) increase SEEs' tariffs and prices in line with their increased costs due to the depreciation of the lira and the revised inflation target; (ii) reduce SEEs' operating expenses, including their wage bill, in real terms; (iii) cut sugar beets quotas from 12½ to 11½ million tons, and increase the support price of sugar beets by no more than targeted inflation; (iv) limit the volume of support purchases of cereals and offload additional grain stocks; (v) 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); (vi) maintain the average price of electricity sold by TEAS at US$4.5 cents/kwh and increase accordingly fees and tariffs of TEDAS, allowing the latter to cover the cost of purchasing electricity from TEAS; (vii) discontinue the policy of subsidizing LPG; and (viii) eliminate all discounts and exemptions on SEE products and services by June 2001. In addition, we will continue to implement the 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. Personnel transferred from one SEE to another will be treated as replacements. In all cases, new hiring is subject to approval by Treasury. Before applying to Treasury for new employment, SEEs will transfer their employees among their regional units, and retiring personnel will not be re-employed by SEEs. No workers will be transferred from the companies in the PA portfolio, funds and revolving funds to the SEEs or to the consolidated budget. Overtime payments will be strictly limited.

33. **Savings are also expected in the EBFs**, in particular by slowing down new expenditure programs. This will reduce their primary deficit from ½ percent of GNP in 2000 to ¼ percent in 2001. The primary surplus of the unemployment insurance fund is projected to increase by ¼ percentage point of GNP, as benefits will start being paid only in mid-2002. The deficit of social security institutions will, as during the previous years, be financed by budgetary transfers so as to maintain a balanced overall position. Local governments are expected to continue to run a small primary deficit. The taking over of their liabilities by Treasury in the case of guaranteed loans will be included as central government expenditure in the 2002 budget (see paragraph 19).

34. **In addition to the above fiscal measures, which will have an immediate effect on the fiscal accounts, we are also taking steps that would allow us to strengthen the tax base and achieve a better distribution of the tax burden over the medium term.** There is a need, in particular, to reduce tax evasion. We plan to significantly broaden the effective taxpayers base by doubling the number of tax identification numbers (TINs) issued by the end of 2002, starting from 15.2 million at end-2000. Among other measures, the rolling out of the TINs to owners of bank accounts, users of banking services, and participants in financial transactions will begin in September 2001 and will be gradually extended through June 2002 by lowering the threshold for mandatory tax registration. To that effect, the

necessary tax regulation will be enacted by end-May 2001 (**a condition for completing the eighth review**). To better exploit the potential offered by the recently completed computerization of operations, and to improve the processing and sharing of taxpayer data (including third-party information), we will merge and reorganize the three data processing centers of the tax administration. Moreover, by strengthening tax collection and enforcing all tax regulations, we intend to reduce by end-2001 the stock of private sector tax arrears, which stood at 2 percent of GNP at end-2000 (including interest and penalties) (**a structural benchmark**). As to tax and social contribution arrears of state-owned enterprises, they will be eliminated by the end of 2002. We will adjust promptly the interest rates on late payment of tax and social security arrears to keep them sufficiently above market interest rates.

35. **The attainment of the 2001 fiscal targets will be monitored through a set of performance criteria and indicative targets**:

- Performance criteria on the primary surplus of the consolidated government sector (CGS, as defined in Annexes B-D) (Annex B).

- Performance criteria on the non-interest expenditure (excluding tax refunds) of the central government (Annex C).

- Indicative floors on the overall balance of the CGS, excluding privatization receipts, so as to monitor the developments not only in the primary balance, but also in interest payments (Annex D).

36. **We believe that the above fiscal measures are sufficient to achieve the program's goals. However, we would introduce additional fiscal measures promptly should it be necessary for the attainment of the key macroeconomic targets.** In particular, additional fiscal measures—the need of which will be examined during the program reviews— would be enacted if nominal interest rates, on a sustained basis, failed to decelerate in line with the program's baseline. Such a policy tightening would be needed to ease pressures on interest rates as well as to support the medium-term fiscal adjustment process.

37. **Public debt management will face major challenges in 2001**. The securitization of the duty losses of the state banks, the replacement of the securities issued in the past to these banks, and the recapitalization of the SDIF banks will increase the amount of marketable securities in the system, and raise the stock of debt that has to be serviced in cash. These new commitments are fully taken into account in projecting our interest burden for 2001 and the following years. It needs to be stressed that, to a large extent, the issue of these securities related to the bank restructuring, which will be completed by early May, and its subsequent servicing does not represent an addition to public debt in the system, but merely its securitization. For example, the payment in cash of the interest on the securities issued to state banks will allow state banks to reduce their borrowing requirement, thus relieving pressure on the money market and facilitating the placement of the government securities needed to service the higher stock of treasury debt.

38. **The availability of foreign financing from official sources will facilitate the rollover of external debt.** Nevertheless, the external borrowing program of the treasury has been based on conservative assumptions on our international bond issues (which has been scaled down to US$ 2½ billion, of which US$ ¾ billion has already been issued). Developments in this area will be monitored through the performance criteria in Annexes G and H.

39. **Domestic debt management will aim at reducing borrowing costs, facilitating the roll over of government paper, and broadening the potential investor base.** The maturity of public debt has shrunk during the crisis. However, the outcome of the most recent treasury bill auctions indicate the return to more normal market conditions and the markets' willingness to invest at longer maturities. The elimination of the overnight position of the state banks—in itself a positive step forward—has, in the short run, been matched, by borrowing by the CBT from commercial banks. However, the maturity at which the CBT has been borrowing has also increased. In the period ahead, the maturity of the debt instruments issued by public institutions is expected to lengthen further, as the conditions in the government securities markets improve, and the CBT reduces its stock of reverse repurchase agreements (partly reflecting its strong profit position, partly the possible early repayment in cash by Treasury of the securities acquired by the CBT from state and SDIF banks). To facilitate this process, and create a smoother borrowing and repayment schedule over time, the domestic borrowing schedule for 2001 has been revised. The government's total financing needs, including the securitization of its obligations to the SDIF and state banks, will be fully and transparently disclosed to the public. Beginning in April, the Treasury has moved from monthly to weekly securities auctions. The amount of securities sold at each auction will be determined flexibly, according to market conditions, and will not be solely determined by the Treasury's immediate financing needs. The primary dealer system will be enhanced, and consideration is being given to introducing some additional methods of trading. The Treasury is also exploring the possibility of lengthening the maturity of public debt through voluntary debt swap operations. Finally, we are considering changes in the structure of the taxation of financial instruments that would facilitate the direct purchases of government securities by individuals, thus reducing the dependence on demand from banks. Possible further steps in this area will be discussed during the eight program review.

Monetary Policy Under the Float

40. **The economic program launched in December 1999 contained an exit strategy from the crawling peg regime with a view to reducing the vulnerability of the monetary framework to real and financial shocks.** The monetary framework would gradually shift from one where the exchange rate played the role as key nominal anchor to one in which the central bank would focus more directly on its final goal of controlling inflation. The December 2000 LoI indicated more specifically the intention of eventually managing monetary policy under a formal inflation targeting regime. However, the implementation of this preannounced gradual shift was overtaken by the float of the lira. The abandonment of the exchange rate anchor makes it necessary to reorient the monetary framework.

41. **In the context of a strengthened banking sector and floating exchange regime, monetary policy will be able to play a more active role and, will be used first and foremost to contain the inflationary impact of the depreciation of the Turkish lira and then to bring inflation down over the next few months.** The monetary policy institutional framework has been strengthened by the approval of amendments to the CBT law granting autonomy to the central bank and with a view to a shift towards a full-fledged inflation targeting framework, as early as possible.

42. **As a key first step in setting up a formal inflation targeting framework, an amendment to the central bank law has been approved to give full operational independence to the central bank in pursuing its primary mandate of maintaining price stability.** This legislation includes several crucial provisions, such as: the establishment of price stability as the primary goal of the central bank; formal reporting to government on the progress in the pursuit of this target; fixed terms of office not only for the Governor and Board members of the central bank (as in the previous legislation), but also for the Deputy Governors; and the creation of a Monetary Policy Committee, which would advise on the design and implementation of monetary policy. The amendments also prohibit any form of new direct lending from the CBT to Treasury (including purchases of government paper on the primary market), following a transition period expiring in early November 2001. The central bank intends to strengthen the technical infrastructure needed to implement inflation targeting, including the improvement in inflation forecasting techniques and in procedures to enhance the monitoring and accountability of monetary policy.

43. **In seeking to resume disinflation over the balance of 2001, the CBT will focus on the control of monetary aggregates**. More specifically:

- The CBT will keep the growth level of base money broadly in line with the indicative ceiling set forth in Attachment E. This path represents our main nominal anchor for the program. Base money is projected to grow in 2001 by 25¾ percent, or by 47 percent after adjusting for the end-2000 Bayram and the cut in the reserve requirement coefficient in early 2001. This is expected to be consistent with the inflation and growth projections set forth in the above sections.

- Given the current environment of unsettled expectations, and the usual problems with estimating money demand in Turkey, the projections of money demand used to derive the base money path are subject to some uncertainty. It will be necessary, therefore, to keep the development of the monetary aggregates under close review. In particular, the CBT stands ready to raise money market interest rates promptly regardless of the position of base money with respect to its indicative targets to counter unexpected inflationary pressures. While the monthly reviews will provide an opportunity to revisit these projections if need be, the CBT will remain in close contact with Fund staff between program reviews to assess developments in the money and foreign exchange markets.

- The attainment of the above indicative targets for base money is expected to be consistent with the decline in nominal and real interest rates from their exceptionally high levels.

