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Turkey: 2002 Article IV Consultation and First Review Under the Stand-By Arrangement—Staff Report; Staff Statement; Public Information Notice and News Brief on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with Turkey and first review under the Stand-by Arrangement, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation and first review under the Stand-by Arrangement, prepared by a staff team of the IMF, following discussions that ended on **March 18, 2002**, 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 April 4, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of **April 15, 2002**, updating information on recent economic developments;

- the Public Information Notice (PIN) and a News Brief summarizing the **views of the Executive Board as expressed during the April 15, 2002, Executive Board discussion** of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Letter of Intent*
Report on Observance of Standards and Codes
Statistical Appendix

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

Staff Report for the 2002 Article IV Consultation and First Review Under the Stand-By Arrangement

Prepared by European I Department in Consultation with Other Departments

Approved by Michael Deppler and Mark Allen

April 4, 2002

- Discussions for the 2002 Article IV consultation and the first review under the stand-by arrangement (SBA) with Turkey were held in Istanbul and Ankara during March 5–18. The staff team comprised Messrs. Kähkönen (head), Aitken, Griffiths, and Rossi (all EU1), Mr. Flanagan (FAD), Messrs. Marston and Josefsson, and Ms. Gutierrez (all MAE), Mr. McGettigan (PDR), and Ms. Ricasa (assistant, EU1). Mr. Brekk, senior resident representative, and Mr. Piñerúa, MAE resident representative, assisted the mission, and the mission cooperated with World Bank staff on structural issues. Mr. Çakir, Advisor to the Executive Director for Turkey, attended several meetings.

- The mission met with the State Minister for Economic Affairs, Mr. Derviş; the State Minister for Foreign Trade, Mr. Toskay; the State Minister for Labor Relations, Mr. Keçeciler; the Minister of Finance, Mr. Oral; the Minister for Privatization, Mr. Karakoyunlu; the Undersecretary of the Treasury, Mr. Öztrak; the Undersecretary of the State Planning Organization, Mr. İzmirlioğlu; the Undersecretary of Finance, Mr. Dikmen; the Governor of the Central Bank of Turkey, Mr. Serdengeçti; the Chairman of the Bank Regulation and Supervision Agency, Mr. Akçakoca; and other senior officials; as well as representatives of labor unions and the private banking and business communities.

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

- Turkey has accepted the obligations of Article VIII, Sections 2, 3, and 4.

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I. Introduction

1. **In the attached letter, the authorities request the completion of the first review under the Stand-by Arrangement (SBA).** The Fund is supporting Turkey's economic program under an SBA covering 2002–04, approved by the Executive Board on February 4, 2002. Total access under the arrangement is SDR 12.8 billion, or 1,330 percent of quota (Appendix I). The next purchase, in an amount equivalent to SDR 867.6 million, is contingent on the completion of this review. The World Bank supports Turkey under a Country Assistance Strategy envisaging lending of up to US$6.2 billion during FY2001–03 (Appendix II).

2. **At the time of the last Article IV consultation, concluded in December 1999, Directors welcomed Turkey's economic program for 2000–02, although subsequent crises have forced a deepening of reform efforts.** Directors commended the authorities' decision to embark on a strong program designed to free the country from high inflation, to strengthen macroeconomic fundamentals, and to address long-standing structural weaknesses. They found the program well balanced, commending the wide-ranging structural reforms, and agreeing that upfront fiscal adjustment was needed to restore fiscal solvency, and that the preannounced exchange rate path would help anchor inflation expectations. In the event, against a background of a fragile banking system and a widening current account deficit, bank liquidity problems led to a serious financial crisis in November 2000. And, in February 2001, Turkey was forced to float its currency after a public dispute between the Prime Minister and the President prompted a further speculative attack. Since then, the authorities have redoubled their reform efforts, first under a strengthened program adopted in May 2001 and now under the new three-year SBA.

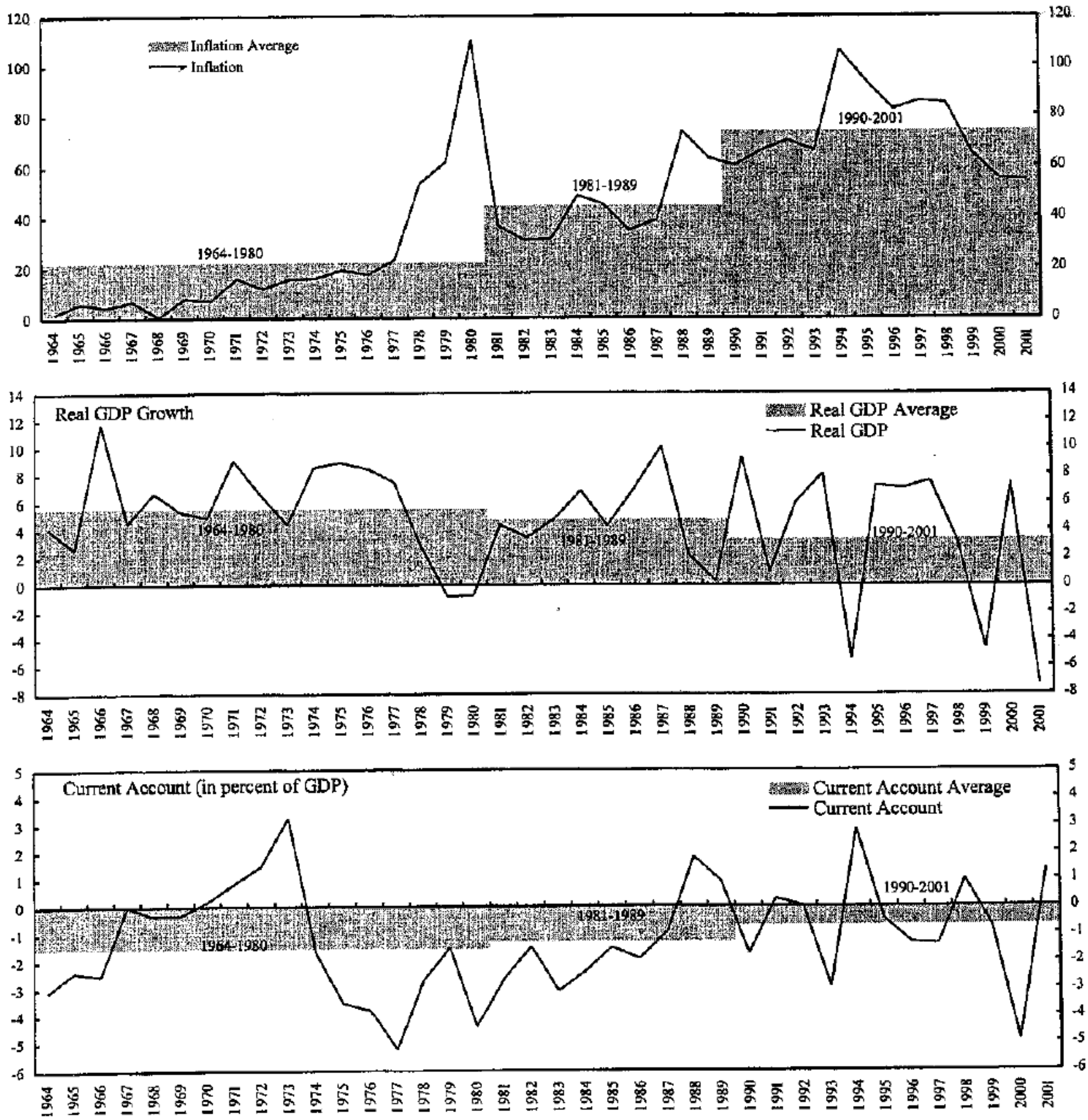
3. **The quality, coverage, and timeliness of statistical reporting by Turkey are generally adequate for program monitoring and surveillance, although some deficiencies remain in fiscal statistics** (Appendix III).

II. Background

4. **Turkey is in the midst of a determined campaign to turn around decades of weakening performance** (Figure 1). Not only has growth been on a downward trend since the 1970s (and inflation on an upward one), it has also become increasingly volatile. Since 1994 alone, Turkey has experienced three severe recessions, two of them triggered by financial crises. Turkey's performance is also weak in comparison with other emerging market countries (Figure 2). In particular, Turkey is the only major emerging market country that has failed to bring inflation firmly under control.

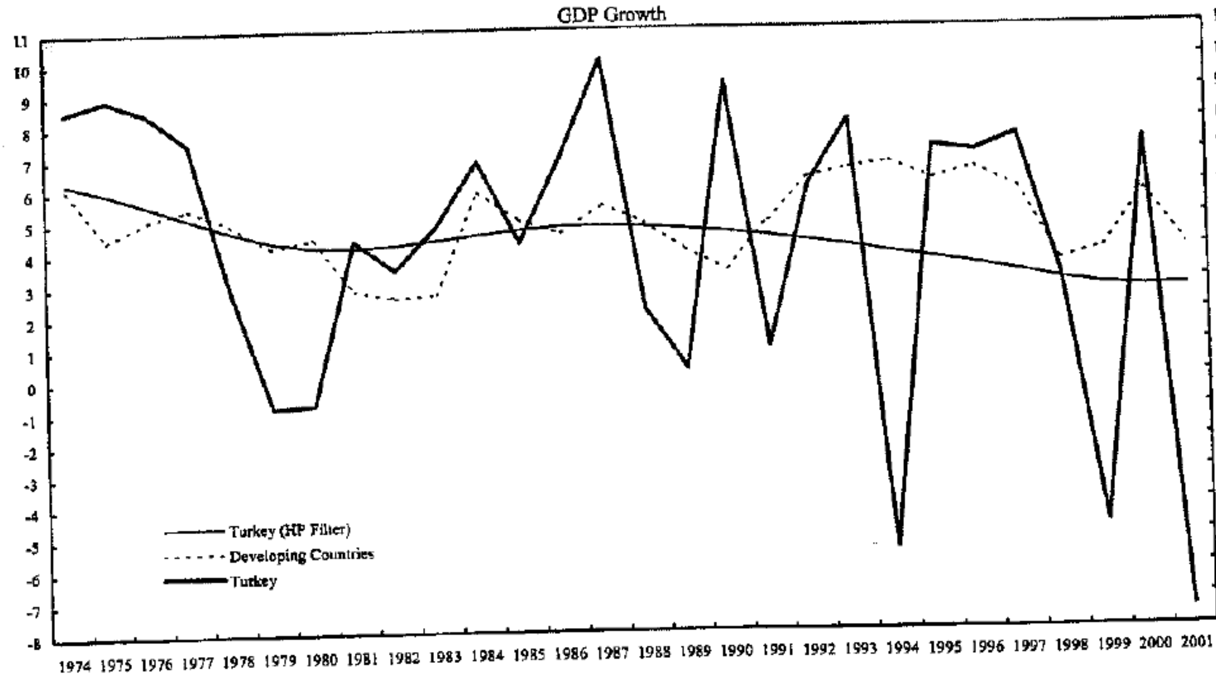
5. **The disappointing performance is rooted in pervasive structural rigidities, weak public finances, and low policy credibility.** It was not until the 1980s that Turkey turned away from an inward-looking import substitution strategy and embarked on a path of economic liberalization. Despite many achievements since then, deep-rooted structural problems remain a drag on growth, in areas as diverse as banking, state involvement,

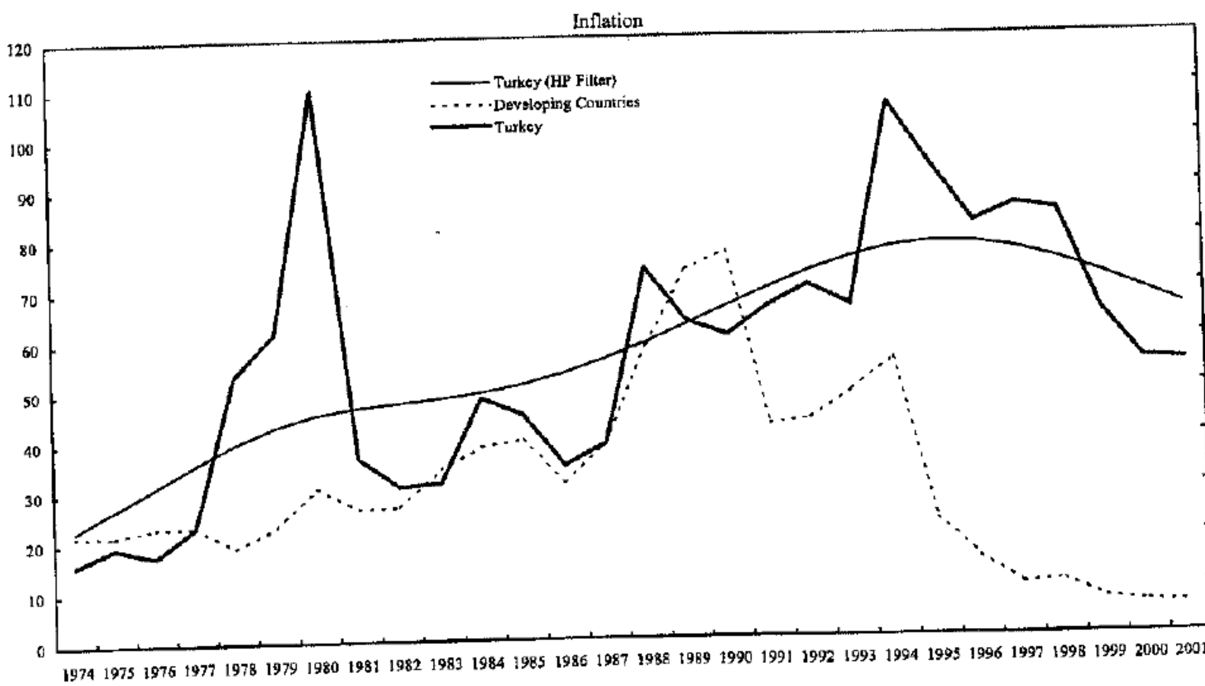
Figure 1. Turkey: The Long View, 1964-2001
(in percent)



Sources: IMF, *International Financial Statistics*; and IMF, *World Economic Outlook.*

Figure 2. Growth and Inflation in Turkey and Developing Countries, 1974-2001
(in percent)





Source: IMF, *World Eonomic Outlook;* and Fund staff calculations.

and foreign direct investment.[1] At the same time, past disinflation attempts have had little success. At first, the limited structural component of fiscal adjustment served to undermine efforts to reduce inflation, with the failure to rein in public expenditures leading to continued reliance on monetary financing. Although the fiscal position began to improve in the mid-1990s, by then, in the absence of a credible nominal anchor to guide expectations, inflation had taken on a life of its own. Appendix IV reviews Turkey's inflation experience and analyzes the underlying causes in more detail.

6. **The past couple of years have witnessed three major attempts at addressing underlying weaknesses.**

7. **The first was during 2000 under the three-year SBA initiated in December 1999.** The program instituted strong fiscal adjustment and a preannounced exchange rate crawl to restore debt sustainability and to break entrenched inflation expectations. The program also included a wide-ranging structural reform agenda—especially in banking, social security, privatization, and agriculture—to set Turkey on a higher sustainable growth path.

8. **Despite some notable achievements, after only 14 months Turkey had experienced two major economic crises.** In 2000, the authorities succeeded in implementing an array of structural reforms, in turning around the public sector primary balance, and in reining in inflation. However, with a worsening current account and a fragile banking system, in late 2000 a liquidity crisis affecting a few domestic banks turned into a full-blown crisis, with a massive loss of reserves. Prompted by political infighting, this was followed by another speculative attack in February 2001, forcing the government to float the currency amidst sky-high interest rates and a renewed acceleration in inflation.

9. **The second phase was the adoption in May 2001 of a strengthened program aimed at restoring investor confidence by addressing the roots of the crises, with the help of additional Fund support.** The authorities' revised program featured a fundamental restructuring of the banking sector (a key source of vulnerability in the past), a commitment to a floating exchange rate (reducing vulnerability to shocks), continued disinflation, further massive fiscal adjustment to underpin debt sustainability, and an enhanced role for the private sector.

10. **Just as the revised program was beginning to show results, September 11 intervened.** In the wake of September 11, the goal of permanently lower inflation with

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[1] Bank credit to the private sector at 25 percent of GNP is one fourth of the average for EU countries; key industries—tobacco, sugar, and telecommunications—remain dominated by state enterprises; the public sector employs over one fifth of the labor force outside agriculture; foreign direct investment at ½ percent of GNP is miniscule compared with leading emerging market countries; and Turkey ranks 54 out of 91 countries in the Transparency International's survey of perceptions of corruption.

sustained higher growth remained elusive. In 2001, annual inflation rose sharply, and Turkey was in the midst of its deepest recession since the 1940s, complete with steep increases in unemployment and widespread difficulties in the corporate sector. Meanwhile, Turkey continued to suffer from an inefficient public sector, barriers to private sector development, a banking sector damaged by the earlier crises, and from a high public debt burden, fuelled in part by publicly funded bank recapitalization. At the same time, deteriorating market sentiment saw the re-emergence of serious financing problems.

11. **In response to September 11, a new intensified medium-term Fund-supported program was initiated, both to protect the economy against future crises, and to continue Turkey's ambitious reform agenda.** Under the 2002–04 program, the continuation of the float will limit the potential for speculative attack, ongoing financial sector reform together with corporate sector restructuring will help strengthen the banking and business sectors, and maintained fiscal discipline should foster medium-term debt sustainability. The program's strong structural reform agenda should, once macroeconomic stabilization is achieved, finally set the stage for sustained economic growth (Table 1 and Annex B of the attached Letter of Intent).

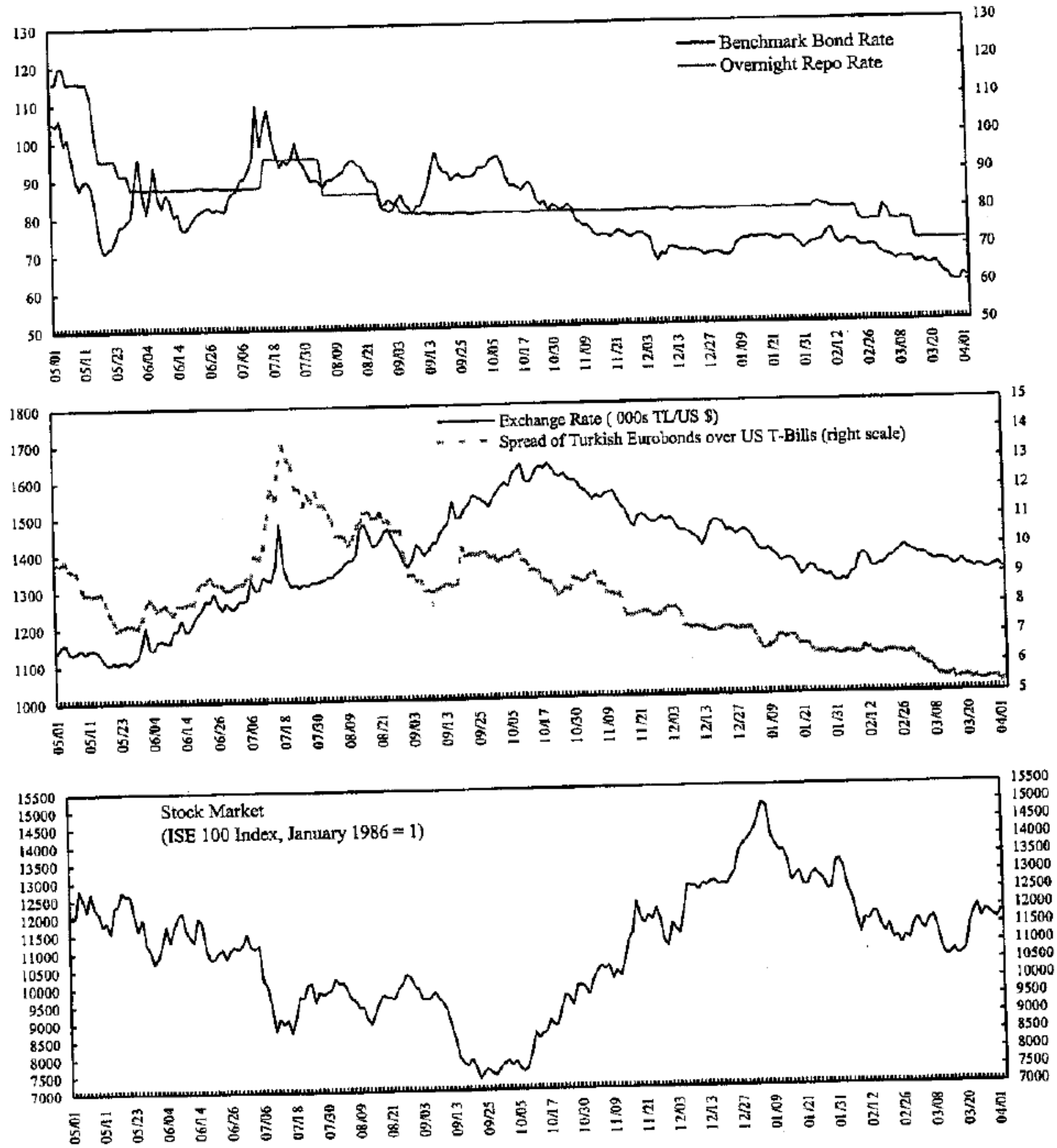
12. **Developments under the new program have been promising:**

- **Financial market conditions have improved markedly from their post-September 11 lows** (Figures 3 and 4). The benchmark bill rate has fallen by some 30 percentage points to the low 60s, and the Turkish lira has appreciated by more than 20 percent to around TL 1.35 million to the U.S. dollar. Against this background, the trend toward dollarization has abated, and even shown signs of reversal in recent months. The stock market, despite recent declines linked to regional security concerns, has risen by almost 50 percent in lira terms since mid-September. Also, the hemorrhaging of external interbank credits (which amounted to US$8 billion in 2001) has ceased.

- **Short-term concerns about the public debt rollover have also largely abated.** This is evident in the consistently high demand in the last few months' treasury bill auctions, and the successful resumption in January of the issuance of floating rate notes with a two-year maturity. The Treasury has also tapped the Eurobond market for US$1.45 billion so far in 2002, while seeing a 120 basis point reduction in benchmark Eurobond spreads over U.S. Treasuries.

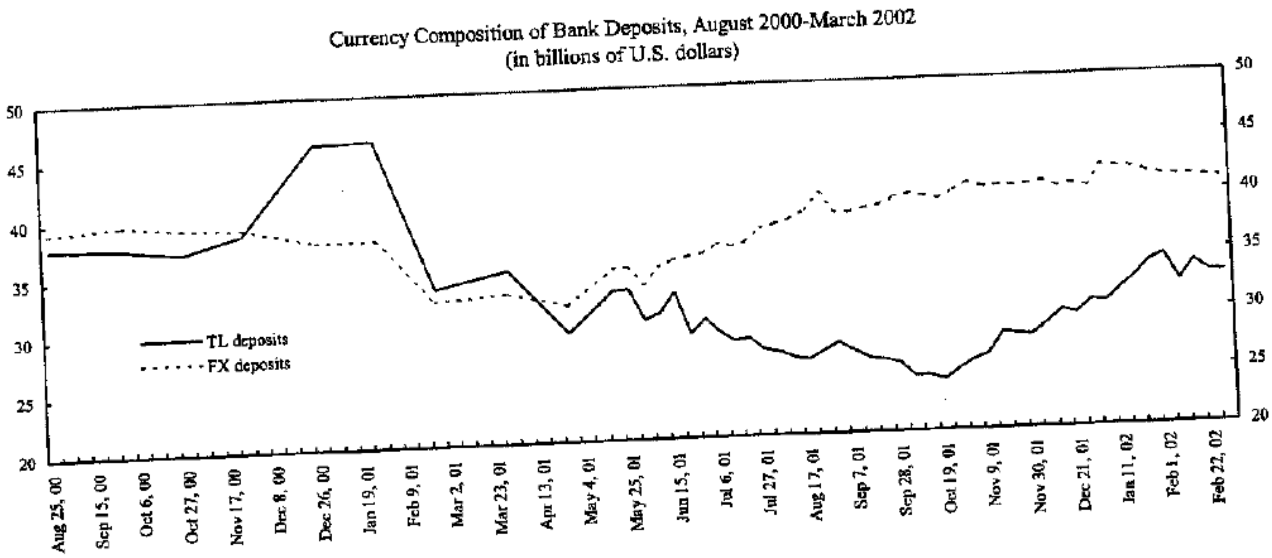
- **Inflation has started to decline** (Figure 5). Seasonally adjusted CPI inflation persisted at 4 percent per month (annualized 60 percent) from September to January, as the impact of the currency appreciation was offset by weather-related increases in food prices and adjustments in administered prices. With the influence of the latter

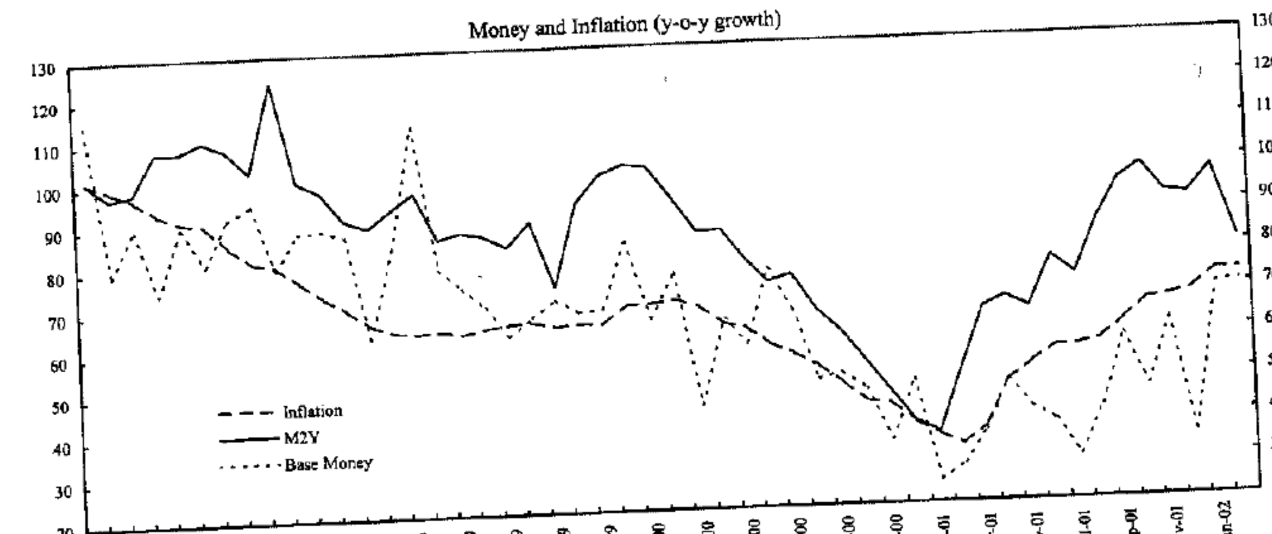
Figure 3. Turkey: Market Developments, 2001-02
(in percent; unless otherwise indicated)



Source: Data from the Turkish authorities.

Figure 4. Turkey: Monetary Developments, 1998-2002

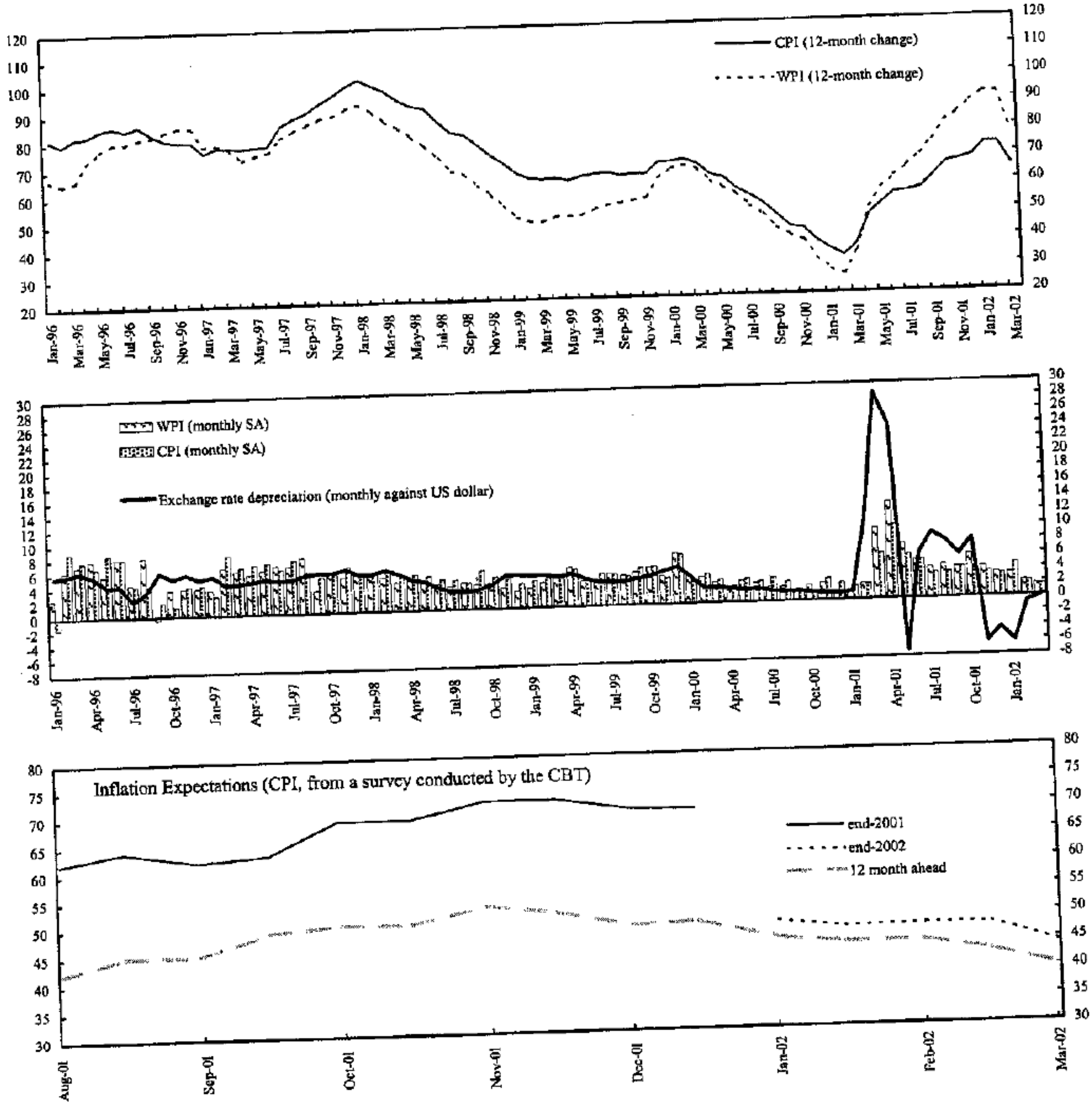




Sources: Central Bank of Turkey; and State Institute of Statistics.

1/ Turkish residents' TL deposits.

Figure 5. Turkey: Inflation, 1996-2002
(in percent)



Source: Data provided by the Turkish authorities.

two factors diminishing, seasonally adjusted inflation came in at 2½ percent (annualized 35 percent) in February. This helped inflation expectations for end-2002 to decline markedly (to 44 percent in early March), and contributed to the decision of the Central Bank of Turkey (CBT) to reduce the overnight rate by 8 points (to 72 percent) in two steps in February–March. Monthly inflation slowed further to a seasonally adjusted 1½ percent in March.

13. **Policy performance under the new program has also been good** (Annexes A and B in the attached Letter of Intent). In January, the authorities met the more than ten prior actions in the fiscal and structural areas needed for the approval of the SBA. Subsequently, all quantitative performance criteria relevant for the first review were met. Base money came in below the end-February ceiling, while NIR and NDA targets were met comfortably (Figure 6). The public sector primary surplus target of 5½ percent of GNP for 2001 was exceeded by almost ½ percent of GNP, and in January the consolidated government sector exceeded its primary surplus target comfortably. Solid progress is also being made in meeting the program's structural conditionality (Table 2). By the beginning of April, the authorities had met three of the six structural benchmarks relevant for the review (relating to anti-corruption and fiscal transparency efforts). Moreover, they were on track to complete shortly the two prior actions for the review (relating to the Law on Public Debt Management and redundancies in state economic enterprises) and the outstanding structural benchmarks (in the banking, fiscal, and expenditure management areas).

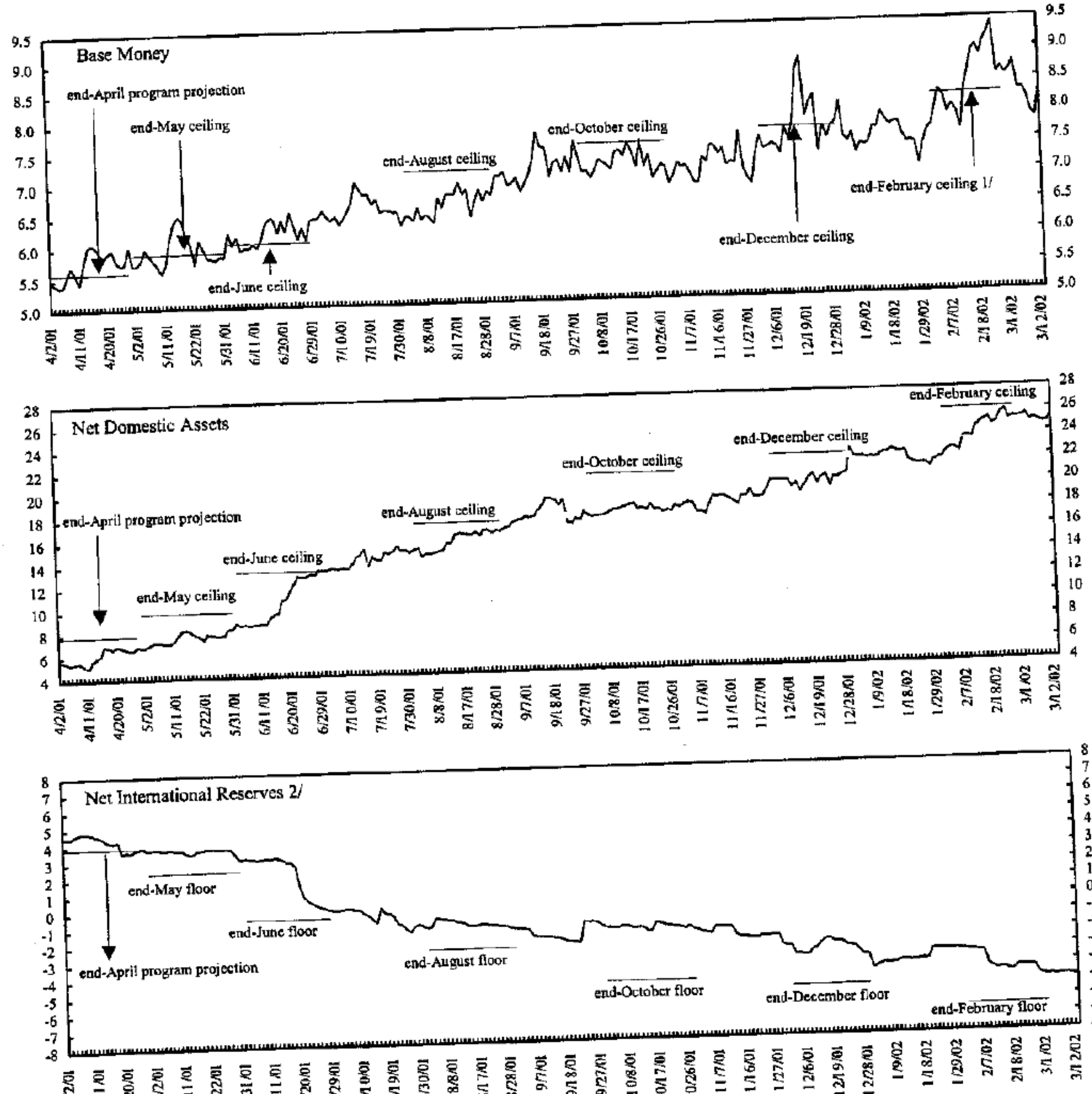
14. **However, near-term risks remain:**

- **Growth prospects remain unclear** (Figure 7). Real GNP fell by 9.4 percent in 2001, largely owing to a sharp decline in the first half of the year. However, there were no clear signs of recovery in the second half, with seasonally adjusted GNP rising by 1 percent in the third quarter and falling by a similar amount in the last quarter. More recent indicators of activity have been mixed. On the domestic side, capacity utilization in manufacturing has continued to increase and the latest business survey data show some signs of optimism, but real bank credit to the private sector has continued to fall and industrial production has been stagnant. On the external side, export growth has slowed, reflecting both the weakness of the global economy and the recent rapid rebound in the Turkish lira. Spending has also been held back by weak workers' remittances which contributed to a steeper drop in GNP than GDP in 2001 (9.4 vs. 7.4 percent).