This decline is expected to reflect primarily the recovery of confidence as the program's policies are implemented and the use of the external resources ease pressures in financial markets. However, the bulk of the sizable external financing available to the CBT under the program will be used to facilitate this decline and restore markets' confidence. The program's performance criteria for net domestic assets of the CBT (NDA) and for net international reserves (NIR), which are presented in Annexes F and G, have been set at a level that would allow the use of the available external financing for this purpose. However, should our program succeed in bringing interest rates down as rapidly as expected, we will keep the change in NIR above the program floor (and NDA below the program's ceiling). Developments in this area, including the behavior of interest rates, NIR, and NDA, will be subject to close scrutiny, in close consultation with the Fund staff, between and during the forthcoming program reviews, to ensure that the program objectives are achieved.

- In case the available external financing is used as explained in the preceding paragraph, the sales of foreign exchange by the CBT on the market will not be aimed at stabilizing the exchange rate at any particular level, but to restore stability in the securities' market and facilitate a rapid reduction in interest rates. While we expect a relative strengthening of the Turkish lira due to the strength of our program and the level of external support, the exchange rate will continue to be determined by the market, in line with the demand and supply of foreign exchange. To this end, most of the market transactions in foreign exchange by the CBT will occur through auctions.

D. Social Dialogue, Incomes Policy, and Protection of the most Vulnerable

44. **Avoiding a damaging wage-price spiral will require more structured incomes policies, including a closer cooperation with the social partners.** The benefits from low inflation will accrue to all sectors of the economy and all segments of the population have to work in harmony to achieve this goal. Moreover, an efficient incomes policy, including a safety net for the most vulnerable, will minimize the adverse effect of the recent crisis on employment and growth. The government policies in this area include three components: (i) wage policies in the public sector; (ii) an active dialogue with the social partners that is conducive to wage and price decisions in line with the inflation target; and (iii) a program of social protection for the most vulnerable.

45. **Wage increases in the public sector will be supportive of our disinflation effort and fully consistent with the fiscal targets**. It is also important and desirable to reduce the disparity between civil servants and government workers which has resulted from the very large increases accorded to public sector workers two years ago. In the medium term, we want to introduce a much stronger link between wage contracts and the performance of individual state enterprises. As detailed above, we will maintain the purchasing power of civil servants wages, first through increases in line with targeted inflation and second through ex-post compensation if inflation exceeds the target (a policy that is different from indexation and is not inconsistent with our disinflation effort). For public sector workers, we will negotiate new two-year wage contracts with the unions representing these workers that are

supportive of the stabilization and reform program. We believe the nominal wage increase during the contract period should have an important signaling effect, and thus constitute one of the anchors of the disinflation program. We will aim at reducing the ratio of average net salaries of public sector workers and civil servants 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, however, exceed 80 percent of the difference between actual and projected inflation, and there will be no such adjustment for the first six-month period.

46. **Rational wage and price setting behavior in the private sector is also essential for the success of the program.** The government will play an active role in the discussions between the social partners to encourage moderate wage and price increases. An intensive dialogue with the employers and trade unions will be established. To this end, following the adoption of the Law on the Economic and Social Council in April, the Council will now be in a position to hold frequent and regular meetings. Moreover, as part of its communication strategy (see paragraph 5), the government will enhance its communication with the public also in this area, so that it will be clear to the social partners that it is in their best interest to set prices and wages so as to support the disinflation program.

47. **Protecting the social welfare of all of Turkey's citizens is a fundamental component of our program.** We intend to strengthen our social protection programs, with the support of the World Bank, to help reduce the impact of the economic downturn on the most vulnerable sections of the population. Regarding social insurance, we have already implemented important reforms including: (i) a reform of the public pension system to safeguard its financial viability; (ii) adoption of legislation to establish a framework for voluntary private pensions; and (iii) introduction of national unemployment insurance. In addition, we will continue to provide severance payments to public sector workers displaced as a result of privatization. With regard to social assistance, we intend to move quickly to provide targeted assistance to vulnerable groups most affected by the crisis. A social assessment has been initiated and we expect support from the World Bank in implementing this urgent assistance program.

Table 1. Turkey: Selected Indicators, 1999-2003

	1999	Prel. 2000	Proj. 2001	2002	2003
Real Sector					
GNP growth rate	-6.1	6.1	-3.0	5.0	6.0
GNP deflator growth (in percent)	55.8	51.6	49.4	28.3	16.5
WPI inflation (12-month, end-of-period)	62.9	32.7	57.6	16.6	12.4
CPI inflation (12-month, end-of period)	68.8	39.0	52.5	20.0	15.0
Average nominal T-bill interest rate	106.2	38.0	81.1	40.6	32.6
Average backward-looking T-bill real interest rate 1/	25.2	-11.4	23.7	6.9	13.2
Average forward-looking T-bill real interest rate 2/	32.0	-6.5	36.4	20.0	18.0
Central Government's Budget (in percent of GNP)					
Primary balance 3/	1.5	4.6	5.1	5.6	5.6
Net interest payments 4/	13.1	15.8	20.1	19.2	16.1
Budget balance	-11.6	-11.2	-15.0	-13.6	-10.5
Operational balance 5/	-4.0	-2.0	-0.6	-4.8	-2.5
Consolidated Public Sector (in percent of GNP)					
Primary balance of public sector	-2.0	2.8	5.5	6.5	6.5
Net interest payments 6/	22.1	21.9	22.6	16.2	13.5
PSBR (incl. CBT profits)	24.2	19.1	17.1	9.7	6.9
Operational balance 5/	-12.4	-6.6	-3.2	-2.3	-0.1
Net Debt of the Public Sector (in percent of GNP) 7/	61.0	58.4	78.5	70.4	64.9
Net external	20.1	19.7	34.2	28.3	23.5
Net domestic	40.9	38.8	44.3	42.1	41.5
Of which: Gross domestic debt of the central government	42.5	41.0	60.9	57.8	57.3
Of which: Auctioned debt	25.8	23.4	23.2	28.3	32.3
Net Debt of the Public Sector (in percent of centered GNP) 8/	48.6	50.6	67.9	63.8	60.5
External Sector					
Current account balance (in percent of GNP)	-0.7	-4.8	-0.6	-0.9	-0.6
Gross external debt (in percent of GNP)	55.0	56.6	66.2	59.6	56.8
Net external debt (in percent of GNP)	34.0	37.0	44.3	39.4	36.2
Monetary Aggregates					
Seignorage 9/	3.2	1.8	1.5	1.0	0.7
Nominal growth rate of broad liquidity	100.0	39.9	59.5	29.7	17.3
Privatization Proceeds (in millions of US$)	139	3,273	3,109	3,500	3,500
Net External Financing of Public Sector (in millions of US$)	1,417	4,134	-291	1,773	-938
Amortization	5,971	6,199	8,535	6,927	8,438
Gross borrowing	7,388	10,333	8,244	8,700	7,500
Of which: Eurobond issues	5,000	7,500	2,500	4,700	4,500
GNP (in trillions of lira)	78,283	125,971	182,439	245,814	303,626

1/ Average of monthly nominal T-bill interest rate divided by 12-month past CPI inflation.
2/ Average of monthly nominal T-bill interest rate divided by 12-month ahead CPI inflation.
3/ Excluding profit transfers from the CBT, interest receipts, and privatization proceeds.
4/ Interest payments minus interest receipts plus profit transfers from the central bank.
5/ Overall balance netted out of the difference between nominal interest payments and real interest payments.
6/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
7/ Gross public debt net of the net assets of the CBT.
8/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.
9/ Change in reserve money (currency issued plus reserve requirements) in percent of GNP.

Table 2. Structural Policy Conditionality, 2001

Action	MEP Ref.	Type of Action	Timing
Banking sector reform			
1. Reduce the SDIF and state banks' overnight position by at least two-thirds from the March 16, 2001 level, including the elimination of overnight positions vis-à-vis commercial banks	¶8	Condition for the completion of the 6th and 7th reviews	...
2. Eliminate the SDIF and state banks' remaining overnight position	¶8	Condition for the completion of the 8th review	...
3. The stock of repos of the SDIF and state banks with the CBT not to exceed TL 7 quadrillion	¶8	Condition for the completion of the 8th review	End-May 2001
4. Establish a common and politically independent board for Ziraat and Halk, reporting to the Treasury, and appoint new management.	¶10	Condition for completion of the 6th and 7th reviews	...
5. Complete financial restructuring of state banks	¶10	Condition for completion of the 6th and 7th reviews	...
6. Close Emlak Bank and transfer its liabilities and some of its assets to Ziraat Bank	¶11	Condition for completion of the 8th review	End-May 2001
7. The SDIF to recapitalize Sümerbank to cover the bank's negative net worth	¶12	Condition for completion of the 6th and 7th reviews	...
8. Recapitalize the remaining SDIF banks to cover their negative net worth	¶13	Condition for completion of the 6th and 7th reviews	...
9. Organize in a second transition bank or put into liquidation the four banks for which there are presently no interested bidders	¶13	Condition for completion of 8th review	End-May
10. Sell, put into liquidation, or otherwise resolve the remaining SDIF banks	¶13	Condition for completion of the 12th review	End-2001

Table 2. Structural Policy Conditionality, 2001

Action	MEP Ref.	Type of Action	Timing
11. Presentation by all capital-deficient banks of detailed capital strengthening plans	¶15	Prior action for 6th and 7th reviews	End-April 2001
12. Parliamentary approval of amendments to Banking Law	¶16	Condition for completion of the 6th and 7th reviews	…
13. Adopt connected lending regulation	¶17	Benchmark	Within one month of approval of amendments to the Banking Law
14. Bring accounting standards for banks in line with international standards	¶17	Benchmark	From the beginning of 2002
Fiscal Transparency and Management			
15. Close the remaining 15 BFs (except DFIF) and 2 EBFs	¶19	Benchmark	End-June 2001
16. At least halve the number of revolving funds	¶19	Benchmark	End-2001
17. Submit to Parliament a Law on Public Finance and Debt Management	¶19	Benchmark	End-June 2001
18. Accompany the draft 2002 budget by accounts and financial outlook for all EBFs and SSIs, revolving funds, contingent liabilities of the Treasury, all SEEs, and local authorities	¶19	Benchmark	…
19. Submit to Parliament a Public Procurement Law in line with UN (UNCITRAL) standards	¶19	Benchmark	October 15, 2001
Increasing the Role of Private Domestic and Foreign Capital in the Turkish Economy			
20. Parliamentary approval of legislation to facilitate Turk Telekom privatization	¶21	Prior action for 6th and 7th reviews	…
21. Appointment of new professional board and management team for Turk Telekom	¶21	Condition for the completion of the 8th review	…
22. Parliamentary approval of Tobacco Law	¶21	Condition for completion of 8th review	May 2001