- **Markets remain fragile, largely because of concerns about military action in neighboring Iraq** (Appendix V and Table 3). In early February the currency depreciated and the benchmark bond rate increased by 4 percentage points. Although markets have since recovered, they continue to view the possibility of a military intervention in Iraq as a key source of vulnerability.

- **The program's ambitious agenda could test the cohesion of the government coalition.** Since the onset of the recent crises, unemployment has increased markedly in Turkey (Box 1). Although the authorities have responded with increased and

Figure 6. Turkey: Monetary Program, 2001-02
(In quadrillions of TL)

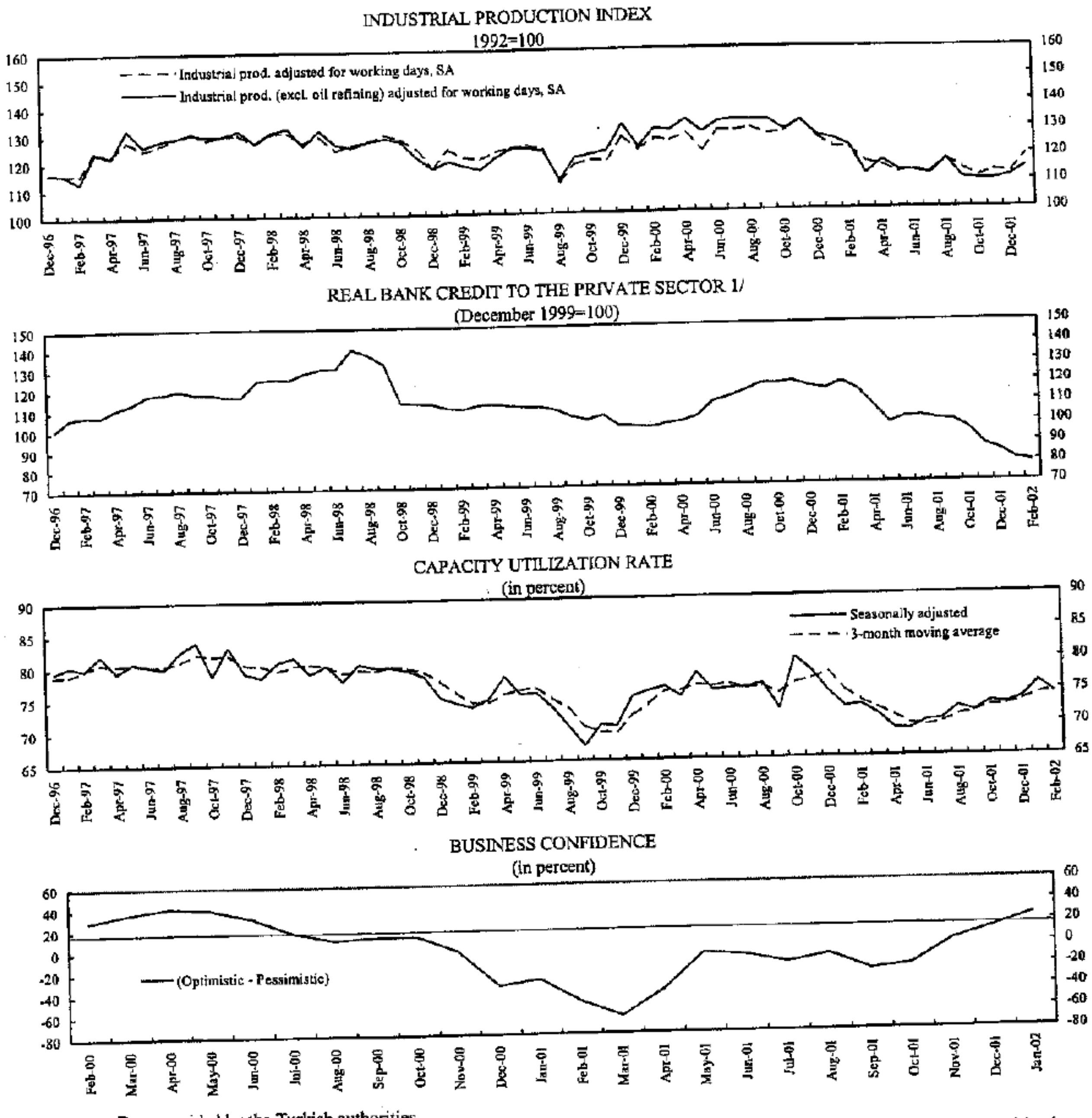


Source: Data from the Turkish authorities.

1/ As explained in Annex J of the Janury 18, 2002 Letter of Intent, the end-February test date was calculated as the four-day average of February 11-12 and March 11-12, to correct for the temporary increase in demand for base money due to the Bayram holiday. All monetary performance criteria and indicative ceilings were met.

2/ In billions of U.S. dollars. Data discontinuity at February 6, 2002 reflects the revised definition of NIR in the new program, which now includes the Treasury's NIR position, and which is calculated at new program cross exchange rates.

Figure 7. Turkey: Output and Demand, 1992-2002



Source: Data provided by the Turkish authorities.

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

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

Box 1. Turkey: Labor Market Developments

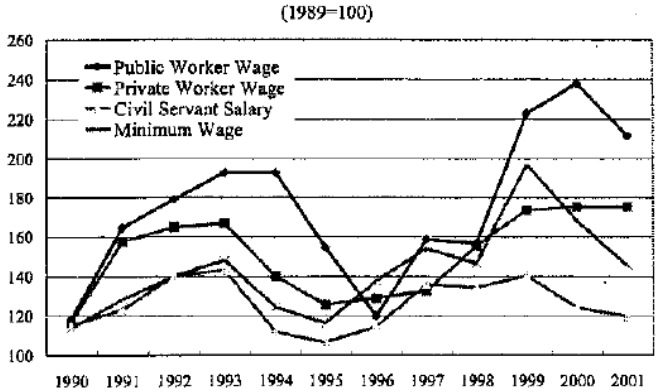
Turkey has generally flexible labor markets. While Turkey suffers from a high tax wedge—estimated by the OECD at about 40 percent in the late 1990s—it nevertheless exhibits many signs of labor market flexibility. The tax base is narrow, and only a small share of the workforce is covered by collective wage agreements. Out of a total of 20 million employees, union coverage is just 2½–3 million, of which only 1 million are covered by collective bargaining agreements. The unemployment insurance system is new, and started making payments only in March 2002. The ratio of unemployment benefits to the average wage earned in the last four months employed is low, at 50 percent, and the duration for unemployment benefit payments is limited to six months. Minimum wages are set far below the average wage (presently about one-fifth of the average formal sector wage), and have not kept pace with real wage increases over the past decade (see the first figure below). According to both labor force survey evidence in Turkey and independent OECD estimates, about half of the workforce is employed in the informal sector. Labor protection legislation is deemed to be fairly liberal by OECD standards, although new legislation now in the pipeline will make firing procedures more restrictive.

Nevertheless, the severity of the recent economic crises has contributed to a sharp rise in unemployment (see the second figure below). Overall unemployment, measured on a households' survey basis, increased to 10½ percent in the fourth quarter of 2001 from 5½ percent in the third quarter of 2000 (before the first crisis broke). Both urban and rural areas have been badly hit, although hidden unemployment in the agricultural sector tends to mask the true scale of the problem in rural areas.

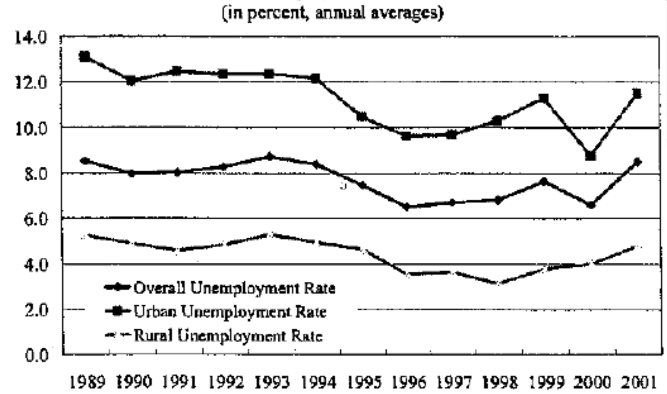
The authorities have responded by enhancing and better targeting their social spending. Despite a tight budget, the authorities are committed to increasing social spending substantially in real terms in 2002. The impact of public sector retrenchment is being addressed through the labor redeployment and reinsertion program (supported under the World Bank's Privatization Social Support Project), and through unemployment insurance payments. The authorities are also implementing a World Bank supported Social Risk Mitigation Project, which seeks to enhance safety net resources available to the poorest households in Turkey.

Looking ahead, transition to a system of wage determination more responsive to underlying economic conditions will help economic efficiency and employment growth. While a small share of those employed is covered by collective wage agreements, such agreements have had an important influence on formal sector wage developments. Also, labor demand in the formal sector may have been constrained by hikes in real wages for unionized workers. There remains considerable scope to reduce the role of indexation in wage contracts, and the public sector could set the example in this regard.

Real Net Wage Indexes
(1989=100)



Unemployment Rates
(in percent, annual averages)



better-targeted social spending, resultant social tensions could test the mettle of the government. Also, the new program, which calls for major, politically difficult reforms in the months ahead (including reducing public employment, privatizing state enterprises, and restructuring private banks) requires the undivided support of the coalition partners. Moreover, the fiscal and monetary restraint foreseen under the program could face resistance, especially if the economy does not recover soon.

III. Report on the Discussions

15. **Against the background of a promising start to the program, but with risks remaining, the discussions focused on keeping policies oriented toward raising Turkey's long-term growth.** The authorities expressed concern about the uncertain prospects for near-term recovery, but agreed with the staff that unwavering implementation of the program was required to allow Turkey to break free from its inflationary past, curb real interest rates, and grow strongly over the medium term. With the macroeconomic framework left broadly unchanged, the authorities stressed their continued commitment to meeting the program's ambitious monetary and fiscal targets. The staff agreed that the improved inflation outlook provided a solid basis for the recent interest rate cuts, and argued that prospects for an early move to inflation targeting had improved. On the fiscal side, the authorities had undertaken some adjustments to policies, but were confident that the 2002 primary surplus target of 6½ percent of GNP would be achieved. They acknowledged that strict adherence to the program's reform agenda was also needed for sustained higher growth. In this regard, the staff stressed the need to move quickly with the bank recapitalization scheme, to move in parallel with corporate debt restructuring, and to press ahead with public sector reform and improving the business climate.

A. Macroeconomic Framework

16. **The authorities and staff concurred that program objectives for 2002 remained feasible, although subject to risks:**

- **Despite acknowledged downside risks, it was agreed to maintain the 3 percent growth projection.** While the evidence so far remained mixed, international and past Turkish experience suggested that the growth target was realistic, especially in light of the improvements in market confidence, and the resulting reduction in interest rates (Box 2). However, both sides thought that the balance of risks was likely to be on the downside, and that the strength of the recovery over the next several months would be particularly important in determining growth prospects for the year. The authorities expressed concern that the recent appreciation of the Turkish lira could hamper already weak net external demand, but the joint assessment was that competitiveness remained broadly adequate (Box 3).

- **Prospects for meeting the 35 percent inflation target had improved.** Noting the favorable February inflation outcome, most private sector representatives met by the mission regarded the 35 percent target as feasible, even though their expectations

Box 2. Turkey: Growth Prospects

Although growth prospects for 2002 remain uncertain, Turkey can still achieve 3 percent real GNP growth in 2002. In 2001 Turkey endured its deepest recession since 1945, weakening the economy severely. Despite this, the experience of other countries and of Turkey itself after earlier financial crises indicates that a relatively rapid turnaround in economic activity is possible (Figure 8). However, counting on such a favorable outcome for Turkey in 2002 would seem premature, given the fragile condition of the economy before the crisis, and the need for continued progress in bank and corporate restructuring. National accounts data for the fourth quarter of last year are, as yet, unavailable, let alone information on 2002. Even so, a modest recovery would still seem feasible, with a pickup in economic activity supported by a gradual recovery in domestic demand.

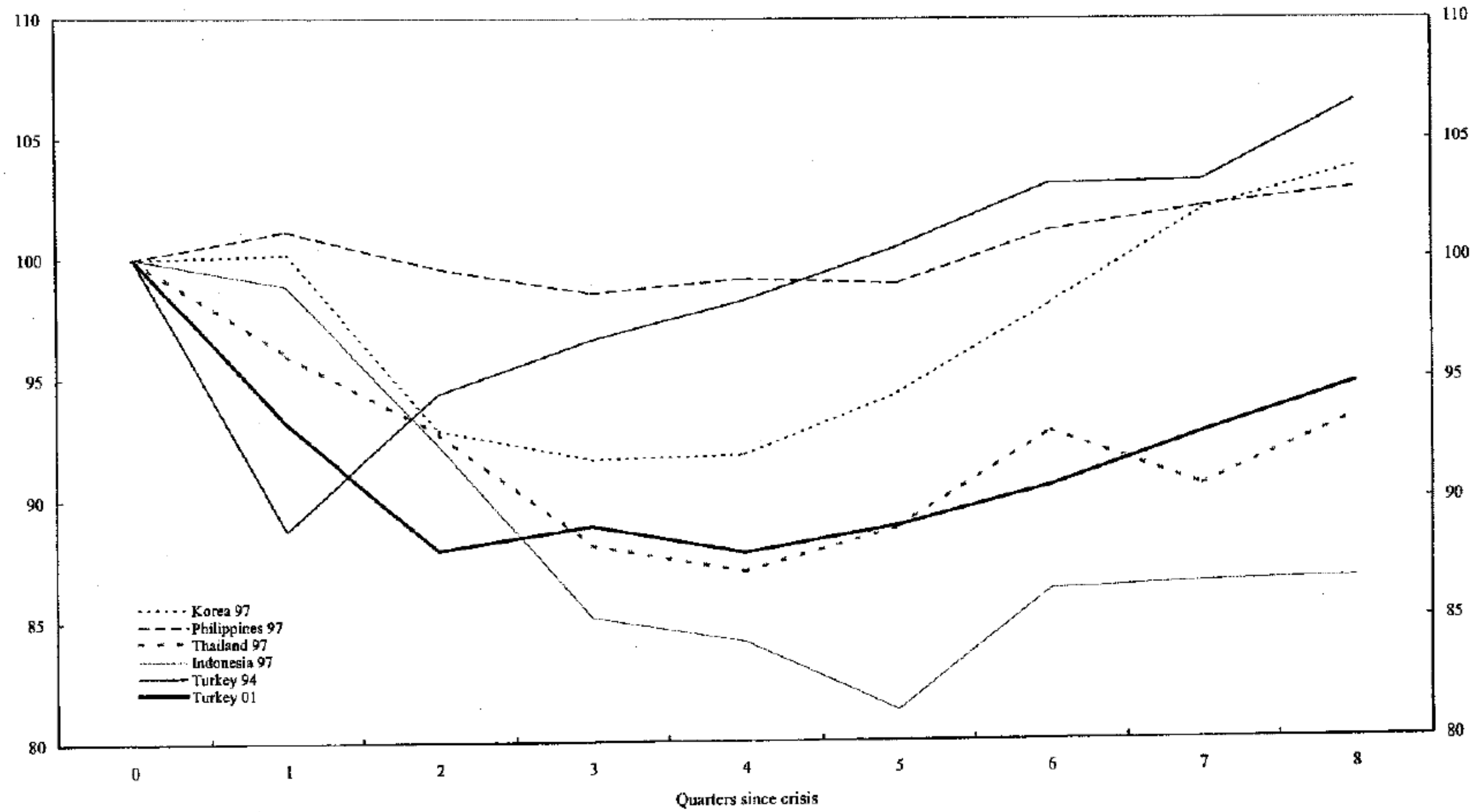
Private consumption and stock building are expected to be the main sources of growth in 2002. Lower inflation, a more stable exchange rate, gradually decreasing interest rates, continued progress in financial sector restructuring, and improved market confidence should support domestic demand in 2002 by boosting real income and wealth, lowering debt-servicing costs, and enhancing credit availability. As a result, private consumption, while remaining well below the level reached during the 2000 boom, should gradually recover in 2002 (Figure 9 shows the recent history of the components of demand). With inventories depleted, stock building is also expected to stimulate growth in 2002. Inventory adjustment has played a major factor in earlier economic recoveries in Turkey—contributing as much as 5 percentage points to growth in 1995, following the previous crisis-induced recession. However, fixed investment will likely be held back by the high corporate debt burden, while small- and medium-size enterprises will continue to suffer from a lack of working capital and weaker balance sheets, although to a lesser degree than in 2001. Net external demand is unlikely to drive growth, given the disappearance of last year's over-depreciation, as well as the mixed outlook for partner country demand. Fiscal policy will be largely neutral in 2002, after being strongly contractionary last year.

Turkey: Sources of Growth, 2000–02

	GNP	Priv. Cons.	Pub. Cons.	Priv. Invest.	Pub. Invest.	Stock Building	Exports	Imports
				(Annual change in real terms)				
2000	6.3	6.2	7.1	16.0	19.6	1.1	19.2	25.4
2001	-9.4	-9.0	-8.6	-35.1	-22.0	-4.0	7.4	-24.8
2002	3.0	3.8	2.6	1.8	-2.7	3.6	-2.1	7.2
				(Contribution, in percent)				
2000		4.2	0.6	3.1	1.3	1.1	5.7	-8.7
2001		-6.1	-0.7	-7.3	-1.6	-4.0	2.4	9.9
2002		2.5	0.2	0.3	-0.2	3.6	-0.8	-2.3

Over the medium term, structural reform and a steady improvement in domestic saving can lead to 5 percent annual real growth. With significant scope for catch-up, both with respect to its own output potential and to output levels in other OECD countries, Turkey can reach this 5 percent target provided that it can break away from the stop-and-go policies of the past, and achieve macroeconomic stability and further progress in structural reform. With the baseline macroeconomic framework conservatively assuming foreign savings that are broadly constant, increased domestic saving will be needed to support the return of investment to pre-crisis levels. While banking sector and structural reform can enhance the prospects for private saving, to ensure this improvement, public saving will need to strengthen, notably through maintenance of the authorities' strong fiscal adjustment efforts. In addition, continued structural reform will be needed to remove the barriers to growth, and to raise total factor productivity. Staff simulations indicate that raising the private investment rate to 20 percent (2 points higher than the average for 1997–2000), expanding employment by 2 percent annually (slightly faster than population growth), and achieving total factor productivity growth of 2 percent annually (compared with the average for of 0.6 percent for 1980–2000) would yield an annual growth rate in the 5–6 range.

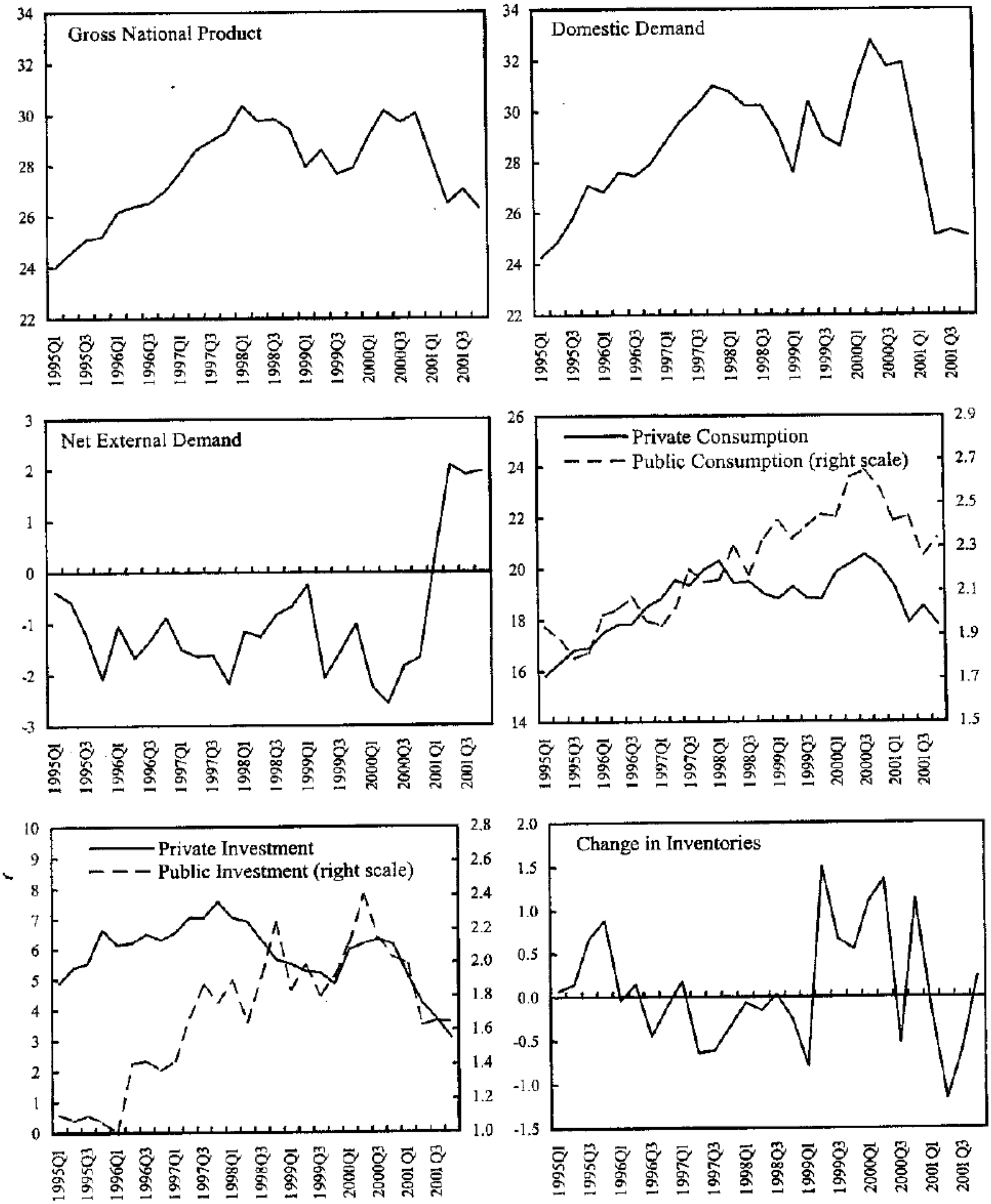
Figure 8. Recovery after Crises in Turkey and Selected Emerging Economies 1/
(Seasonally Adjusted; Quarter 0 = 100)



Source: National Statistical Authorities, and Fund staff calculations.

1/ Last five quarters for Turkey 01 are projections.

Figure 9. Turkey: Aggregate Demand, 1995-2001
(seasonally adjusted; in trillions of Turkish liras at 1987 prices)



Source: State Institue of Statistics

Box 3. Turkey's Competitiveness

The rapid rebound in the Turkish lira in recent months has prompted renewed concerns about Turkey's external competitiveness. This box assesses Turkey's export performance, real effective exchange rate (REER) indicators, and wider supply-side competitiveness.

From the 1980s onward overall export performance has been impressive, with the result that Turkey has steadily gained market share in its major partner markets (Figure 10). For most of the 1980s, Turkey's market share increased, helped by a steadily declining REER, but also reflecting a shift away from an inward-looking trade regime to an export-led growth strategy (Figure 11). Despite a rapid REER appreciation from the late 1980s through 1994, fuelled by large capital inflows after the liberalization of the capital account, export performance in EU markets remained strong through 1999. However, during 2000, while following a quasi-currency board monetary rule, Turkey's REER appreciated rapidly. This, combined with a rapid rebound in domestic demand, was reflected in a widespread loss of market share.

Moving to recent developments, price-based REER indicators suggest that the competitiveness gains following the February 2001 devaluation have largely been unwound, although the ULC indicator paints a more favorable picture (Figure 12). The staff estimated that, before the February 2001 devaluation, the Turkish lira was overvalued by about 15 percent using the CPI-based REER, the most commonly used competitiveness measure. On this basis, while it appears that the lira is not yet overvalued, further real appreciation could justify competitiveness concerns. At the same time, however, the considerable improvement in cost competitiveness should act as a counterbalance to any further real, price-based appreciation.

Econometric studies undertaken by both the staff and the authorities support these findings:

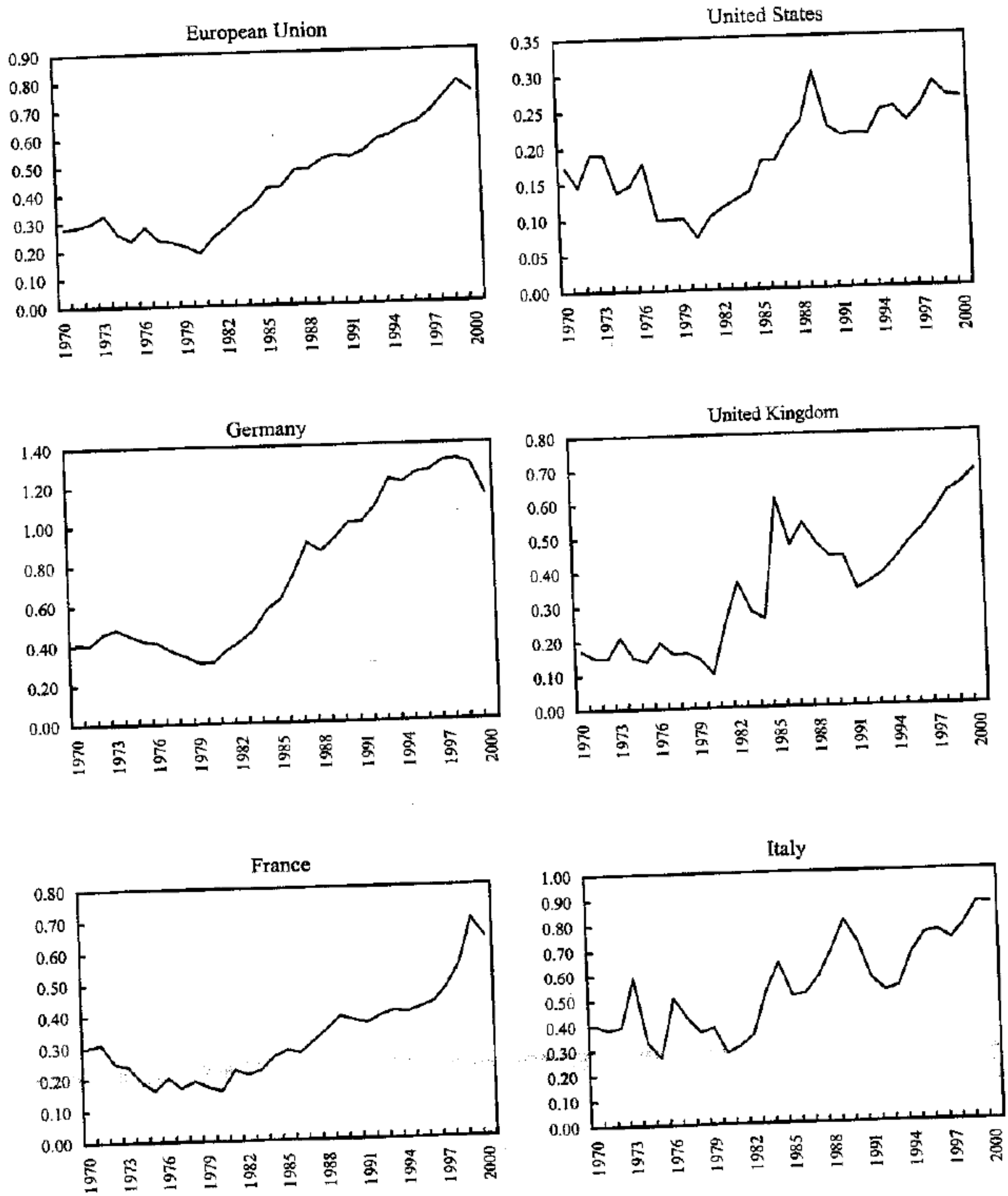
- Updating the fundamental balances approach used at the time of the last SBA, **the staff estimates that the real exchange rate could appreciate by about 15 percent on average in 2002—broadly in line with program assumptions—while remaining consistent with long-run solvency** (see SM/99/294 for a description of this methodology). Using previous baseline assumptions for growth, interest rates, transfers, and real exchange rate movements, it is found that stabilizing the current net debt to GDP ratio is consistent with a current account deficit of some 2¾ percent of GDP. Estimates of short-run export and import REER elasticities indicate that, as the domestic output gap is closed fully—not projected to happen within a single year—a real appreciation of about 15 percent over the 2001 level would be consistent with a current account balance that stabilized the net debt/GDP ratio in Turkey over the medium term.

- **The Treasury has found**, using econometric estimates of the equilibrium real exchange rate, that the REER was significantly overvalued prior to the February 2001 devaluation **and that the lira has now returned to equilibrium levels.**

- **The CBT** has undertaken a disaggregated analysis of competitiveness across a variety of Turkish industries, and **has found that the positive impact of exchange rate devaluations can be quite short lived, and that structural improvements are needed to boost competitiveness over the medium term.**

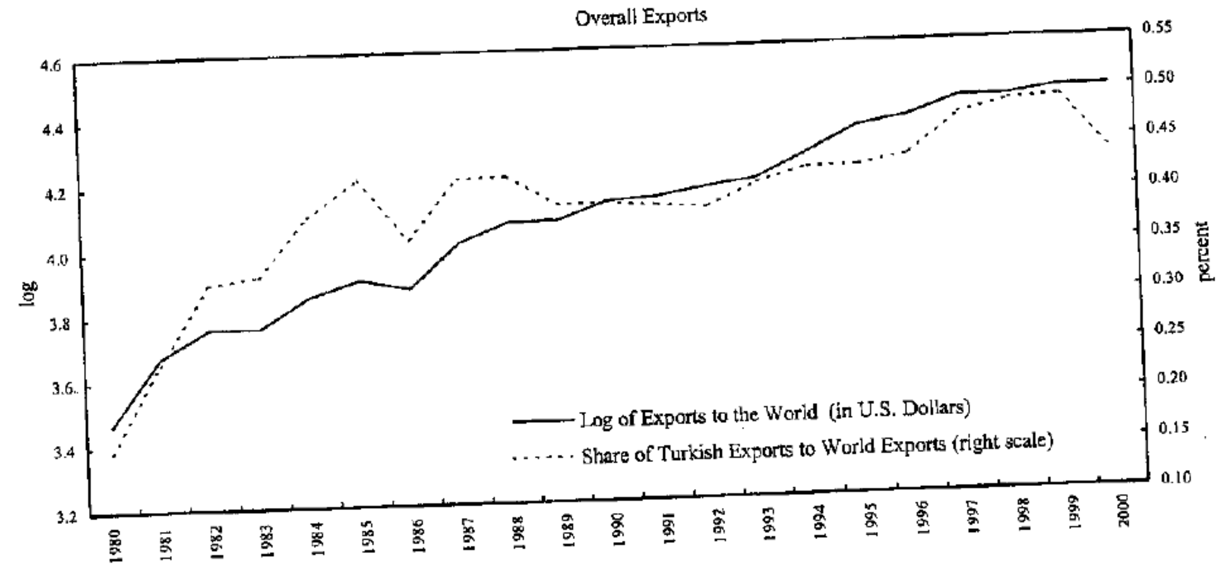
Price-based real exchange rate movements must ultimately be underpinned by supply-side reforms if competitiveness in the wider sense is to be achieved. The new three-year SBA recognizes this, and aims to promote Turkey's competitiveness and growth by bolstering reforms in such diverse areas as banking, fiscal policy, private sector development, and foreign direct investment. The World Competitiveness Report attempts to summarize supply-side competitiveness in a single rating. In 2001, Turkey was ranked 33 out of 75 countries, with positive factors such as labor market flexibility and free capital markets offset by problems with red tape and macroeconomic instability.

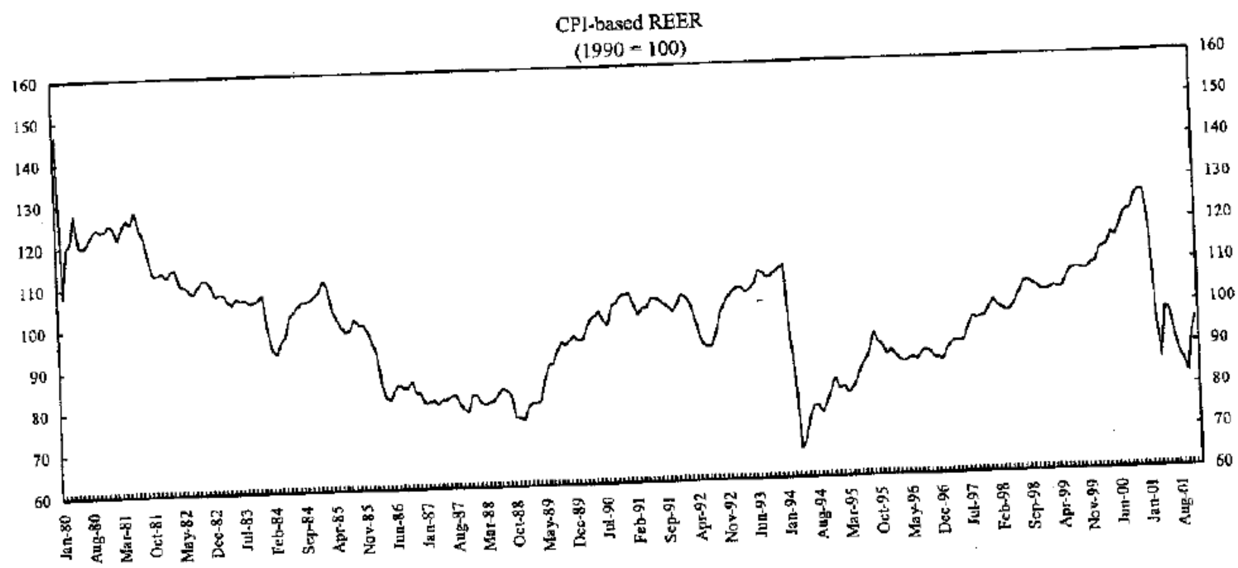
Figure 10. Turkey: Export Market Shares in Selected Partner Imports, 1970-2000
(in percent)



Source: IMF, *Direction of Trade Statistics.*

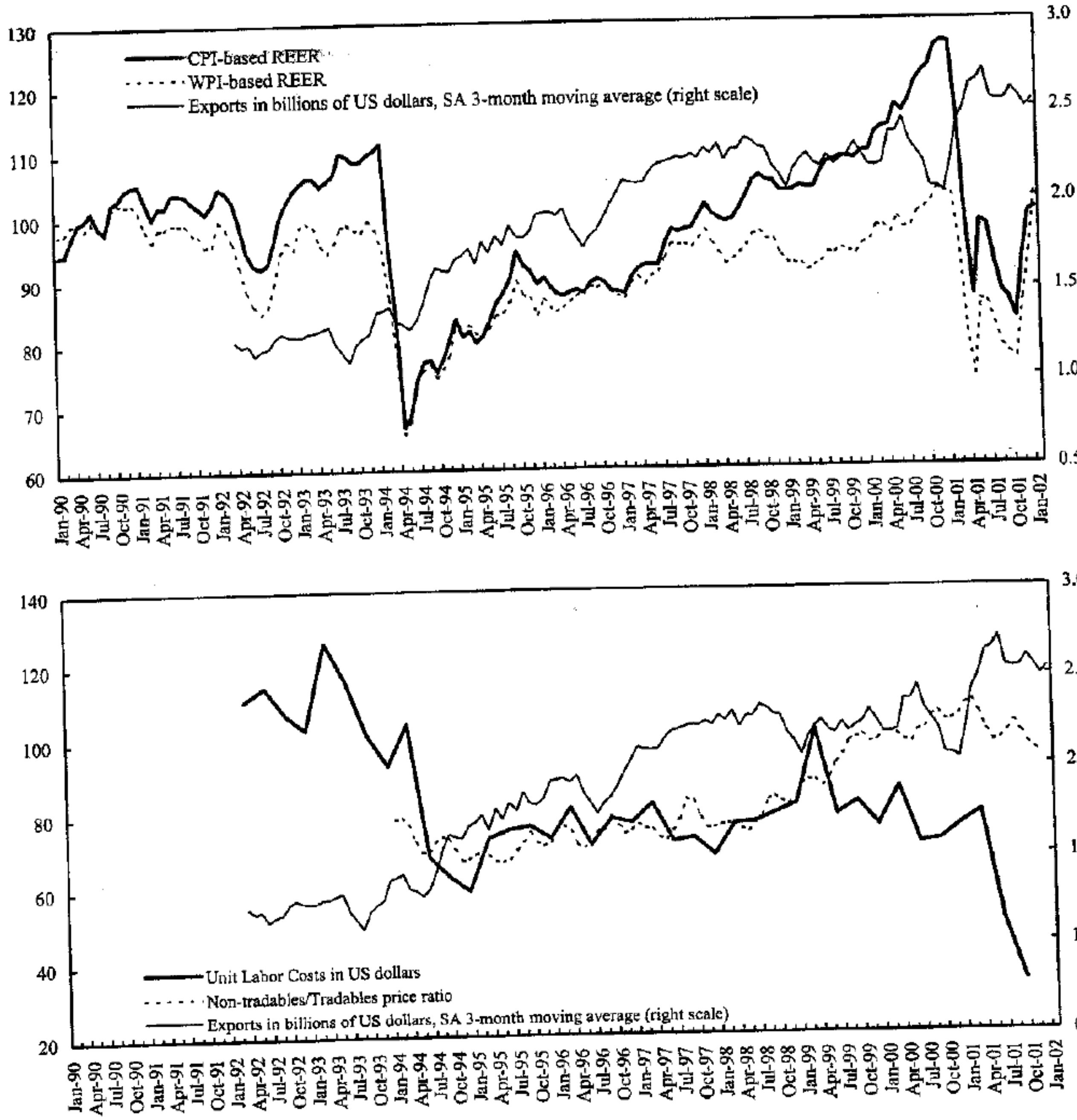
Figure 11. Turkey: Export Performance and Real Effective Exchange Rate, 1980-2001





Source: IMF, *Information Notice System*; and data from the Turkish authorities.