Table 2. Structural Policy Conditionality, 2001

Action	MEP Ref.	Type of Action	Timing
23. Passage by Parliament of a law fully implementing the constitutional amendment on international arbitration	¶22	Benchmark	Before Parliament's 2001 summer recess
Fiscal Policy and Public Debt Management			
24. 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 existing regulations	¶30	Prior action for 6th and 7th reviews	...
25. Approval of supplementary budget in line with program expenditure figures	¶31	Condition for completion of 8th review	...
26. Enact tax regulation to extend the use of Tax Identification Numbers	¶34	Condition for completion of 8th review	End-May 2001
27. Reduce the stock of private sector tax arrears from the end-2000 level of 2 percent of GNP (including interest and penalties)	¶34	Benchmark	End-2001

Table 3. Turkey: Public Sector Primary Balances, 2000-02
(In percent of GNP)

	2000	2001						2002
		Original program			New program			
	Estimate	Baseline	Measures 1/	Program	Revised Projections 2/	New Measures 3/	Program	Program
Public sector	**2.8**			**5.0**	**2.4**	**3.1**	**5.5**	**6.5**
Central government 4/	**4.6**	**3.3**	**2.3**	**5.6**	**2.8**	**2.3**	**5.1**	**5.6**
Total revenue	25.4	24.0	2.0	26.0	24.0	1.0	25.0	25.3
Tax revenue	21.0	19.6	1.8	21.4	19.5	0.9 5/	20.4	20.7
Nontax revenue 4/	4.3	4.4	0.2	4.6	4.5	0.1 6/	4.6	4.6
Noninterest expenditure	20.8	20.7	-0.4	20.4	21.2	-1.3	19.9	19.7
Personnel	7.9	8.1	-0.2	7.9	8.0	-0.2 7/	7.8	7.8
Other current	2.8	2.8	0.0	2.7	3.2	-0.5 8/	2.6	2.6
Transfers (excl. credit subsidies)	8.1	7.6	-0.1	7.5	7.7	-0.5 9/	7.1	7.1
Credit subsidies	0.1	0.0	0.0	0.0	0.0	0.2	0.2	0.0
Investment	1.8	2.3	0.0	2.2	2.3	-0.3 10/	2.1	2.1
Rest of the public sector	**-1.8**			**-0.6**	**-0.4**	**0.8**	**0.4**	**0.9**
EBFs	-0.5			-0.2	-0.5	0.2 11/	-0.3	-0.1
Unemployment insurance fund	0.3			0.5	0.6	0.0	0.6	0.6
Local governments	-0.1			-0.1	-0.1	0.0	-0.1	-0.1
SEEs	-1.5			-0.9	-0.5	0.6 12/	0.1	0.5
Social insurance institutions	0.0			0.0	0.0	0.0	0.0	0.0
Memorandum item:								
GNP (in trillions of TL)	125,971	154,679	154,679	154,679	182,439	182,439	182,439	245,814

Sources: Turkish authorities; and Fund staff estimates.

1/ Excluding the extension, in 2001, of temporary revenue measures taken in 1999-2000.

2/ Taking into account the revised macroeconomic framework after the February 2001 crisis.

3/ New measures relative to the original program. Spending cuts in footnotes 8-12 are expressed with respect to the revised projections, in which real spending is kept constant relative to the original program.

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

5/ Increase in the VAT by one percentage point and increase in petroleum excises.

6/ Increase in highway tolls.

7/ Limitation in hiring of civil servants, in medical expenses for civil servants, and in wage increases for public workers.

8/ Reductions in real spending by raising nominal allocations by less than the revision in inflation.

9/ Cuts in expenses of social security funds, budgetary funds, and agricultural subsidies.

10/ Cuts in investment expenditure.

11/ Cuts in expenditure of the privatization fund and other funds.

12/ Savings in wages (negotiation of lower wage increases) and operating expenses.

Table 4. Consolidated Net Debt of the Public Sector, 1999-2003
(In percent of GNP)

	1999	2000	2001	2002	2003
A. Central government plus central bank	**52.2**	**49.8**	**71.4**	**65.6**	**62.1**
a. Central bank net assets	**9.0**	**7.8**	**4.4**	**6.5**	**8.0**
NFA	10.0	6.0	-1.5	1.5	3.3
Of which : foreign liabilities	7.6	6.3	15.3	10.8	9.2
Free reserves in FX	1.2	1.4	3.0	2.9	2.7
Claims on banks	3.1	4.5	10.1	8.9	8.3
Free reserves in Lira	0.6	0.5	0.5	0.5	0.5
Central government deposits	2.2	0.9	0.6	0.5	0.4
Other liabilities	0.1	0.0	0.0	0.0	0.0
b. Central government	**62.4**	**58.8**	**83.0**	**78.3**	**75.6**
External	22.2	18.8	22.8	21.0	18.8
Domestic	42.5	41.0	60.9	57.8	57.3
Debt sold at auction	25.8	23.4	23.2	28.3	32.3
Debt for bank recapitalization	16.7	17.4	29.9	22.9	19.0
Debt taken over from the PPF	0.0	0.0	1.4	1.1	0.9
Other	0.0	0.2	0.1	0.1	0.1
CBT credit	...	...	6.3	5.5	5.0
Deposits	2.3	1.0	0.7	0.5	0.4
c. Central government debt held by the CBT	**1.2**	**1.2**	**7.1**	**6.1**	**5.5**
B. Rest of the public sector	**8.7**	**8.6**	**7.1**	**4.7**	**2.8**
Foreign debt	**6.6**	**5.5**	**7.0**	**5.9**	**5.2**
Net Domestic debt	**2.1**	**3.1**	**0.1**	**-1.2**	**-2.4**
Unemployment insurance fund	0.0	-0.3	-1.2	-2.0	-2.8
Other	2.1	3.4	1.3	0.8	0.4
C. Net debt of the public sector	**61.0**	**58.4**	**78.5**	**70.4**	**64.9**
Net external debt	20.1	19.7	34.2	28.3	23.5
Net domestic debt	40.9	38.8	44.3	42.1	41.5
Share of foreign debt in total net public debt	**32.9**	**33.7**	**43.6**	**40.1**	**36.1**
D. Gross external public debt	**36.4**	**30.6**	**45.1**	**37.7**	**33.2**
Memorandum items:					
Centered GNP 1/	98,210	145,320	210,958	271,127	325,748
In percent of centered GNP					
Net Debt of the Public Sector	**48.6**	**50.6**	**67.9**	**63.8**	**60.5**
FX denominated/indexed net debt	16.0	18.3	34.6	30.2	26.1
Lira denominated net debt	32.6	32.4	33.3	33.7	34.4

1/ Measured as the sum of the last two quarters GNP plus the first two quarters GNP of the following year.

Table 5. Turkey: Public Sector Debt from Bank Recapitalization

(In trillions of Turkish lira)

	End-2000	April 2001
Total	**21,934**	**43,857**
SDIF recapitalization	3,842	13,719
Recapitalization in December 2000 1/	3,842	4,510
Additional recapitalization in 2001	...	9,209
Recapitalization of Emlak	0	2,400
State banks (Ziraat & Halk)	18,093	27,738
Unsecuritized duty losses	15,196	...
Securitized duty losses	2,897	...

1/ The increase in the TL stock in 2001 reflects the impact of the depreciation on securities issued in FX.

Table 1. Turkey: Quantitative Performance Criteria and Indicative Targets

	December 31, 2000		January 31, 2001		February 28, 2001		March 31, 2001	
	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome
I. Performance criteria								
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira)	4,500						1,850	N.A.
Adjustment for earthquake-related expenditures	1,343							
Adjusted floor	3,157	4,651						
2. Ceiling on the stock of net domestic assets of the CBT (in trillions of Turkish lira)	1,650	1,073	900	-458	0	2,442	0	5,117
3. Floor on net international reserves (in millions of US$)	10,400		10,700		12,600		12,700	
Adjustment for disbursements of foreign loans in excess of baseline								
Adjusted floor (in millions of US$)	10,400	12,379	10,700	13,038	12,600	8,119	12,700	4,693
4. Ceiling on contracting or guaranteeing of new external public debt (in millions of US$)	23,500	19,082					5,500	1,035
5. Ceiling on the stock of public short-term external debt outstanding (in millions of US$)	1,100	1,000					1,100	1,000
6. Ceiling on the cumulative primary expenditure of the central government (in trillions of Turkish lira)							5,830	5,480
II. Indicative targets								
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira)			400	1,276	1,220	1,981		
2. Floor for the cumulative overall balance of the consolidated government sector (in trillions of Turkish lira)	-18,750						-2,620	N.A.
Adjustment for earthquake-related expenditures	1,343							
Adjusted floor	-20,093	-16,663						
3. Floor on the cumulative primary balance of the consolidated government sector including privatization proceeds (in trillions of Turkish lira)	6,700						3,320	N.A.
Adjustment for earthquake-related expenditures	1,343							
Adjusted floor	5,357	6,582						

Source: Data provided by the Turkish authorities.