Figure 12. Turkey: Competitiveness Indicators, 1990-2002
(1990=100)



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

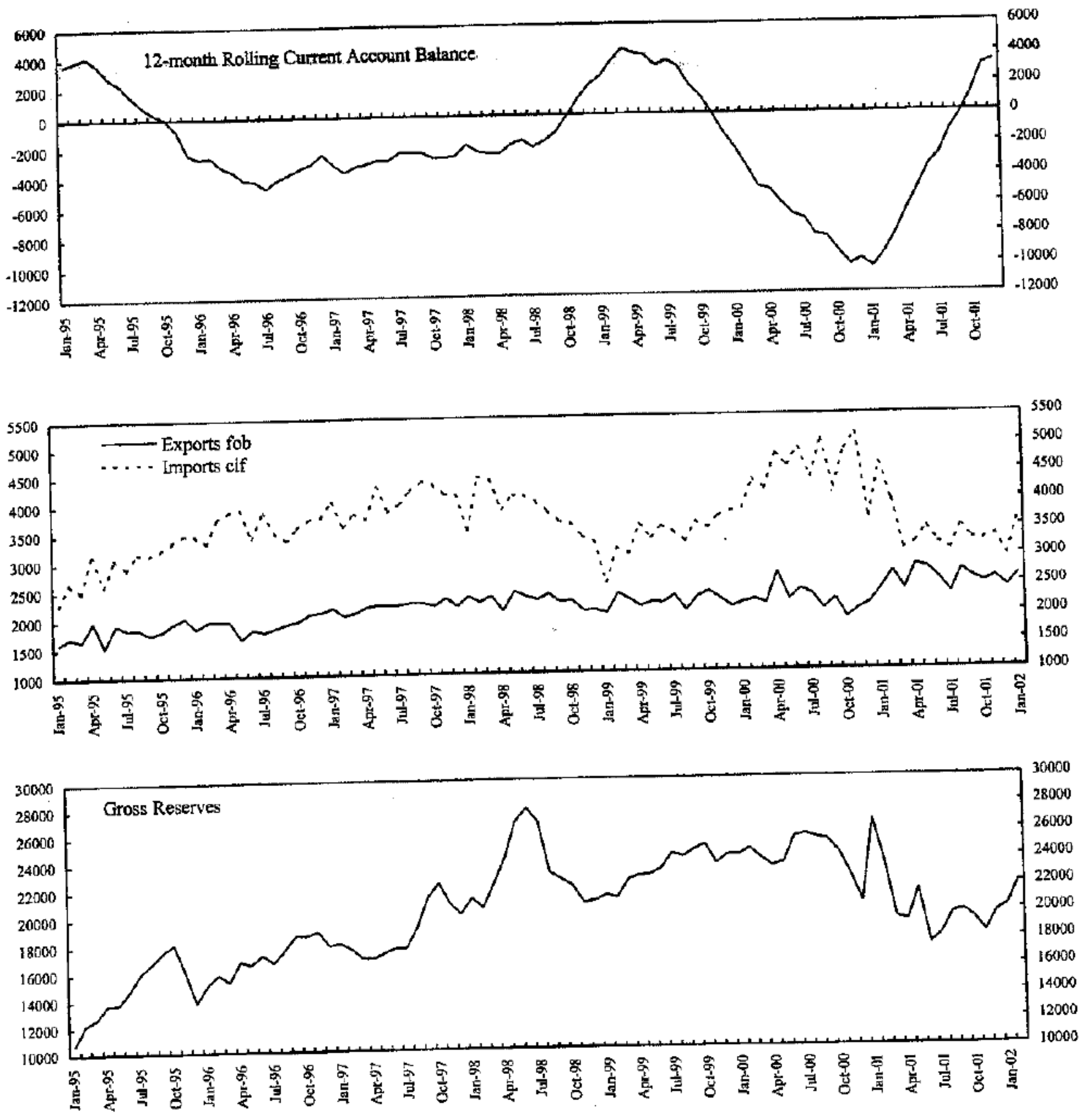
were for an outcome in the 40–45 percent range. The CBT was committed to meeting the target, which according to the staff's analysis remained realistic (as discussed in Appendix IV). Nevertheless, it was agreed that the difficulty of achieving the year-end target should not be underestimated, given the extent of backward indexation, the higher-than-anticipated oil prices, and the resilience of market expectations.

- **As for the balance of payments, the current account projections were left broadly unchanged,** with the unanticipated real exchange rate appreciation and higher oil prices offsetting the impact of the better-than-projected 2001 outturn (Table 4 and Figure 13). On the capital account side, it was agreed to retain fairly conservative assumptions: projected Eurobond drawings in 2002 were increased by US$½ billion to reflect Turkey's improved capital market access, while projected declines in interbank credit lines have been lowered by US$1 billion to reflect the improved rollovers in recent months. Gross reserves were, as a result, set to increase by US$4½ billion in 2002, US$1¼ billion higher than predicted earlier.

17. **The staff and authorities discussed a baseline medium-term scenario illustrating how strong implementation of the government's economic program could deliver sustainable growth of about 5 percent, as well as a reduction in inflation to single digits** (Table 5). With the framework deliberately centered around a conservative current account projection, the key to achieving the medium-term targets would be a strong pick-up in national saving, which would finance higher private investment, while allowing for a reduction in net external debt from its current 53 percent of GNP to 33 percent by 2006. This would also strengthen Turkey's capacity to repay the Fund (see paragraph 19 below). Both sides agreed that fiscal discipline and continued reform of the financial and corporate sectors were required to support private saving and factor accumulation. The staff also stressed that factor accumulation had to be complemented by stronger productivity growth, which would require further structural reforms to modernize the economy and attract foreign direct investment. The authorities agreed on the importance of such a strategy for achieving debt sustainability, and for improving the prospects for EU accession. Under the baseline scenario, net public debt would decline steadily from last year's 93 percent of GNP to below 60 percent by 2006.

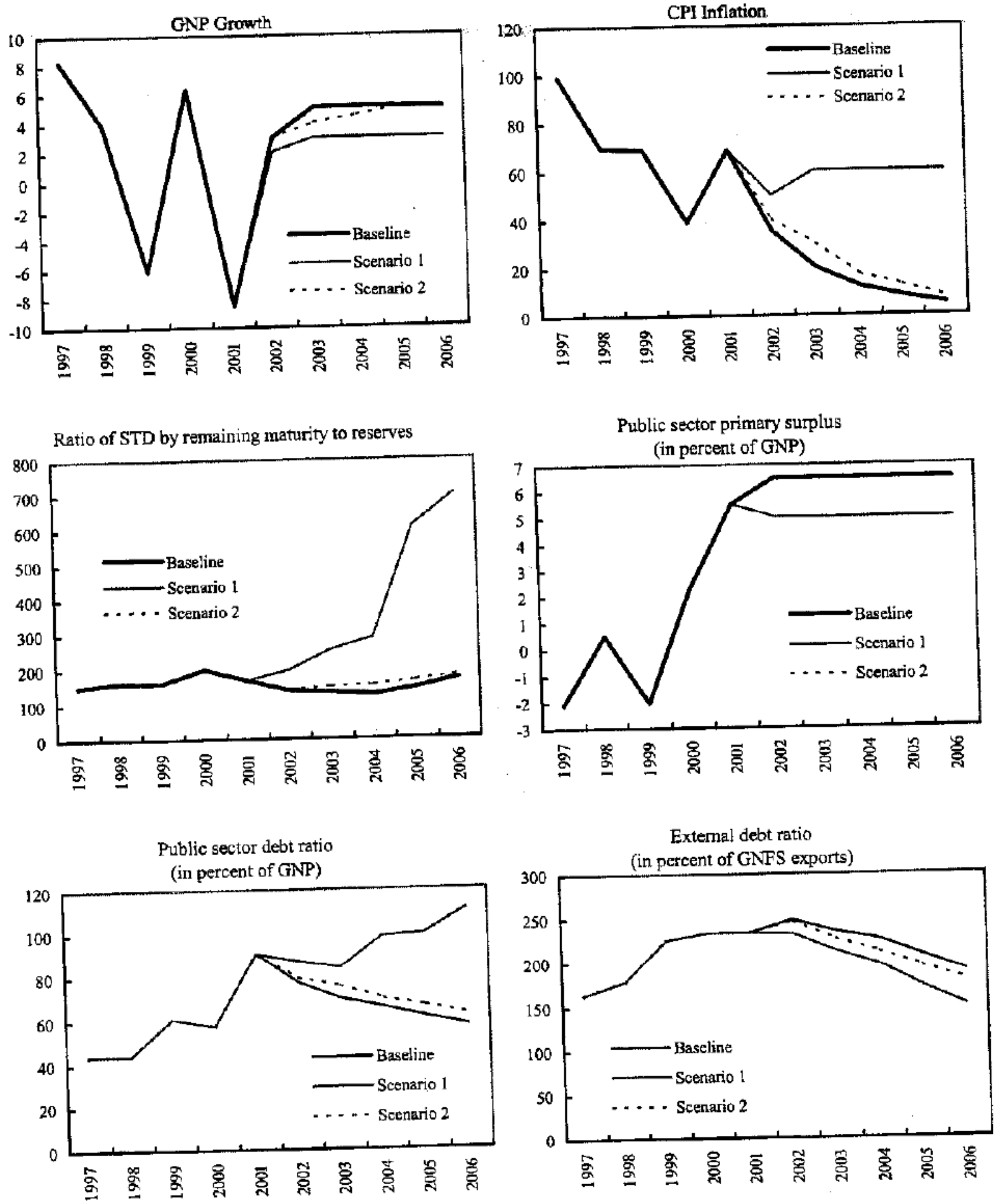
18. **Strong policy implementation is essential for such a favorable outcome** (Figure 14). The staff presented an alternative scenario (Scenario 1 in the figure) where reform fatigue set in, and policy implementation weakened. The resulting relaxation in fiscal policy and reduction in public saving, together with delays in structural reform, would raise real interest rates, inflation, and ultimately hurt output growth. External and domestic vulnerability indicators would weaken significantly. The staff and authorities agreed that such a scenario is highly unlikely to materialize under current conditions, provided program implementation remained strong. Strong implementation would also stand a fair chance of insulating Turkey from moderate external shocks. In such circumstances, temporary reduced access to international capital markets (Scenario 2) would only result in a slight delay to non-

Figure 13. Turkey: Balance of Payments Indicators, 1995-2001
(in millions of U.S. dollars)



Sources: State Institute of Statistics; and IMF, *International Financial Statistics*.

Figure 14. Turkey: Medium-Term Scenarios, 1997-2006
(in percent; unless otherwise stated)



Source: Data from the Turkish authorities; and Fund staff projections.

inflationary, sustainable growth in the medium term, without compromising the gradual reduction of the public debt ratio projected under the baseline scenario.

19. **Although Fund exposure is very high, the macroeconomic framework indicates that Turkey would be in a position to discharge its obligations to the Fund in a timely manner** (Tables 6 and 7). Turkey's unblemished record of payments to the Fund, the authorities' continued commitment to its intensified reform program, and the increasing evidence of better access to the international capital markets provide assurances in this respect. Turkey's obligations to the Fund will, however, continue to be substantial over the medium term, with payments to the Fund projected to peak at US$10 billion, or 15 percent of exports of goods and nonfactor services in 2006. Close monitoring of Turkey's capacity to repay the Fund will therefore continue, and corrective measures will be called for if projections turn out less favorable than expected.

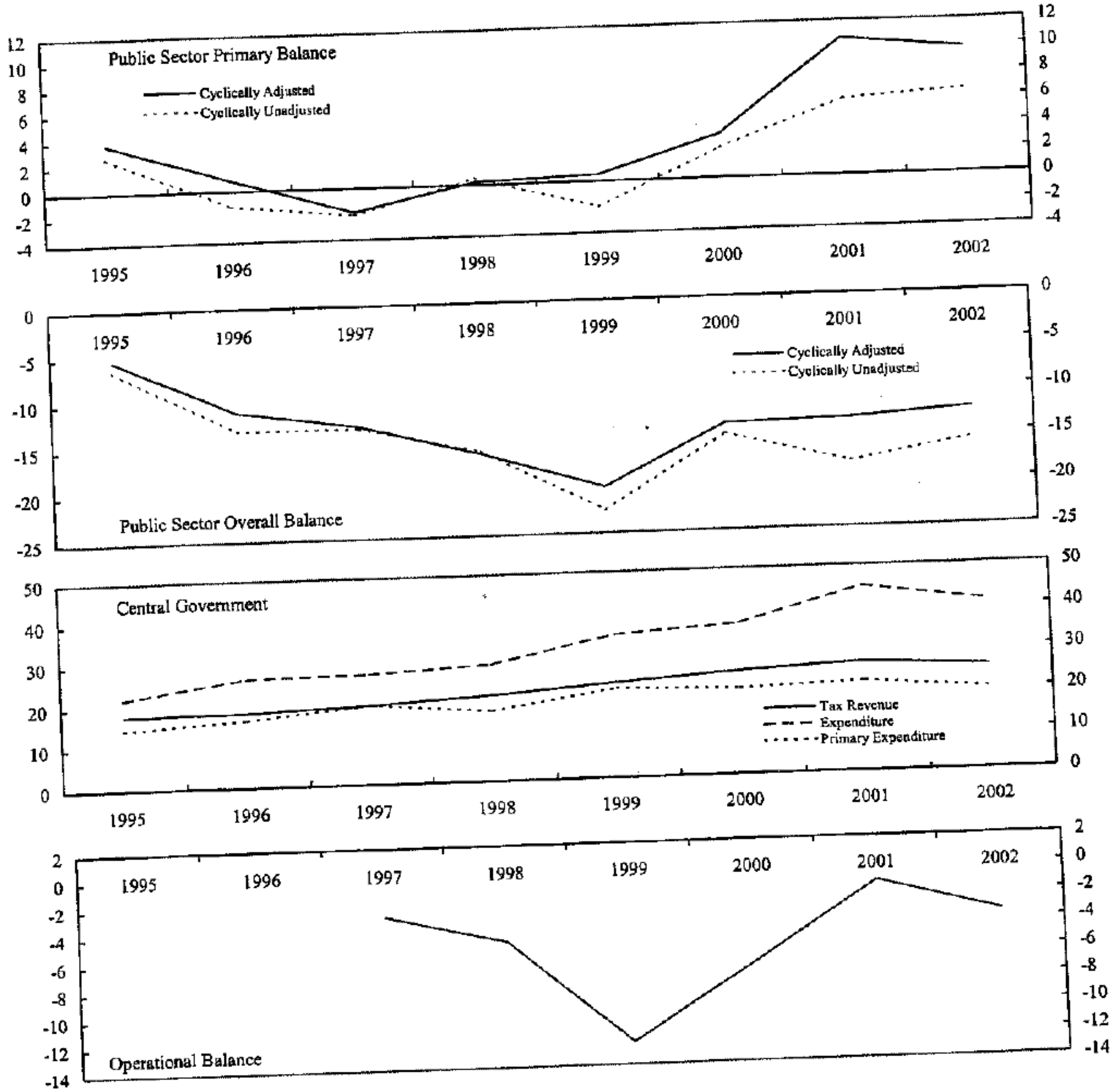
B. Fiscal Policy and Debt Management

20. **The turnaround achieved in the fiscal position since 1999 is impressive** (Figure 15). The public sector primary balance had improved from a deficit of 2 percent of GNP in 1999 to a surplus of almost 6 percent of GNP in 2001. This had set the stage for fiscal sustainability, a central plank of the new program. The staff was pleased that most of the recorded improvement—some 4½ percent of GNP—had come from the broader public sector (outside the central government), as this had been the source of much of the fiscal pressure during the 1990s. However, the staff saw room for improvement in the composition of central government adjustment, which had relied almost entirely on revenue enhancement. Accordingly, over the medium term restraining expenditures (while protecting social spending) and allowing the revenue ratio to fall would be appropriate. The authorities agreed with the need for tax cuts and protection of social spending. As regards 2001, while welcoming the overall strong fiscal performance, the staff expressed concern about the high level of primary spending during December. The authorities explained that this had reflected an end-year reduction of arrears. Both sides agreed that this underscored the need for better expenditure control (see paragraph 33 below).

21. **The turnaround is continuing in 2002, with budget developments on track to meet the program's public sector primary surplus target of 6.5 percent of GNP** (Table 8 and ¶5).[2] Within that envelope, the authorities had decided to take further steps to help stimulate employment growth, and so had delayed the annual increase in the contribution base for one social security fund and deferred tax payments for new employees. To offset the revenue loss from these measures, and from lower-than-programmed increases in the petroleum consumption tax, the authorities indicated that they would reduce investment expenditures, and widen the scope of the generic drug program in social security institutions. They also expected to receive a dividend from the state-owned Ziraat Bank (the

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

Figure 15. Turkey: Fiscal Indicators, 1995-2002
(in percent of GNP)



Source: Data from the Turkish authorities; and Fund staff calculations.

budget assumed no profit transfer). The staff agreed with the authorities that these adjustments, together with the favorable budgetary developments through February and the unchanged macroeconomic assumptions, did not jeopardize attainment of the primary surplus target. On the macro side, the main change had been the exchange rate, but this would be largely neutral for the public sector, provided the agreed price path for state economic enterprises was maintained. Both sides recognized risks to the fiscal position, especially from rising energy prices, but concurred that a full reassessment would be done at the time of the next program review in May, when more information about budget performance and macroeconomic prospects would be available.

22. **Public debt management was being strengthened as planned.** The improvement in confidence and the alleviation of short-term concerns about the public debt rollover had enabled the Treasury to significantly lengthen the maturity of domestic borrowing, beginning with the successful reintroduction in January of floating rate note issues (with a two-year maturity, compared to an average maturity of new issues in 2001 of six months). The Treasury had also tapped the Eurobond market for almost US$1½ billion so far in 2002 (more than half of the original program projection for the full year), at favorable yields and with maturities of up to ten years. The Treasury intended to continue pursuing a debt management strategy aimed at lowering interest rates and improving the term structure of its debt, with a view to reducing the rollover burden in 2003. In addition, further steps were being taken to strengthen debt management. The Law on Public Debt Management (which was passed by parliament in late March, and will be supplemented by soon-to-be-issued supporting regulations) calls for organizational changes within Treasury aimed at improving risk assessment and fostering closer coordination in managing the domestic and international debt portfolios (¶6).[3] Moreover, the Treasury had recently intensified its communications with commercial banks and institutional investors, and the coordination of its borrowing program with the CBT (see paragraph 27 below).

C. Monetary Policy

23. **Amid improving confidence in the floating exchange rate regime, discussions focused on achieving successful disinflation, the appropriate monetary policy response to signs of balance of payments improvement, and ways to make the money and foreign exchange markets more efficient.** Over the past year, the CBT had shown increasing adeptness in managing the floating exchange rate. Although the business and banking communities (and parts of the government) through much of last year had been loathe to abandon the crawling peg, the floating rate system was now more widely accepted. This had given greater flexibility to the CBT's monetary policy, first through the use of base money

[3] More generally, the Public Debt Management Law lays the foundation for a comprehensive risk management framework, confirms the Treasury as the single borrowing agency for the central government, and creates a more transparent framework for public debt management and the issuance of government guarantees.

targets to contain the surge in prices after the February 2001 devaluation, and later, backed by fiscal adjustment and structural reform, through targeting a reduction in inflation. Looking forward, key issues were whether the early introduction of formal inflation targeting would help this disinflation effort, how monetary policy should respond to the balance of payments improvement, and concrete steps to improve the functioning of the money and foreign exchange markets.

24. **Although the prospects for lowering inflation to 35 percent by end-year had improved, the CBT was not yet ready to announce the start of formal inflation targeting** (¶7). Both sides agreed that in recent months progress had been made toward meeting the preconditions for successful inflation targeting: concerns about public debt sustainability had diminished, the bank recapitalization scheme was on track, financial markets had stabilized, and technical preparations were proceeding apace (as witnessed by the increasing role played by the Monetary Policy Committee, and the release of comprehensive and timely survey data on inflation expectations). However, while remaining committed to the launch of inflation targeting during 2002, the CBT argued that announcement of a start date was premature. Although February's low inflation had led to a significant fall in inflation expectations, which had warranted a further cut in the overnight rate, the CBT believed that a track record needed to be built up to make the introduction of formal inflation targeting credible. In addition, the CBT noted that backward indexation remained pervasive, particularly for wages, public sector prices, and government user fees. The staff agreed that administered price increases added to the price level, but stressed that maintaining a sound fiscal position was a sine qua non for an effective disinflation policy. In addition, although Turkish inflation was inertial, there was also evidence of forward-looking price setting behavior (Appendix IV). In such a context, a credible disinflation strategy, such as through the use of a clear nominal anchor based on formal inflation targeting, could lower inflation expectations and break inertia. On balance, the CBT agreed with the staff that the case for an early introduction of inflation targets had strengthened and that the conditions should be in place by mid-2002.

25. **The authorities and staff agreed that structural reform could also play a major role in reducing inflation inertia** (¶14). Efforts to reduce overstaffing and lower wage indexation in the public sector would reduce costs (thereby lessening price pressures) and set an example for wage setting in the rest of the economy. In addition, measures to enhance the business environment and to reduce state ownership in the economy would help promote competition, and more market-oriented wage and price setting. While private labor markets were generally flexible, the government's increased efforts to highlight the 35 percent inflation objective could also lead to more rational wage- and price-setting behavior.

26. **The CBT was making use of the better-than-expected balance of payments position to build up foreign exchange reserves** (¶8 and Tables 9 and 10). Although the floating exchange rate made it essential to avoid any appearance that the exchange rate was being targeted, the recent improvement in the balance of payments provided an opportune moment for the CBT to accumulate foreign exchange reserves, especially given longer-term repayment needs. By end-February, net international reserves were already some

US$1.6 billion above the program floor. So far, this accumulation had taken place passively, as improved confidence and the reduced pressure on interest rates had allowed the CBT to offset the impact of the Treasury's foreign exchange borrowing on liquidity through money market operations, rather than foreign exchange sales (which had been the CBT's main way of mopping up liquidity during 2001, and which have been built into the program's baseline in 2002 as well). However, both sides agreed that if the balance of payments were to strengthen further, and reverse currency substitution continued, it would be appropriate for the CBT to accumulate more reserves. Although this could be achieved by relying on the Treasury to borrow in foreign exchange and deposit the proceeds, there would likely also be scope for the CBT to make foreign exchange purchases in its own right. In the event, in late March the CBT announced the start of daily auctions to purchase foreign exchange, with the amount set at US$20 million per day for April.

27. **The staff stressed that to keep base money within the target path, the monetary impact of any reserve increase needed to be sterilized, ideally through use of longer-term instruments that would minimize the risk of sudden sharp outflows.** The sterilization would not be trivial. Paradoxically, the authorities' successful efforts to solve the state banks' liquidity problems in 2001, together with the recent improvement in market confidence, had resulted in a sharp increase in the CBT's net borrowing position from private banks.[4] Moreover, the CBT's instruments for sterilization were wholly short term (overnight and one week). Against this background, the staff pointed out the desirability of substantially reducing the CBT's short-term position, both to contain a potential source of vulnerability, and to create a genuine overnight market. This could be accomplished by lengthening the maturity of CBT's instruments, and by greater cooperation on sterilization policy with the Treasury. The authorities recognized the need for concerted efforts at sterilization. In late March, the CBT initiated the lengthening of its maturities by announcing the start of weekly auctions of one-month central bank deposits. For their part, Treasury officials indicated their intention to continue to lengthen the maturity of the government's borrowing, and to borrow in excess of redemptions to the extent market conditions allow.

28. **The authorities noted that distortions remained in the money and foreign exchange markets, and that these markets were not sufficiently deep.** In large part, these distortions arise from discriminatory taxation and some design aspects of CBT monetary instruments (Box 4). Changes in the structure of money and foreign exchange markets over the past year have also increased market shallowness. In the money market, the sharp

[4] In the first half of 2001, in the context of a fundamental financial restructuring of state banks, the authorities had eliminated these banks' short-term borrowing from the interbank market. This was accomplished through the CBT acting as an intermediary, borrowing short term from the private banks and onlending to state banks. More recently, private banks have shown an increased willingness to hold the liquidity created by treasury bill net redemptions in the form of TL rather than foreign exchange. As a result, the CBT's reverse repo position has grown sharply over the past year, from 10 percent to 90 percent of base money.

Box 4. How Taxes and Reserve Requirements Distort Turkey's Money and Foreign Exchange Markets

The structure of Turkish money and foreign exchange markets has developed to take advantage of the complex system of differential taxes and reserve requirements. This has resulted in high transactions costs, segmented and shallow markets, and a tendency toward disintermediation. The staff estimates that limited remuneration of reserves has, by itself, increased Turkish lira (TL) spreads by 3 percentage points and foreign exchange (FX) spreads by 1 percentage point.

Turkey's transactions taxes distort financial markets and reduce banking sector profitability substantially:

- Taxation of **Turkish lira bank borrowing and lending** varies depending on the counterparty. This causes unnecessary market segmentation and illiquidity. Lending to the CBT is subject to a 1.81 percent commission; borrowing from the CBT is subject to a similar commission, plus a 1 percent transactions tax. Lending to commercial banks is free from tax, but the borrower must again pay a 1 percent transactions tax. Repos are exempt from transactions taxes, but both borrower and lender must pay a 0.41 percent commission; in addition, the interest income is subject to a 22 percent withholding tax. These intermediation costs are on top of the withholding tax paid by bank customers and taxes for the so-called resource utilization fund. All of these taxes, together with the lack of inflation accounting, reduce the profitability of providing banking services.

- All **foreign exchange transactions** are subject to a 0.1 percent transactions tax on the notional value, and forward transactions bear an additional 0.7 percent stamp duty. In addition, future transactions were subject to taxation on daily mark to market gains, rather than when exercised. To avoid the taxes, banks have increased their transactions with offshore branches, which has stimulated creation of an offshore market.

In addition, there are a variety of reserve and liquidity requirements differentiated by currency, parts of which are remunerated but at less than market rates:

- TL deposits are subject to a 4 percent mandatory **reserve requirement**, remunerated on a quarterly basis at a rate set by the CBT. The current rate is 40 percent, while the rate on TL-denominated treasury bills of the same maturity is 65 percent. FX deposits are subject to an 11 percent reserve requirement which is non-remunerated.

- In addition, TL and FX deposits are subject to **liquidity requirements** (8 percent and 3 percent, respectively). The liquidity requirements for TL deposits can be met with a variety of different instruments: a minimum of 4 percent of the requirement must be held as securities at a special account at the CBT, a maximum of 2 percent can be held in cash, and 2 percent is held in a non-interest bearing free reserve account at the CBT. In the case of FX deposits, at least 1 percent of the requirement has to be held in securities, and a maximum of 2 percent can be held in cash. Liabilities other than deposits are also subject to liquidity requirements of 12 percent for TL liabilities and 14 percent for FX liabilities. Again, part of the requirement has to be held in free reserves at the central bank: 6 percent and 11 percent, respectively, for TL and FX liabilities. A maximum of 2 percent can be held as cash (convertible foreign exchange in the case of FX liabilities), while the rest has to be held in securities.

Insufficient averaging of reserve requirements also hinders the development of interbank money and foreign exchange markets. Liquidity requirements can be met by averaging over the holding period. However, only partial averaging is allowed for reserve requirements, and the averaging period of one week makes even this partial allowance very restrictive. The limited averaging results in funds being locked in at the CBT, rather than allowing banks to lend lira or foreign exchange when other banks face temporary withdrawals. Releasing such funds could increase liquidity in the interbank market, and provide useful signals of incipient pressures in the money and foreign exchange markets to the CBT.

increase in the CBT's net borrowing (described above) had created a one-sided market, leaving the CBT with complete control of the overnight rate and muting any market interest rate signals. This had resulted in a more than halving of average interbank turnover between the first half of 2001 and February 2002. In the foreign exchange markets, a reduction in the open foreign exchange positions of private banks from US$8½ billion at end-2000 to US$1¼ billion in January 2002, combined with a reduction in the number of market participants due to SDIF bank interventions, had sharply reduced average daily trading volumes and concentrated trades among a very few banks. While these changes in market structure were certainly needed, the staff and authorities agreed that the combination of these changes with other distortions tended to weaken monetary transmission and distort market signals.

29. **In response, the authorities were making efforts to smooth the functioning of the money markets and the floating exchange rate regime (¶9).** They agreed that Turkey would only be able to develop a sound and efficient banking system if costs of intermediation could be reduced. A recently established multi-agency working group on money and foreign exchange markets was now meeting regularly, and progress was being made both in regulatory reform and in tax treatment of futures contracts. In addition, the CBT was gradually disengaging from its "blind broker" role (acting on behalf of market participants to preserve anonymity), and was increasing the remuneration and averaging period for bank reserves. Mindful of the need to reduce the burden on the banking system, and to contain offshore disintermediation, the authorities also agreed to eliminate the stamp duty on forward contracts (which had prevented market development), and the tax on interbank foreign exchange transactions. A full review of the taxation of financial instruments would await the more fundamental tax reform planned for October.

D. Structural Reform[5]

Financial sector

30. **The staff commended the authorities for having introduced in a short time radical reforms to secure a fundamental improvement in Turkey's banking system.** [6]

[5] Box 5 provides a summary of the coverage and status of structural conditionality in the program, areas covered by World Bank lending and conditionality, and structural measures not included in the program.

[6] A comprehensive analysis of the Turkish banking system was issued as a supplement to the staff report for the request for the stand-by arrangement ("Banking System Developments and Reforms," EBS/02/8, Sup. 1, 1/25/2002).

Box 5. Structural Conditionality

Coverage of structural conditionality under the three-year Stand-By Arrangement

The program aims at reinvigorating structural reforms, while incorporating those policy actions that were already agreed under the previous program (as set out in Table 2 of the November 20 Memorandum on Economic Policies and Annex B of the Letter of Intent attached to EBS/01/192, 11/21/01). The main areas covered by the program's structural conditionality continue to fall into two categories: (i) **measures with a direct and significant bearing on the attainment of macroeconomic stability**, which include extensive conditionality in the banking sector, the key source of weakness underlying the recent crises; and (ii) **measures that will improve medium-term growth prospects**, which, in addition to banking reforms, include measures to strengthen tax policy and expenditure management, and steps to enhance the role of the private sector in the economy. Since Turkey's problems largely reflect a lack of confidence stemming from structural weaknesses in the economy, the credibility of the program depends fundamentally on the strength of the structural effort. **In addition, structural conditionality has been introduced in the context of the IMF safeguards assessment** to improve further the transparency and effectiveness of the CBT's control, accounting, reporting, and auditing systems.

Status of structural conditionality from earlier programs

Previous programs featured key structural conditions, many of which were prior actions for program reviews (see EBS/01/69, 5/7/01). Comprehensive structural reforms have focused on banking sector restructuring, fiscal transparency, private sector development, and governance. While privatization has proceeded rather slowly, in part owing to weak market conditions, major progress has been made in other areas. The proposed program builds on these important results, with strong upfront conditionality. All prior actions (as set out in Annex C of the January 18, 2002 Memorandum on Economic Policies attached to EBS/02/8, 1/18/02), including banking sector restructuring, privatization, and private sector development, for Board approval of the program were met.

Structural areas covered by World Bank Lending and conditionality

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

Other relevant structural conditions not included in the proposed program

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

For many years the banking system suffered from excessive risk taking, abuse by owners, weak regulatory and supervisory frameworks, lack of mechanisms to handle weak banks, and macroeconomic volatility. Moreover, until last year, state banks had created huge distortions because of the run-away accumulation of government receivables ("duty losses"), resulting in escalating liquidity needs and chronic under-capitalization. Adjustment programs since 1999 have sought to correct these deficiencies through macroeconomic stabilization, deep structural reforms to bring the operating rules and banking environment up to international standards, and a concerted strategy to deal with system weaknesses. The authorities can already point to clear achievements, notably in restructuring the state banks. After a program in 2001 to regularize the state banks' financial position, operational restructuring of state banks in preparation for privatization is also moving ahead (¶11). As regards private banks, the Saving Deposit Insurance Fund (SDIF) has intervened in 19 banks since 1997, of which 4 have been sold, 8 have been merged (5 banks merged into one which was sold subsequently, and 3 banks merged into one whose license was later revoked), another 3 have been closed and liquidated, while the remaining 4 are in various stages of resolution (¶12). The authorities' efforts in 2001 to induce financially weak private banks to raise their capital were important, but insufficient to deal with the deterioration in banks' financial condition. As part of the new Fund-supported program, the authorities strengthened their strategy by introducing a scheme to allow the use, under strict conditions, of public money to assist banks in their recapitalization efforts. The legal framework for this scheme was put in place at the beginning of February 2002.

31. **With the restructuring program for state banks and smaller private banks well advanced, discussions focused on rehabilitating the core private banking system** (Table 11). The authorities explained that the first stage of a three-stage implementation process, involving a targeted valuation of bank portfolios to get reliable estimates of banks' net worth, would be completed by end-March as scheduled. In the event, this was true except for a few banks. Preparations for the second phase, where third-party audit firms would verify compliance with the regulations and guidelines associated with the targeted assessment exercise, were also on schedule. The Bank Regulation and Supervision Agency (BRSA) had already issued additional instructions for the second phase, and expected to appoint the audit firms by end-March. Looking ahead, the BRSA would inform banks by mid-May of the amount of capital, if any, they would need to raise by end-June. Both the authorities and the banks noted that it may take banks more than the 1½ months allowed in the existing timetable to call shareholder meetings and raise private capital to qualify for public support. The staff agreed that a slight delay would not detract from the success of the recapitalization scheme, but stressed the need to maintain the momentum of the process.