Table 2. Turkey: Performance Criteria on the Cumulative Primary Balance of the Consolidated Government Sector

	Floors (In trillions of Turkish lira)
Cumulative primary balance from January 1, 2001, to:	
May 31, 2001 (performance criterion)	3,250
July 31, 2001 (performance criterion)	4,250
September 30, 2001 (performance criterion)	6,200
December 31, 2001 (performance criterion)	9,250

1. The primary balance of the *consolidated government sector* (CGS), Table 2, comprises the primary balances (primary revenue minus noninterest expenditures) of the consolidated central government (consolidated budget), the extrabudgetary funds (EBFs) identified below, the eight state economic enterprises (SEEs) identified below, the social security institutions (SSIs), the unemployment insurance fund, and any new government funds and institutions established after March 31, 2001. 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 7.

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 quarterly baseline reported in Annex J.

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 state banks.

Extra budgetary funds

5. The three EBFs included in the definition of the performance criterion for 2001 are: the defense fund, the privatization fund, and the mass housing fund.

6. The balances of the following budgetary funds and EBFs—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: petroleum consumption fund; revenue improvement administration fund; support stabilization fund; resource utilization fund; fuel price stabilization fund; budget education health tax fund; and social aid and solidarity fund.

State economic enterprises

7. The eight 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), TEAS (electricity), TEDAS (electricity distribution), and BOTAS (natural gas). 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.

8. Net financing from the banking system (excluding pre-export financing from the Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2000 the stock of net banking claims on SEEs as defined above stood at TL 291 trillion, valued at the exchange rates on that day.

9. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2000 the stock of external loans stood at TL 2,694 trillion, valued at the exchange rates on that day.

Social security institutions

10. The deficits of the social security institutions (SSIs) are covered by transfers from the central government budget, and their primary balance is projected to be in balance in 2001. 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 December 31, 2000, while ES and SSK had no expenditure arrears.

Adjusters

11. 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.

Table 3. Turkey: Performance Criteria on the Cumulative Primary Expenditure of the Central Government

	Ceilings (In trillions of TL)
Cumulative primary expenditure from January 1, 2001 through:	
May 31, 2001 (performance criterion)	11,400
July 31, 2001 (performance criterion)	17,450
September 30, 2001 (performance criterion)	23,600
December 31, 2001 (performance criterion)	34,230

1. The primary expenditure of the consolidated central government (Table 3) comprises the cumulative noninterest expenditure of the consolidated central government (consolidated budget). The quarterly ceilings will be monitored from above the line on a modified cash basis (the so-called consolidated budget adjusted non-interest expenditure).

2. For purposes of the program, primary expenditure (Table 3) will exclude tax rebates, transfers to Eximbank, treasury payments of guaranteed debt up to the quarterly baseline reported in Annex J, and any payment related to bank recapitalization and to the restructuring of state banks.

3. The deficits of the social security institutions (SSIs) are covered by transfers from the central government budget. The ceiling on the primary expenditure of the central government (Table 3) will be adjusted downward 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. As of December 31, 2000, the stock of arrears of Bag Kur stood at TL 120 trillion, while the two other institutions had no expenditure arrears.

4. The ceiling on the primary expenditure of the central government (Table 3) will be adjusted downward for any off-budget expenditure of the central government.

Table 4. Turkey: Indicative Floors on the
Cumulative Overall Balance of the Consolidated Government Sector 1/

	Floor (In trillions of TL)
Cumulative overall balance from January 1, 2001 to:	
May 31, 2001 (indicative floor)	-4,750
July 31, 2001 (indicative floor)	-11,750
September 30, 2001 (indicative floor)	-18,150
December 31, 2001 (indicative floor)	-26,450

1/ See Annex B for the definition of the consolidated government sector.

1. The overall balance of the consolidated government sector (CGS), Table 4, comprises the primary balance of the CGS as defined in Annex B, 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 March 31, 2001. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of Annex B. Revenues of the CGS will be defined as in paragraph 2 of Annex B; i.e., excluding privatization proceeds.

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

Table 5. Turkey: Performance Criteria on the Net Domestic Assets of the Central Bank of Turkey

	Ceilings (In trillions of lira)
Outstanding NDA as of April 30, 2001 (projected):	7,780
May 31, 2001 (performance criterion) 1/	9,750
June 30, 2001 (performance criterion) 1/	13,250
August 31, 2001 (performance criterion) 1/	15,850
October 31, 2001 (performance criterion) 1/	19,500
December 31, 2001 (indicative ceiling) 1/	21,000

1/ The compliance with the performance criterion (indicative target) shall be based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

1. The net domestic assets (NDA) of the Central Bank of Turkey (CBT) are defined as base money less the net foreign assets of the CBT valued in Turkish lira at end-month actual exchange rates.

2. Base money is defined as currency issued by the CBT, plus the banking sector's deposits in Turkish lira with the CBT. Indicative ceilings for base money are shown in Table 5.a. below.

3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex F), medium-term 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 March 31, 2001, net foreign assets of the CBT amounted to TL 9,012 trillion.

4. The cumulative net change in the devaluation account from its balance at end-1999 (excluding any distribution–in cash or through the write-off of government paper held by the CBT or by any other means–of unrealized foreign exchange profits) will be subtracted from the end-period NDA stock as calculated above.

5. 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:

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

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. The averaging period will not be changed during 2001.

6. 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.

7. 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 5a. Turkey: Indicative Ceilings for Base Money

	Ceilings (In trillions of Turkish lira)
Outstanding base money as of April 30, 2001	5,850
May 31, 2001 (indicative ceiling) 1/	5,900
June 30, 2001 (indicative ceiling) 1/	6,050
August 31, 2001 (indicative ceiling) 1/	6,300
October 31, 2001 (indicative ceiling) 1/	6,800
December 31, 2001 (indicative ceiling) 1/	7,300

1/ These ceilings shall be based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

Table 6. Turkey: Performance Criteria on Changes in Net International Reserves

	Floors on change in NIR during the specified periods 1/ (In millions of U.S. dollars)
Outstanding stock as of April 30, 2001:	3,860
May, 2001 (performance criterion)	-1,500
June, 2001 (performance criterion)	-2,900
July-August, 2001 (performance criterion)	-2,000
September-October, 2001 (performance criterion)	-2,600
November-December, 2001 (indicative floor)	-600

1/ The change is computed as the difference in NIR stocks between the beginning and the end of each period.

1. 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.

2. 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 November 30, 2000 average London fixing market price of US$269.05 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$426 million on November 30, 2000). The special Dresdner portfolio (amounting to US$898 million on November 30, 2000) 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 November 30, 2000 amounted to US$19,428 million.

3. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL-denominated liabilities indexed to any exchange rate) 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 liabilities arising from balance of payments support borrowing irrespective of their maturity. On November 30, 2000 reserve liabilities thus defined amounted to US$8,331 million.

4. The net forward position is defined as the difference between the face value of foreign currency-denominated central bank off-balance sheet (forwards, swaps, options, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of November 30, 2000 these amounts were zero.

5. 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 rates specified.

6. The limits on the changes in net international reserves for June and subsequent periods specified in the above table will be increased by either the unused portion of the limit on the change in net international reserves from the previous period or by 25 percent of the limit during the current period, whichever is less.

7. The change in net international reserves will be evenly distributed within each period.

Table 7. Turkey: Performance Criteria on the Stock of Short-Term External Debt Outstanding

	Ceilings (In millions of US$)
Outstanding stock as of December 31, 2000:	1,000
June 30, 2001 (performance criterion)	2,100
September 30, 2001 (performance criterion)	2,100
December 31, 2001 (performance criterion)	2,100

The limits specified in Table 7 apply to the stock of debt of maturity of one year or less, owed or guaranteed by the consolidated government sector (as defined in Annex B). The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the IMF on 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 I.

Table 8. Turkey: Performance Criteria on Contracting and Guaranteeing of New External Debt

	Limits (In millions of US$)
Cumulative flows from end-December 1999 to end-December 2000	19,082
Cumulative flows from end-December 2000	
June 30, 2001 (performance criterion)	7,500
September 30, 2001 (performance criterion)	12,000
December 31, 2001 (performance criterion)	17,000

The limits specified in Table 8 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex B) 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.

Table 9. Cross-Exchange Rates for Program Purposes 1/

	Value per U.S. Dollar	Value per Euro
Program exchange rate		
Euro	1.15500	
Austrian schilling		13.7603
Belgian franc		40.3399
Finnish markka		5.94573
French franc		6.55957
Deutsche mark		1.95583
Irish pound		0.78756
Italian lira		1,936.27
Japanese yen	109.87	
Luxembourg franc		40.3399
Netherlands guilder		2.20371
Portuguese escudo		200.482
Spanish peseta		166.386
Swiss franc	1.750	
United Kingdom pound	0.702	

1/ These program exchange rates shall apply to the performance criteria/indicative ceiling or floors for the period December 31, 2000-end December, 31 2001; currencies not specified here shall be converted at the representative exchange rates reported to the IMF as of November 29, 2000.

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.

Table 10. Turkey: Program Baseline for Selected Variables

	2001			
	Mar. 31	June 30	Sept. 30	Dec. 31
Payment of debt guaranteed by the consolidated government sector (in trillions of TL) 1/	200	800	1,200	1,700
(in millions of US$)	257	750	1,100	1,600

1/ For the purpose of the program monitoring, these flows in U.S. dollar will be converted at the average TL/US$ exchange rate of the quarter.

INTERNATIONAL MONETARY FUND

TURKEY

Sixth and Seventh Reviews Under the Stand-By Arrangement—Foreign Exchange Exposures in the Banking Sector

Prepared by Warren Coats (MAE)

Approved by Stefan Ingves

May 10, 2001

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TURKEY: FOREIGN EXCHANGE EXPOSURES IN THE BANKING SECTOR[1]

Executive Summary

1. **At the end of December 2000, private Turkish banks (i.e., excluding banks taken over by the Savings Deposit Insurance Fund—SDIF) reported net foreign exchange liabilities of US$1.4 billion, which was 12 percent of their capital.** When consolidated with financial subsidiaries, their net open positions were US$1.7 billion or 12 percent of their capital. This exposure on average is well under the 20 percent of capital limit permitted by Turkish regulations. A small number of individual banks have been out of compliance with this regulation from time to time, but appropriate measures have been taken to correct the problem in all instances. More recently, following the floating of the Turkish Lira (TL), banks have closed their open position down to US$0.4 billion (5 percent of capital).

2. **Because the financial incentive to be short in foreign exchange is so strong, many in the market and financial press have questioned the accuracy of these data**, which are based on daily average exposures reported weekly by banks to the Banking Regulation and Supervision Agency (BRSA). Putting aside frequent misunderstandings of what the data say, such as failing to include off balance sheet hedges, there is some suspicion that the reported data do not reflect the true positions of many banks. A frequently heard claim, for example, is that many forward purchases of foreign exchange (especially those from related non-financial companies, which are therefore not included in the consolidation), are not genuine or sound and thus do not really protect the bank from exchange rate risk.

3. **The BRSA Sworn Bank Auditors (SBAs) refute these claims.[2]** Three MAE missions examined the issue of foreign exchange exposures. The missions found that the SBAst conduct frequent and thorough on-site examinations and are convinced that banks report their exposures in accordance with regulations. At the same time, many banks claim that it is easy for them to increase their exposures by using specially designed financial

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[1] Prepared by Warren Coats (MAE) and Peter Phelan (U.K. Financial Services Agency, retired). The report was reviewed by the Banking Regulation and Supervision Agency, which agreed with its findings.

[2] The SBAs are the well-qualified, on-site bank examiners of the BRSA. Quoting from the Banking Law: "Assistant sworn bank auditors shall be appointed from among candidates who have received a graduate degree in relevant fields and has successfully passed a competitive examination. Those who have worked as an assistant sworn bank auditor for at least three years shall be appointed a sworn bank auditor by virtue of a resolution adopted by the Board with affirmative votes of minimum five members after they have successfully passed the proficiency examination." (Competition for acceptance to the SBAs is high, and they enjoy a reputation with the pubic for high competence and honesty.)

structures that are not specifically covered by the reporting requirement. Banks claim that they have actual foreign exchange exposures in excess of the prudential limits and that they have profited from these exposures (because of the high interest rates on TL assets compared to the rates on foreign exchange liabilities) even when taking account of the losses from the recent devaluation. Again, the SBAs refute these claims. In fact, with regard to the 13 commercial banks taken over by the SDIF in the last few years, 9 of them used such financial structures. However, the structures were detected by the SBA before these banks were taken over and they failed primarily for other reasons. No further structures where found in the audits of these banks after their takeover. This increases the mission's confidence that the SBAs find reporting abuses in banks when they exist.

4. **Three important questions need to be answered:** (a) what are banks' foreign currency exposures and are they excessive?; (b) have banks suffered financially from their foreign exchange exposures, whatever they actually are?; and (c) is the regulatory regime adequate?

5. **With regard to the first question, it seems unlikely that banks' foreign currency exposures are dramatically different than reported by them to the BRSA/Central Bank of Turkey** (CBT) and are certainly substantially less than those reported by the press and foreign bank analysts. Except for the SDIF banks, the reported exposures are reasonable given the risks and expected return. Nonetheless, some banks insist that they have larger exposures than they report. While supervision seems good, those banks that are determined to hide larger exposures are probably able to do so—at least for a while.

6. **With regard to the second question, the large interest rate spread between foreign currency liabilities and TL assets implies that banks made money on average from their exposures even after deducting the devaluation losses experienced so far, no matter what size their exposure.** By late April the TL/U.S. dollar rate had depreciated by almost 45 percent. Whether banks' exposures will prove profitable in the end depends on what the real depreciation ultimately is in relation to the interest rate spreads that were gained.

7. **With regard to the third question, it would be a supervisory concern if regulations were inadequate and poorly monitored.** But regulations and supervision are adequate. A new market risk regulation, which becomes effective January 1, 2002, provides an appropriate and adequate tool for containing and monitoring foreign exchange exposures in relation to capital. The risk of non-performance of a forward foreign exchange purchase or calling a foreign currency guarantee is a credit risk. These risks should be limited by the over all credit exposure to individual or related counterparties.

8. **The mission recommended that:** (a) the BRSA refute market claims that exposures are larger than reported and provide information on an ongoing basis to clarify the situation; (b) review and improve accounting and reporting standards, especially with regard to off balance sheet items; (c) the 20 percent of capital limit be waived for banks with adequate risk-management systems that adopt the capital charge required under the new market risk

regulation in line with best international practices; and (d) the implementation of the new regulation be brought forward on a voluntary, bank-by-bank basis.

I. Introduction

9. Because the interest differential between foreign currencies and TL has been so large (in relation to the announced rate of depreciation), questions have been raised as to whether banks (and perhaps also the wider economy) have exposed themselves to an excessive amount of exchange rate risk and whether their exposure has resulted in serious loss of capital from the recent devaluation. There is a market perception that banks are significantly overexposed and have incurred heavy losses as a result. The validity of this perception has very immediate implications for the condition of the banking sector following the floating of the TL in February and the policies needed to deal with it.

10. An MAE mission investigated this question in visits to Turkey in February and March (with further follow up in April). Over the two visits, the mission met with BRSA officials, in particular the SBAs, and six commercial banks (large, small, and foreign). More generally, the mission was also concerned whether existing regulations are adequate and whether foreign currency exposures imply a major vulnerability for the banking system.

11. After summarizing the regulatory framework, the Section III examines the data on foreign exchange exposures submitted by banks to the CBT and the BRSA. It then examines misunderstandings and claims in the market with regard to the size of these exposures. Section III provides the mission's assessment of the answers to these questions and Section IV sets out its recommendations.

II. Size and Regulation of Open Positions

A. Regulatory Framework

12. Prudential regulations limit banks' exposures to exchange rate risk to 20 percent of their capital (i.e., the excess of foreign currency liabilities over foreign currency assets, both on and off the balance sheet, must be less than 20 percent of capital). This limit applies to each bank individually (including its branches abroad) and when its balance sheet is consolidated with the assets and liabilities of its financial subsidiaries. There is also an older style regulation on the ratio of foreign exchange assets and liabilities (see Table 1).[3]

[3] It should be noted that prudential regulations prior to the establishment of the BRSA in August 2000 were issued by the Treasury in its capacity as supervisory authority for banks.

13. In addition to these regulations, the CBT, in cooperation with the BRSA, sent a letter to all banks in October 2000 stating the criteria that would be followed in disqualifying forward purchases of foreign exchange when calculating banks' net open position. These included non-market terms for the contracts. Supervisors are empowered to require the unwinding of any illegitimate transaction and the recalculation of the open position. If this creates a violation of the limit, the appropriate penalties are exacted. The BRSA can also take further action against a bank if there seems to be an endemic problem. This procedure has been followed fully in Turkey since the creation of the BRSA, but as noted below, less than 1 percent of banks' foreign currency assets have been disqualified.

14. These regulations will be replaced on January 1, 2002, by the new regulation on capital charges for market risk that was issued at end-January 2001. The new regulation, which also covers foreign exchange risks, is comprehensive and in line with the recommendations of the Basel Committee for Banking Supervision.

Table 1. Turkey: Current Foreign Exchange Regulations

Regulation	Issued	Ratio	Penalty for non-compliance	Reporting
1. Communiqué on the "Consolidated NFX/Capital base" standard ratio	CBT and Treasury issued Dec 21, 1999, effective June 1, 2000	Net Foreign Exchange Position < 20% of capital base, on a consolidated basis.	Banks to increase capital, within 6 months, to a point where the ratio is met	Monthly (based on end month)
2. Communiqué on "Total NFX/Capital Base"	CBT and Treasury issued and effective Aug 29, 1998	Net Foreign Exchange Position < 20% of capital base, on a solo basis.	100% of the excess position to be held at CBT as non-interest-bearing demand deposits	Weekly (based on daily average)
3. Circular on Management of Foreign Exchange Positions	CBT issued August 5, 2000, effective September 1, 2000	(1) Liquid FX Assets > 10% of liquid FX liabilities (2) 80% < FX Assets/FX Liabilities <110% (3) 75% < FX Assets/FX Liabilities < 115% for convertible currencies	On the excess position, 1.5 times CBT rediscount ratio for short-term credits. CBT can apply different ratios to different banks or group of banks.	Weekly

Sources: BRSA and CBT

B. Reported Exposures

15. On December 30, 2000, Turkish banks reported U.S.$105 billion in foreign currency assets and U.S.$110 billion in foreign currency liabilities for a net exposure of US$5.4 billion. Excluding SDIF banks, the net exposure was US$1.4 billion (Table2)[4] This

[4] Unless stated otherwise, the banking sector will refer to banks other than SDIF banks. SDIF banks have both a large foreign currency exposure and negative net worth, thereby distorting (continued…)

was 12 percent of these banks' capital, well within the prudential limits. On a consolidated basis, these banks' net open position was US$1.7 billion, or 12 percent of capital. At the same time, three banks were out of compliance with the prudential limits on a solo basis and eight banks were out of compliance on a consolidated basis. In the latter group, one is a state bank, four are small investment banks, and three are private commercial banks. In the previous month these three commercial banks had been in compliance with the regulation.

16. On March 16, 2001, following the floating of the TL, the latest date for which data are available on a solo basis, non-SDIF Turkish banks reported US$78.9 billion in foreign currency assets and US$79.4 billion in foreign currency liabilities for a net exposure of US$ 0.4 billion. This was 5 percent of capital. Thus, since the floating of the TL, banks have significantly closed their foreign currency exposures.