32. **To increase the prospects of successful bank rehabilitation and restore growth, the authorities were developing a framework for corporate debt restructuring** (¶13 and Box 6). They agreed with the staff that rapid progress in corporate debt restructuring was needed to complement bank rehabilitation, as high interest rates and sluggish demand had brought Turkish corporates under considerable distress. To facilitate the restructuring of the debts of the **largest borrowers**, the authorities had in January 2002 put in place the legal foundation for a voluntary market-based framework (the "Istanbul Approach"). A framework agreement for the debt workouts had been finalized, although it had yet to be signed by the

Box 6. Corporate Debt Restructuring: Experience in Other Countries

Countries facing financial crises have adopted two main approaches to dealing with nonperforming assets: centralized out-of-court corporate debt workouts, and asset management companies (AMCs). In practice, countries have often chosen a mixture of these approaches. While evidence on the relative merits of the two approaches is inconclusive, it does offer suggestions as to how to increase the likelihood of success. However, experience does uniformly suggest that there are no easy solutions to corporate debt restructuring.

Out-of-court debt workouts are appropriate for corporations that have prospects of successful rehabilitation. While such workouts can be left decentralized, this can become unmanageable when a large number of creditors and corporations are involved, and creditors lack restructuring expertise. Many crisis countries have tried to formalize the out-of-court approach, by signing legally binding agreements that allow for enforcement of agreements reached among the majority of creditors, or for compulsory arbitration. Advocates of this approach argue that banks are better placed than AMCs to resolve NPLs, as they have the loan files and institutional knowledge of the borrower.

AMCs have been set up to expedite corporate restructuring, and as vehicles for banks to dispose rapidly of their assets. The AMC approach allows for restructuring skills and resources to be consolidated within one agency, improving asset recovery. Centralization can also facilitate securitization of assets, improve collection of connected loans, enhance creditor leverage over debtors, and reduce inter-creditor conflict. Removing distressed loans also allows banks to focus on their day-to-day activities, rather than tie up resources in complex loan workouts.

While both approaches have a mixed record, studies have identified factors that improve the likelihood of success (see references below). In the case of **out-of-court workout frameworks**, experience from Argentina, Chile, Hungary, Japan, Norway, Poland, and Thailand suggests that chances of success are enhanced by limited lending to related parties, adequately capitalized banks, proper incentives for banks, and appropriate accounting and legal rules. Also, financial institutions need sufficient skills and resources to deal with the problem loans. The most used incentive for restructuring has been for banks to recognize the NPLs up front by fully provisioning for these—banks would then have to restructure loans to benefit from any upside performance of the debtors. Some countries have also provided Tier-2 capital to offset the costs of restructuring debts. As regards **AMCs**, experience from Finland, Ghana, Mexico, the Philippines, Spain, Sweden, and the United States suggests that success depends on having assets that are easily sold, professional management, political independence, a skilled resource base, appropriate funding, adequate bankruptcy and foreclosure laws, good information and management systems, and transparency in operations and processes. In East Asia, Malaysia's AMC was relatively successful, owing to a strong bankruptcy system.

The need for corporate restructuring to stimulate economic recovery in Turkey is urgent. The authorities have articulated a near-term strategy that combines an out-of-court workout arrangement (the "Istanbul approach") and the establishment of a majority privately owned AMC to recover and restructure medium-size loans. These components are to be supported by a high-level coordinating group that would elaborate proposals to encourage the participation of banks and corporates in the Istanbul Approach. World Bank support for this effort, and for facilitating corporate debt restructuring more generally, will be important. The authorities are also committed to reforming the bankruptcy law and execution procedures in line with the recommendations of an insolvency ROSC prepared by the World Bank. Beyond the general incentive of booking losses and recouping from the upside, there are as yet no explicit carrots in the arrangements. While the large concentration of NPLs on a few borrowers facilitates the out-of-court approach, the ownership links between corporates and banks are likely to complicate the restructuring. Owing to the time required to set up the AMC and implement the ongoing bank recapitalization scheme, large-scale corporate restructuring is unlikely to start until the third quarter of 2002.

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creditors, given that their capital positions were being assessed as part of the bank recapitalization program. A high-level committee, with representatives from government agencies and the business and banking communities, would take the lead in elaborating policy proposals, consistent with preserving the transparency and integrity of the bank recapitalization process, to encourage the participation of banks and corporates in the Istanbul Approach. The Committee would also work with different agencies to set up by June 2002 a database to monitor the corporate sector, including its debt position. The authorities expected World Bank support for this effort, and for facilitating corporate debt restructuring more generally. To promote the restructuring of **medium-size loans**, the SDIF recently announced its intention to help set up by August 2002 a majority privately owned asset management company. As regards **small borrowers**, the well-capitalized public banks had started to restructure the debts of their clients. Ziraat Bank had offered a debt restructuring agreement to almost 30,000 smaller customers, who account for 8 percent of their total NPLs. Individual protocol agreements were being sought for the 200 clients that account for the remaining 92 percent: so far 25 had been signed.

Other structural reforms

33. **Key fiscal reforms were broadly on track** (¶15):

- **With World Bank assistance, the authorities had completed a macro-level study of state economic enterprises that suggested overstaffing amounting to some 40,000–60,000 employees (out of 420,000).** (This estimate excludes 15,000 workers who have retired under a voluntary scheme introduced in December 2001). The authorities and the staff agreed that there was now a need to convert these estimates into company- and position-specific retrenchment targets, and update the estimate of net retrenchment costs. The authorities expected to complete this process by end-May, by use of the High Auditing Board, and in consultation with the World Bank. In the interim, the program of voluntary early retirements would proceed with an end-June target of reducing the identified redundancies by one third. The staff viewed this progress as satisfactory, but cautioned that further delays would put the end-October target of reducing the redundancies by two thirds at risk. The staff also cautioned that the retrenchment would likely need to include layoffs at some point: it was highly unlikely that all redundant workers would wish to retire, and there would be little point in retiring nonredundant workers, who would have to be replaced. While the authorities indicated their strong preference for avoiding layoffs in the public sector, they noted their intention to expand the scope of their study of redundancies to also cover the central government.

- **Preparations for the first phase of tax reform were largely complete.** The authorities had prepared a draft of the Special Consumption Tax Law and expected to submit it to parliament in early April, after considering technical advice from the Fund and the World Bank. However, they expressed concern about aggressively reducing tax distortions on interest income in the context of the April reform, preferring to deal with this (and the revenue implications) in the context of the direct tax reform phase planned for October. They indicated, however, that they would reduce disparities among the withholding tax rates on deposits in April. The staff expressed concern about the introduction of new tax incentives (see paragraph 21 above), and urged that further incentives be avoided, consistent with the authorities' tax reform strategy which saw a need to simplify and reduce incentives.

- **Revenue administration reform measures in 2002 would focus on strengthening auditing and enforcement.** The existing audit regime is highly fragmented with little coordination, and it is estimated that Turkey needs another 3,000–4,000 auditors to reach OECD standards. Accordingly, the priority measures, which were made benchmarks under the program, focus on devoting more resources to tax audit, and using existing resources more efficiently (by coordinating the operations of all tax audit units through an annual plan). Reforms with a more medium-term focus, such as the introduction of a functional organization in the General Directorate of Revenues (GDR), will be supported under the World Bank's proposed PFPSAL II program. The staff emphasized that to see the full benefit of this reorganization, all tax audit units would need to be consolidated under the GDR at the earliest opportunity. One other reform measure, formulating a plan to address public sector tax arrears, is expected to assist the process of state economic enterprise and local government restructuring, when the authorities fiscal program for 2003 is formulated this fall.

- **Progress was also being made in transparency and public expenditure management reforms.** The authorities had completed an arrears survey for end-2001, which revealed the existence of only a small amount (0.05 percent of GNP) of unpaid bills, some of which were disputed. The staff welcomed this news, but noted that many overcommitments had accumulated during 2001, as indicated by the high December expenditure numbers. The authorities agreed to better monitor the problem in 2002 by initiating semi-annual surveys of commitments (against authorizations) with the first one to be carried out at mid-year. The staff encouraged the authorities to continue to reduce the number of revolving funds (since not all ministries had yet consolidated these). As regards establishing the procurement agency, a key step in implementing the Public Procurement Law enacted in January, the authorities indicated that its Board of Directors would be in place shortly.

34. **Privatization is to be given new impetus** (¶16). State ownership remains prevalent in many sectors, including transportation, agricultural processing, energy, and telecommunications. To promote high sustained growth, the program aims to lay the legislative basis for divestiture, and streamline the operations of companies slated for sale, to make them viable and more attractive for potential investors. The staff urged the authorities to make use of the improved market conditions to pursue privatization more aggressively. The authorities noted that they would complete a public offering of POAŞ (petroleum retailer) in March, and that they were following up on the preparatory work for other companies, in petroleum refining, tobacco and alcohol production, sugar refining, telecommunications, and energy. In the energy area, the privatization of power generation plants and distribution companies was on hold, pending the Constitutional Court's decision on transfer of operating rights contracts, but the authorities were committed to working with the World Bank to find a way forward.

35. **The government was taking further steps to improve external communication** (¶17). An Investor Relations Office had been set up within the Treasury to act as a focal point for two-way communication with investors. Moreover, the launch of an Investor Council consisting of major international investors with an interest in Turkey was planned for July. Preparations were well underway, with the support of the World Bank.

36. **Follow-up steps were agreed to further enhance the role of the private sector and fight corruption** (¶17 and 18). The staff commended the authorities for having already implemented several measures in an action plan that the Council of Ministers adopted in January to improve the business and investment climate. The staff also welcomed an action plan to enhance transparency adopted by the government in February, and urged its timely implementation. The authorities committed themselves to forming a ministerial commission with a supporting committee to oversee the implementation, and to publishing the action plan. Both sides agreed that putting in place the measures under the action plan, including introducing performance standards for public sector employees, increasing public access to information, and improving audit systems, should help strengthen governance over the medium term.

E. Other Issues

37. **The authorities provided an update of developments regarding Turkey's accession to the EU.** Turkey applied for EU membership in the late 1980s, but was accepted as a candidate country only in 1999 at the Helsinki Summit. Unlike the other EU candidate countries, Turkey has not yet started membership negotiations. Currently, the work toward membership is focused on scrutiny of Turkey's legislation and its consistency with the Acquis Communautaire, which is proceeding with technical assistance from the EU Commission. EU's next Regular Report on Turkey is expected to be completed by fall 2002, at which time a recommendation will be issued on whether membership negotiations should be started. The key outstanding issues are political, and include finding a solution to the Cyprus issue, allowing education and broadcasting in languages other than Turkish, lifting the death penalty, and improving human rights.

38. **The discussions also covered developments in trade policy** (Box 7). The staff noted that Turkey's trade reform efforts over the past few decades had been strong, with the progressive lowering of tariffs and other import levies, the removal of non-tariff barriers to trade, and the revamping of trade-related legislation in line with EU standards. However, the contrast between the treatment of manufacturing—where substantial liberalization had taken place—and agriculture, was striking. In response, the authorities indicated that they had lowered agricultural tariffs in line with the WTO Agreement on Agriculture, that fundamental agricultural reforms were ongoing, and that further trade liberalization would depend on reforms taking place elsewhere. They also noted the obstacles Turkish exporters were facing abroad.

Box 7. Turkey: Trade Policy Developments

Turkey has undertaken substantial trade liberalization since the early 1980s. The 1996 customs union agreement between Turkey and the EU eliminated tariffs on manufactured imports originating in the EU, and introduced the EU common external tariff for manufactures. Turkey has also revamped competition, customs, and intellectual property rights legislation in line with EU standards. Turkey also now has a more transparent trade regime, as most quantitative import restrictions and import levies have been eliminated (apart from a very selective application of the Mass Housing Fund levy), export incentives have been reduced, and customs administration has been improved.

As a result, Turkey's trade regime is regarded as moderately restrictive, with a rating of 5 on the Fund's 10-point index of aggregate trade restrictiveness.[1] The simple average tariff now stands at 12.4 percent, down from almost 50 percent in the early 1990s. Nontariff barriers have also been lowered, with mandatory import licenses for all products being replaced in 1996 by limited licensing requirements for security, safety, and environmental reasons.

Turkey has entered into several other regional and bilateral trade agreements. Under the customs union agreement with the EU, Turkey has adopted all of the preferential agreements the EU has concluded with third countries. Turkey also signed a free trade agreement with the European Free Trade Association (EFTA), which entered into force on April 1, 1992, and was the founder of the Black Sea Economic Cooperation Organization (BSEC) and the Economic Cooperation Organization (ECO), both of which aim at comprehensive trade liberalization among member states. Other bilateral trade agreements, with the Baltics, East European countries and Israel, are listed in a Statistical Appendix table.

Although much has been achieved, problems remain. Protection of manufactures is very low (no tariffs for EU and EFTA countries, and a simple average tariff of 4.5 percent for other countries), but the agricultural sector continues to enjoy substantial protection, with a simple average tariff of around 55 percent for all third-party countries. The customs union agreement has also resulted in the introduction of quantitative restrictions on textiles and clothing and tariff quotas, and quotas have been imposed on certain imports from China. And, although improvements have been made at customs, delays remain common. Finally, the authorities indicate that customs posts remain closed with Armenia for security reasons.

The authorities remain committed to further liberalization. In accordance with the WTO Agreement on Agriculture, Turkey continues to lower its agricultural tariffs. Also, in accordance with the WTO Agreement on Textiles and Clothing, Turkey is set to abolish its quotas on textile and clothing imports by end-2004. Turkey is also set to abolish its quotas on imports from China by this date. With these additional reforms, it is expected that Turkey will have a trade restrictiveness index of 2 by the end of the program period.

Finally, Turkey faces many barriers to trade with third countries. Turkish exports have been subjected to anti-dumping and countervailing duties in 11 countries, and safeguard measures have been applied or investigations initiated by 6 countries; the authorities report that certain countries are very aggressive in this area. The Turkish textile and clothing sector is subject to quantitative restrictions by the United States, and is subject to high tariffs in certain Eastern European, Far East, and North African countries. The authorities also mention the recent EU decision on minimum toxin standards for hazelnuts, figs, and pistachios—significant export products for Turkey—as an example of a new nontariff barrier, although discussions with the EU are ongoing.

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[1]This index was developed at the International Monetary Fund, "Trade Liberalization in Fund-Supported Programs" (EBS/97/163, 8/27/97), and attempts to summarize overall trade restrictiveness using tariff levels and nontariff barriers.

39. **The Turkish authorities have taken major steps to combat money laundering and the financing of terrorism.** Turkey became a member of the Financial Action Task Force (FATF) in September 1991. The Law on the Prevention of Money Laundering, which defines and criminalizes money laundering activities, was enacted in November 1996. The Law also created the Financial Crimes Investigation Board (FCIB, established in February 1997), an enforcement agency within the Ministry of Finance. The Board monitors compliance with the Law through the collection of information from a wide range of institutions active in both financial and real asset markets. The Board has issued several regulations and communiqués establishing guidelines for identifying and reporting suspicious transactions, including two regulations specifically dealing with the financing of terrorism. Turkey has also signed all UN conventions relating to the financing of terrorism. In addition, in December 2001 the Council of Ministers issued a decree freezing all assets of terrorist organizations as requested in UN Security Council Resolution 1373. An assessment made in 2000 by the FATF—and made public in its plenary session in Paris that year—concluded that Turkey has in place appropriate rules and procedures to combat money laundering. The FCIB has itself participated in FATF assessments of two other member countries. The FCIB conducts self-assessment exercises twice a year.

40. **The authorities updated the staff on their progress with implementing the recommendations of the 2000 fiscal Report on Observance of Standards and Codes (ROSC).**[7] The staff agreed that much progress had been made, including the closure of a large number of extrabudgetary, budgetary, and revolving funds; the establishment and piloting of new (GFS consistent) accounting and classification standards; the passage of the Public Debt and Financial Management Law; and steps to improve budget preparation. However, the staff also noted that an ambitious agenda remains ahead, including fully implementing and extending accounting reforms throughout the public sector; enhancing information disclosure in the budget; and overhauling the scope, coverage and responsibilities of external audit.

IV. Safeguards Assessment

41. **The authorities agreed with the findings and recommendations of the Fund's safeguards assessment.** In line with Fund policy, the CBT is subject to a safeguards assessment in the context of the present SBA. Over the last two years, the CBT has made good progress in the external audit process, improved significantly its financial reporting framework, and elaborated a set of well-developed internal controls. Also, the CBT Law provides a generally sound legal basis for the autonomy of the CBT. The safeguards assessment has identified a few areas in which the CBT could further strengthen its operations and internal control mechanisms. Since the Treasury acts as the fiscal agent for transactions with the Fund, the assessment also suggests actions to clarify the CBT/Treasury relationship with the Fund. In this context, the staff has been informed that the Board of Treasury Controllers will audit the Treasury component of the consolidated NIR and NDA

[7] An updated fiscal ROSC is being issued as a supplement to this staff report.

program data, namely short-term foreign exchange denominated debt. Some of the actions identified in the safeguards assessment have been included under Fund conditionality (¶19).

V. Staff Appraisal

42. **With its new three-year program, Turkey is taking a further decisive step away from the interventionist policies of the past, and is well on its way to a stronger performance in the future.** Past financial indiscipline and structural weaknesses prevented Turkey from realizing its economic potential. For several decades, inflation rose while growth trended down, and both inflation and growth were highly volatile. These problems had their roots in fiscal laxity, deficiencies in governance, lack of a nominal anchor, and inefficiencies and nontransparencies in the public sector. At the same time, Turkey remains beset by barriers to private sector development, and a banking sector damaged by the two recent crises. The authorities' program for 2002–04 is designed to build on the progress achieved under the previous SBA, both by addressing these issues and by reducing the vulnerability of the economy to shocks.

43. **Turkey is maintaining the positive momentum in macroeconomic adjustment and structural reform established in the run-up to the approval of the new SBA in February.** Macroeconomic policies have remained on course: all applicable performance criteria and indicative targets were observed. Also, the government has continued to press ahead with structural reform, notably the identification of public sector staffing redundancies and the adoption of the legislative basis for improved public debt management.

44. **The results are encouraging, but downside risks remain.** The authorities' efforts have been rewarded by a more rapid decline in interest rates than assumed in the program, a strong balance of payments position and an associated appreciation of the lira, and a drop in inflation and in inflation expectations. At the same time, the balance of risks regarding the real GNP growth target of 3 percent for 2002 has shifted toward the downside, and concerns about possible military action in neighboring Iraq are keeping financial markets alert.

45. **While fiscal developments remain on track, strict budget implementation must continue, to avoid renewed concerns about the debt position.** The staff commends the authorities' unwavering commitment to the target of a public sector primary surplus of 6.5 percent of GNP for 2002. The introduction of cost-saving measures in the social security administration to offset the lower-than-planned increase in the petroleum consumption tax and easing of taxes to stimulate employment is welcome in that regard. At the same time, the government must remain mindful of the downside risks, especially in light of the adverse effect on the budget of higher-than-expected petroleum prices, and stand ready to take further offsetting measures to safeguard the primary surplus target. Rapid implementation of the new Law on Public Debt Management and continued active debt management policies will also be key to convincing observers that the government debt position will remain manageable.

46. **To be sustainable, the achievement of the overall budget targets will need to be underpinned by decisive reforms in public employment and budget mechanisms.** The staff is encouraged by the government's efforts to improve expenditure management,

streamline tax policy, and strengthen revenue administration, the latter supported by a number of new benchmarks. On the tax side, it will be important to avoid complicating the tax code with additional incentives. On the expenditure side, the key challenge in the near term will be to come up with precise and credible estimates of overstaffing in state economic enterprises that will lay the basis for the much-needed downsizing in this sector.

47. **The scope for monetary policy to promote disinflation and enhance confidence is increasing.** One avenue is a move to inflation targeting, which could help further anchor inflation expectations. In this regard, recent inflation developments have been encouraging, and with strong efforts by the CBT and the government, the preconditions to introduce formal inflation targeting could well be in place by midyear. In the meantime, the authorities must continue to adhere strictly to the program's base money targets. Another is reserve management. The CBT should continue to make use of the better-than-expected balance of payments developments to build up foreign exchange reserves, which should further improve confidence. The authorities' recent move to pre-announced foreign exchange purchase auctions is most welcome in this regard. At the same time, it is important that Treasury and the CBT coordinate on the sterilization of the monetary impact of these purchases. Also, further development of the money and foreign exchange markets could help ensure a smoother functioning of the floating exchange rate regime. The authorities' plans to lower distortionary taxes and reform the system of reserve requirements are a welcome step in the right direction.

48. **Progress in the structural areas needs to be more even.** Good progress is being made on banking sector reform, including the implementation of the bank recapitalization plan, but further movement on corporate debt restructuring is needed, in particular to ensure that the framework for the restructuring (the "Istanbul Approach") is made operational without delay. In this context, it is essential to protect the transparency and integrity of the banking reform strategy. Stronger efforts are also needed in other structural policy areas. Privatization must be speeded up now that market conditions are more favorable. Inefficiencies in state economic enterprises are core factors behind Turkey's disappointing growth performance. The program contains a well-defined and focused agenda for privatizing key infrastructure companies during the program period, and the authorities need to proceed expeditiously in this critical area. Similarly, the government needs to be forceful in demonstrating its commitment to dealing with deficiencies in the investment environment and the perceptions of corruption that have plagued Turkey in the past.

49. **The staff commends recent moves to improve transparency and data provision.** The quality, coverage, and timeliness of statistical reporting by Turkey are generally adequate for program monitoring and surveillance, as noted in the recently issued ROSC data module. Although some deficiencies remain in fiscal statistics, the staff commends the recent extensive improvements in fiscal transparency, as identified in an updated fiscal ROSC. The staff also welcomes the authorities' commitment to act upon the recommendations of the Fund safeguards assessment. Implementation of the recommended actions should provide assurances that the CBT's control, accounting, reporting, and auditing systems, including for Fund disbursements, are adequate to ensure the integrity of operations.

50. **In light of the strong program implementation and positive initial results, the staff recommends the completion of the first review under the SBA.** Strict program implementation and large-scale support from the international community have so far combined to produce positive results. As risks remain, the best approach for the government is to press ahead with its program strategy and refrain from actions that would undermine confidence. In that regard, the policy performance over the last year is encouraging, and gives assurance that the program will remain on course. On this basis, the staff recommends the completion of the first review.

51. It is proposed that the next Article IV consultation be held with Turkey on the standard 12-month cycle.

Table 1. Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In percent)			
Real sector						
Real GNP growth rate	-6.1	6.3	-9.4	3.0	5.0	5.0
GNP deflator	55.8	50.9	57.8	53.2	24.4	13.1
Nominal GNP growth rate	...	60.4	42.9	57.8	30.7	18.8
WPI (12-month, end-of-period)	62.9	32.7	88.6	31.0	16.2	12.0
CPI (12-month, end-of period)	68.8	39.0	68.5	35.0	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.1	65.6	46.0	38.1
Average ex-ante real interest rate 1/	32.0	-9.5	31.1	30.8	27.5	20.0
			(In percent of GNP)			
Central government budget						
Primary balance 2/	1.5	4.2	4.6	5.3	5.6	5.6
Net interest payments 3/	13.1	15.8	21.8	19.0	17.3	13.5
Overall balance	-11.6	-11.6	-17.2	-13.7	-11.7	-7.8
Consolidated public sector						
Primary balance	-2.0	2.3	5.9	6.5	6.5	6.5
Net interest payments 4/	22.1	21.9	23.5	17.6	15.6	12.5
PSBR (including CBT profits)	24.1	19.6	17.6	11.1	9.1	6.0
Operational balance	-12.4	-6.9	-1.2	-3.5	-4.4	-3.0
Net debt of public sector	61.0	57.4	93.3	77.2	69.7	65.7
Net external	20.1	18.3	36.8	33.4	29.2	27.1
Net domestic	40.9	39.1	56.5	43.8	40.6	38.6
Net debt of public sector (in percent of centered GNP) 5/	48.6	51.3	75.7	68.6	65.1	61.7
External sector						
Current account balance	-0.7	-4.9	2.3	-1.2	-1.0	-1.1
Gross external debt	55.1	59.4	80.2	67.5	65.4	61.7
Net external debt	33.7	39.2	54.5	44.4	42.7	39.0
Short-term external debt (by remaining maturity)	20.8	23.0	22.7	18.2	17.5	17.4
Monetary aggregates						
Seignorage 6/	3.2	1.8	1.0	1.0	0.7	...
Nominal growth of M2Y broad money (in percent)	98.7	39.6	88.3	40.2	27.4	17.1
			(In billions of U.S. dollars, unless otherwise indicated)			
Privatization proceeds	0.1	3.3	2.8	1.5	2.5	1.0
Net external financing of central government	1.4	4.1	-3.7	0.0	-1.7	-1.0
Amortization	6.0	6.2	8.2	6.5	8.4	8.0
Gross borrowing	7.4	10.3	4.5	6.5	6.7	7.0
Of which : Eurobond issues	5.0	7.5	2.2	3.0	4.5	4.7
GNP	187.4	201.3	146.5	...	...	...
GNP (in quadrillions of Turkish lira)	78.3	125.6	179.5	283.2	370.1	439.5

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

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation. With average maturity of newly issued debt less than one year, and with FRNs paying quarterly coupons, this measure overstates the effective real interest rate when inflation is declining.

2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds.

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

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

5/ 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.

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

Table 2. Turkey: Prior Actions and Benchmarks Relevant for the First Review

Action	January LOI Paragraph	Type	Status as of April 2, 2002
Fiscal policy			
Complete by end-March 2002 the remaining measures to reach the public sector primary surplus target of 6.5 percent of GNP for 2002: (i) the Minister of Finance to identify savings from closing regional administrations and other regional line agency offices, and block relevant budget appropriations, and (ii) SEEs to approve budgets in line with cost reductions mandated	14	Benchmark	*Underway:* (i) *Done.* (ii) Most SEEs have approved budgets in line with cost reductions mandated, and the others have been instructed to correct their budgets.
Banking reform			
BRSA to appoint by end-March 2002 third-party auditing firms to verify that the guidelines for targeted evaluations of private banks' portfolios have been followed	30	Benchmark	*Underway.* Selection process of auditing firms has been initiated. It is expected to be completed by April 10.
Public sector reform			
Establish an independent procurement agency by end-March 2002	40	Benchmark	*Underway.* All the preparatory work has been completed. The board of the agency is expected to be appointed shortly, following the issuance of an enabling regulation.
By end-January 2002: (i) identify all redundant workers and positions in SEEs; and (ii) eliminate all open, unfilled, redundant positions	41	Prior actions for first review	(i) *Underway.* Redundancies have been tentatively identified as 40,000–60,000. Final estimates are expected to be available by end-May. (ii) *Done.*
Pass the Law on Public Debt Management and issue two supporting communiqués	42	Prior actions for first review	*Underway.* The Law was passed on March 28. Communiqués are in preparation, and will be issued after the President has signed the Law.
Close 548 additional revolving funds by end-March 2002	42	Benchmark	*Done.*
Complete by end-March 2002 a survey of end-2001 commitments in excess of appropriations	42	Benchmark	*Done.*
Enhancing the role of the private sector			
The Council of Ministers to adopt by end-January 2002 a strategy for increasing transparency and combating rent-seeking activities	47	Benchmark	*Done.* Decree signed on February 13.

Table 3. Turkey: Indicators of External Vulnerability, 1998–2004 1/
(In percent, unless otherwise noted)

	1998	1999	2000	2001	Projections 2002	2003	2004
CPI inflation (end year)	69.7	68.8	39.0	68.5	35.0	20.0	12.0
Public sector borrowing requirement (percent of GNP)	15.4	24.2	19.6	17.6	11.1	9.1	6.0
Net debt of the public sector (percent of GNP)	43.7	61.0	57.4	93.3	77.2	69.7	65.7
Export volume (percent change)	5.8	0.7	9.5	14.7	1.1	6.2	7.0
Import volume (percent change)	0.6	-13.3	31.4	-23.0	9.2	10.1	7.3
Current account balance, in percent of GNP	1.0	-0.7	-4.9	2.3	-1.2	-1.0	-1.1
Capital account balance (in billions of US$)	-1.5	6.6	6.8	-16.2	-1.4	2.8	7.4
Of which: Foreign direct investment	0.6	0.1	0.1	2.8	1.0	1.0	1.3
Foreign portfolio investment	-6.1	0.2	-5.2	-4.6	-0.5	-0.5	0.7
Gross official reserves, in billions of US$ 2/	20.9	24.3	23.2	19.8	24.2	25.5	29.7
In months of imports of goods and NFS	4.1	5.3	4.0	4.4	4.9	4.8	5.1
In percent of broad money	32.3	32.5	27.8	27.0	29.5	26.9	28.7
Gross total external debt, in billions US$	97.2	103.1	119.6	117.5	124.0	127.0	131.8
In percent of GNP	47.2	55.1	59.4	80.2	67.5	65.4	61.7
In percent of exports of goods and NFS	178.3	225.6	233.8	233.7	247.9	234.8	225.7
Gross short-term external debt, in billions US$ 3/	33.8	39.0	46.3	33.2	33.4	34.0	37.1
In percent of gross total external debt	34.8	37.8	38.7	28.3	26.9	26.8	28.2
In percent of gross official reserves	161.9	160.7	199.6	167.9	137.8	133.1	124.8
Debt service 4/	26.0	34.1	37.0	43.2	41.5	43.3	39.5
REER appreciation (CPI based, period average) 5/	8.5	4.1	9.9	-23.5	...	...	...
REER appreciation (CPI based, end of period) 5/	3.9	5.6	13.7	-26.3	...	...	...
Capital adequacy ratio 6/	12.4	9.1	17.3	16.8	...	...	...
State and SDIF banks	8.6	8.2	7.9	27.6	...	...	...
Private banks	12.0	9.0	18.3	10.9	...	...	...
Foreign banks	21.0	20.3	29.4	29.5	...	...	...
Nonperforming loans (in percent of total) 6/	6.7	9.7	9.2	12.9	...	...	...
Real broad liquidity, percentage change 7/	3.4	16.6	0.9	3.9	4.2	6.2	4.5
Real credit to the private sector, percentage change 7/	-6.6	-14.6	23.8	-29.9	-2.7	6.2	4.5
Banks' net foreign asset position, in millions of US$	-3,018	-3,176	-5,883	...	...	...	...
Banks' net open exchange position, in millions of US$	-2,898	-2,608	-5,437	...	...	...	...
Spread on Turkish dollar Eurobonds (in basis points) 8/	548	550	443	718	600	...	...

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

1/ For 2002-04, program projections.

2/ As of end-January 2002, reserves stood at US$20.0 billion.

3/ By residual maturity.

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

5/ As of August 2001.

6/ As of September 2001; November 2001 for nonperforming loans.

7/ Deflated by the CPI.

8/ For 2002, as of April 2, 2002.

Table 4. Turkey: Balance of Payments, 1998-2005
(In billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Current account balance	2.0	-1.4	-9.8	3.3	-2.2	-2.0	-2.4	-2.2
Trade balance	-14.2	-10.4	-22.4	-4.8	-7.1	-8.2	-9.0	-10.6
Exports (fob)	31.2	29.3	31.7	35.1	36.1	37.7	41.0	44.3
Of which: Exports (fob) in trade returns	27.0	26.6	27.8	31.2	32.1	33.5	36.4	39.3
Shuttle trade	3.7	2.3	2.9	0.9	0.9	0.9	1.0	1.1
Imports (fob)	-45.4	-39.8	-54.1	-39.9	-43.2	-45.9	-50.0	-54.9
Of which : Imports (cif)	-45.9	-40.7	-54.5	-40.5	-43.8	-46.6	-50.8	-54.7
Energy imports (cif)	-4.5	-5.3	-9.5	-8.3	-7.3	-7.8	-8.2	-8.6
Services (net)	10.5	3.9	7.4	4.1	0.2	1.2	1.1	2.2
Services (credit)	25.8	18.7	22.3	17.9	15.8	18.8	20.9	23.0
Of which:								
Interest	2.5	2.4	2.8	2.8	1.9	2.4	3.5	4.5
Tourism receipts	7.2	5.2	7.6	8.1	6.1	8.0	8.5	9.0
Other receipts 1/	10.5	7.1	7.9	3.6	4.2	4.6	4.9	5.4
Services (debit)	-15.3	-14.8	-15.0	-13.8	-15.6	-17.6	-19.9	-20.8
Of which: Interest	-4.8	-5.5	-6.3	-7.1	-7.8	-9.0	-10.5	-10.6
Private transfers (net)	5.6	4.8	5.0	3.8	4.4	4.8	5.4	5.9
Of which: Workers remittances	5.4	4.5	4.6	2.8	3.4	3.8	4.2	4.7
Official transfers (net)	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Capital account balance	0.4	4.7	9.4	-13.9	-1.4	2.8	7.4	8.7
(including errors and omissions)	-1.5	6.6	6.8	-16.2	-1.4	2.8	7.4	8.7
Direct investment 2/	0.6	0.1	0.1	2.8	1.0	1.0	1.3	1.6
Portfolio investment in securities 2/	-6.1	0.2	-5.2	-4.6	-0.5	-0.5	0.7	0.8
Public sector (central and local governments and EBFs)	-1.9	1.2	6.2	-1.9	1.3	-0.5	1.1	1.5
Bonds (net)	-0.3	3.1	6.1	0.1	0.9	0.6	1.7	1.9
Eurobond drawings	2.7	5.0	7.5	2.1	3.0	4.5	4.7	5.0
Eurobond repayments	-3.0	-1.9	-1.4	-2.0	-2.1	-3.9	-3.1	-3.1
Loans (net)	-1.7	-1.9	0.1	-2.0	0.4	-1.1	-0.6	-0.3
Loan disbursements	1.2	1.0	3.7	2.6	3.8	2.7	2.8	2.9
Loan repayments	-2.8	-2.9	-3.6	-4.6	-3.5	-3.8	-3.4	-3.2
Central Bank of Turkey, Dresdner (net)	0.7	-0.2	0.7	0.8	0.3	0.6	0.7	0.8
Domestic money banks (net)	1.9	0.5	2.1	-9.1	-4.1	0.9	1.6	1.4
Domestic money banks (FX deposits abroad, -: accumulation)	-0.8	-1.8	-1.9	1.0	0.0	0.0	0.0	-0.1
Domestic money banks (other, net)	2.7	2.4	4.0	-10.1	-4.1	0.9	1.6	1.5
Domestic money banks (medium- and long-term, net)	0.5	0.2	-0.2	-1.0	-0.9	0.3	0.8	0.5
Domestic money banks (short-term, net)	2.2	2.2	4.2	-9.1	-3.3	0.6	0.8	1.0
Interbank credit lines from foreign commercial banks	0.1	2.1	4.7	-6.9	-2.5	0.5	0.6	0.7
Other private sector (net)	5.3	2.8	5.6	-1.8	0.7	1.2	2.0	2.7
Other private sector (medium- and long-term, net)	4.2	2.3	4.9	0.3	-0.5	0.0	0.4	0.9
Other private sector (short-term, net)	1.1	0.5	0.6	-2.1	1.2	1.2	1.6	1.8
Errors and omissions	-2.0	1.9	-2.7	-2.4	0.0	0.0	0.0	0.0
Overall balance	0.4	5.2	-3.1	-12.9	-3.6	0.8	5.0	6.5
Overall financing	-0.4	-5.2	3.1	12.9	3.6	-0.8	-5.0	-6.5
Change in net international reserves (+ denotes decline)	-0.4	-5.2	3.1	12.9	3.6	-0.8	-5.0	-6.5
Change in gross official reserves (+ denotes decline)	-0.2	-5.9	-0.2	2.7	-4.4	-1.3	-4.2	1.5
Change in reserve liabilities (IMF)	-0.2	0.7	3.3	10.2	8.1	0.5	-0.8	-8.0
Purchases	0.0	0.8	3.4	11.4	14.4	1.0	1.0	0.0
Repurchases	-0.2	-0.1	-0.1	-1.1	-6.3	-0.5	-1.8	-8.0

Table 4 (concluded). Turkey: Balance of Payments, 1998-2005
(In billions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Memorandum items:								
Trade in goods and services								
As percent of GNP								
Current account balance, including shuttle trade	1.0	-0.7	-4.9	2.3	-1.2	-1.0	-1.1	-1.0
Trade account balance, including shuttle trade	-6.9	-5.6	-11.1	-3.3	-3.9	-4.2	-4.2	-4.6
Exports of goods and nonfactor services	26.5	24.4	25.4	34.3	27.2	27.8	27.3	27.1
Imports of goods and nonfactor services	27.2	26.2	31.2	31.8	27.7	28.1	27.8	28.1
Percent change								
Value growth in exports of goods (including shuttle trade)	-4.4	-6.1	8.0	10.9	2.8	4.4	8.8	8.1
Value growth in exports of goods (excluding shuttle trade)	2.7	-1.7	6.1	19.2	2.8	4.4	8.8	8.1
Value growth in imports of goods	-5.3	-12.5	36.0	-26.3	8.3	6.4	8.9	9.7
Volume growth in exports of goods	5.8	0.7	9.5	14.7	1.1	6.2	7.0	6.7
Volume growth in imports of goods	0.6	-13.3	31.4	-23.0	9.2	10.1	7.3	6.5
Terms of trade	3.3	-4.2	-6.4	1.4	2.7	1.8	0.1	0.1
Reserve and debt indicators								
Gross foreign reserves (Central Bank of Turkey)								
In billions of US$	20.9	24.3	23.2	19.8	24.2	25.5	29.7	28.2
Months of goods and NFS imports	4.1	5.3	4.0	4.4	4.9	4.8	5.1	4.5
External debt (end-of-period)								
In billions of US$	97.2	103.1	119.6	117.5	124.0	127.0	131.8	130.5
Percent of GNP	47.2	55.1	59.4	80.2	67.5	65.4	61.7	56.3
Percent of exports of goods and NFS	178.3	225.6	233.8	233.7	247.9	234.8	225.7	207.7
Net external debt (end-of-period) 3/								
In billions of US$	63.1	63.2	78.9	79.8	81.5	83.0	83.4	83.3
In percent of GNP	30.6	33.7	39.2	54.5	44.4	42.7	39.0	35.9
Short-term debt (end-of-period)								
In billions of US$	21.2	23.5	28.9	17.6	15.8	17.8	20.4	23.4
Ratio to foreign reserves	101.6	96.7	124.6	89.0	65.3	69.9	68.7	83.0
Short-term debt plus MLT repayments								
In billions of US$	33.8	39.0	46.3	33.2	33.4	34.0	37.1	40.2
Ratio to foreign reserves	161.9	160.7	199.6	167.9	137.8	133.1	124.8	142.5
Debt service ratio 4/	26.0	34.1	37.0	43.2	41.5	43.3	39.5	37.3

Sources: Data provided by the Turkish authorities; and IMF 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: Medium-Term Macroeconomic Framework, 1997-2006

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
					Projections					
					(Percent change)					
GNP and prices										
Real GNP	8.3	3.9	-6.1	6.3	-9.4	3.0	5.0	5.0	5.0	5.0
CPI (end of period)	99.1	69.7	68.8	39.0	68.5	35.0	20.0	12.0	8.0	5.0
(period average)	85.7	84.6	64.9	54.9	54.4	49.9	26.2	14.4	9.8	6.2
					(In percent of GNP)					
Saving and investment										
Foreign saving (current account deficit)	1.4	-1.0	0.7	4.9	-2.3	1.2	1.0	1.1	1.0	1.0
Gross national saving	25.4	26.2	23.8	20.1	20.8	18.4	20.6	23.6	24.9	26.1
Private	33.1	34.4	38.8	31.6	39.1	28.4	28.0	28.0	28.0	27.7
Public	-7.7	-8.2	-15.0	-11.5	-18.2	-10.0	-7.4	-4.5	-3.1	-1.6
Gross national investment	26.8	25.2	24.5	25.0	18.6	19.6	21.6	24.7	25.8	27.0
Private	19.1	17.6	17.0	18.0	11.6	13.7	16.0	19.0	20.0	21.0
Public	7.7	7.6	7.5	6.9	7.0	5.9	5.6	5.7	5.8	6.0
Public sector										
Central govt. revenue	19.3	21.0	23.2	25.1	26.6	25.1	24.2	23.9	23.7	23.5
Central govt. non-interest expenditure	19.4	17.2	21.8	20.9	21.9	21.8	19.1	18.8	18.5	18.4
Public sector primary balance	-2.1	0.9	-2.0	2.3	5.9	6.5	6.5	6.5	6.5	6.5
Interest payments	11.0	16.2	22.1	21.9	23.5	17.6	15.6	12.5	10.9	9.4
Overall balance	-13.1	-15.4	-24.2	-19.6	-17.6	-11.1	-9.1	-6.0	-4.4	-3.1
Operational balance	-2.9	-4.6	-12.4	-6.9	-1.2	-3.5	-4.4	-3.0	-2.3	-1.8
Debt dynamics										
Net public debt	42.9	43.7	61.0	57.4	93.3	77.2	69.7	65.7	61.2	57.1
External debt	22.5	19.3	20.1	18.3	36.8	33.4	29.2	27.1	25.7	24.6
Domestic debt	20.4	24.4	40.9	39.1	56.5	43.8	40.6	38.6	35.5	32.6
Net public debt (in percent of centered GNP) 1/	32.1	37.5	48.6	51.3	75.7	68.6	65.1	61.7	58.6	54.9
Nominal interest rate on TL debt (average, in percent)	105.2	115.7	106.2	38.0	99.1	65.6	46.0	38.1	29.8	25.7
Real interest rate (average, in percent)	29.9	30.9	32.0	-9.5	31.1	30.8	27.5	20.0	18.0	18.0
					(In billions of U.S. dollars)					
Balance of payments										
Current account	-2.6	2.0	-1.4	-9.8	3.3	-2.2	-2.0	-2.4	-2.2	-2.2
Trade balance	-15.4	-14.2	-10.4	-22.4	-4.8	-7.1	-8.2	-9.0	-10.6	-11.0
Exports	32.6	31.2	29.3	31.7	35.1	36.1	37.7	41.0	44.3	47.8
Imports	-48.0	-45.4	-39.8	-54.1	-39.9	-43.2	-45.9	-50.0	-54.9	-58.8
Services and income (net)	7.9	10.5	3.9	7.4	4.1	0.2	1.2	1.1	2.2	2.4
Receipts	21.3	25.8	18.7	22.3	17.9	15.8	18.8	20.9	23.0	24.2
Payments	-13.4	-15.3	-14.8	-15.0	-13.8	-15.6	-17.6	-19.9	-20.8	-21.8
Of which: Interest	-4.6	-4.8	-5.5	-6.3	-7.1	-7.8	-9.0	-10.5	-10.6	-10.8
Transfers (net)	4.9	5.7	5.2	5.2	4.0	4.6	5.1	5.6	6.2	6.4
Of which: Worker remittances	4.2	5.4	4.5	4.6	2.8	3.4	3.8	4.2	4.7	5.0
Memorandum items:										
Gross official reserves	19.6	20.9	24.3	23.2	19.8	24.2	25.5	29.7	28.2	25.7
(in months of imports of GNFS)	3.8	4.1	5.3	4.0	4.4	4.9	4.8	5.1	4.5	3.8
Current account balance (in percent of GDP)	-1.4	1.0	-0.7	-4.9	2.3	-1.2	-1.0	-1.1	-1.0	-0.9
Net external debt/GDP (in percent)	27.4	30.6	33.7	39.2	54.5	44.4	42.7	39.0	35.9	33.2
External debt service/exports of GNFS (in percent)	57.1	63.3	86.0	88.8	108.5	94.6	79.2	79.1	88.7	90.2
External debt service/GDP (in percent)	15.3	16.8	21.0	22.6	37.3	25.8	22.1	21.6	24.0	24.4
Export volume (percent change)	21.6	5.8	0.7	9.5	14.7	1.1	6.2	7.0	6.7	6.7
Import volume (percent change)	19.5	0.6	-13.3	31.4	-23.0	9.2	10.1	7.3	6.5	6.1
Terms of trade (percent change)	-0.2	3.3	-4.2	-6.4	1.4	2.7	1.8	0.1	0.1	0.1
Nominal GNP (in quadrillions of TL)	29.4	53.5	78.3	125.6	179.5	283.2	370.1	439.5	506.1	563.7
Nominal GNP (in billions of US$)	193.9	205.5	187.4	201.3	146.5	...	...	...	...	...

Sources: Turkish authorities; and IMF staff projections.

1/ 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.

Table 6. Turkey: Indicators of Fund Credit, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
Outstanding Fund credit (end of period)							
In billions of SDRs	3.2	11.2	17.5	17.9	17.3	11.2	3.6
In percent of quota	333	1165	1817	1859	1798	1157	375
In percent of exports of G&NFS	8.1	28.5	45.0	42.6	38.2	22.9	6.9
In percent of public sector external debt	6.6	19.8	27.5	27.9	26.7	18.5	6.6
In percent of overall external debt	3.5	12.2	18.2	18.1	16.9	11.0	3.7
In percent of foreign reserves	18.0	72.4	92.9	90.3	75.1	51.0	18.1
Debt service due to the Fund							
In billions of SDRs	0.1	1.2	6.0	1.3	1.9	6.3	7.5
In percent of quota	13	128	621	133	194	650	781
In percent of exports of G&NFS	0.3	3.2	15.6	3.1	4.2	13.0	14.5
In percent of public sector external debt service	0.5	4.1	27.6	6.4	9.1	29.3	33.3
In percent of overall external debt service	0.7	6.1	31.2	6.1	8.2	25.5	28.9
In percent of foreign reserves	0.7	8.1	32.1	6.5	8.2	28.9	38.0

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

Table 7. Turkey: External Financing Requirements and Sources, 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross financing requirements	28.1	27.6	35.5	49.1	43.2	35.6	35.6	36.6	39.6
Current account deficit (excluding official transfers)	3.0	-1.8	1.7	10.1	-3.1	2.4	2.2	2.6	2.5
Amortization on debt securities	1.7	3.3	2.0	1.7	2.1	2.5	4.1	3.1	3.6
Of which: Public sector	1.5	3.0	1.9	1.4	2.0	2.1	3.9	3.1	3.1
Deposit money banks	0.2	0.3	0.1	0.4	0.0	0.4	0.2	0.0	0.4
Medium and long-term debt amortization	6.1	8.2	10.6	13.8	15.3	13.1	13.5	13.1	13.1
Of which : Public sector 1/	2.5	2.8	2.9	3.6	4.6	3.5	3.8	3.4	3.2
Private sector	2.8	3.0	5.2	7.9	8.9	8.5	8.8	8.8	8.8
Deposit money banks	0.8	2.3	2.4	2.3	1.9	1.2	1.0	1.0	1.2
Short-term debt amortization	17.3	18.0	21.2	23.5	28.9	17.6	15.8	17.8	20.4
Public sector 1/	1.0	0.9	0.9	0.7	1.7	0.8	0.8	0.9	0.9
Private sector	7.9	8.6	9.2	9.6	10.4	8.3	9.4	10.6	12.2
Deposit money banks	8.4	8.5	11.2	13.2	16.9	8.5	5.6	6.4	7.4
Available financing	28.1	27.6	35.5	49.1	43.2	35.6	35.6	36.6	39.6
Foreign direct investment (net)	0.6	0.6	0.1	0.1	2.8	1.0	1.0	1.3	1.6
Portfolio flows	3.3	-3.4	5.4	2.8	-2.5	2.5	4.2	5.6	6.1
Public sector	2.9	2.7	5.0	7.5	2.1	3.0	4.5	4.7	5.0
Deposit money banks	0.6	0.0	0.2	0.5	0.0	0.0	0.2	0.2	0.3
Private sector (net)	-0.1	-6.1	0.2	-5.2	-4.6	-0.5	-0.5	0.7	0.8
Medium and long-term debt financing	10.9	12.2	10.9	19.1	13.2	12.8	13.3	14.2	15.1
Of which : Public sector 1/	2.0	1.8	0.9	4.4	3.2	4.1	3.3	3.4	3.6
Private sector	6.4	7.2	7.5	12.8	9.2	8.0	8.8	9.2	9.6
Deposit money banks	2.5	3.1	2.6	1.9	0.9	0.7	1.3	1.6	1.8
Short-term debt financing	20.1	21.6	24.2	28.3	18.6	15.8	17.8	20.4	23.4
Official transfers	0.3	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Other 2/	-3.8	-3.0	-0.3	-4.5	-2.1	-0.3	-0.2	-0.2	-0.3
Accumulation of reserves net of IMF	-3.3	-0.4	-5.2	3.1	12.9	3.6	-0.8	-5.0	-6.5
Accumulation of gross reserves	-3.3	-0.2	-5.9	-0.2	2.7	-4.4	-1.3	-4.2	1.5
IMF (net)/exceptional CBT financing	0.0	-0.2	0.7	3.3	10.2	8.1	0.5	-0.8	-8.0
Purchases	0.0	0.0	0.8	3.4	11.4	14.4	1.0	1.0	0.0
Repurchases	0.0	0.2	0.1	0.1	1.1	6.3	0.5	1.8	8.0

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

1/ General government and Central Bank of Turkey.

2/ Errors and omissions.

Table 8. Turkey: Public Sector Primary Balances, 2000-02

	2000	2001			2002		
	Est.	Prog.	Est.	Diff.	Prog.	Est.	Diff.
	(In trillions of Turkish lira)						
Public sector	2,882	10,554	10,568	14	18,439	18,439	0
Central government 1/	5,286	9,156	8,330	-827	15,297	15,297	0
Total revenue	31,550	47,397	47,684	287	71,340	71,453	113
Tax revenue	26,087	39,500	39,768	268	61,785	61,718	-67
Nontax revenue 1/	5,463	7,897	7,916	19	9,555	9,735	180
Noninterest expenditure	26,265	38,241	39,355	1,114	56,043	56,156	113
Personnel	9,982	14,935	15,204	269	22,514	22,514	0
Other current	3,635	4,800	5,023	223	7,283	7,283	0
Transfers 2/	10,397	14,736	15,226	490	20,510	20,623	113
Investment	2,251	3,770	3,902	132	5,736	5,736	0
Rest of the public sector	-2,404	1,398	2,239	841	3,142	3,142	0
EBFs	-225	-161	149	310	-677	-677	0
Unemployment insurance fund	334	1,120	1,098	-22	748	748	0
Local governments	-302	33	17	-16	-82	-82	0
SEEs 3/	-2,211	405	1,025	620	3,061	3,061	0
Social insurance institutions	0	0	-50	-50	0	0	0
Revolving funds 4/	61	40	-1	-41	92	92	0
	(In percent of GNP)						
Public sector	2.3	5.7	5.9	0.2	6.5	6.5	0.0
Central government 1/	4.2	5.0	4.6	-0.4	5.4	5.4	0.0
Total revenue	25.1	25.7	26.6	0.9	25.2	25.2	0.0
Tax revenue	20.8	21.4	22.2	0.8	21.8	21.8	0.0
Nontax revenue 1/	4.4	4.3	4.4	0.1	3.4	3.4	0.1
Noninterest expenditure	20.9	20.7	21.9	1.2	19.8	19.8	0.0
Personnel	7.9	8.1	8.5	0.4	7.9	7.9	0.0
Other current	2.9	2.6	2.8	0.2	2.6	2.6	0.0
Transfers 2/	8.3	8.0	8.5	0.5	7.2	7.3	0.0
Investment	1.8	2.0	2.2	0.2	2.0	2.0	0.0
Rest of the public sector	-1.9	0.8	1.2	0.5	1.1	1.1	0.0
EBFs	-0.2	-0.1	0.1	0.2	-0.2	-0.2	0.0
Unemployment insurance fund	0.3	0.6	0.6	0.0	0.3	0.3	0.0
Local governments	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
SEEs 3/	-1.8	0.2	0.6	0.4	1.1	1.1	0.0
Social insurance institutions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 4/	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:							
GNP (in trillions of TL)	125,596	184,667	179,480	-5,187	283,241	283,241	0
Military expenditure (in percent of GNP)	4.4	4.3	4.4	0.1	4.3	4.3	0.0
Social spending (in percent of GNP) 6/	14.2	15.3	16.1	0.8	16.0	16.0	0.0

Sources: Turkish authorities; and Fund staff estimates.

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

2/ Excluding recapitalization of state banks.

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

4/ Added to the public sector balance for 2002. Not included in the 2000-01 primary surplus calculation.

5/ To be defined by the authorities.

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

Table 9. Turkey: Monetary Aggregates, 1999-2002
(In quadrillions of Turkish Lira)

	1999 Dec.	2000 Dec.	2001 Sep. Actual	2001 Dec. Proj.	2002 Dec. Proj.	Flow increase Dec. 2001 to Dec. 2002
Net foreign assets 1/	6.0	2.8	-2.5	-3.9	17.7	21.6
(in billions of U.S. dollars)	11.1	4.1	-1.6	-2.7	9.8	12.5
CBT	7.5	6.6	-3.1	-5.7	9.2	14.9
(in billions of U.S. dollars)	14.0	9.9	-2.0	-3.9	5.1	9.0
Deposit money banks	-1.6	-3.9	0.6	1.8	8.5	6.8
(In billions of U.S. dollars)	-2.9	-5.8	0.4	1.2	4.7	3.5
Net domestic assets	34.2	53.3	102.1	109.4	130.3	20.8
Net claims on government	17.0	30.9	78.1	90.6	108.8	18.3
CBT	-1.9	-0.2	22.9	31.9	22.9	-9.0
Deposit money banks	18.8	31.1	55.2	58.7	85.9	27.3
Claims on business sector 2/	18.3	31.2	37.1	37.0	48.9	11.9
Turkish lira claims	11.2	21.8	20.5	22.3	31.5	9.2
Foreign exchange claims (est.) 1/	7.1	9.4	16.6	14.8	17.5	2.7
Other items (net)	-1.1	-8.8	-13.1	-18.2	-27.5	-9.3
Broad money (M2Y)	40.2	56.0	99.6	105.5	148.0	42.5
Lira broad money (M2)	22.0	31.1	40.6	48.3	67.7	19.4
Foreign exchange deposits 1/	18.2	24.9	59.1	57.3	80.3	23.1
Repos	4.1	6.0	4.0	2.8	4.5	1.7
Broad liquidity	44.2	62.0	103.7	108.3	152.4	44.1
Reserve money	3.9	5.8	7.6	7.8	10.9	3.0
Memorandum items:						
Annual percent change						
Broad money (M2Y)	98.7	39.6	91.5	88.3	40.2	...
Lira broad money (M2)	92.5	41.5	56.3	55.1	40.2	...
Foreign exchange deposits 1/	106.6	37.3	126.4	129.6	40.3	...
Claims on business sector 2/	50.8	70.3	25.6	18.9	32.1	...
Turkish lira claims	65.8	94.9	-1.8	2.1	41.3	...
Foreign exchange claims (est.) 1/	32.0	31.6	91.3	57.9	18.3	...
Net claims on government	134.2	81.7	278.5	193.3	20.2	...
CBT	...	...	...	...	-28.3	...
Deposit money banks	155.1	65.2	149.0	88.5	46.5	...
In billions of U.S. dollars						
Broad money (M2Y)	74.6	83.4	65.0	73.3	82.1	8.8
Lira broad money (M2)	40.9	46.3	26.5	33.5	37.5	4.0
Foreign exchange deposits	33.7	37.1	38.5	39.8	44.6	4.8
Foreign exchange claims (est.)	13.2	13.9	10.8	10.3	9.7	-0.6
Net claims on government	31.6	46.0	51.0	62.9	60.4	-2.5
Credit to the private sector	34.0	46.4	24.2	25.7	27.2	1.4
Base money/GNP 3/	5.0	4.6	4.1	4.3	3.8	...
Broad money (M2Y)/GNP 3/	51.3	44.6	54.0	58.8	52.2	...
Lira broad money (M2)/GNP 3/	28.1	24.8	22.0	26.2	23.9	...
Money multiplier						
Broad money (M2Y)	10.4	9.7	13.1	13.5	13.6	...
Lira broad money (M2)	5.7	5.4	5.3	6.2	6.2	...

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

1/ Evaluated at current exchange rates.

2/ Includes credit to local governments and state economic enterprises.

3/ Evaluated as percent of annual average GNI .

Table 10. Turkey: Central Bank Balance Sheet, 2000-2002

	2000	2001				2002					
	Dec.	March	June	Sep.	Dec.	February		April	June	Sep.	Dec.
	Actual	Actual	Actual	Actual	Actual	Prog.	Actual	Prog.	Prog.	Prog.	Prog.
Central Bank balance sheet					(In quadrillions of Turkish lira) 1/						
Net foreign assets	3.3	1.2	-5.5	-10.2	-12.8	-2.5	-1.7	-1.9	-1.1	-0.6	0.0
Gross foreign assets	15.6	20.6	22.2	30.6	28.5	29.9	31.2	30.6	31.4	32.1	32.8
Gross foreign liabilities	12.3	19.4	27.7	40.8	41.2	32.4	32.9	32.5	32.5	32.7	32.8
International reserve liabilities	3.1	6.1	11.9	19.7	20.7	11.7	11.9	11.7	11.7	11.7	11.7
Other reserve liabilities 2/	4.9	5.4	6.9	10.5	10.1	10.1	11.6	10.1	10.1	10.1	10.1
Banks' foreign exchange deposits with CBT	4.3	7.9	8.9	10.6	10.4	10.6	9.4	10.7	10.7	10.9	11.0
Net domestic assets	2.5	4.4	11.9	17.8	20.6	10.7	10.3	10.8	10.4	11.2	10.9
Claims on central government (net)	0.4	-0.8	17.5	22.2	31.6	22.6	22.6	22.6	22.6	22.6	22.6
Claims on other public sector (net)	-0.3	-0.5	-0.7	-0.7	-1.0	-1.0	-0.8	-1.0	-1.0	-1.0	-1.0
Claims on banks	5.7	10.8	0.5	2.3	-2.0	-3.1	-1.8	-3.3	-3.9	-3.5	-4.2
Other items (net)	-3.3	-5.0	-5.5	-5.9	-8.1	-7.8	-9.7	-7.5	-7.3	-6.9	-6.5
Base money	5.8	5.6	6.4	7.6	7.8	8.3	8.6	8.9	9.2	10.6	10.9
Currency issued	3.8	3.6	4.4	5.1	5.3	5.6	5.9	6.0	6.3	7.4	7.3
Bank deposits in liras	2.0	2.0	2.0	2.5	2.5	2.7	2.7	2.9	3.0	3.2	3.6
Required reserves	1.4	1.2	1.3	1.4	1.6	1.8	1.7	1.9	2.0	2.1	2.3
Free reserves	0.6	0.8	0.7	1.1	0.9	0.9	1.0	1.0	1.0	1.1	1.2
Memorandum items:					(In billions of U.S. dollars)						
Gross international reserves	23.2	19.5	17.5	20.0	19.8	20.8	21.7	21.8	22.3	22.8	22.8
Gross international liabilities	18.3	18.4	21.9	26.6	28.6	22.5	22.9	22.6	22.6	22.7	22.8
Net foreign assets	4.9	1.1	-4.4	-6.7	-8.9	-1.7	-1.2	-1.3	-0.8	-0.4	0.0
plus CBT forward position	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
plus other reserve liabilities	7.3	5.1	5.4	6.9	7.1	7.1	8.1	7.1	7.1	7.1	7.1
minus Dresdner one-year deposits	0.6	0.6	0.6	0.6	0.7	0.7	0.9	0.7	0.7	0.7	0.7
minus defense fund	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Net international reserves 3/	11.1	5.0	0.1	-0.9	-3.0	4.2	5.6	4.6	5.1	5.5	5.9
Net international reserves 4/	11.1	4.7	0.0	-1.3	-3.4	...	...	...	...	...	...
Definitions in the 2002 program (CBT plus Treasury)					(In billions of U.S. dollars)						
Net international reserves (Treasury) 5/ 6/	...	...	...	...	-1.3	-10.7	-10.5	-11.8	-12.9	-14.0	-15.6
Net international reserves (Treasury plus CBT) 5/	...	...	...	...	-4.2	-6.5	-4.9	-7.2	-7.8	-8.5	-9.7
					(In quadrillions of Turkish lira, program exchange rate)						
Net foreign assets (Treasury)	...	...	...	...	-1.8	-15.4	-15.1	-16.9	-18.5	-20.1	-22.4
Net foreign assets (Treasury plus CBT)	...	...	...	...	-14.6	-17.8	-16.8	-18.8	-19.7	-20.7	-22.4
Net domestic assets (Treasury) 7/	...	...	...	...	1.8	15.4	15.1	16.9	18.5	20.1	22.4
Net domestic assets (Treasury plus CBT)	...	...	...	...	22.4	26.1	25.4	27.7	28.9	31.3	33.3
Base money (Treasury plus CBT)	...	...	...	...	7.8	8.3	8.6	8.9	9.2	10.6	10.9
Exchange rate (TL per U.S. dollar, in millions)	0.67	1.06	1.27	1.53	1.44	...	1.39	...	...	...	...

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

1/ Consistent with program assumptions, all foreign currency aggregates are valued at current exchange rates through end-2001, and at the program exchange rate of TL 1.44 million per U.S. dollar thereafter.

2/ Mainly Dresdner deposit liabilities.

3/ At current cross exchange rates.

4/ At cross exchange rates used in the 2001 program.

5/ At end-December 2001 cross exchange rates (i.e. cross exchange rates for the 2002 program)

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

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

Table 11. Turkey: Banking System - Selected Indicators, 1998-2001 1/

(In trillion Turkish liras)

	1998	1999	2000		2001			
			Sep.	Dec.	March	June	Sep.	Nov.
				Banking System				
Total assets	40,988	79,763	108,524	117,649	132,292	164,580	180,709	178,262
Cash and claims on CBT	2,665	5,097	6,199	6,235	7,788	8,847	10,895	11,284
Claims on other banks	3,923	7,766	12,411	13,599	13,701	18,015	17,584	15,978
Securities portfolio	9,688	22,040	27,185	31,251	35,089	62,170	68,643	69,388
Loans, net	14,689	22,601	34,569	35,789	41,043	44,713	51,525	49,236
Other assets	10,024	22,258	28,161	30,775	34,670	30,835	32,063	32,377
Total liabilities	40,988	79,763	108,524	117,649	132,292	164,580	180,709	178,262
Deposits	24,194	48,272	65,298	68,143	80,277	96,380	113,128	110,555
Borrowing from banks	4,663	10,070	14,567	15,996	21,126	23,376	24,091	19,523
Repos	4,153	7,645	11,952	12,843	11,210	12,702	10,979	10,318
Other liabilities	4,689	9,539	10,574	12,207	14,571	15,726	16,898	20,910
Shareholders' equity (including profits)	3,290	4,235	6,133	8,461	5,108	16,397	15,613	16,955
Memorandum items:								
Capital adequacy ratio (in percent)	...	...	8.3	17.3	7.7	20.3	16.8	...
NPLs (in percent) total loans	6.7	9.7	8.7	9.2	8.7	13.6	15.6	12.9
Provisions (in percent) NPLs	44.2	61.9	57.6	59.8	58.2	67.4	65.4	55.9
Net profit (loss) after tax	760	-305	-705	-888	-4663	-4925	-5107	-2,646
ROA (in percent)	1.9	-0.4	-0.6	-0.8	-3.5	-3.0	-2.8	-1.5
ROE (in percent)	23.1	-7.2	-11.5	-10.5	-91.3	-30.0	-32.7	-15.6
Share in assets (in percent)	100	100	100	100	100	100	100	100
Share in deposits and repos (in percent)	100	100	100	100	100	100	100	100
				Private Banks 2/				
Total assets	23,596	42,165	60,235	56,179	66,338	79,903	93,741	93,545
Cash and claims on CBT	1,514	2,707	3,627	3,362	4,574	5,579	6,844	7,371
Claims on other banks	2,688	5,386	8,317	9,769	9,851	12,695	10,712	8,990
Securities portfolio	6,478	14,335	17,053	13,491	13,407	16,165	23,178	24,290
Loans, net	8,793	12,445	20,915	19,587	22,696	27,014	31,939	31,147
Other assets	4,124	7,292	10,323	9,971	15,809	18,449	21,068	21,747
Total liabilities	23,596	42,165	60,235	56,179	66,338	79,903	93,741	93,545
Deposits	13,652	23,160	32,745	30,827	40,490	51,189	63,659	63,701
Borrowing from banks	3,006	6,508	9,323	10,045	12,750	14,137	13,586	12,577
Repos	2,633	4,654	6,766	3,918	700	2,355	2,820	2,911
Other liabilities	1,894	3,036	3,704	3,503	4,708	4,374	5,057	5,381
Shareholders' equity (inclusing profits)	2,411	4,806	7,697	7,886	7,690	7,848	8,619	8,975
Memorandum items:								
Capital adequacy ratio (in percent)	...	...	16.7	18.3	15.9	10.6	10.9	...
NPLs (in percent) total loans	6.9	3.5	3.4	3.5	3.8	4.5	4.4	4.5
Provisions (in percent) NPLs	41.2	62.2	69.3	63.0	52.5	45.4	45.2	45.4
Net profit (loss) after tax	660	1618	632	1276	181	66	755	886.5
ROA (in percent)	2.8	3.8	1.0	2.3	0.3	0.1	0.8	0.9
ROE (in percent)	27.4	33.7	8.2	16.2	2.4	0.8	8.8	9.9
Share in assets (in percent)	57.6	52.9	55.5	47.8	50.1	48.5	51.9	52.5
Share in deposits and repos (in percent)	57.4	49.7	51.1	42.9	45.0	49.1	53.6	55.1

Table 11 (continued). Turkey: Banking System - Selected Indicators, 1998-2001 1/

(In trillion Turkish liras)

	1998	1999	2000		2001			
			Sep.	Dec.	March	June	Sep.	Nov.
				State Banks 3/				
Total assets	14,150	27,104	37,362	40,655	42,052	47,911	51,710	54,632
Cash and claims on CBT	1,067	1,999	2,377	2,588	2,670	2,761	3,167	3,370
Claims on other banks	652	1,088	2,257	1,639	1,835	2,427	4,227	4,260
Securities portfolio	2,660	4,671	7,070	8,139	11,551	26,386	27,732	30,445
Loans, net	4,267	6,521	9,331	10,025	10,744	9,662	10,428	10,132
Other assets	5,503	12,825	16,327	18,265	15,253	6,675	6,156	6,427
Total liabilities	14,150	27,104	37,362	40,655	42,052	47,911	51,710	54,632
Deposits	9,838	19,204	25,562	27,606	29,219	29,294	33,479	34,706
Borrowing from banks	368	630	1,369	1,339	2,207	1,621	1,812	1,765
Repos	1,284	1,922	4,446	4,949	6,191	7,995	5,566	3,419
Other liabilities	2,116	4,317	4,825	5,659	6,025	6,737	6,692	10,243
Shareholders' equity (including profits)	544	1,031	1,159	1,101	-1,591	2,263	4,161	4,499
Memorandum items:								
Capital adequacy ratio (in percent) 4/	...	...		7.9	-1.6	26.8	26.8	...
NPLs (in percent) total loans	5.3	9.1	11.3	11.1	12.2	22.3	28.1	30
Provisions (in percent) NPLs	30.2	35.1	26.3	30.3	42.7	59.1	50.8	51
Net profit (loss) after tax	78	284	41	-177	-3028	-955	-407	-48
ROA (in percent)	0.5	1.0	0.1	-0.4	-7.2	-2.0	-0.8	-0.1
ROE (in percent)	14.3	27.6	3.5	-16.1	...	-42.2	-9.8	-1.1
Share in assets (in percent)	34.5	34.0	34.4	34.6	31.8	29.1	28.6	30.6
Share in deposits and repos (in percent)	39.2	37.8	38.8	40.2	38.7	34.2	31.5	31.5
				SDIF Banks 4/				
Total assets	667	5,480	4,042	12,912	14,037	25,916	22,399	16,484
Cash and claims on CBT	9	248	43	103	194	134	125	74
Claims on other banks	47	211	252	535	479	1,186	501	905
Securities portfolio	351	2,511	2,119	8,572	9,212	18,738	16,744	13,007
Loans, net	158	1,052	979	2,533	2,750	2,327	2,314	928
Other assets	102	1,458	650	1,169	1,402	3,531	2,716	1,570
Total liabilities	667	5,480	4,042	12,912	14,037	25,916	22,399	16,484
Deposits	446	5,363	6,327	8,827	9,361	14,523	14,157	9,413
Borrowing from banks	29	263	367	819	1,824	3,272	3,767	645
Repos	226	1,426	964	3,993	4,307	2,299	2,524	3,957
Other liabilities	69	968	587	1,329	1,294	1,546	1,400	1,831
Shareholders' equity (including profits)	-104	-2,540	-4,204	-2,056	-2,749	4,276	551	638
Memorandum items:								
Capital adequacy ratio (in percent)	...	...	...	...	...	72.3	30.0	...
NPLs (in percent) total loans	49.7	61.9	64.6	41.4	36.8	59.2	68.7	74.9
Provisions (in percent) NPLs	80.9	75.3	78.2	80.3	77.2	85.8	86.5	76.8
Net profit (loss) after tax	-127	-2547	-1697	-2314	-2048	-4483	-6172	-4,439
ROA (in percent)	-19.0	-46.5	-42.0	-17.9	-14.6	-17.3	-27.6	-26.9
ROE (in percent)	...	...	...	...	...	-104.8	-1,120.0	-695.4
Share in assets (in percent)	1.6	6.9	3.7	11.0	10.6	15.7	12.4	9.2
Share in deposits and repos (in percent)	2.4	12.1	9.4	15.8	14.9	15.4	13.4	11.1

Table 11 (concluded). Turkey: Banking System - Selected Indicators, 1998-2001 1/

(In trillion Turkish liras)

	1998	1999	2000		2001			
			Sep.	Dec.	March	June	Sep.	Nov.
			Foreign and Investment Banks					
Total assets	2,576	5,014	6,886	7,903	9,864	10,850	12,860	13,601
Cash and claims on CBT	75	143	152	182	350	373	759	469
Claims on other banks	536	1,082	1,585	1,657	1,537	1,707	2,143	1,823
Securities portfolio	199	523	942	1,049	919	880	989	1,647
Loans, net	1,471	2,583	3,344	3,645	4,853	5,710	6,844	7,029
Other assets	295	683	862	1,370	2,206	2,179	2,124	2,633
Total liabilities	2,576	5,014	6,886	7,903	9,864	10,850	12,860	13,601
Deposits	258	546	664	882	1,207	1,374	1,832	2,736
Borrowing from banks	1,259	2,670	3,507	3,792	4,345	4,346	4,926	4,536
Repos	10	-357	-224	-17	11	52	69	31
Other liabilities	609	1,218	1,458	1,716	2,544	3,068	3,750	3,455
Shareholders' equity (including profits)	439	937	1,481	1,529	1,758	2,010	2,283	2,842
Memorandum items:								
Capital adequacy ratio (in percent)	...	...	28.7	29.4	29.8	31.3	29.5	...
NPLs (in percent) total loans	2.1	2.1	2.2	1.8	2.1	2.8	2.9	3.2
Provisions (in percent) NPLs	54.0	31.3	43.2	51.8	55.8	45.5	45.6	44.9
Net profit (loss) after tax	150	340	320	328	231	447	717	954
ROA (in percent)	5.8	6.8	4.6	4.1	2.3	4.1	5.6	7.0
ROE (in percent)	34.1	36.3	21.6	21.4	13.2	22.2	31.4	33.6
Share in assets (in percent)	6.3	6.3	6.3	6.7	7.5	6.6	7.1	7.6
Share in deposits and repos (in percent)	0.9	0.3	0.6	1.1	1.3	1.3	1.5	2.3

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

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

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

3/ These include 3 state banks (Emlak Bank was closed and its assets and liabilities merged with Ziraat Bank).

4/ In March 2001, three SDIF banks did not report. End- December data is reported for these three banks.

5/ CARs are reported on a quarterly basis.