17. Data on foreign exchange exposures are carefully checked by the SBAs, the on-site examination teams of the BRSA. They are confident that the data reported by banks are broadly correct, and banks have confirmed that, from their perspective, returns are completed accurately and in accordance with the regulations.

C. Hidden Exposures

18. Despite the figures reported above, there is a perception by many in the market that bank foreign exchange exposures are significantly larger than reported. To some extent, this perception results from various misunderstandings that the authorities have failed to correct. Some have focused **on the net on-balance sheet open position of the entire banking system.** The end December 2000 exposure measured in this way was U.S.$18 billion, with capital of U.S.$11.4 billion. However, the entire banking system includes the banks that have failed and been taken over by the SDIF. These banks generally have large negative net worth and large foreign currency exposures that the SDIF has been slow to correct; nonetheless, all such exposures are guaranteed by the government. A more meaningful measure of the exposure risk to the banking sector (though not of the potential cost to the government), therefore, is obtained by excluding the SDIF banks. The end-December 2000 net on-balance sheet open position of the banking system excluding the SDIF banks was US$13.7 billion, with capital of US$12.1 billion.[5]

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the picture if aggregated with other banks. Their losses are guaranteed and paid for by the Treasury/SDIF. State-owned banks are included. As they do not do a large foreign currency business and comply with the limits, including or excluding them does not materially change the picture.

[5] Most of the SDIF banks were recapitalized in December. As a result, their positive net worth was restored until interest rate increases reduced the value of the government securities that they received.

Table 2. Turkey: Net Foreign Exchange Position of Banks
(In billion US dollars, as of end-December 2000)

	Banking system	Banking system excl. SDIF banks
On a solo basis		
FX assets	104.7	99.2
FX liabilities	110.1	100.6
Net FX position	-5.4	-1.4
Net FX position (%) capital	-48.2	-11.7
On a consolidated basis 1/		
Net FX position	-5.7	-1.7
Net FX position (%) capital	-43.0	-12.4
Memorandum Items (as of end-October)		
Forward FX purchase contracts	40.4	
o/w: with related parties	11.0	
Forward FX selling contracts	33.5	
o/w: with related parties	10.4	
Net FX forward contracts	7.0	
o/w: with related parties	0.6	

Source: BRSA.

1/ Data are based on solo positions of banks that report on a solo basis and on consolidated positions of banks that report on a consolidated basis. All banks with financial subsidiaries or affiliates report on a consolidated basis.

19. These figures, however, exclude foreign currency indexed assets and liabilities and off-balance sheet hedges. The indexed and off balance sheet items are quite properly included in the prudential limits on foreign currency exposures. Thus, the more comprehensive measure of exposures reported to the CBT and the BRSA for end-December 2000 for the entire banking system amounted to US$5.4 billion, or 48 percent of capital. For the banking system excluding SDIF banks it was US$1.4 billion, or 12 percent of capital, which is the more appropriate measure of the system's exposure.[6]

[6] In January 2001, banks entered into US$27 billion in forward foreign currency sales and US$36 billion in forward foreign currency purchases. The net forward purchases of US$9 billion, contributed to the cover for what would otherwise have been net foreign currency liabilities of US$11 billion.

Forward contracts and their quality

20. Market analysts have not accepted the validity of such off-balance sheet hedges. Attention has particularly been directed to the suspicion that some amount of the off balance sheet forward purchases of foreign exchange have not resulted from commercial needs of bank customers to hedge, but rather have been entered into at banks' initiative for the purpose of covering an otherwise excessive exposure. Such contracts would not be fulfilled if the counterparties were unable to provide the foreign exchange. Normally, forward contracts are provided by banks for their customers wishing to hedge the exchange risk of expected foreign currency receipts or expenditures. Thus, they are able to fulfill the contract out of foreign currency receipts and would not be affected by changes in the exchange rate.

21. Some of these forward contracts are with non-financial firms within the same group as the bank, and questions have been raised whether these contracts were made at arms length with normal market terms and meeting normal market conditions, i.e., whether they were "fake." The mission investigated these concerns in several ways. The BRSA requires banks to report information on all forward contracts, including the counterparties. These data show that forward purchase contracts with related parties account for about 27 percent of all such contracts as of the end of October 2000. However, the SBAs have found that virtually all forward contracts with related parties are genuine. They have disallowed a negligible number of all foreign exchange forward contracts (less than 1 percent during one year) from their exposure calculations.

22. There are perhaps sometimes misunderstandings of terminology. Market participants often refer to "fake" transactions, to refer to foreign exchange transactions that are purely speculative, i.e., not directly linked to an underlying trade or investment transaction, or designed to hide an exposure (see the next section). Speculative forward contracts are not "fake", per se. A genuine forward contract may be with a counterparty that is speculating rather than hedging a currency position. This is normal behavior and poses no particular risk to the bank if the counterparty is creditworthy (able to sustain the possible losses and fulfill the contract).[7] Thus, the issue of the forward foreign currency contracts should properly be seen as one of counterparty risk and whether banks have properly evaluated and limited that risk.

23. The SBAs carry out a detailed analysis of banks' counterparty credit risk. They check that appropriate analysis has been undertaken by the bank, that relevant limits are in place, including ones for off-balance sheet exposures in foreign exchange, and that exposures are in

[7] In the London foreign exchange market, for example, transactions consist primarily of such speculative deals. In 1998, out of a daily turnover of US$637 billion on the London market, at most 7 percent were with non-financial counterparties (*Central Bank Survey of Foreign Exchange and Derivatives Market Activity, 1998*, Bank for International Settlements, May 1999).

accordance with such limits. Limits for foreign exchange exposures are typically calculated at a percentage of face value. The SBAs have found no examples in the last year of banks undertaking foreign exchange business without proper analysis and/or outside duly authorized limits. They are thus confident that, although "friendly" deals of the kind postulated cannot be completely ruled out (see below), they do not occur to any important extent, either as to numbers or amounts.

24. "Fake" would be an appropriate term to use only in cases where, at the outset, it was manifestly impossible for the counterparty to fulfill its side of the bargain, or there was no intention of doing so. The first point would be picked up by the SBAs, who review counterparty credit analysis as mentioned above. The second is more difficult to assess, particularly at the outset, but should be revealed on maturity of the deal. The SBAs should pick up unexplained failures to pay on the part of counterparties that are not appropriately dealt with by the bank concerned. The SBAs are confident that such deals are extremely limited in number. The mission accepts this view.

"Fake" reporting and window dressing

25. Banks could enter into "fictitious" hedges, e.g., by doing a hedging transaction (such as a forward contract) with a friendly counterparty just before a reporting date, and unwinding the transaction shortly thereafter. According to the SBAs, this does occur from time to time, but regulations forbid it and, indeed, since the open position has to be maintained within limits on a daily basis (albeit that reports are weekly for solo banks) there would be no point in such transactions.[8] Window-dressing transactions for external presentation purposes are another matter, but would still be caught by the regulations if they were breached, e.g. by being cancelled prematurely. The SBAs claim considerable experience in detecting such deals, which are of declining significance.

26. Banks might also attempt to hide their exposures in branches or subsidiaries abroad. The position and activities of branches are, of course, consolidated with the rest of the bank in its weekly report of daily data. It is true that Turkey does not have Memoranda of Understanding with other banking centers that would enable the SBAs to examine individual files there. The SBAs refer specifically to the Cayman Islands in this connection. However, Turkish banks have to report consolidated data to the supervisors in Turkey (i.e., data that are inclusive of branches and subsidiaries in other centers) which are checked against the banks' books in Turkey. Such checks have revealed nothing untoward. Moreover, such offshore activity represents a relatively small part of Turkish banks' balance sheets, and information on significant counterparties should be available in accounting records in Turkey. Again, the SBAs are confident that it is not possible for banks to hide meaningful activity from them in this way.

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[8] On the other hand, the monthly consolidated report is based on the data from the last day of the month only and could thus give rise to month-end window-dressing behavior.

27. Returns on the open position are submitted by banks weekly on a solo basis and monthly on a consolidated basis[9], to both the CBT and BSRA. They are cross checked, with discrepancies being explored with the relevant bank, and are also checked by the SBAs as part of their regular examinations. These regular examinations take place at least once a year, are comprehensive, and are carried out by a professionally trained staff, using a modified CAMELS framework. While errors and omissions undoubtedly occur (as is the case everywhere) the mission believes that systematic and extensive misreporting would not escape the authorities' attention on a regular and ongoing basis.

28. At the request of the mission, the SBAs reviewed their bank examination reports for the year 2000. In that year, as usual, all banks were visited. From this review, it was ascertained that:

- Fewer than 1 percent of total deals by volume were excluded by the SBAs from the calculation of the banks' open positions on the basis that they breached regulations or the CBT's directive on acceptable forward foreign exchange contracts.

- Three banks were found to be in breach of the open position limit as a result of the adjustments to the calculations. This is in addition to those banks that reported open position breaches in their normal reporting.

- No examples were found of deals undertaken that were not in conformity with counterparty limits, including limits for connected parties, nor any that lacked proper commercial justification.

29. During each examination, the SBAs looked at a significant sample of all transactions. In the foreign exchange area in 2000, the examinations covered at least 50 to 60 percent of the deals by volume and counterparty. For banks in difficulty, most of the deals were examined.

30. An examination of a foreign exchange deal by the SBAs entails checking that dealing and accounting records are proper, and that deals conform with dealing and counterparty limits in force, have an underlying commercial validity, are in conformity with regulations and CBT guidelines, and are properly included in returns to the regulatory authorities. Some more limited sampling is undertaken to ensure that deals are done at market rates.

31. The SBAs are confident that banks' reporting is generally of a high standard and the figures produced fairly reflect the underlying reality.

[9] Means consolidation of financial companies within the banking group.