TURKEY: FUND RELATIONS
(As of February 28, 2001)

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

II. General Resources Account:	Millions of SDRs	Percent of Quota
Quota	964.00	100.00
Fund holdings of currency	14,494.09	1,503.54
Reserve position in Fund	112.78	11.70

III. SDR Department:	Millions of SDRs	Percent of Allocation
Net cumulative allocation	112.31	100.00
Holdings	22.22	19.78

IV. Outstanding Purchases and Loans:	Millions of SDRs	Percent of Quota
Stand-by Arrangements	13,281.36	1,377.73
First credit tranche	361.50	37.50

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
			In millions of SDRs	
Stand-By	02/04/02	12/31/04	12,821.20	7,326.40
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00
Stand-By	07/08/94	03/07/96	610.50	460.50

VI. **Projected Obligations to Fund:**
Under the Repurchase Expectations Assumptions[1]
(In millions of SDRs; based on existing use of resources and holdings of SDRs)

	Forthcoming				
	2002	2003	2004	2005	2006
Principal		1,223.90	5,905.60	5,597.50	915.80
Charges/Interest	437.00	576.50	455.90	163.50	9.70
Total	437.00	1800.40	6,361.50	5,761.00	925.50

[1] Disbursements made after November 28, 2000—with the exception of disbursements of emergency assistance and loans from the Poverty Reduction and Growth Facility—are expected to be repaid on the expectations schedule. Countries may request the IMF Executive Board to make repayments according to the obligations schedule if their external payments position is not strong enough to meet the repayment expectations without undue hardship or risk. Please note: Repayments under the Supplemental Reserve Facility are scheduled to be repaid on the expectations schedule.

VII. **Safeguard Assessments**:

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

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

Under the new SBA, approved on February 4, 2002 the CBT is subject to a full safeguards assessment, which entails two phases. Stage One (off-site assessment) was completed on February 25, 2002 and recommended completion of Stage Two (on-site assessment). The latter was completed on April 4, 2002 ahead of the Board discussion on the First Review under the program as mandated by the Fund's safeguards assessment policy. The conclusions of the on-site assessment are reported in Section IV of this report.

VIII. **Exchange Rate Arrangement**:

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

IX. **Article IV Consultations**:

The 1999 Article IV staff report (EBS/99/225) was issued on December 10, 1999, the accompanying Selected Issues and Statistical Appendix (SM/99/294) was issued on December 14, 1999. Board discussion took place on December 22, 1999 (EBM/99/137).

X. ROSCs

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

XI. Technical Assistance: (1993–present)

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

Department	Timing	Purpose
MAE	July 2000	Inflation targeting
STA	September 2000	Balance of payments statistics
MAE	Sept. 2000–April 2001	Banking sector reform
MAE	April 2001	Debt management
FAD/STA	May 2001	Fiscal accounting and reporting
MAE	September 2001	Inflation targeting

TURKEY: RELATIONS WITH THE WORLD BANK GROUP

I. LENDING ASSISTANCE

A. IBRD

1. **The World Bank Group's assistance program to Turkey is guided by the revised Country Assistance Strategy (CAS) discussed by the Bank's Board of Directors in July 2001.** The revised CAS includes additional IBRD support on Special Structural Adjustment Loan (SSAL) terms of up to US$1.2 billion, for a total possible lending of US$6.2 billion in the period FY2001–03, of which US$2.9 billion was committed as of November 2001. Delivery of this expanded assistance program is fully on track. Policy based lending in the revised CAS is centered around the Programmatic Financial and Public Sector Adjustment Lending (PFPSAL) program, which focuses on structural and institutional reforms in the banking and public sectors. The first PFPSAL of US$1.1 billion was approved by the Bank's Board and disbursed in a single tranche in July 2001. Negotiations on the second PFPSAL in the amount of US$1.35 billion have been completed. The second PFPSAL is designed as a three-tranche operation, and its discussion by the Bank's Board is on hold pending completion of prior actions. Follow-up programmatic operations to support continuation of the Government's financial sector reform and public sector reform programs are envisaged during the remainder of the current CAS period. The World Bank Group is preparing a new CAS (for FY2003–05), which will be completed in the Fall of 2002.

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

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

B. IFC

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

C. MIGA

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

approximately 4 percent of the total portfolio. While MIGA's exposure is currently concentrated in the financial sector, the agency continues efforts to extend coverage to infrastructure and services projects.

II. Nonlending Assistance

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

TURKEY: STATISTICAL INFORMATION

1. Turkish macroeconomic statistics have some important shortcomings, but are usually published in a timely fashion. A ROSC data module mission visited Turkey in October 2001 and the report is published in the Fund's website. It concluded that Turkey's consumer and producer price indices, monetary data, and balance of payments data, broadly follow international standards, although there are some issues of classification and of valuation in monetary and balance of payments data. National accounts data are based on the 1968 Systems of National Accounts (SNA), as opposed to the 1993 SNA. On the fiscal side, while budgetary data are generally sound from a methodological perspective, the nonbudget sector falls short of international requirements for classification detail. These deficiencies mean that only budget sector data are useable for fiscal analysis. Turkey is a subscriber to the Fund's Special Data Dissemination Standard (SDDS).

Real sector data

2. Data on wholesale and consumer prices are published monthly, with a very short lag. Monthly data on various production indices are published with lags of some five to six weeks, while quarterly national accounts are published with a three-month lag (although the second and third quarters are more timely—a 70-day lag)). The State Institute for Statistics (SIS) also publishes national accounts data from the income side.

3. There are a wide range of available data on labor market developments, with the biannual Household Labor Force Survey (HLFS) being replaced with a monthly survey at the beginning of 2000. These new data are published quarterly with a three month lag. Coverage of wage developments in the private sector has improved significantly through the use of quarterly surveys of the manufacturing sector.

Fiscal data

4. Budgetary data are published monthly, with a lag of some two to three weeks. However, the coverage of the budget is incomplete, with sizable fiscal operations being conducted through extra budgetary funds, for which data are available only with long lags. The task of fiscal analysis is further complicated by the omission of certain types of fiscal transactions from the fiscal accounts; by the failure to account for sizable quasi-fiscal operations carried out by state banks and SEEs; and by technical problems associated with consolidating the cash-based accounts of governmental entities with the accrual-based accounting of SEEs. It is difficult to reconcile the fiscal data, the monetary data, and the balance of payments data, especially in the accounting of external debt flows and central government deposits. Under the IBRD-financed Public Financial Management Project (PFMP), the authorities will adopt an improved budget coding system, a chart of accounts, and a new debt management database.

5. Turkey reports fiscal data for publication in *Government Finance Statistics Yearbook*. The latest data available are for 2000 and cover the central government budgetary sector (including annex budget units). Data are not provided for extrabudgetary and social security

units. No monthly and quarterly data have been reported for publication in *International Financial Statistics*.

Monetary data

6. Data on the central bank balance sheet, and provisional data on the main monetary aggregates and total domestic credit, are published weekly, with a one and two-week lag, respectively. Data on the monetary survey and deposit interest rates are published monthly, with about a two-to-three-month lag. The CBT does not expect to fulfill the timeliness requirement of the SDDS for the analytical accounts of the banking sector in the short term due to delays in the preparation of year-end bank balance sheets and ongoing restructuring in the banking system.

7. The central bank reports monthly data to STA with about a two-to-three-month lag. The authorities recently made substantial revisions to their monetary data—particularly in the accounts of the monetary authorities—on the proper treatment of repo transactions as collateralized loans, on Fund accounts, and on valuation adjustments. These revisions have led to improvements in the data, but some issues remain, including the proper treatment of foreign exchange swaps.

8. The CBT has started implementing market valuation for all securities for the balance sheet of December 2001. The CBT also plans to reorganize reporting forms for banks in line with the guidelines of the *Monetary and Financial Statistics Manual* (e.g., to publish separately data on subsectors 'nonfinancial private corporations' and 'households'); compilation and dissemination of monetary data in the new format is expected to be completed in 2003.

9. Comparison of monetary data submitted to STA and EUI shows substantial discrepancies, particularly for net foreign assets and other items net. The authorities have been notified of the discrepancies and are investigating the matter.

External sector

10. The Central Bank of the Republic of Turkey (CBT) is responsible for the compilation and the dissemination of the balance of payments of Turkey. The methodology used is essentially set forth in the Fund's BPM5. The CBT obtains data from a variety of sources, including foreign exchange records of banks, the State Statistics Institution (SIS) for merchandise trade, and surveys of tourism receipts and expenditure, from the international transactions reporting system (ITRS).

11. As a subscriber to the SDDS, Turkey complies with its commitment: monthly balance of payments statistics are disseminated with two to three months lag. International reserves are disseminated weekly with a one-week lag, the template on international reserves and foreign currency liquidity (reserve template) is disseminated monthly within one month after the reference period, and the merchandise trade data are compiled and disseminated monthly with one to two months lag. The exchange rate is made available to the public on a daily

basis with one day lag. As Turkey does not yet compile the international investment position (IIP), it has agreed on a transition plan to disseminate the IIP annual statements by no later than June 2002. As yet, the authorities compile and disseminate the larger part of the external sector data with the periodicity and timeliness prescribed by the SDDS. Currently, data on balance of payments and trade have been compiled and disseminated by Turkey for November 2001.

12. The data sources are broadly sufficient to compile major items of the balance of payments statistics. However, some major transactions of inflows of services, income, and current transfers, as well as foreign direct investment, are not identified and/or properly classified. The central bank periodically reviews the bank's foreign exchange records to overcome, to the extent possible, problems of coverage and misclassification.

13. The balance of payments compilation system relies on transactions reported by banks and involving foreign exchange conversions (to/from Turkish lira to other currencies). As a result the compilation system does not capture neither the transactions settled by other means than the banking system, nor the transactions between residents and non-residents denominated in Turkish liras, USD or other currencies and settled by the banks. As a result, the banks' foreign exchange records need to be supplemented with estimation techniques and other sources.

14. Regarding valuation issues, The Turkish balance of payments values financial assets at historic or nominal value, which does not allow for a proper assessment of the external vulnerability in the case of price fluctuations: end-month stock data on public and private medium- and long-term debt are reported at nominal values (as reported by the Treasury); Monetary gold holdings by the Central bank have not been revalued with market prices, and they are still valued at fixed price since end 2000. The Central bank security holdings are reported at face value in the balance of payments.

15. Regarding compilation methods and classification, foreign currency deposits held with the central bank by Turkish citizens residing abroad ("Dresdner deposits") are not yet adequately treated in Turkey's reserve template. The central bank includes the full amount of these deposits in the reserve template under official reserve assets, but only registers Dresdner deposits with an original maturity of one year or less as predetermined drains. Deposits with an original and remaining maturity of one year or less should be treated as short-term predetermined drains, and deposits with a remaining maturity of more than one year should be treated as contingent liabilities. The authorities have confirmed that they will adopt this approach by mid-2002. In addition, commercial bank's placements at the central bank from reserve requirements denominated in foreign currency are included in the reserve template under official reserves assets. The authorities have also agreed to record these placements in the reserve template as contingent liabilities in the near future.

Turkey: Core Statistical Indicators
(April 2, 2002)

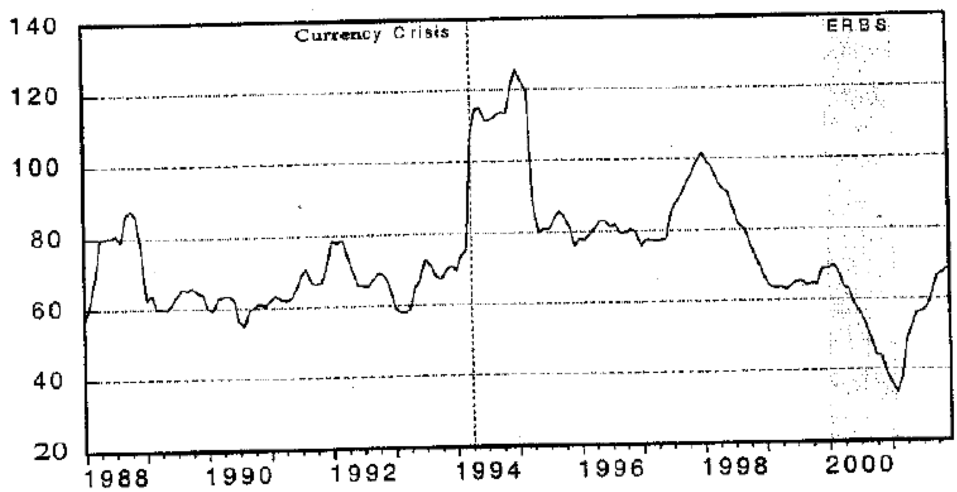
	Exchange Rates 1/	Interna-tional Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates 2/	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance 3/	GDP/GNP
Date of latest observation	April 2	April 2	April 2	April 2	Mar. 8	April 2	Feb. 2002	Jan. 2002	Dec. 2001	Jan. 2002	Q4 2001
Date received	April 2	April 2	April 2	April 2	Mar. 29	April 2	Mar. 3	Mar. 30	Feb. 19	Mar. 30	Mar. 31
Frequency of data	Daily	Daily	Daily	Daily	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Daily	Daily	Daily	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of data	CBT Reuters	CBT	CBT	CBT	CBT	CBT Reuters	SIS Press release	SIS	CBT	TRE Press release	SIS Press release
Mode of reporting	Email	Email	Email	Email	Email	Email	Website	Website	Email	Fax	Website
Confidentiality		4/	4/								
Frequency of publication	Daily	Weekly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

1/ TRE=Undersecretariat of the Treasury; SIS=State Institute for Statistics; CBT=Central Bank of Turkey.
2/ Interest rates for overnight interbank transactions and treasury bill auctions are available on a daily basis; data on deposit interest rates are provided on an end-week basis, with the most recent data available being for March 15, 2002.
3/ Consolidated budget only; data on general government position is available only on an annual basis.
4/ Daily data on international reserves and reserve money are provided to the Fund on a confidential basis.

UNDERSTANDING THE INFLATION PROCESS IN TURKEY[1]

1. **Turkey is one of the few remaining high-inflation countries in the world.** Since 1990, Turkey has steadily climbed the ranks of high inflation countries, so that in 2001 it made the top five, with an annual average inflation rate of 54.4 percent, with only Angola, Belarus, the Democratic Republic of Congo, and Zimbabwe higher. Indeed, worldwide performance has so left Turkey behind that even if Turkey succeeded in reaching its 35 percent inflation target, it would still have the ninth highest inflation rate in the world (whereas this would have put Turkey in 30th place only ten years earlier). As well as having one of the highest inflation rates in the world, Turkey has also had one of the most persistent, being one of the few countries to neither collapse into hyperinflation, nor achieve successful disinflation. But it was not always this way—in the 1960s and 1970s, Turkish inflation averaged a quite respectable 10 percent.

Annual Inflation: 1988 to 2001



2. **In the last 15 years Turkey's economic experience has come to be closely linked with chronic inflation, at first because of loose fiscal policy.** In the late 1980s and early 1990s Turkish inflation ratcheted upward, essentially because of loose fiscal policy. In 1988, the cause was fiscal expansion ahead of elections. In 1993 it was a combination of rising deficits and the Treasury's failed strategy of trying to rely solely on external financing and monetization and cancelling domestic debt auctions in a flawed attempt to reduce domestic interest rates. In the latter case, the result was a spectacular exchange rate collapse in 1994, and a surge in inflation.

[1]Prepared by the European I Department with contributions from the Research Department. This note also draws on detailed material prepared by the Central Bank of Turkey and the Turkish Treasury.

3. **Although the fiscal position has since improved significantly, inflation has taken on a life of its own, and appears to have become inertial.** While the headline public sector deficit remains high, this is largely the consequence, not the cause, of high inflation. Excluding nominal interest payments, which largely reflect ongoing inflation, the primary public sector balance has been in modest deficit from 1996 to 1999, followed by significant surplus in 2000–02. With the fiscal fundamentals increasingly sound, inflation has taken on more of a self-fulfilling character, and has been accommodated by the central bank. Alper and Ucer (1998) have argued that this is due to a policy of implicit real exchange rate targeting. However, while real exchange rate depreciation was a key element of the policy mix in the 1980s, during the second half of the 1990s the real exchange rate actually appreciated. A more plausible explanation of the monetary accommodation may be that the CBT's monetary policy simply validated inflation expectations to limitthe real costs of debt servicing, and ease the Treasury's debt rollover problems (Celasun (2001)). Just as unanticipated inflation can reduce the real debt burden, by raising the ex post real interest rate unanticipated disinflation can increase it, constraining the CBT's ability to disinflate far ahead of market inflation expectations.

4. **As a consequence, Turkish inflation has become highly persistent and inertial.** In the short run, inflation depends largely on inflation in the recent past. In an attempt to minimize the output and debt servicing costs of disinflation, in the 1990s the CBT followed a largely accommodative monetary policy, which validated this inflation inertia. It also meant that inflation continued to increase, and took on its own life, linked less closely to fundamentals.

5. **The output costs of disinflation will depend on the sources of Turkey's inflation inertia.** To the extent that inflation inertia is entrenched and due to structural rigidities, output costs of disinflation could be significant. With short-run price movements largely predetermined, lower money supply growth leads to a reduction in the real money supply, and a contraction in aggregate demand. However, inflation inertia could just reflect sticky inflation expectations, either among wage and price-setters or for bondholders, output costs could be much lower. High inflation expectations among bondholders raise nominal interest rates, with monetary policy having to validate to ensure low ex post real interest rates for debt servicing. In this case, fiscal adjustment and assurances that the fiscal deficit can be financed are key to breaking the inflation inertia—the CBT can then disinflate, with the Treasury able to bear the burden of high real interest rates, at least temporarily, while inflation is being reduced. This underlines the importance of monetary policy strategies that lower inflation expectations, as these can ease the debt problem and the output costs typically associated with disinflation.

6. **The remainder of this note** documents some of the structural causes of inflation inertia, presents empirical evidence suggesting that inertia is not an insuperable obstacle to disinflation, and presents econometric estimates that show that, under plausible assumptions, the current program may be successful in reaching its ambitious disinflation objectives.

Structural sources of inflation inertia

7. **Anecdotal evidence suggests that, apart from certain sections of the public sector, inflation inertia is a defensive reaction to past inflation, rather than an active source of inflationary pressure.**

Table 1. Turkey: Developments in Overall and Relative Prices, 1994 to 2001

	Weight in CPI	Regulated	Year on year inflation		From 1994 to 2001:	
			Dec-00	Dec-01	Inflation	Change in relative price
Overall CPI	100.0		39.0	68.5	4,586	100.0
Food, Beverage and Tobacco	31.1		33.0	80.2	3,887	84.7
Food	26.8		36.1	78.4	3,830	83.5
Bread and Cereals		*	37.1	91.2	4,363	95.1
Sugar		*	14.6	121.0	4,425	96.5
Coffee, Tea (reg.) and Cocoa		*	18.4	37.4	3,833	83.6
Cigarettes and Tobacco	2.4	*	11.3	111.6	4,307	93.9
Clothing and Footwear	9.7		35.8	65.2	3,776	82.3
Housing and Rent	25.8		46.3	59.6	5,751	125.4
Water		*	51.4	77.3	8,114	176.9
Electricity		*	35.1	119.1	4,551	99.2
Gas		*	37.7	156.1	5,607	122.3
Furniture and Furnishings	9.4		43.5	72.7	3,644	79.5
Health	2.8		51.0	58.4	5,437	118.5
Medical supplies		*	44.1	92.2	3,959	86.3
Medical services		*	57.0	41.6	6,648	144.9
Transport	9.3		27.7	77.5	5,300	115.6
Leisure	3.0		36.6	61.7	4,119	89.8
Education	1.6	*	27.5	52.4	5,319	116.0
Hotels	3.1		45.9	46.2	4,666	101.7
Misc.	4.4		48.3	81.2	4,441	96.8
Communications	1.9	*	62.4	82.0	4,259	92.9
Postal Services		*	15.7	50.0	4,046	88.2
Telecoms		*	62.9	82.3	4,260	92.9

Source: State Institute of Statistics

8. **Inertia in pricing is largely concentrated in the public sector.** Administered prices account for one-fifth of the CPI (and almost one quarter of the WPI)—significant proportions. During 2000, administered prices were raised by less than the overall CPI, temporarily assisting the disinflation effort. However, this was reversed in 2001, due to exchange rate depreciation and the need for fiscal adjustment. Prices subject to regulation include:

- **Food prices.** Main items include: wheat (supported by trade barriers, and with a significant impact on the CPI since the bread has a 4.1 percent weight), tobacco (where, in addition to excise taxes, there is a government monopoly which adjusts its price in line with the agriciltural support price), sugar and tea.

- **Household utility prices.** Electricity prices have risen in line with the exchange rate depreciation, but increases may also reflect inefficiencies in production and distribution. Municipalities have used water and gas prices as an additional revenue source, raising prices above the overall CPI. Mail and telecommunications prices are also regulated, with the latter intended to be privatized shortly.

- **Medical product prices** are determined not by competition but controlled by the Ministry of Health, at a flat rate for the whole country, based on cost-plus considerations (but on an ad-hoc basis, not by using an automatic formula).[2] After receiving applications for price increases, the Health Ministry determines uniform price adjustments. Apart from adding to inflation, the arbitrary cost-plus price-setting scheme decreases incentives for firms to improve efficiency. High indsutry concentration also does not help.

- **Medical service prices** are determined twice a year by the Turkish Doctors' Association, with minimum and maximum rates published on their website. This is suggestive of co-ordinated price setting. In both 2000 and 2001 medical service increased faster than overall inflation.

- **Private schools** set their prices every August, and are required to keep their prices fixed through the remainder of the school year. Since the CPI exceeded the official target in both 2000 and 2001, the relative price has fallen: private education prices increased only by 27.5 percent year on year in December 2000, and 52.4 percent in the year to December 2001. With costs increasing faster than this, there is considerable inertial pressure to increase prices above the current 35 percent inflation target, in order to restore relative prices.

- In addition, the budget's use of a **backward-looking revaluation coefficient** (based on the average annual increase in the WPI, compared to the previous year) to determine many taxes and government user fees leads to inertia.

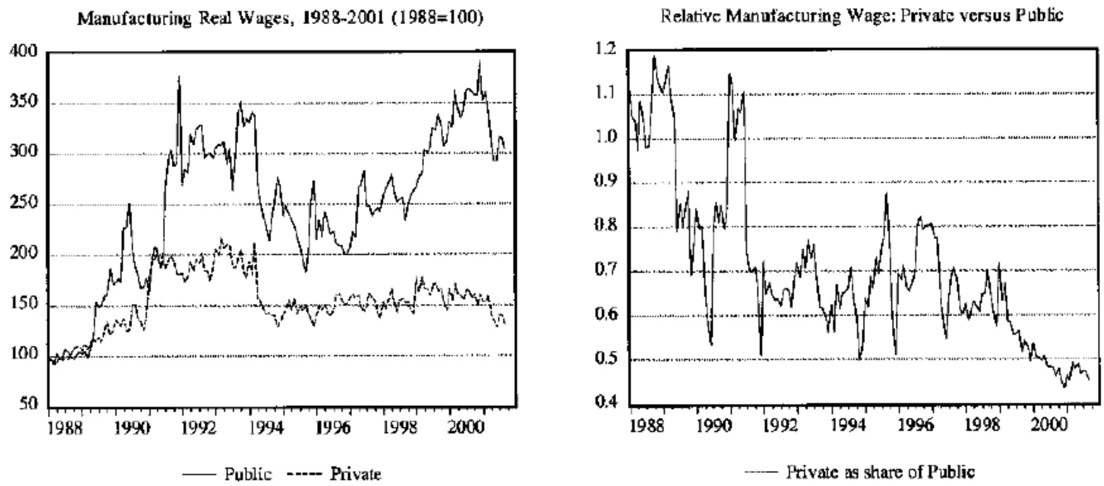
With competition, and hard budget constraints, lacking in many of these sectors, there is considerable scope for cost pressures and inefficiency to distort relative prices. This has the potential to create inflationary pressure, and to increase the cost of disinflation. Alternatively prices may be raised to meet fiscal targets. This underlines the importance attached in the program to promoting competition, private sector development, and structural reform. And also to tax reform, to avoid over-reliance on increases in excises to meet fiscal targets.

9. **Inertia in wage-setting is also due mainly to the government sector:**

- **Wages of public sector enterprise workers have added to inflation pressures.** Public sector workers' wages are determined every two years, the next wage agreement due early next year. Under the current wage agreement set in May 2001, public sector wages were increased by 15 percent in the first half of 2001, 15 percent

[2] However, imported retail medical products adjust automatically to the exchange rate.

Manufacturing Wages: Public and Private Sector



in the second half of 2001 (with 80 percent catch-up of any excess CPI inflation), 10 percent in the first half of 2002 (again with 80 percent catch-up), and 10 percent in the final half of 2002 (with full catch up). While not seeming to impart any inflationary impulse (because actual inflation has exceeded these targets, causing real wages to decline), the agreement actually validates earlier significant real wage increases that were caused by failure to renegotiate the 1999 and 2000 wage agreement to include the downward revision to the inflation target under the 2000 program. As a result, public manufacturing wages increased by more than 35 percent from 1998 to 2000 (year average basis); the corresponding increase for the private sector was only 6 percent. Public sector manufacturing worker wages are now more than double those of private manufacturing workers.[3]

- **Although indexed for inflation, civil servant salaries exert less inflationary pressure.** Civil servant salaries are adjusted twice a year. In 2002, by 10 percent in January and 5 percent in July, with full catch-up for any excess inflation, and a 2 percent real wage increase in the first half of the year. However, civil servant salaries are considerably lower than their public sector worker counterparts, and their relative wage far less distorted.

- **Conversely, private sector labour markets are flexible and, given the current economic recession, are not a powerful source of inflationary pressure.** Although information on private labour markets is more limited, the evidence suggests that these are quite flexible. There is little collective bargaining in the private sector—

[3] Even so, there are differing degrees of wage flexibility within the public sector, especially among firms in preparation for privatization. For example, Turkish Airlines staff have accepted reductions in real wages and staffing in response to the post September 11 collapse in air travel.

roughly 350,000 private sector workers are covered, compared to almost double that in the public sector. However, the private sector does use increases in public sector wages, or in the minimum wage (which is set every six months by a tripartite government-unions-employers committee), as an indicative path for their own wage agreements.

Empirical evidence on the role of inertia in price-setting

10. **Although these structural rigidities exist, empirical evidence suggests that the degree of inflation inertia is not a binding constraint to disinflation in Turkey.** Estimates of structural inflation equations prepared by the Fund's Research Department indicate that in recent disinflation attempts, and in particular during the exchange rate based stabilization, price-setters have become increasingly forward-looking. Following Calvo (1983), one way to measure this is to assume that a constant share of firms in the economy changes prices every quarter, while the rest keeps their prices constant. We depart from Calvo's model in assuming that only a fraction δ of the firms is forward looking, and the rest is backward looking.[4] Backward-looking price setters use a rule of thumb: they "update" the average new price in the most recent round of price adjustments by the most recently observed inflation rate. The resulting inflation rate in period t, π_t equals:

$$\pi_t = (1-\delta)\pi_{t-1} + \delta E_t \pi_{t+1} + \lambda(V_t^* - P_t) \qquad (1)$$

where $V_t^*-P_t$ corresponds to the forward-looking firms' optimal real price for period t, empirically proxied by measures of excess demand and marginal costs. The degree of inflation inertia is governed by the parameter δ. The higher is the share of backward-looking price setters the larger is the weight $1-\delta$ on the lagged inflation term. We estimate equation (1) with quarterly CPI and private sector manufacturing price (PMPI) data using actual future inflation rates in place of expected inflation rates and the generalized method of moments technique.[5]

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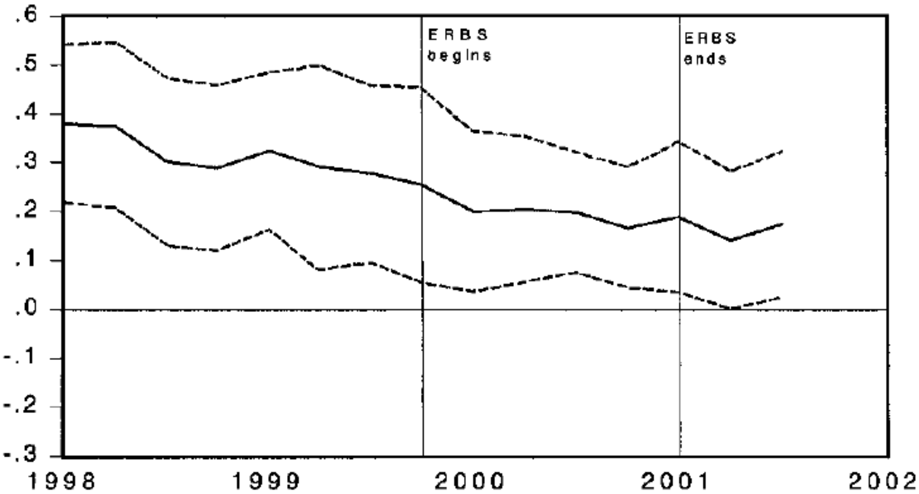
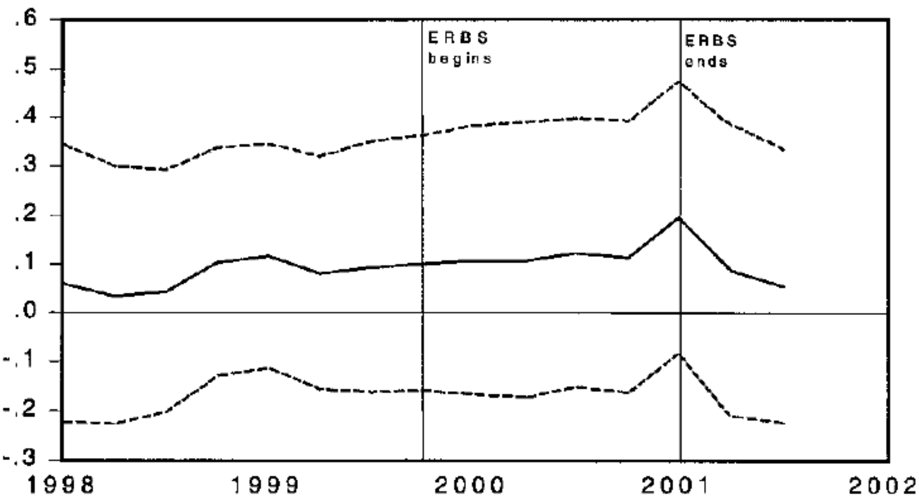
[4] Celasun (2001), whose estimates we update, takes the same approach; see also Chadha, Masson and Meredith (1992). Fuhrer and Moore (1995), Driscoll and Holden (2001), and Jadresic (1999) provide other rationalizations of variations of equation (1).

[5] In addition to the lagged and future inflation terms, in the equation for CPI inflation we include other terms proxying the excess demand and the marginal costs of the tradable and nontradable components of the CPI: the real wage, the real exchange rate, the relative price of tradables with respect to nontradables in the CPI index (to capture the excess demand for nontradables), and the imports-to-GDP ratio (to capture the excess demand for tradables.) In the equation for PMPI inflation, we include the real wage, foreign prices (the exchange rate multiplied by the U.S. wholesale price index), and the prices of goods produced by the public sector (proxied by the public sector wholesale price index), which increase significantly private sector manufacturing prices.

Lagged inflation coefficient in CPI
(recursive GMM estimates and 95 percent confidence band; 1990:Q1 - 2



Lagged inflation coefficient in PMPI
(recursive GMM estimates and 95 percent confidence band; 1988:Q4 - 2



11. **Recursive estimates of the δ coefficient suggests that the degree of forward-looking price setting behaviour has been increasing.** Equation (1) was first estimated including observations up to 1998:Q1; the sample was then extended one quarter at a time through 2001:Q3. The figure presents the estimates of the backward-looking coefficient 1-δ for CPI inflation (top panel) and PMPI inflation (bottom panel) obtained in each of these sample periods. The CPI estimates show some evidence of inflation inertia but the weight on lagged inflation falls from about 40 percent in the 1990:Q1–1998:Q1 sample to 20 percent in the full sample, suggesting that price setters' behavior has become increasingly forward-looking, possibly as a result of the disinflation strategy followed in recent years. Forward-

looking behavior dominates PMPI inflation to an even greater extent, as the coefficient 1-δ is never statistically different from zero. Given that most goods in the PMPI index are tradables, the lack of inflation inertia for this category of prices is not surprising.

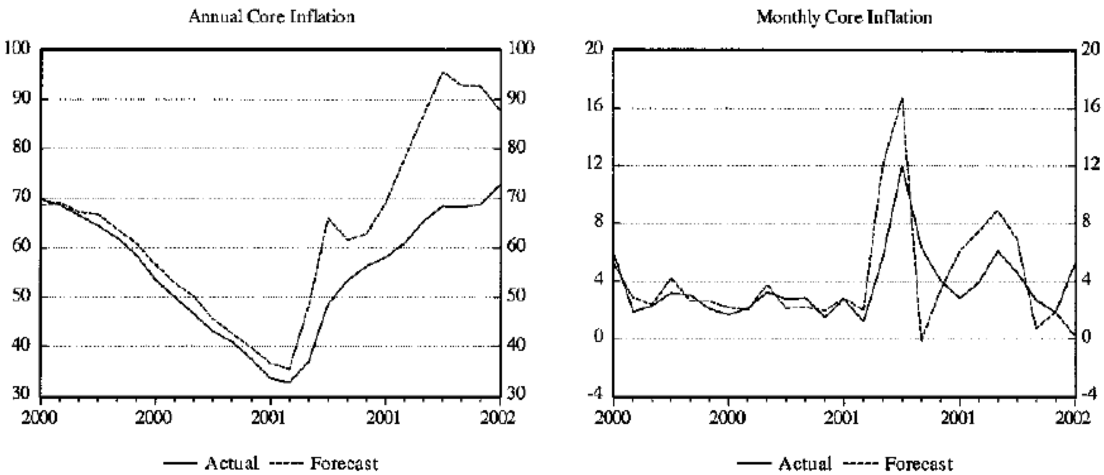
Achieving the 2002 inflation target

12. **The presence of inflation inertia raises the question of whether this year's 35 percent inflation target can be reached without significant costs in terms of lost output.**

13. **To answer this question, we have updated earlier estimates of the staff's inflation equation.** In this error-correction model, the core price index (defined here to exclude food, rent, utility and cigarette prices) is assumed in the long run to depend on the nominal effective exchange rate, private sector manufacturing wages, oil prices and, as a proxy for domestic demand pressure, capacity utilization. In the short run, core inflation depends on movements in electricity prices, oil prices, and the effective exchange rate, and also responds to reduce the deviation of the core price index from its implied long run equilibrium (the so-called "error-correction" term). The estimated error-correction term is consistent with long-run homogeneity: proportionate increases in wages, oil prices and the exchange rate lead to an equi-proportionate increase in the core price level. Seasonal dummies are also included (where significant), together with a dummy to explain the sudden surge in inflation in June 1997.

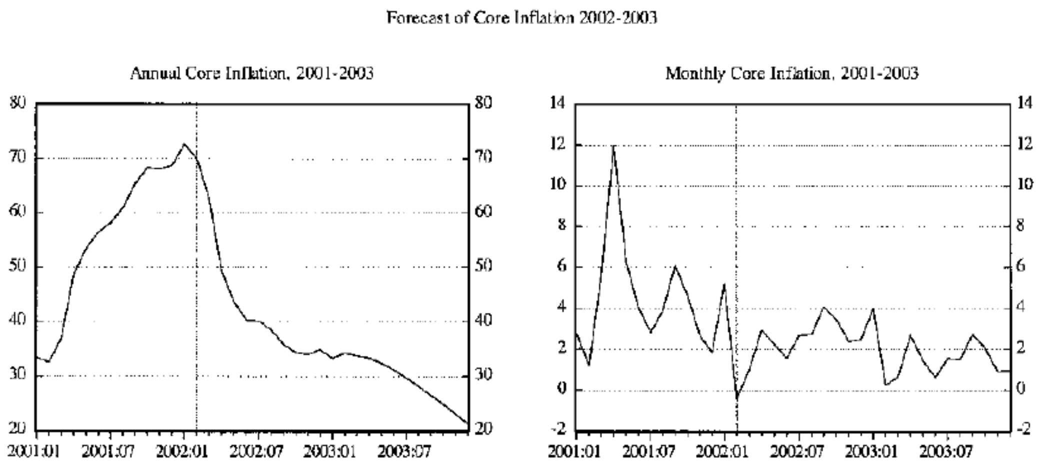
14. **First, we assessed the explanatory power of the existing inflation equation** by re-estimating it through December 1999, and then used it to produce a dynamic forecast of recent inflation experience (i.e. by using actual values of the right hand side explanatory variables, together with the forecast (as opposed to the actual) value of core inflation).