Friendly counterparties and structures

32. Nonetheless, many banks claim that their exposures do significantly exceed the 20 percent limit. A number of Turkish banks visited by the mission in February (before the TL was floated) and in mid March (after the floating) stated that their foreign exchange exposures significantly exceeded the 20 percent limit. These banks insisted that they were typical of other private banks in this regard.

33. While these banks report correctly what they are asked to report to the BRSA/CBT, they claim that it is easy for them to find structures that are not covered in the regulations, which therefore do not need to be reported. Some examples of such structures were described to the mission to illustrate the possibilities.

- *Special structures provided by London investment banks.* The London bank might book a TL loan to a Turkish bank but shift all of the TL exposure back to the Turkish banks and will thus be willing to offer the loan on the equivalent of U.S. dollar terms. Such an arrangement, in economic terms, is really a dollar exposure.

- *Structures designed with domestic counterparties*. The Turkish bank can borrow TL from a domestic company with the economic features of a dollar loan. Again the bank has an open position (and the high return, and risk, that can generally be earned from it), but records matching TL assets and liabilities.

- *The consolidated reporting requirements enable banks to circumvent the open position limit.* Banks have to report their *solo* open position on daily average basis, but *consolidated* positions of the financial group need only be reported as of the end of the month. Thus, for all but that reporting day, banks can, quite legitimately, lay off some of their open positions with other members of the group. This is in addition to any positions maintained with non-financial related parties, mentioned above.

34. The SBAs maintain that these structures would be detected in their examinations and that they have not found them in significant numbers. This conclusion is strengthened by the findings in the 13 banks that have been taken over by the SDIF in recent years, in which on-site examinations by the SBAs have been undertaken. In 9 of these banks, financial structures designed to hide foreign currency exposures were found and corrected. All such discoveries were made before the banks were taken over by the SDIF. After they were taken over, further intensive examinations by the SBAs, with the full support and assistance of the new SDIF appointed managements, have found no additional cases where there was any deliberate or material misreporting of foreign exchange exposures. Special structures to hide foreign currency exposures no longer existed in these banks.

III. Mission Assessment

A. Actual Exposures

35. Turkey has satisfactory foreign currency exposure regulations and extensive and appropriate reporting requirements.[10] When taking all exposures (on-and-off balance sheet) into account, as is appropriate, for all banks other than SDIF banks, the average exposure of the system is well within the 20 percent of capital limit on both a solo and a consolidated basis. The few banks that have occasionally exceeded the limit in the past year (generally because of low capital) have been dealt with through supervisory measures in a satisfactory manner.

36. Market analysts often quote much larger exposures, well in excess of the limits. These estimates fail to include the off-balance sheet hedges and/or include SDIF banks. More careful analysts have avoided these mistakes but still questioned the soundness of some of the off balance sheet hedges, in particular the forward purchases of foreign exchange (sometime from parties related to the bank).

37. The SBAs routinely conduct very professional and comprehensive on-site examinations of these hedges and other foreign currency activities of banks. They have not found any material evidence that would support the doubts raised about off-balance sheet hedges. More generally, their examinations confirm the general accuracy of banks' reported data and the conclusion that banks' exposures are what they report them to be. The evidence from banks taken over by the SDIF also supports this conclusion.

38. Some banks do maintain that they use special structures that do not need to be reported to maintain exposures that are larger than the limit. Thus the evidence contains some contradictory elements. The mission is prepared to believe that some banks are able to hide the full extent of their exposures, and the financial incentive to do so is not in question. Given the lack of hard evidence and the confidence of the SBAs that they would be able detect such structures, the mission tends to discount bank claims of large exposures. These claims in any event would suggest exposures much smaller than those generally claimed by the financial press.

B. Implications for Bank Capital

39. Have banks lost money on their foreign currency exposures as a result of the recent devaluation? An assessment requires combining the past gain in interest income from net short positions with the recent loss from devaluation. A short position (no matter how large) would only require a TL/U.S. dollar interest rate spread of 40–50 percent for one year to

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[10] While existing regulations are satisfactory, they are being replaced soon by more modern and effective regulations (see section C below).

generate an income sufficient to cover the devaluation losses incurred in February/March 2001. This compares with the 70 percent actual spread in January 2001 and over 90 percent in April 2001. During the February crisis, overnight TL interest rates where temporarily several thousands of a percent (uncompounded) and some banks with excess TL liquidity claim to have recouped the foreign exchange short position losses from the devaluation within a week. In addition, the extent to which any losses on speculative forward contracts may be converted into credits that eventually go bad cannot be known for some time. In addition, some amount of foreign exchange and foreign exchange indexed credits may become non-performing over the next year or two. More generally, NPLs are also likely to rise as a result of the high interest rates and economic slowdown. It is not possible to estimate the relevant interest rate spread (adjusted for the exchange rate change) leading up to the losses from the February devaluation, but it is not obvious that most banks have lost money by being short when taking both factors into account.

40. The mission's assessment is that most banks did not incur significant net losses as a result of the devaluation of some 40–50 percent experienced so far. However, any increases in bank capital over the past year have been significantly reversed by the devaluation in most banks. Many banks have now become undercapitalized, more as a result of interest rate losses on their maturity mismatch than from open foreign currency positions.

41. Have banks' foreign currency exposures put too much capital at risk? The reward from short positions has been large for some years, but if too much capital is at risk it can still be lost if a devaluation is large enough (relative to the expected real return). The extent of the devaluation cannot be known in advance. However, the exchange rate has already overshot its purchasing power parity level so that a large further devaluation seems unlikely. The banks that claimed to have larger than permitted exposures maintained that their foreign exchange positions are based on a proper assessment of the risks and rewards involved. While the better-run banks may well have managed their foreign exchange risks appropriately, this may not be the case for all banks.

42. With a floating exchange rate the risk of a given exposure has increased. Against this, the still high interest rate differentials between foreign currency and TL make open positions potentially very profitable. Thus banks could continue to absorb quite a lot of additional risk. In the existing environment banks may be expected to reduce but not eliminate their open positions, as in fact they have done. Open positions in banks can only be reduced in the short run at the expense of CBT international reserves or by getting the real sector of the economy or the government to accept a larger share of the exposure.

C. Policy Implications

43. Foreign exchange exposures in the banking sector are large for the normal circumstances Turkey seeks to achieve. Under such circumstances greatly reduced interest rate spreads and modest exchange rate volatility would change the risk return relationship and should cause properly run banks to reduce their exposures on their own accord.

44. Until normality has returned, the weakened banking system must rebuild its capital base. At the moment, short foreign currency positions represent one of the few ways in which the banking system can earn a profit from which to rebuild capital. Moreover, an over-hasty closing of open positions could risk an overshooting of the exchange rate, whether this is forced by the regulators, or chosen by banks who become increasingly nervous of the risk they are running, notwithstanding the rewards.

45. The market risk regulation adopted by the BRSA earlier this year, which goes into effect January 1, 2002, will introduce a very important improvement in the regulatory environment. It is thorough and comprehensive, and brings Turkish regulation in this area in line with best international practice. It will place the onus on banks to define and monitor the risks they take and to assign capital to cover them. Banks will have no scope to hide behind technicalities of foreign currency exposure limits and reporting requirements. There is, therefore, less scope for banks to hide their true exposures. Furthermore, because they will be able to have open positions if properly capitalized, they may be more willing to reveal their true position (if they were able to hide it before).

IV. Recommendations

46. Resolving the general macroeconomic problems of Turkey (high inflation and high fiscal deficits) will help resolve any problems that might exist with regard to banks' foreign exchange exposures by removing the financial incentive for large exposures. Further consolidation of the banking sector through mergers of viable banks and takeovers and liquidations of non-viable banks, will also improve banks' risk management and increase the profitability of "normal" banking. All of these will lead banks to reduce their reliance on short foreign currency positions as a source of income. For the moment, it is desirable to proceed cautiously and to avoid extreme action. Specific recommendations include the following:

47. **Provide more information to the public in a transparent way.** Misinformation about foreign exchange exposures has gone uncorrected by the BRSA. Thus the public and market analysis have become more inclined to believe that these exposures are a larger problem than do the authorities or the mission. The BRSA needs to make a large and sustained effort to improve its provision of information to the public about its policies and banking sector developments.

48. **Introduce the market risk regime ahead of schedule on a voluntary basis.** The new market risk regime is due to come into effect on January 1, 2002, and the relevant regulation has already been published. Given that the new regulation will soon come into force and that many banks have already started preparations to meet its requirements, it appears unnecessary to streamline, temporarily, the current regulations, despite the fact that they may appear unduly complex.

49. **Given banks' claims that they have already been deciding on their own risk appetite in foreign exchange rather than aligning themselves with the regulation, there**

would be merit in allowing banks that wished to do so to adopt the new market risk regime ahead of schedule. Many banks have already introduced systems and managerial arrangements for the new rules, and there would, in these circumstances, seem to be no point in waiting. For such banks the implementation might be brought forward on a voluntary, bank-by-bank basis. In exchange for the early adoption of the market risk approach, banks would be freed from the existing regulations in this area. Greater transparency should result.

50. **Include forward foreign exchange contracts in the credit exposure limits.** The primary concern and potential weakness in the prudential regime concerns the counterparty credit risk implicit in speculative forward purchases or sales of foreign currency. This exposure (weighted by the probability of a large devaluation) should be included in the over all exposure limits to individual counterparts (including related parties). At present it is not. In order to add these exposures to the credit limit regulation, the Banking Law will need to amended to change the definition of credit.

51. **Improve accounting and reporting standards.** Banks have claimed that they have been able to avoid the regulations in ways that stood up to intensive scrutiny by the SBAs. A working party composed of representatives of the banks, the SBAs and the accounting profession to review reporting arrangements and recommend improvements would be the most appropriate way to achieve real improvements in the future. In addition, the monthly consolidated report to the CBT/BRSA, which is based on the end of month position, should be based on the average of the daily positions.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves Augmentation of Turkey's Stand-By Credit to US$19 Billion

The Executive Board of the International Monetary Fund (IMF) today approved an augmentation of Turkey's three-year Stand-By Arrangement by SDR 6.4 billion (about US$8 billion), bringing the total to SDR 15 billion (about US$19 billion). The Board's decision was made in conjunction with the completion of the sixth and seventh reviews of Turkey's economic program. Today's decision will enable Turkey to draw up to SDR 3 billion (US$3.8 billion) immediately. Further drawings of SDR 1.2 billion (about US$1.5 billion) each will be made available not earlier than June 25 and July 25 and of SDR 2.4 billion (about US$3 billion) each not earlier than September 20 and November 15 following the completion of further reviews of the program.

The stand-by credit was approved in December 1999 for SDR 2.9 billion (about US$3.7 billion--see Press Release 99/66). In December 2000, SDR 5.8 billion (about US$7.3 billion) in additional financial resources were made available under the Supplemental Reserve Facility (SRF--see Press Release 00/80). So far, Turkey has drawn a total of SDR 3.9 billion (about US$4.9 billion) from the IMF.

Following the Executive Board discussion on Turkey, Stanley Fischer, First Deputy Managing Director and Acting Chairman, said:

"The Fund welcomes the strengthened program prepared by the new economic team in Turkey. Full implementation of this program should restore macroeconomic stability and address the structural root causes of the country's problems, thereby laying the foundations for the resumption of growth.

"The Turkish program aims at strengthening confidence, addressing the costs arising from the crisis by increasing the primary fiscal surplus, speeding up the reform of the banking sector, and undertaking wide-ranging structural reforms. Decisive implementation of the program's policies, together with the availability of significant additional external support, should initiate a virtuous cycle characterized by lower interest rates, stronger public finances, and a recovery of economic activity.

"The Fund commends the depth and breadth of the new economic program. The emphasis on banking reform is appropriate, especially given the structural weaknesses in this area that were seen during the recent crises. The elimination of public sector banks' large overnight exposure, their full recapitalization, and the overhaul of their governance structure will go a long way to strengthen the financial sector. In addition, measures to privatize key companies and reform major domestic markets, including the telecommunications, electricity, natural gas, tobacco, and sugar markets, and to enhance governance and improve transparency, are essential elements of the program.

"The program's macroeconomic policies are strong, in particular the major fiscal effort that the Turkish authorities are undertaking to re-establish fiscal solvency. On monetary policy, the adoption of the new central bank law will give the central bank operational independence in the pursuit of price stability. In the short term and before a full-fledged inflation targeting framework is put in place, monetary policy will focus on the control of monetary aggregates in the context of a floating exchange rate framework.

"The IMF is demonstrating its backing for this ambitious program by providing exceptional financing in its support. Its success will take both determined implementation by the authorities and sustained support by the private sector," Mr. Fischer said.

ANNEX

Program Summary

Following the second financial crisis in a short time in February 2001, the Turkish government has put together a strengthened program to address the root causes of the country's economic problems. The **revised program** aims at cushioning the short-term macroeconomic impact of the recent turmoil, while laying the foundation for the resumption of disinflation and growth. To achieve these goals, the authorities have adopted a three-pronged strategy: 1) structural policies to correct the distortions underlying the crises, enhance transparency in economic management, and improve governance in both the public and private sectors; 2) fiscal and monetary policies to restore financial stability and facilitate disinflation; and 3) a strengthened social dialogue to promote wage moderation and social protection.

The program's **structural policies** are geared toward a fundamental change in the way business is done in Turkey. A major bank restructuring will be implemented, aimed at removing the structural weaknesses highlighted during the recent crisis. It includes recapitalization of banks under government control, accompanied by measures to enhance governance in public and private banks to prevent past problems from recurring. Fiscal transparency will be increased and the role of the private sector in the economy will be strengthened through the removal of obstacles to privatization and the promotion of foreign direct investment. In addition to taking steps to facilitate the privatization of Turk Telekom, the government is implementing measures to reform the sugar, tobacco, and natural gas markets, and sell the state enterprises operating in these sectors.

The program includes a major **fiscal adjustment** effort, needed to help finance the additional interest costs arising from the increase in debt. The fiscal measures aim to strengthen the primary fiscal position of the public sector, reduce the government's immediate borrowing requirement, and ensure the long-term sustainability of public debt. The new target for the primary surplus of the public sector is now 5½ percentage points of GNP in 2001, requiring additional measures amounting to 3 percentage points of GNP. The government will also continue efforts to involve the social partners in supporting the program, in part through incomes policies aimed at supporting disinflation and removing some of the existing distortions in the public sector wage structure.

Monetary policy will pursue disinflation under a floating exchange rate framework. In the short run, it will center on the pursuit of monetary aggregates, but over time the authorities intend to shift to a full-fledged inflation-targeting regime.

These very strong domestic measures are complemented by additional external financing and **private sector involvement.** The additional financing from the international financial institutions in support of the authorities' program not only fulfills financial requirements, but also helps reassure markets. To boost confidence further, the program includes voluntary private sector involvement, in line with the authorities' strong preference for market solutions.

As a result of the revised policies and the availability of foreign financing, the program envisages a gradual but **steady improvement in economic conditions.** Real interest rates are expected to decline from their presently very high levels. GNP growth is projected at negative 3 percent in 2001, mainly as a result of negative growth in the first two quarters. However, the program expects a turnaround for the third quarter, reflecting the recovery of exports and in tourism, and the expected decline in interest rates. As the recovery continues, GNP is expected to grow annually by 5-6 percent in 2002 and 2003. While the inflation outlook over the next few months is uncertain, the authorities intend to bring inflation to 2 percent a month by the last quarter of this year. The program projects CPI inflation to reach 52½ percent in 2001 (December/December) and 20 percent in 2002. The external current account balance is projected to improve markedly as a result of the recession, increased competitiveness and an acceleration in exports.

Table 3. Turkey: Selected Indicators, 1999-2003

	1999	Prel. 2000	Proj. 2001	2002	2003
Real Sector					
GNP growth rate	-6.1	6.1	-3.0	5.0	6.0
GNP deflator growth (in percent)	55.8	51.6	49.4	28.3	16.5
WPI inflation (12-month, end-of-period)	62.9	32.7	57.6	16.6	12.4
CPI inflation (12-month, end-of-period)	68.8	39.0	52.5	20.0	15.0
Average nominal T-bill interest rate	106.2	38.0	81.1	40.6	32.6
Average backward-looking T-bill real interest rate 1/	25.2	-11.4	23.7	6.9	13.2
Average forward-looking T-bill real interest rate 2/	32.0	-6.5	36.4	20.0	18.0
Central Government's Budget (in percent of GNP)					
Primary balance 3/	**1.5**	**4.6**	**5.1**	**5.6**	**5.6**
Net interest payments 4/	**13.1**	**15.8**	**20.1**	**19.2**	**16.1**
Budget balance	**-11.6**	**-11.2**	**-15.0**	**-13.6**	**-10.5**
Operational balance 5/	-4.0	-2.0	-0.6	-4.8	-2.5
Consolidated Public Sector (in percent of GNP)					
Primary balance of public sector	**-2.0**	**2.8**	**5.5**	**6.5**	**6.5**
Net interest payments 6/	22.1	21.9	22.6	16.2	13.5
PSBR (incl.CBT profits)	**24.2**	**19.1**	**17.1**	**9.7**	**6.9**
Operational balance 5/	**-12.4**	**-6.6**	**-3.2**	**-2.3**	**-0.1**
Net Debt of the Public Sector (in percent of GNP) 7/	**61.0**	**58.4**	**78.5**	**70.4**	**64.9**
Net external	20.1	19.7	34.2	28.3	23.5
Net domestic	40.9	38.8	44.3	42.1	41.5
of which: Gross domestic debt of the central government	42.5	41.0	60.9	57.8	57.3
of which: Auctioned debt'	25.8	23.4	23.2	28.3	32.3
For bank recapitalization	16.7	17.4	29.9	22.9	19.0
Net Debt of the Public Sector (in percent of centered GNP) 8/	**48.6**	**50.6**	**67.9**	**63.8**	**60.5**
External Sector					
Current account balance (in percent of GNP)	**-0.7**	**-4.8**	**-0.6**	**-0.9**	**-0.6**
Gross external debt (in percent of GNP)	55.0	56.6	66.2	59.6	56.8
Net external debt (in percent of GNP)	34.0	37.0	44.3	39.4	36.2
Monetary Aggregates					
Seignorage 9/	3.2	1.8	1.5	1.0	0.7
Nominal growth rate of broad liquidity	100.0	39.9	59.5	29.7	17.3
Privatization Proceeds (in millions of US$)	139	3,273	3,109	3,500	3,500
Net External Financing of Public Sector (in millions of US$)	1,417	4,134	-291	1,773	-938
Amortization	5,971	6,199	8,535	6,927	8,438
Gross borrowing	7,388	10,333	8,244	8,700	7,500
of which: Eurobond issues	5,000	7,500	2,500	4,700	4,500
GNP (in trillions of lira)	78,283	125,971	182,439	245,814	303,626

1/ Average of monthly nominal T-bill interest rate divided by 12-month past CPI inflation.
2/ Average of monthly nominal T-bill interest rate divided by 12-month ahead CPI inflation.
3/ Excluding profit transfers from the CBT, interest receipts, and privatization proceeds.
4/ Interest payments minus interest receipts plus profit transfers from the central bank.
5/ Overall balance netted out of the difference between nominal interest payments and real interest payments.
6/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
7/ Gross public debt net of the net assets of the CBT.
8/ Defined as the sum of quarterly GNP in the last two quarters of the year and in the first two quarters of the following year.
9/ Change in reserve money (currency issued plus reserve requirements) in percent of GNP.