Core Inflation: Dynamic Forecast, Using Equation Estimated Through December 1999



15. **The equation gives plausible projections.** For 2000 predictions are close to the actual outcome. For 2001 the equation over-predicts inflation, probably because the equation gives weight to the full impact of the depreciation, and insufficiently captures the effects of the domestic demand recession in dampening inflation, which can be seen as a kind of structural break.

16. **To assess the prospects for the current disinflation program, the equation was re-estimated, and simulations carried out for 2002 and beyond.** The re-estimated equation is broadly similar, except that the wage coefficient is somewhat higher, and that on the effective exchange rate somewhat smaller. Assumptions for the explanatory variables are needed in order to project inflation. For illustrative purposes, the exchange rate is assumed to increase to end the year at around TL 1.8 million to the dollar, a 24 percent depreciation from its February level, followed by a further depreciation of just under one percent per month in 2003, to reach TL 2 million to the dollar. Oil and electricity prices are assumed to increase similarly. In line with the projected recovery, capacity utilization is assumed to increase to average 75 percent in 2002 (from 71.7 percent in 2001), still well below the 78 percent average for 1992–2000. The greatest uncertainty comes from projecting wages, since data is only available through September 2001. The projection assumes that these increased by 3 percent in each of the last three months of 2001, and then increase at an annualized 35 percent rate in 2002, in line with the inflation target. This assumption turns out to be consistent with holding real wages (deflated by the core CPI) roughly constant at their September 2001 levels—although this means no reversal of the steep real wage decline that took place in the first part of 2001.



17. **Using these assumptions, the model projects core inflation falling to around 35 percent this year, and to close to 20 percent in 2003, suggesting that the program's inflation targets are feasible.** Indeed, February's low headline inflation figure, together with survey evidence suggesting a sharp drop in inflation expectations (albeit these are well above the target) are consistent with this finding.

18. **However, while the program's inflation targets appear feasible, structural reform and steps to lower inflation expectations (which might include early introdction of inflation targeting) could also help.** By increasing price flexibility and reducing distortions, structural reform contributes not just to boosting sustainable growth, but also to reducing the costs of disinflation. With the budget financing outlook now considerably stronger, because of both fiscal reform efforts and increased international financial support, the fiscal deficit is now much less of a constraint to the CBT from controlling monetary growth, and hence from lowering inflation. To minimize the costs of disinflation, reducing the inertial element in price setting can play an important role. Indeed, the use of the exchange rate as a nominal anchor in the 2000 program was intended to break inertial inflation, by concentrating inflation expectations on pre-determined exchange rate movements. However, while that program failed, the need to reduce inertia remains. While structural measures can help, the early and credible introduction of inflation targeting could provide the clear nominal anchor that is needed to overcome inflation inertia.

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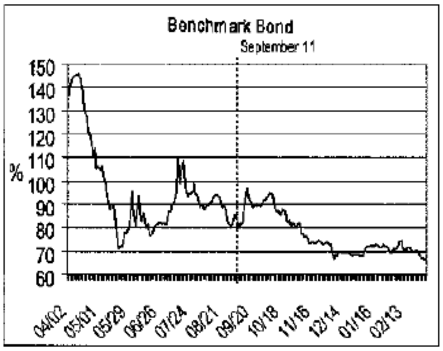
TURKEY: REPORT ON EXTERNAL AND FINANCIAL VULNERABILITY

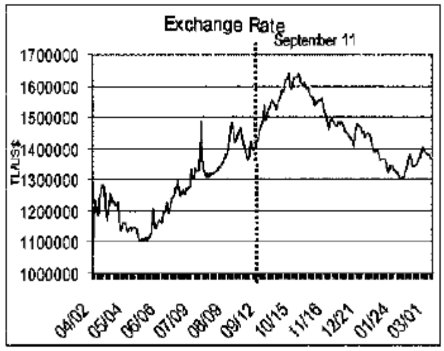
1. While the prospects for a new program supported by a new stand-by arrangement (SBA) have helped improve financial market sentiment in 2002, other factors have caused increased short-term volatility in the financial markets. The exchange rate appreciated by 5.8 percent from end-December to some TL/US$1,360,000 on March 7. While the compounded interest rate on the benchmark bond fell by 3 percentage points to 66 percent, the stock market declined by almost 16 percent in the same period. Credit risk remains a source of vulnerability in banking sector, and the external vulnerability continued.

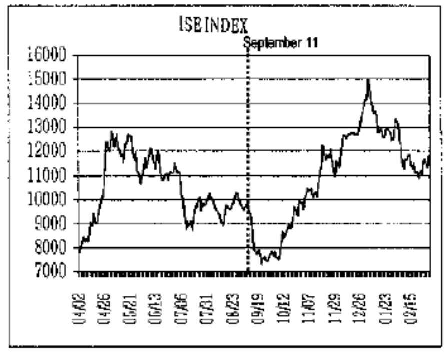
Financial and monetary indicators

2. The compounded interest rate on the benchmark bond declined to 69 percent on January 31, after having moved in a range of 70–73 percent during the month. The stock market recovered by almost 9 percent from end-December to January 7, driven by initial positive expectations concerning the bank recapitalization plan and the likelihood of elimination of textile quotas on Turkish exports after the Prime Minister's visit to the United States. Despite the decline of almost 4 percent in January, the stock market index in U.S. dollar terms registered a recovery of more than 6 percent due to the appreciation of the Turkish lira. In early February, financial markets were affected by mixed news: the approval of the new SBA, upgrades by leading international rating institutions of Turkey's outlook from stable to positive, the announcement of higher-than-expected CPI inflation outcome in January and rising concerns about Iraq. Volatility in the financial markets increased further. The exchange rate depreciated on February 11 to some TL/US$1,400,000 in the interbank foreign exchange market, representing a depreciation of almost 8 percent compared with end-January. The compounded yield on the benchmark bond rose by 5 percentage points to 74 percent over the same period. The stock market declined by more than 15 percent in the first week of February, driven partly by the fall in tourism shares of 36 percent. Citing its cautious optimism for the inflation in the period ahead, the CBT reduced on February 20 its short-term overnight borrowing rate by 2 percentage points to 57 percent. Financial markets' initial response to the CBT's short-term interest rate cut was limited while the concerns about Iraq were still prevailing in the financial markets. The exchange rate depreciated by 4.5 percent from February 14 to some TL/$1,400,000 on February 27. While the compounded yield on the benchmark bond declined 1 percentage point to 70 percent over the same dates, concerns about the outcome of the implementation of the bank recapitalization scheme were added further into a decline in the stock market of almost 6 percent in the same period. In early March, financial indicators stabilized as the concerns about imminent military action in Iraq receded, and the February inflation outcomes came out lower than expected. The exchange rate appreciated by 2.6 percent from February 27 to some TL/US$1,360,000 on March 7, and the compounded yield on the benchmark bond declined by 4 percentage points to 66 percent. The stock market recovered by 5.1 percent from end-February to March 7.

3. While the spreads on Turkish government securities declined in the U.S. dollar bond market, the spreads in the Eurobond market increased due to a decline in the risk appetite of European investors who incurred losses due to the crisis in Argentina.







FINANCIAL AND MONEY MARKET INDICATORS (*)	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02	Latest
1.Bond Yield (% Compound)	53.6	157.6**	140.5	106.7	95.5	81.0	91.5	81.4	89.6	81.6	74.2	68.8	69.2	69.9	65.9
Volume (TL. Tr.)	41.8	0.4**	3.9	2.5	188.7	8.8	144.5	48.0	112.3	38.8	6.3	1.0	23.9	8.9	9.5
2. O/N Interest Rate (% simple)	54	121	83	77	63	63	67	61	59	59	59	59	59	57	57
3. Treasury Eurobond Spreads (2010 maturity) (basis pts.)															
Denominated in US$	736	1026	1130	902	873	888	1116	957	997	940	809	700	665	677	651
Denominated in Euro	477	553	577	522	488	477	676	588	695	685	584	514	560	566	573
4. ISE 100 Index (1986=1)															
TL Based	10685	8792	8023	12367	10880	11204	9914	9879	7626	9549	11634	13783	13252	11056	11621
US$ based	916	556	458	633	525	521	436	424	292	361	460	558	591	464	..
5. NDA of CBT (Tr. TL.)	236	3897	5802	6907	8357	13299	14703	16380	17902	18277	19439	20752	19461	25443	25202
6. Gross Reserves of CBT (US$ Mil.)	24518	21270	18822	18461	20621	17279	17606	18790	18882	18637	17610	19182	19800	21261	21042
7. Base Money (TL. Tr.)	4506	5071	5578	6022	5822	6412	6285	6752	7611	7157	7317	7803	7647	8648	8307

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

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

(***) Figures reported are for the June 2001 paper up until May 9th, 2001, for the March 2002 paper up until December 5th, 2001, and for the April 2002 paper up until January 7th, 2002, and for the July 2002 paper

Real sector and government budget indicators

4. January CPI inflation was higher than expected due to a rise in the prices of the food products and the restoration of regular VAT rates on some consumer durables following the temporary VAT rate reductions in November–December 2001. The February CPI inflation, however, was lower than expected. Monthly increases in food and housing prices, which account

REAL SECTOR AND GOVERNMENT BUDGET INDICATORS	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02	Latest
1.CPI (monthly % change)	2.5	1.8	6.1	10.3	5.1	3.1	2.4	2.9	5.9	6.1	4.2	3.2	5.3	1.8	..
2.WPI (monthly % change)	2.3	2.6	10.1	14.4	6.3	2.9	3.3	3.5	5.4	6.7	4.2	4.1	4.2	2.6	..
3. Inflation Expectations***	25.0	35.0	55.0	59.6	56.5	55.8	56.7	45.0	48.9	49.9	51.5	50.1	45.4	43.3	39.8
4. Industrial Production Index (1997=100)	91.4	88.5	85.9	87.1	93.4	93.6	90.1	92.3	95.3	98.7	98.2	89.0	88.6	..	..
5. Capacity Utilization of Private Manuf. Ind. (%)	68.3	65.5	61.8	63.8	62.3	66.3	65.4	64.9	66.8	67.8	67.8	67.6	68.2	..	..
6. Production Expectation Survey (%)****	10.2	19.8	18.1	-5.6	37.5	34.5	23.7	33.2	39.3	10.3	-3.5	-28.9	-3.8	-19.1	..
7.Consolidated Gov't Primary Balance (Tr. TL.)	1292	2306	1122	1326	1084	509	670	1921	853	1020	1864	-1467	1429	..	..
8. Gov't domestic debt service next month (TL. tr.)	..	..	..	..	..	5150	6400	7200	6700	7800	5645	7448	4678	5972	..
9.Bid/cover ratio in TB auctions	1.64	1.61	2.5	1.25	1.61	1.26	2.08	1.17	2.14	1.59	1.25	1.27	1.26	1.52	1.28

(***) Figures reported up until July 2001 represent percent change expected in WPI in the subsequent 12 months, and from August 2001 on represent percent change expected in CPI in the subsequent 12 months

(****) Difference between the percentage of respondents expecting a higher production vs.lower production in the present month (data are collected in the previous month) together for 56.9 percent of the CPI index, were lower in February. Regarding the future course of inflation, the CBT's inflation expectation surveys suggest a decline in inflation expectations: the CPI inflation expected for the next 12 months as of early March, was 39.8 percent (appropriate mean) compared with 50.1 percent as of end-December 2001. As to domestic demand, forward looking indicators of the CBT's Business Tendency Survey pointed to sharp improvements in the net positive expectations for the volume of goods to be sold in domestic markets and new orders from the domestic market over the next three months. Production indicators, however, suggest a mixed picture. After a rise of 1.7 percent from October to November, the seasonally adjusted industrial production index declined by 6.9 percent from November to December, reflecting partly the effect of long public holidays in December. However, seasonally adjusted industrial production index rose by 12 percent from its low level in December 2001 to January 2002, reaching the highest level since February 2001. Moreover, the CBT's January Business Tendency Survey suggested sharp improvements both in business confidence and expectations for the volume of output over the next three months. The seasonally adjusted capacity utilization rate in private manufacturing industry continued its upward trajectory started in October with a cumulative rise of 6.7 percentage points from September 2001 to January 2002. After a decline of 2.4 percent in November, VAT revenues accrued from domestic activities rose in nominal terms by 11 and 2.5 percent in December 2001 and January 2002 respectively, reflecting partly the effects of temporary reductions in the VAT.

5. As to the SDIF bank resolutions, Sitebank was sold to Novabank on January 16, and EGS Bank was transferred to Bayindirbank, and its banking and deposit taking license was revoked on January 18. Toprakbank was offered for sale on January 31, but the bidding deadline was later extended until April 24. The partnership rights and management and supervision of Tarisbank

BANKING AND FINANCIAL SYSTEM INDICATORS

	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Latest
1. Capital Adequacy Ratio														
Total			3.2	..	..	19.7	..	..	15.9	..	..	..	..	..
Excl. SDIF			14.8	..	..	14.3	..	..	16.1	..	..	..	..	..
2. NPLs / Credit to Private Sector (%)														
Gross	11.0	11.3	11.9	13.1	14.4	15.7	14.4	19.4	19.2	18.8	16.0	15.2	15.3	15.8
Net (of Provisions)	4.0	4.3	4.5	4.9	4.5	4.5	3.3	6.9	6.6	6.8	7.2	6.9	5.4	5.7
3. Open FX Position / Capital Base														
Total														
Total Net FX Position (US$ Million)	-5324	-4310	-5149	-5336	-803	-242	-766	-724	-695	-880	-685	-129	13	239
Open FX Position/ Capital Base (%)	-66	-77	-88	-122	-20	-5	-12	-7	-7	-10	-9	-2	0	2
Excl. SDIF														
Total Net FX Position (US$ Million)	-1012	-765	-479	-517	-159	317	78	475	470	319	333	312	378	613
Open FX Position/ Capital Base (%)	-8	-10	-6	-8	-2	5	1	6	6	4	4	4	4	6
4. Proxy for Av. Maturity Gap (months) (*****)	3.5	2.8	3.0	3.0	3.5	3.4	3.6	4.0	3.7	4.5	3.5	..	..	
5.Deposits (Tr. TL)	57,051	63,063	71,518	74,697	75,248	83,605	85,412	91,844	100,082	104,429	101,862	103,768	100,102	101,184
TL/Total (%)	55.0	50.8	51.5	48.0	48.6	45.7	42.0	41.6	39.2	38.4	40.6	43.4	45.0	44.5
FX/Total (%)	45.0	49.2	48.5	52.0	51.4	54.3	58.0	58.4	60.8	61.6	59.4	56.6	55.0	55.5
6. Credit to Private Sector (TL tr.)	32,404	34,502	35,947	37,909	37,016	39,972	40,480	43,682	46,797	47,484	43,630	42,331	41,754	42,123
7. Credit to Private Sector / Deposits (%)	56.8	54.7	50.3	50.7	49.2	47.8	47.4	47.6	46.8	45.5	42.8	40.8	41.7	41.6
8.External Loans due next month (US$ Ml.)	6490	5765	5515	5591	4242	5291	1383	1520	2555	1073	1743	433	475	..

(*****) The difference between the average (weighted) maturities of assets and liabilities were transferred on February 20 to the previous shareholders in line with a legal decision. The implementation of the bank recapitalization plan accompanied by corporate debt restructuring as well as recent upgrades of the outlook of all Turkish banks from negative to stable should help increase confidence in the banking sector.

External indicators

6. The real exchange rate appreciated by 10.2 and 4.9 percent in January and February 2002, bringing the cumulative appreciation since October 2001 to almost 40 percent. The current account surplus in January–November 2001 reached US$3.5 billion compared with a deficit of US$9.1 billion over the same period in 2000. The shrinking trade deficit continued to be the major driving force behind the current account surplus: in 2001, exports grew by 12.3 percent and imports contracted by 25.7 percent. In the period ahead, exports might be hampered due to real appreciation and global slowdown after the September 11 events: after a year-on-year export growth of 13.3 percent in November, exports grew only by 1.9 percent in December. Furthermore, the preliminary figures of Union of Turkish Exporters suggested a year-on-year decline in exports of 7 percent in February 2002 after a growth of 4.3 percent in January. The CBT's Business Tendency Survey, however, points to considerable improvements in January 2002 in the net positive expectations related the export prospects over the next three months. Although the tourism receipts increased on year-on year basis by 6.5 percent in January–November 2001, in the months ahead, the outcome might be lower due to fallout of September 11 attacks and concerns about a military conflict in Iraq: following the declines on year-on-year basis of 9.5 and 13.5 percent in October and November 2001 respectively, the SIS data indicate that the number of foreign visitors to Turkey declined on year-on-year basis by 6.1 percent and 14.7 percent in December 2001 and January 2002.

7. On the capital account side, total outflows reached US$12.4 billion over January–November 2001 compared with total inflows of US$9.5 billion over the same period in 2000. The capital inflow of US$492 million in October was followed by an outflow of US$2.2 billion in November. The portfolio investment outflows of US$113 million and US$468 million in October and November, respectively, were mainly due to security purchases of residents abroad. The outflows in November due to security sales by non-residents in Turkey amounted to US$154 million on a net basis. The inflows due to a net decrease in the banks' FX holdings with foreign correspondent banks and outflows due to repayment by banks of loans contributed to short-term outflows of US$245 million in October. The net increase of US$1.2 billion in bank's FX holdings with the foreign correspondent banks was the main reason for the short-term capital outflow of US$1.4 billion in November. Net errors and omissions posted in November a positive outcome of US$902 million, for the first time since May 2001, bringing the non-recorded capital outflows to US$3.7 over January–November 2001. The external vulnerability continued in October and November: the ratio of total short term to reserves posted an improvement from 110 percent in September to 101 percent in October mainly due to a decline of more than 9 percent in total short-term debt stock, driven mainly by the declines in the FX credit stock of the banks and the stock of trade credits for imports. But the ratio increased again to 106 percent in November as a slower decline in short-term debt was counteracted by a worsening in reserves.

	EXTERNAL INDICATORS														
	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02	Latest
1. REER (WPI) (1996=100)	105.3	99.4	84.7	78.6	89.6	87.9	84.1	80.2	79.6	78.8	87.5	95.3	105.0	110.1	..
2. Exports (US$ million)	2236	2516	2546	2607	2884	2561	2483	2578	2601	2809	2831	2536	..	..	..
3. Imports (US $ million)	3985	3513	3088	3013	3537	3267	3353	3386	3264	3175	3455	3473	..	..	..
4. Current Account (US $ million)	-675	-95	243	628	353	212	412	812	797	597	252	..	..	..	..
5. Change in foreign banks exposure (US $ million)	-280.6	-1525.2	-933.2	-172.2	-884.6	-1841.1	-2000.7	422.5	-3677.1	2253.0	402.0	-391.8	-165.0	-85.4	215.1
6. Short-term external debt/reserves	1.18	1.29	1.42	1.43	1.19	1.32	1.18	1.10	1.10	1.10	1.01	1.05	..	..	..

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

Ankara, April 3, 2002

Dear Mr. Köhler:

1. **Our economic program for 2002–04, which the IMF supports under a stand-by arrangement approved in February, is off to a good start.** The last five months have marked an important turning point for the Turkish economy. Since late October 2001, the confidence that returned to financial markets is reflected in the Turkish lira gaining value, interest rates declining, and the stock market recovering.

2. **The positive developments reflect our continued strong policy efforts.** We have met the end-January performance criterion for the consolidated government sector surplus, and the end-February performance criteria for base money and net international reserves (Annex A). We have also continued to make progress in structural areas, including several structural benchmarks (Annex B). Moreover, we expect to complete shortly the two prior actions for the first review, namely passing the Law on Public Debt Management and issuing supporting regulations, and identifying redundancies in state enterprises and eliminating unfilled positions. The latter measures are an important part of our strategy of pursuing state enterprise reforms aimed at increasing efficiency and eliminating the burden imposed on employment and growth in the rest of the economy by excess costs and staffing in the state sector.

3. **On this basis, we request that the first review under the stand-by arrangement be completed.** Our targets and policies remain as set out in the January 18 Letter of Intent. This letter updates on policy developments and describes additional steps we plan to take to achieve the program targets.

4. **The key challenge now is to steer the right course that will allow Turkey to realize both the 3 percent growth target and the 35 percent inflation target set for 2002.** Both targets are equally important. An economic recovery has to take hold so that we start generating employment again, so that hope in the future can gain momentum, and so that financial markets evaluate positively not only short-term prospects but also the medium-term outlook for the Turkish economy. At the same time, we must and will use the opportunity offered by current circumstances to decisively break inflation expectations and secure the realization of our inflation target. The February outcome shows that we are at a turning point. Inflation is at the root of most of the problems suffered by the otherwise very dynamic Turkish economy. We must reduce inflation to 35 percent this year and to single digits in the medium term. This is an essential condition for rapid, equitable, and truly sustainable growth.

Fiscal policy and debt management

5. **Our fiscal policy remains firmly geared to achieving a public sector primary surplus of 6.5 percent of GNP in 2002.** We estimate the 2001 outcome at 5.9 percent of GNP, above the target of 5.5 percent of GNP. Building on this strong performance, and with tax revenue exceeding projections and spending restraint continuing in January, we comfortably met the end-January 2002 performance criterion on the consolidated government sector primary surplus (which is cumulative from January 1, 2001). Further, we are close to meeting the structural benchmark on completing the remaining measures from the fall fiscal package: most state economic enterprises (SEEs) have approved budgets in line with cost reductions mandated, and we have instructed the others (which had already approved their budgets before the savings measures were defined) to correct their budgets; and we are finalizing the identification of savings from closing regional administrations and other line agency offices. For the latter measure, broad budget appropriations have already been blocked, and implementation of closures is expected by end-June. To offset the lower-than-expected petroleum consumption tax revenue so far this year and the government's recent decision to support job creation (through delaying half of the increase in the social security contribution base by three months, and introducing limited tax incentives), we are taking additional measures. In particular, we will keep investment expenditure in one of our social security institutions (SSK) at the level originally planned in the investment program for 2002, which will entail a saving of TL 195 trillion, and we will implement a generic drug purchase program in another (Emekli Sandıgı) by end-April. In addition, we now expect a dividend of TL 180 trillion from the state-owned Ziraat bank, whereas the budget assumed no profit transfer from state banks this year. We are confident that the measures we have taken will be sufficient to enable us to meet our fiscal targets. However, should signs of deviations emerge, we will not hesitate to take decisive and timely action to safeguard these targets.

6. **We are taking further steps to strengthen government debt management.** With the re-introduction of floating rate note issues in January, the maturity of newly auctioned debt has increased sharply. In addition, parliament has passed the Law on Public Debt Management, and we expect and the supporting regulations to be in place shortly. In line with international practice, this law will establish a Treasury office covering the presently dispersed responsibilities for formulating overall public debt strategy and assessing risk management, and should allow closer coordination in managing the domestic and international debt portfolios. Details on the operations of this office will be spelled out in a government communiqué to be issued in June. Further organizational and, if needed, legislative improvements will be made based on the recommendations of a comprehensive study on debt strategy and risk management, which will be undertaken by Treasury with the contributions of external consultants and completed by June 2002.

Monetary and exchange rate policy

7. **The Central Bank of Turkey (CBT) will continue to focus its policies on keeping inflation within the targeted 35 percent for 2002.** While ensuring that our base money and net international reserves (NIR) targets continue to be met, we are preparing for the

introduction of inflation targeting, and expect that the pre-conditions will be met by mid-year.

8. **While adhering to the floating exchange rate regime, the CBT will use the improvement in the balance of payments and reverse currency substitution to build up its foreign exchange reserves.** As interest rates have declined, the CBT has been in a stronger position to offset any use of the Treasury's foreign exchange receipts for domestic payments through money market operations, rather than foreign exchange auctions. Accordingly, NIR is now well above the program floor. If the balance of payments were to strengthen further, and reverse currency substitution to continue, we would consider making foreign exchange purchases in a transparent manner to further bolster our reserve position. We therefore expect to be able to preserve our improved international reserve position and stay well above the formal target. From a medium-term perspective, reserve accumulation will enhance market confidence and enable Turkey to better withstand external shocks. As before, discretionary intervention in the foreign exchange market will be strictly limited, though the CBT stands ready to intervene to dampen excessive volatility in the foreign exchange market.

9. **We will take steps to develop deeper and more liquid foreign exchange and money markets.** The CBT has already announced a program to phase out its intermediary role as a "blind broker", beginning in March 2002, which will promote interbank markets. To encourage the development of futures markets, the Ministry of Finance has clarified that profits taxes will not be levied on daily mark-to-market profits, but on profits when the contract is closed. To encourage development of the foreign currency market, we will eliminate stamp duties on forward contracts and remove the tax on interbank foreign exchange transactions by end-May, 2002. Also by end-May, we will require withholding for interest earned through transactions intermediated by Takasbank, with a view to reducing segmentation in the interbank market. To rationalize the system of reserve requirements, the CBT has announced, effective from May 2002, increases in (i) the scope and length of the averaging of reserve requirements, and (ii) the remuneration of both Turkish lira and foreign currency reserves, linking remuneration to market rates. Remuneration will take place at less than market rates, since these are riskless assets. Many of these initiatives have been developed by a multi-agency working group, which will continue to identify measures to ensure the successful development of money and foreign exchange markets.

Financial sector reform

10. **Implementation of the recapitalization scheme for private banks is proceeding as envisaged.** Since the amended banking law took effect on February 1, the Bank Regulation and Supervision Agency (BRSA) has issued regulations and guidelines, and briefed banks and auditors about the details of the scheme. The banks' external auditors are expected to complete the targeted assessments of the banks' capital needs by end-March as scheduled. The BRSA has started the selection of third-party audit firms to carry out the second reviews, designed to verify auditor compliance with regulations and guidelines in estimating the capital needs. We expect the BRSA to appoint the auditing firms within a week (allowing us

to meet an end-March structural benchmark with minimal delay). To clarify the conditions for government support, the BRSA is preparing prototype contracts to be signed between the Saving Deposit Insurance Fund (SDIF) and the majority shareholders on the pledging of shares, share buy-backs, and the conversion of Tier–2 capital into Tier–1 capital.

11. **The operational restructuring of state banks in preparation for privatization is also moving ahead after the passage in January of the required legislation and decree.** The Joint Board of Ziraat and Halk has already taken the initial steps leading to the closure by mid-year of 827 branches (458 in Ziraat and 369 in Halk): as of March 7, 119 branches had been closed. As regards the privatization of Vakif Bank, five potential bidders have expressed interest and are conducting due diligence. Bids are expected in May.

12. **The SDIF is committed to resolving the remaining intervened banks and to ensuring transparency in its operations.** It is taking steps toward resolving the four intervened banks still under its ownership. Three potential bidders are carrying out due diligence on one of them (Toprak) and are expected to present their bids by April 9. A second bank (Bayindir) is acting as a bridge bank, and once the resolution process has been completed a decision will be made whether to sell or liquidate the bank. The resolution of the remaining two banks (Taris and Türk Ticaret) has been temporarily halted by court decisions. To promote transparency, an auditing firm has been appointed to carry out the annual audit of the SDIF, which we expect to be completed by end-April (meeting a structural benchmark), by which date the SDIF will also start presenting monthly balance sheets.

13. **To complement bank rehabilitation, we are taking steps to promote corporate debt restructuring.** The voluntary market-based framework introduced in January 2002 (the "Istanbul Approach") will facilitate restructuring of the debts of large borrowers. In support of this, a framework agreement to be jointly signed by the creditors and used as the basis for the debt workouts has been finalized, but has yet to be signed. The Production and Finance Committee, chaired by the Treasury, and with high-level representatives from government agencies and the business and banking communities, is meeting regularly. To accelerate the restructuring process, we will establish a secretariat to this committee in April. The committee will complement existing incentives by developing further measures, consistent with preserving the transparency and integrity of the bank recapitalization exercise, to catalyze banks' and corporates' participation in the "Istanbul Approach". This committee will also work with the relevant government agencies to establish by June 2002 a database to monitor corporate debt. In addition, the SDIF has announced that a private asset management company will be set up by end-August 2002, with the SDIF owning a minority share.

Other structural reforms

14. **The government is supporting growth and the reduction of inflation through major structural reforms.** In addition to our prudent fiscal policies, our efforts to restructure the banking system, reduce overstaffing in the public sector, increase the role of the private sector in the economy, and improve the business environment will promote growth and enhance price competition. The government will also undertake reforms to de-

index the economy, and lessen inflation expectations. In the ongoing negotiations on new two-year private sector wage contracts the government will, in its role as an intermediary, stress to labor unions and employers the need to reduce backward indexation. Moreover, in the first of a planned series of meetings, the Treasury, the State Planning Organization, and the CBT met in February with labor unions and employers' associations to discuss wage and price policies consistent with the 35 percent inflation target.

15. **Important steps to strengthen government finances and public sector efficiency are being taken as planned.** A more efficient public sector and a more equitable and efficient tax system are essential to pave the way for rapid growth and new productive employment creation throughout the economy. The steps we are taking include the following:

- To **rationalize employment in the public sector**, we have eliminated all open unfilled redundant positions at state economic enterprises (SEEs), and we have tentatively identified the number of redundant public workers in SEEs to be in the range of 40,000–60,000 positions. By end-April we will determine how best to meet our target of reducing the identified redundancies by one third by end-June. In parallel, we will sharpen the tentative estimate, based on aggregate analysis, by using company-specific information, and will by end-May produce final estimates. Our aim remains to reduce the redundancies by two thirds by end-October 2002 (a structural performance criterion), and to eliminate them altogether by end-June 2003. For the central government, the Ministry of Finance and the Treasury are in the process of completing an evaluation of redundancies, and will by end-September 2002 formulate an action plan to address them. The process aiming at improved public sector efficiency has been underway since last September, and good progress has been possible through voluntary retirement of workers receiving the severance payments they are entitled to. We will continue with this strategy, and will rely on layoffs only when necessary.

- The first phase of **tax reform**, focusing on simplifying indirect taxation, will soon be fully in place. This phase will also include initial steps to reduce distortions associated with the taxation of interest income, and rationalize taxes on financial transactions. In particular, we will reduce disparities among the withholding tax rates on deposits. We are preparing the necessary draft legislation, and expect parliament to adopt the legislation in April. Further steps to rationalize the taxation of financial transactions will be taken in the second phase of our tax reform program this fall.

- We have identified key actions to be taken during 2002 to **reform the revenue administration**. By end-July, we will institute an audit coordination unit in the Ministry of Finance, and require that it produce a coordinated audit plan for the following year by end-November (completion of the first such plan by November 2002 is a new **structural benchmark**). By end-September, the Minister of Finance will adopt a strategy to strengthen the collection of outstanding public sector tax arrears (a new **structural benchmark**). In the budget for 2003, we will provide resources to increase the number of auditors by 400 to move toward OECD standards (inclusion of such resources in the draft budget submitted to parliament is a new **structural benchmark** for October 17). Finally, to help overhaul our revenue administration in the medium term, we will implement a functional reorganization, beginning at end-June.

- To **strengthen expenditure management**, we have consolidated revolving funds, reducing their number by 589, and completed our survey of end-2001 expenditure commitments in excess of appropriations (with these actions, we have met two structural benchmarks). To enable us to monitor and address commitments on a regular and timely basis, we will from now on conduct such surveys twice a year (as of end-June and end-December), with the aim of having the results available within six weeks after the end of each period. We have also completed all the preparatory work to establish an independent procurement agency (an end-March structural benchmark), and expect the board of the agency to be appointed shortly, following the issuance of an enabling regulation.

16. **As market conditions have improved, we will give privatization new impetus.** In March, we completed the second public offering of shares in POAŞ (petroleum distribution company)on schedule, raising US$167 million for 16.5 percent of the shares in the company. We are also preparing for the third equity offering of TÜPRAŞ (petroleum refinery), aiming to close this deal by end-June depending on market conditions. We plan to offer a minimum 16 percent stake, which would bring TÜPRAŞ under majority private ownership. In addition, restructuring and corporatization studies regarding TEKEL's tobacco and alcohol entities and the determination of SEKER's (sugar company) privatization strategy are underway. A privatization plan for Türk Telekom will be adopted by the Council of Ministers in April as planned. Following the Constitutional Court decision regarding the pending transfer of operating rights (TOOR) contracts, we will determine which, if any, investors are eligible for Treasury guarantees and inform by end-June 2002 those eligible of the amendments needed to bring the contracts in compliance with the license regulations of the Energy Market Regulation Agency and the Electricity Markets Law. With the exception of these eligible projects, the government will transfer all state-owned thermal generation and electricity distribution assets under the scope of privatization by end-July 2002. Moreover, the eligible contracts for which the financial arrangements have not been finalized by end-January 2003 will be cancelled, and the related assets transferred under the scope of privatization by end-February 2003. As regards pre-privatization restructuring, the Privatization Administration has merged two maritime companies under its portfolio and decided to merge another four companies with Sumerholding. Moreover, one tourism company will be liquidated shortly. As a result of these steps, we expect significant savings in operating and overhead costs.

17. **We are continuing efforts to improve the business environment.** We have prepared legislation reducing the number of documents needed to obtain investment incentives, implemented an employee code of ethical conduct for customs, and submitted to the Council of Ministers legal amendments to strengthen the Turkish Patent Institute. Also, we have started the preparation of a new Law on Foreign Direct Investment and legal

documents facilitating hiring, including of foreign personnel. Moreover, an Investor Relations Office was set up within the Treasury in February, and this office will open an interactive website in April. Finally, to promote Turkey as an investment destination and learn from international perspectives we have scheduled the inaugural meeting of the Investor Council for July 2002. Once established, we foresee that the Council, consisting of top-level officials of major international corporations, will meet annually.

18. **Transparency in the public sector will be improved through a phased implementation of our action plan.** On February 13, the Council of Ministers adopted a decree spelling out an action plan to enhance transparency and good governance. This plan is part of a broader public sector reform effort, encompassing also public expenditure management and civil service reform. To oversee the implementation of this plan, a Ministerial Steering Group for public sector reform, as well as a subcommittee to provide support to the Steering Group in implementing the action plan to enhance transparency and good governance, will be established by end-April 2002 (a new **structural benchmark**). We will accelerate the ongoing work in public administration reform and define additional conditionality in this area in later program reviews. In the meantime, we have defined the following steps to improve transparency:

- publication of (i) the above-mentioned action plan to enhance transparency and good governance, and (ii) the Report on the Observance of Standards and Codes (ROSC) on the quality of economic data, carried out in consultation with the IMF;

- improvement of the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators by end-2002 (a new **structural benchmark**); and

- increase in access to information, through the preparation of an Information Act, defining the rights of citizens to request information and the obligation of public organizations to provide information by end-2002.

19. **In the context of an IMF safeguards assessment, which is required for new Fund-supported programs, we have formulated a plan that will further improve the transparency and effectiveness of the CBT's control, accounting, reporting, and auditing systems.** With effect from 2001 financial statements, the CBT will publish audited financial statements consistent with IAS. Starting with the 2002 financial statements, the CBT will clarify disclosures of the Fund position and the relationship with the Treasury, and limit the amount of profits available for distribution to realized profit, less unrealized losses. The CBT will expand the role of its existing audit committee, and from now on, when mandating an external audit firm, will include among the duties of the external auditor to issue a report reviewing the consistency between the program data reported to the IMF (specifically covering base money, net international reserves, and net domestic assets) and the audited financial statements. In this regard, by May 15, 2002 the CBT will ask the existing audit firm to prepare such a report, and will issue it by July 15, 2002 (a new **structural performance criterion**). Also by May 15, 2002, the CBT and Treasury will issue

a Memorandum of Understanding to clarify the Treasury/CBT relationship with the Fund. Moreover, the CBT will reorganize by end-2002 the internal audit function. To this end, it will (i) adopt a new charter, which will detail the mission, scope, accountability, independence, responsibility, and authority of the audit function in line with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors. The CBT will also (ii) formulate an implementation plan identifying staffing levels, reporting lines, scope of audits, risk assessment methodologies, and developing an internal audit manual and training programs (measures (i) and (ii) constitute a new **structural performance criterion**). For the purposes of the safeguards assessment, an internal audit of foreign exchange management and program data as of end-2002 will be conducted by May 15, 2003 (a new **structural benchmark**).

20. **Finally, we continue to receive support for the structural and social components of our program from the World Bank.**

Very truly yours,

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

Turkey: Quantitative Performance Criteria and Indicative Targets Relevant for the First Review

	Ceiling/Floor	Outcome
	January 31, 2002	
I. Performance criteria		
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira) 1/	9,802	13,153
	February 28, 2002	
2. Ceiling on contracting or guaranteeing of new external public debt (in millions of US$)	6,500	1,645
3. Ceiling on the stock of public short-term external debt outstanding (in millions of US$)	1,000	0
4. Floor on level of net international reserves (in millions of US$)	-6,500	-4,907
5. Ceiling on base money (in trillions of Turkish lira) 2/	8,250	7,823
II. Indicative targets		
	January 31, 2002	
1. Floor on the cumulative overall balance of the consolidated government sector (in trillions of Turkish lira)	-32,448	-33,564
	February 28, 2002	
2. Ceiling on the stock of net domestic assets of the CBT 2/ (in trillions of Turkish lira)	26,100	24,318

1/ For January 31, 2002, the ceiling applies to the cumulative primary expenditure of the central government since January 1, 2001. For the other test dates, the starting date is January 1, 2002.

2/ Target calculated as the four working day average of February 11-12 and March 11-12, 2002, to take account of the transitory impact of the Bayram religious holiday on currency demand.

STRUCTURAL POLICIES, 2002–04

Action	Type	LOI Para[1/]	Status, April 2, 2002
Fiscal policy			
1. Implement all further measures to reach the 6.5 percent primary surplus target that are technically feasible to put in place in January:	PA for SBA	13	
(i) Council of Ministers to approve a reduction in the share of central government tax revenues accruing to metropolitan municipalities to 4.1 percent			***Done.***
(ii) issue a circular to implement attrition rules			***Done***.
(iii) the Minister of Finance to approve a reallocation of spending to ensure adequate funding for DIS for agriculture			***Done***.
2. Increase the PCT (on items excluding natural gas) by 1 percent in real terms in early February		14	***Not done.*** Increase was equal to January WPI inflation.
3. By end-March 2002, (i) the Ministry of Finance to identify savings from closing regional administrations and other regional line agency offices, and block relevant budget appropriations in the budget, and (ii) SEEs to approve budgets in line with the cost reductions mandated	BM	14	***Underway***. (i) In March, savings from closing regional administrations and other regional line agency offices were identified, and relevant budget appropriations were blocked in the budget. A decree regarding closure of regional administrations and other regional line agency offices is expected to be issued shortly. (ii) Most SEEs have approved budgets in line with cost reductions mandated, and the others have been instructed to correct their budgets. Treasury auditors will monitor implementation.
4. Keep investment expenditure in SSK at the level originally planned in the investment program for 2002, implement generic drug purchase program in ES by end-April, and receive profit transfer of TL 180 trillion from Ziraat Bank		5 of April 2002 LOI	
5. Refrain from introducing any new tax exemptions or incentives, except those specified in the tax reform plan		14	***Not fully complied with.*** Payroll and personal income tax deferments were introduced in March 2002 as part of an effort to stimulate employment.

Action	Type	LOI Para[1/]	Status, April 2, 2002
6. Refrain from introducing any new discounts or exemptions for SEEs, except those pursued for commercial reasons by enterprises' managements		14	***Done.*** The president approved Law No:4736 on January 18, 2002 preventing any new discounts or exemptions for SEEs.
Public debt management			
7. Continue to lengthen average maturity in Treasury bill auctions and public offerings to the extent demand allows and encourage a diverse range of investors		18	***Underway.***
8. Resume in January 2002 the program of FRN auctions. Before the first issue publicize a revised standard method of price and yield calculations, in line with international practice		19	***Done.***
9. Reintroduce a primary dealer program by end-September 2002	BM	19	***Underway.*** Discussions with candidate primary dealers are taking place.
10. Continue to issue, subject to market conditions, domestic FX denominated and FX indexed bonds, as well as international bonds		19	***Underway.*** Taking into account redemptions and market conditions, FX denominated and FX indexed securities will be issued.
11. The Treasury to conduct a study of its operational mechanisms, procedures, and structure to improve its risk and debt management, including through closer coordination between domestic and international borrowing. The recommendations of this study will be implemented by mid-2002		19	***Underway.*** As an interim step the new Debt Management Law calls for the establishment of a middle office in the Treasury in charge of developing overall debt strategy and managing risk.
12. Issue in June government communiqué that spells out details of the operations of the middle office that will formulate overall public debt strategy		6 of April 2002 LOI	
13. The Treasury to develop its cash management operations, acting in coordination with the CBT		19	***Underway.*** The new Debt Management Law includes a clause calling for the preparation of technical infrastructure for cash management operations in coordination with the CBT.

Action	Type	LOI Para[1/]	Status, April 2, 2002
14. The Treasury to intensify its dialogue with the full range of investors, including bilateral contacts and group discussions with institutional investors and intermediaries, and enhanced retail outreach		19	***Underway.*** With the target of broadening the investor base, discussions are ongoing on the conditions of a security which is planned to be issued for insurance companies. A series of meetings has been started with private banks, which will provide feedback about market developments and specific concerns banks have.
Monetary and incomes policy			
15. Ensure that any new laws or regulations do not undermine the independence enshrined in the CBT law		21	***Done.*** All new laws and regulations are consistent with CBT independence.
16. CBT to continue its technical preparations for the introduction of inflation targeting, including improved modeling and forecasting of inflation		22	***Underway.*** Work ongoing at the CBT covers short- and near-term forecasting, and development of the data base.
17. Move to inflation targeting		22	***Preparations underway.*** In addition to progress in establishing the necessary technical infrastructure (see item 16 above), favorable developments in disinflation and inflation expectations, fiscal policy, and the banking sector are expected to allow the pre-conditions for formal inflation targeting to be met by mid-2002.
18. Seek a significant reduction of the ex-post indexation element contained in current wage contracts during the next public worker collective bargaining round and civil service salary adjustment, and use the Economic and Social Council as a forum for incomes policy discussions with the private sector		23	***Underway.*** An exploratory meeting between labor unions and the authorities to achieve this goal was held in February.
19. a. Consider the possibility of reducing backward indexation of administered prices without compromising SEEs' financial conditions		23	***Partially done.*** Most SEE prices have not been changed monthly during 2002 but rather at discrete intervals in line with WPI; the exception is energy prices which are closely tracking world market prices.

Action	Type	LOI Para[1/]	Status, April 2, 2002
b. In the ongoing negotiations on new two-year private sector wage contracts the government to stress to labor unions and employers the need to reduce backward indexation		14 of April 2002 LOI	
20. Encourage a successful conclusion by end-February 2002 of banks' discussions to establish interbank borrowing reference rates in Turkish lira out to at least three-month maturity to enhance money market liquidity and transparency, and to provide accurate reference rates for financial instruments		25	***Underway.*** A working group established under coordination of the Banks Association is discussing proposals, and measures are being introduced to deepen the interbank money market. Reference rates are evolving but will depend on increased market activity along the yield curve.
21. The CBT to gradually end its practice of acting as a blind broker during 2002		25	***Underway***. The phasing out by end-2002 has been announced by the CBT.
22. Working group to facilitate the development of financial markets to identify concrete actions by end-January 2002 in the areas of taxation, accounting, and regulation. The first measures will be put in place by end-February 2002		25	***Underway***. Interagency committee chaired by CBT with membership from Banks Association of Turkey, BRSA, MOF and ISE, established and has held two meetings. Taxation of revaluation profits clarified in February, and prudential rules on market risks effective since January.
23. The Privatization Agency to authorize companies in its portfolio to transact their foreign exchange business at the market rate (not at the CBT official rate). The oil and gas companies (TÜPRAŞ and BOTAŞ) to work with state banks to improve their foreign exchange practices, to minimize lumpy transactions in the foreign exchange market		25	***Done.***
24. To encourage development of the foreign currency market, eliminate stamp duties on forward contracts and remove the tax on interbank foreign exchange transactions by end-May 2002		9 of April 2002 LOI	***Underway***. A preliminary meeting between MoF, BRSA, CMB and CBT was held on March 26.
25. Require as of end-May withholding of interest earned through transactions intermediated through Takasbank		9 of April 2002 LOI	

Action	Type	LOI Para[1/]	Status, April 2, 2002
26. To rationalize the system of reserve requirements the CBT, effective from may 2002, to (i) increase the scope and length of the averaging of reserve requirements, and (ii) increase the remuneration of both Turkish lira and foreign currency reserves, linking remuneration to market rates		9 of April 2002 LOI	***Done.*** The communiqués on required reserves and liquidity requirement were issued in the Official Gazette on March 29, 2002, and will be effective on date of issue starting from the tables dated May 10, 2002.
27. Multi-agency working group to continue to identify measures to ensure the successful development of money and foreign exchange markets		9 of April 2002 LOI	***Underway.*** Multi-agency working group chaired by the CBT with the participation of Bankers' Association of Turkey, BRSA, MOF, ISE, IGE, Treasury, and CMB has held two meetings related to the development of the derivatives markets and TL reference rate fixing. Taxation and accounting problems of the futures transactions have been addressed by the MOF and BRSA, respectively.
Banking reform			
28. Pass necessary legal amendments, and issue a Council of Ministers Decree for staff reductions in state banks	PA for SBA	28	***Done.***
29. By end-June 2002, reduce the number of state bank branches by 800. In this context also reduce staffing correspondingly	PC	28	***Underway.*** The process has been initiated, and the number of staff will be gradually reduced by the targeted number by June 2002.
30. For Vakif Bank privatization, bids to be invited from potential investors in May		28	***Underway.*** Five potential bidders have expressed interest and are conducting due diligence; potential bidders are waiting for the audit results being carried out under the new public support scheme. Bids are expected in May.
31. BRSA to issue guidelines for targeted evaluations of private banks in preparation for the public support scheme for private banks	PA for SBA	30	***Done.***
32. The targeted evaluation of loan portfolios, collaterals, and certain other exposures to be performed by banks' existing external auditors to be completed by end-March		30	***Underway.*** Necessary regulations are in place in accordance with Banking Law No. 4389, provisional Article 4. Audit process is underway.

Action	Type	LOI Para[1/]	Status, April 2, 2002
33. Third-party auditing firms to be appointed by the BRSA by end-March 2002 to verify that the guidelines have been followed, and to ensure the integrity of the process	BM	30	***Underway.*** Regulation on third-party reviews was published in Official Gazette on March 27, 2002. Selection process of auditing firms has been initiated, and letters for initiating third-party reviews has been sent to external auditors.
34. a. The BRSA to (i) complete the final interpretation of the evaluations by end-April and (ii) send letters to banks stipulating required actions on the basis of this interpretation by May 15	PA for second review (action # (ii))	30, 31	
b. Evaluation results to be fully incorporated into banks' end-June 2002 financial statements			
c. Banks to apply for participation in the scheme before end-May 2002			
d. Recapitalization scheme to be completed before end-June 2002			
e. The BRSA to prepare prototype contracts to be signed between the Saving Deposit Insurance Fund (SDIF) and the majority shareholders on the pledging of shares, share buy-backs, and the conversion of Tier-2 capital into Tier-1 capital		10 of April 2002 LOI	
35. The legal framework and related regulations for the public support scheme for private banks to become effective in January 2002	PA for SBA	32	***Done.***
36. The BRSA to undertake legal consultations, as necessary, to ensure implementation of the public capital support scheme as planned		32	***Done.***
37. Resolve by end-2001 all banks taken over by the SDIF before November 2001, with the exception of two banks whose resolution has been halted by courts	PA for SBA	33	***Done.***
38. Determine final resolution method for the medium-size bank taken over in November 2001 by February 2002		33	***Done.*** The bank was offered for sale on January 31, 2002. Three potential bidders have expressed interest and are conducting due diligence. Bids are due by April 9, 2002.
39. The SDIF to prepare a monthly balance sheet starting end-March 2002 and become subject to annual external audits; the external audit for 2001 will be completed by end-April 2002	BM (the latter action)	34	***Underway.*** Agreement with audit firm has been signed. External audit will be started in early April 2002.
40. Laws and regulations regarding loan classification, loan loss provisioning, and collateral valuation will be amended as necessary following the portfolio reviews by end-June 2002		35	***Underway.*** Will be done under the framework of Istanbul Approach if needed.

Action	Type	LOI Para[1/]	Status, April 2, 2002
41. Pass legal amendment in January 2002 to eliminate with immediate effect the existing four-year transition rule for loan loss provisioning	PA for SBA	35	***Done.***
42. Start trial implementation of new accounting system [for banks] in line with IAS in January 2002	PA for SBA	35	***Done.***
43. Following the trial implementation the BRSA to evaluate the experience and issue by end-June 2002 a revised regulation on the new accounting standards to ensure that banks' end-2002 balance sheets comply with IAS	PC for end-June	35	
44. Improve reporting requirements based on the findings of the independent assessments, and strictly enforce the quality and timeliness of the reporting as of end-June 2002		35	
45.a. Off-balance sheet repos to be included on balance sheet as of February 1, 2002		35	***Done.***
b. Capital charges for market risks to be calculated on a solo basis as of January 1, 2002 and on a consolidated basis as of July 1, 2002			
c. Regulation on monitoring of internal control and risk management systems to become effective January 1, 2002			
Corporate debt restructuring			
46. Introduce in January 2002 a voluntary market-based framework (the "Istanbul Approach") for dealing case-by-case with multicreditor exposures to large and medium-size borrowers		36	***Underway.***
47. Create in early 2002 a multiagency Coordination Committee with private sector participation under the Treasury, responsible for facilitating and monitoring the corporate debt restructuring process, as well as identifying and proposing the removal of impediments that may exist		36; 13 of April 2002 LOI	***Not done.*** Work to be carried out by the Production and Finance Committee chaired by the Treasury.
48. Establish secretariat to the Production and Finance Committee in April		13 of April 2002 LOI	
49. Production and Finance Committee to develop further measures, consistent with preserving the transparency and integrity of the bank recapitalization exercise, to catalyze banks' and corporates' participation in the "Istanbul Approach"		13 of April 2002 LOI	
50. Production and Finance Committee to work with the relevant government agencies to establish by June 2002 a database to monitor corporate debt		13 of April 2002 LOI	***Underway.*** The CMB has issued the regulation on the reporting requirements. Firms are expected to start reporting in June 2002.

Action	Type	LOI Para[1/]	Status, April 2, 2002
51. A private asset management company will be set up by end-August 2002, with the SDIF owning a minority share		13 of April 2002 LOI	*Underway.* The authorities have requested technical assistance for drafting a proposal for potential investors.
52. The Ministry of Justice to prepare an action plan based on the findings of a World Bank Report on Standards and Codes (ROSC) on Turkey's insolvency regime and form a Commission to prepare necessary amendments to the Bankruptcy Law		37	*Underway.*
53. Support the upgrading administrative procedures in the judiciary to improve the capacity of the courts		37	
54. The CMB to introduce international accounting standards, including inflation accounting provisions, by January 1, 2003.		38	*Underway.* The CMB has issued the regulation. Firms are taking steps to adopt the new accounting framework. It is expected that many firms will start accounting under the new rules in June 2002.
55. Starting end-March 2002, the CMB to require corporate groups to provide consolidated financial statements and to set up a dedicated group to monitor their finances		38	*Underway.* The CMB has issued the regulation.
56. Starting end-March 2002, the CMB to require corporate groups with financial affiliates to provide consolidated group statements and share those statements with the BRSA		38	*Underway.* The CMB has issued the regulation. The Accounting Standards and Corporate Finance departments of the CMB will monitor the accounts.
Public sector reform			
57. Parliament to approve Public Procurement Law in line with UN (UNCITRAL) standards in January 2002	PA for SBA	40	*Done.*
58. Establish an independent procurement agency by end-March 2002	BM	40	*Underway.* All the preparatory work has been completed, and the board of the agency will be appointed shortly, following the issuance of an enabling regulation.
59. Change laws and regulations to make them consistent with the new public procurement framework		40	
60. Parliament to amend the Public Procurement Law by end-May 2002, to (i) bring the real value of the thresholds toward those in line with international best practice and (ii) extend the minimum time period for procurement applicable for cases below the thresholds	PA for second review	40	

Action	Type	LOI Para[1/]	Status, April 2, 2002
61. Compile a comprehensive list of public investment projects to be phased out in time to make decisions for the 2003 budget		40	*Underway.* Rationalization of public investment program will continue in 2003 within the framework of a High Planning Council Decision. The Decision will be communicated to spending agencies with 2003 Investment Circular in June 2002. Then, the list will be compiled concurrently with 2003 investment programming process that will be finalized by end-2002.
62. Approval by Council of Ministers in January 2002 of plan to reform the tax system	PA for SBA	40	*Done.*
63. Enact the first phase of the tax reform plan by end-April 2002	BM	40; 15 of April 2002 LOI	*Underway.* Draft Special Consumption Tax Law (implementing indirect tax changes) has been prepared, and the World Bank and the Fund have provided comments. In addition, disparities among the withholding tax rates on deposits will be reduced.
64. Submit to parliament legislation for the second phase of the tax reform plan by end-October 2002	BM	40	*Underway.* A World Bank technical assistance mission is expected in April.
65. Reorganize tax administration in line with the study carried out with the World Bank:		40 and 15 of April 2002 LOI	*Underway.*
a. By end-July, institute an audit coordination unit in the Ministry of Finance, and require that it produce a coordinated audit plan by end-November each year	BM (first such plan by Nov 2002)		
b. By end-September, the Minister of Finance to adopt a strategy to strengthen the collection of outstanding public sector tax arrears	BM		
c. In the budget for 2003, include resources to increase the number of auditors by 400 (for October 17) to move toward OECD standards	BM		
d. To help overhaul the revenue administration in the medium term, implement a functional reorganization, beginning at end-June			
66. Council of Ministers to adopt a civil service reform strategy by end-2002		40	

Action	Type	LOI Para[1/]	Status, April 2, 2002
67. As part of the preparatory work for item 66, by end-March 2002 establish a ministerial committee to carry out a functional review of government, which will be completed by end-September 2002		40	***Underway.*** A commission to coordinate necessary work will be established in line with the CoM decision dated February 4, 2002.
68. By end-September, have in place an integrated system to monitor total general government and SEE employment levels on a quarterly basis	BM	40	***Underway.*** A circular (dated December 14, 2001, No. 94997) has been sent to SEEs; monitoring of SEE employment levels will start on a quarterly basis as of March.
69. 15,000 individuals (public sector workers) to have been retired or notified of their retirement by mid-January 2002	PA for SBA	41	***Done.***
70. By end-January 2002,	PAs for first review		
(i) identify all redundant workers and positions in SEEs		41	(i-ii) ***Underway.*** Preliminary estimates by SEE management and unions fall short of WB estimates; work to reconcile the numbers is underway, at which point specific redundant positions in SEEs will be identified.
(ii) sharpen tentative estimate based on aggregate analysis, by using company-specific information and by end-May produce final estimates		15 of April 2002 LOI	
(ii) eliminate all open, unfilled redundant positions		41	***Done.*** Treasury has sent a circular (No:4654/4655) to SEEs requesting the elimination of 90–100 percent of their open positions. There will be no open, unfilled redundant positions in SEEs as of end May 2002.
71. Extend voluntary retirement offers to the recently identified redundant workers in Türk Telekom and in the Privatization Agency portfolio of companies; for those who accept, provide payments, and allow them to retire, no later than end-March 2002		41	***Underway.*** 3,635 out of 7,477 applied have retired so far and rest were expected to have retired by end-March 2002 for Turk Telekom. Work on assessment of redundant workers is proceeding with the World Bank, and the retirement offer remains open.
72. Through voluntary retirement offers, and layoffs only when necessary, reduce the number of redundant workers by one-third by end-June, and cumulatively by two-thirds by end-October 2002	PC (the Oct action)	41	

Action	Type	LOI Para[1/]	Status, April 2, 2002
73. By end-June 2003, phase out the remaining redundancies		41	
74. The Ministry of Finance and the Treasury to formulate by end-September 2002 an action plan to address redundancies in the central government		15 of April 2002 LOI	
75. Audit SEE compliance with this program on a quarterly basis		41	*Underway.* Treasury Controllers will be responsible for auditing.
76. To strengthen the legal framework for fiscal policy pass the Law on Public Debt Management and issue two supporting communiqués	PAs for the first review	42	*Underway.* The law has passed by parliament on March 28, and the supporting communiqués are being prepared.
77. Submit to parliament by end-June 2002 a Law on Financial Management and Internal Control consistent with best international practices	BM	42	*Underway.* A strategy regarding the Law on Financial Management and Internal Control has been sent to the Auditing Working Group and discussed at a meeting on February 5, 2002. Moreover, a seminar was organized in March to ensure consistency with EU practices.
78. Close, by end-March 2002, 548 additional revolving funds	BM	42	***Done.***
79. Incorporate in the draft budget for 2003 the revenue and expenditures under Law 3418	BM for Oct 17, 2002)	42	
80. Eliminate the earmarking under Law 3418 and Law 4306		42	
81. Amend by July 2002 the governing legislation for the remaining EBFs to require passage of their budgets by parliament, external audit of their accounts (reported to parliament), and monthly reporting of their accounts, on a consolidated basis, with the central government's accounts	BM	42	
82. Eliminate the remaining budgetary fund (the Support Price and Stabilization Fund) in three years, when the World Bank's Agricultural Reform Implementation Project ends		42	
83. In the draft 2003 budget to be submitted to parliament (i) include net lending as an appropriation, and (ii) extend accounting and coding reforms to all consolidated budget agencies, and to general government units on a pilot basis	BMs for Oct 17, 2002)	42	*Underway.* To extend coding reforms to general government units on a pilot basis, the MoF has prepared a budget implementation circular. Studies on accounting reform are progressing as planned.

Action	Type	LOI Para[1/]	Status, April 2, 2002
84. Complete, by end-March 2002, a survey of end-2001 commitments in excess of appropriations	BM	42	***Done.***
85. To monitor and address [expenditure] commitments on a regular and timely basis, conduct surveys of commitments in excess of appropriations twice a year (as of end-June and end-December), with the aim of having the results available within six weeks after the end of each period		15 of April 2002 LOI	
86. Address the impact of public sector retrenchment through the labor redeployment and reinsertion program and through unemployment insurance		42	***Underway.*** Unemployment insurance payments started in March 2002.
Enhancing the role of the private sector			
87. The Privatization Administration (PA) to proceed with the public offerings of POAŞ by end-March 2002 and the public offering of TÜPRAŞ by end-June 2002 and launch the initial public offering for THY as soon as market conditions allow		45	***Underway.*** The second public offering of POAS was completed in March, with a 16.5 percent stake sold to foreign and domestic investors. The third public offering of TUPRAS shares is planned for the second quarter, and privatization of THY still depends on market conditions.
88. CoM to adopt a privatization plan for Türk Telekom in April 2002	PA for the second review	45	***Underway.*** A report of consultants to be finalized for Türk Telekom; road map regarding the privatization strategy will be drawn up by April 2002.
89. Parliamentary approval of Tobacco Law	PA for SBA	45	***Done.***
90. Prepare and adopt a privatization plan for TEKEL by end-September	PA for fourth review	45	***Underway.*** A restructuring study is being undertaken to provide a basis for privatization plan.
91. Proceed with the privatization of ŞEKER, with the first step being the adoption of a privatization plan by May 2002		45	***Underway.*** PA is working with other related agencies for the privatization plan of SEKER.
92. a. In the electricity sector, in January 2002, subject to legal clarification, the Council of Ministers to adopt a government decree annulling with immediate effect all the projects for which transfer of operating rights (TOOR) contracts are pending		45	***Changed.*** See item b.

Action	Type	LOI Para[1/]	Status, April 2, 2002
b. Following the Constitutional Court decision regarding the pending transfer of operating rights (TOOR) contracts, determine which, if any, investors are eligible for Treasury guarantees and inform by end-June 2002 those eligible of the amendments needed to bring the contracts in compliance with the license regulations of the Energy Market Regulation Agency and the Electricity Markets Law. With the exception of these eligible projects, transfer all state-owned thermal generation and electricity distribution assets under the scope of privatization by end-July 2002. Moreover, the eligible contracts for which the financial arrangements have not been finalized by end-January 2003 will be cancelled, and the related assets transferred under the scope of privatization by end-February 2003		16 of April 2002 LOI	
93. By March 2002, the Ministry of Energy to inform the PA which electricity assets will be privatized, and by April 2002 the prequalification tenders for the distribution companies will be launched		45	***Underway.*** Working groups have finalized their reports, and the PA is ready for the privatization of the generation and distribution assets. As soon as the distribution regions are transferred, the pre-qualification tender will be launched.
94. Complete the transfer of gas distribution companies to the PA by March 2002		45	***Underway.*** High Planning Council Decision is about to be finalized after which a Privatization High Council Decision will be sought.
95. The PA to go forward with the divesting of ETI Krom AŞ, ETI Elektrometalurji AŞ, ETI Gümüs AŞ, which are in the PA portfolio, as soon as licenses are transferred from ETI Holdings		45	
96. The PA to continue its divestment of ERDEMIR, and of tourism and fertilizer assets in its portfolio. The PA also to continue divesting its portfolio of small and medium-size companies		45	
97. Build on efforts made in 2001 (including legal amendments and simplified procedures) to increase the sale of government land. Initiate a study to evaluate how the remaining obstacles to government land sales could best be removed		45	
98. The Council of Ministers to adopt in January 2002 follow-up actions to FIAS study to make Turkey more attractive for domestic and foreign investors	PA for SBA	46	***Done***.
99. Submit to the parliament by end-May 2002 a new draft Law on Foreign Direct Investment in line with the findings of the FIAS study	BM	46	***Underway.*** FIAS study is expected to be finalized in early May, and the draft law is planned to be submitted to parliament on schedule.

Action	Type	LOI Para[1/]	Status, April 2, 2002
100. Submit to the parliament by end-March 2002 a draft law on work permits prepared by Ministry of Labor and Social Security, and issue a communiqué by end-April 2002 on the implementation procedures for employing foreign personnel employed by foreign capital companies as soon as the new law is approved by parliament		46	***Underway.*** A draft law on work permits has been submitted to parliament, and is currently with the relevant commission.
101. Complete by end-February 2002 legislation reducing the number of documents needed to obtain investment incentives		46	***Underway.*** MoF (GD of Revenues) and Treasury coordinating relevant work.
102. Establish and implement by end-February 2002 an employee code of ethical conduct for proceedings at customs		46	***Underway.*** A communiqué was issued on September 11, 2001.
103. Submit to the Council of Ministers by end-January 2002 legal amendments to strengthen the Turkish Patent Institute		46	***Underway*** **.** Draft law has been submitted to the Prime Ministry, and is expected to be opened to CoM signature soon.
104. The Council of Ministers to adopt a strategy by end-January 2002 for increasing transparency and combating rent-seeking activities	BM	47	***Done.*** Decree signed on February 13.
105. Define and include as program conditionality concrete follow-up actions for the remainder of the 2002–04 program period based on the plan in #102:		47 and 18 of April 2002 LOI	***Done.***
a. Establish by end-April 2002 a Steering Group for public sector reform, as well as a subcommitee to provide support to the Steering Group in implementing the plan to enhance transparency and good governance	BM		
b. Publish (i) the above-mentioned action plan to enhance transparency and good governance, and (ii) the Report on the Observance of Standards and Codes (ROSC) on the quality of economic data, carried out in consultation with the IMF			***Done.***
c. Improve the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators by end-2002			
d. Increase access to information, through the preparation of an Information Act, defining the rights of citizens to request information and the obligation of public organizations to provide information by end-2002	BM		
106. Establish an Investor Relations Office by February		48	***Done.***
107. Establish an Investor Council consisting of prominent business representatives from Turkey and abroad		48	***Underway.*** Inaugural meeting scheduled for July.

Action	Type	LOI Para[1/]	Status, April 2, 2002
108. Further strengthen the efforts of the of the Treasury, the CBT, and the BRSA to explain policies under the economic program in their respective areas, including through the arrangement of regular (bimonthly) press conferences by the Treasury		48	*Underway.*
Safeguards Assessment			
109. Follow-up measures in the context of Safeguards Assessment:		19 of April 2002 LOI	
a. With effect from 2001 financial statements the CBT to publish audited financial statements consistent with IAS			
b. Starting with the 2002 financial statements, the CBT to clarify disclosures of the Fund position and the relationship with the Treasury, and limit the amount of profits available for distribution to realized profit, less unrealized losses			
c. CBT to expand the role of its existing audit committee			*Underway.* The Audit Committee will meet twice a year with the external audit firm and, once established, with the internal audit department. It will also review the CBT's overall risk management practices and systems of internal control.
d. Include among the duties of the external auditor to issue a report reviewing the consistency between program data reported to the IMF (specifically covering base money, net international reserves, and net domestic assets) and the audited financial statements			
e. By May 15, 2002 the CBT to ask the existing audit firm to prepare such a report, to be issued by July 15, 2002	PC (issuance of report)		
f. By May 15, 2002, the CBT to issue a Memorandum of Understanding to clarify the Treasury/CBT relationship with the Fund.			
g. The CBT to reorganize by end-2002 the internal audit function. To this end, it will (i) adopt a new charter, which will detail the mission, scope, accountability, independence, responsibility, and authority of the audit function in line with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors, and (ii) formulate an implementation plan identifying staffing levels, reporting lines, scope of audits, risk assessment methodologies, and developing an internal audit manual and training programs	PC (measure (i) and (ii))		
i. Internal audit department to conduct an audit of foreign exchange management and program data as of end-2002 by May 15, 2003	BM		

1/ Unless otherwise noted, paragraph numbers refer to January 18, 2002 Letter of Intent.

Statement by the IMF Staff Representative
April 15, 2002

1. **This statement provides an update on economic and policy developments since the staff report (EBS/02/61, 4/4/02) was issued.** The new information does not change the thrust of the staff appraisal.

2. **The authorities have now met in substance all the outstanding structural conditions relevant for the first review:**

- **They have fully met the prior action regarding the Law on Public Debt Management.** The Law was passed by parliament on March 28 and signed by the President on April 8. Two supporting communiqués—one on government debt guarantees and the other on nonguaranteed foreign borrowing by state entities outside the central government—were issued on April 12. While this was within five days of the scheduled Board meeting, the World Bank and Fund staffs did review the regulations, and found them to be to their satisfaction.

- **Satisfactory progress has been made toward completing the prior action regarding the identification of redundancies in state economic enterprises (SEEs).** As noted in the staff report, all open, unfilled, redundant positions in SEEs have been eliminated. Based on an aggregate study the authorities have tentatively identified the number of remaining redundant workers in SEEs as 40,000–60,000. However, these estimates need further refinement. The authorities have committed themselves to producing final estimates by end-May, using company-specific information. Moreover, the authorities have reaffirmed their commitment to reduce the number of redundant workers by one third by end-June and two thirds by end-October 2002, and completely by end-June 2003. On this basis, the staff views progress in meeting this prior action as satisfactory.

- **All six structural benchmarks relevant for the first review have been met.** Three of them had been observed by the time the staff report was issued. The three remaining benchmarks have since been met, as follows. On April 10, the BRSA appointed the third-party auditing firms that are needed as part of the banking restructuring plan. On April 8, the government appointed the board of the independent procurement agency. And by April 12 all SEEs had in place budgets in line with mandated cost reductions.

3. **Market sentiment has remained quite positive, and interest rates have been reduced further on the heels of another low inflation outcome in March.** Between end-March and April 12, the Turkish lira appreciated by a further 4 percent relative to the U.S. dollar (to a shade below TL 1.3 million to the U.S. dollar), the interest rate on the benchmark treasury bill (maturing in February 2003) declined by 5 points to 57 percent, and stock prices increased by 6 percent. The favorable March inflation outcome (monthly CPI increase of 1.2 percent) helped to reduce inflation expectations further (by about 4 points, to 39 percent

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for end-2002 in the survey conducted by the CBT in early April) and prompted the CBT to reduce its overnight rate by 300 basis points on April 8, to 66 percent.

4. **The staff supports the authorities' request to waive the applicability of the end-March performance criterion on the cumulative primary balance of the consolidated government sector.** The relevant full information is not yet available. Partial data for the central government suggest that the performance criterion is likely to have been met.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/46
FOR IMMEDIATE RELEASE
April 19, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Turkey

On April 15, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Background

Turkey is in the midst of a determined campaign to turn around decades of weak performance. Not only has growth been on a downward trend since the 1970s (and inflation on an upward one), it has also become increasingly volatile. This performance reflects pervasive structural rigidities, weak public finances, and low policy credibility. Despite many achievements since the economic liberalization of the 1980s, deep-rooted structural problems remain a drag on growth, and past disinflation attempts have had little success.

The past couple of years have witnessed three major attempts at addressing underlying weaknesses. The first was during 2000 under the three-year Standby Agreement initiated in December 1999. The program instituted strong fiscal adjustment and a preannounced exchange rate crawl to restore debt sustainability and to break entrenched inflation expectations. The program also included a wide-ranging structural reform agenda—especially in banking, social security, privatization, and agriculture—to set Turkey on a higher sustainable growth path. Despite some notable achievements in structural reforms, in turning around the public sector primary balance, and in reining in inflation, a worsening current account and a

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the April 15, 2000 Executive Board discussion based on the staff report.

fragile banking system led in late 2000 to a liquidity crisis which turned into a full-blown crisis, with a large loss of reserves. Prompted by political tensions, this was followed by another speculative attack in February 2001, forcing the government to float the currency amidst high interest rates and a renewed acceleration in inflation.

The second phase was the adoption in May 2001 of a strengthened program aimed at restoring investor confidence by addressing the roots of the crises, with the help of additional IMF support. The authorities' revised program featured a fundamental restructuring of the banking sector (a key source of vulnerability in the past), a commitment to a floating exchange rate (reducing vulnerability to shocks), continued disinflation, substantial fiscal adjustment to underpin debt sustainability, and an enhanced role for the private sector. Just as the revised program was beginning to show results, the events of September 11 triggered a deterioration in market sentiment and a re-emergence of serious financing problems. Meanwhile, Turkey continued to suffer from an inefficient public sector, barriers to private sector development, a banking sector damaged by the earlier crises, and a high public debt burden, fuelled in part by publicly-funded bank recapitalization.

In response to September 11, the Turkish government initiated a new intensified IMF-supported program, both to protect the economy against future crises, and to continue Turkey's ambitious reform agenda. Under the 2002–04 program, the continuation of the float will limit the potential for speculative attacks. Ongoing financial sector reform together with corporate sector restructuring will help strengthen the banking and business sectors, and continued fiscal discipline should foster medium-term debt sustainability. The program's strong structural reform agenda should, once macroeconomic stabilization is achieved, finally set the stage for sustained economic growth.

Developments under the new program have been promising. Financial market conditions have improved markedly from their post-September 11 lows; the benchmark bill rate has fallen sharply, and the Turkish lira has appreciated by more than 20 percent to around TL 1.3 million to the U.S. dollar. Against this background, the trend toward dollarization has diminished, and even shown signs of reversal in recent months, the stock market has risen by over 50 percent in lira terms since mid-September, and the roll-off of external interbank credits has ceased. Short-term concerns about the public debt rollover have also largely abated, allowing a lengthening of maturity of domestic debt and strong demand for new Eurobond issues. Inflation has started to decline, helping to reduce inflation expectations and allowing the Central Bank of Turkey (CBT) to reduce the overnight rate by 14 points (to 66 percent) in three steps over the past two months.

A large number of policy measures have been taken under the new program. In January, the authorities met more than ten prior actions in the fiscal and structural areas needed for the approval of the SBA. Subsequently, all quantitative performance criteria relevant for the first review were met. Base money came in below the end-February ceiling, while Net International Reserves and Net Domestic Assets targets were met comfortably. The public sector primary surplus target of 5.5 percent of GNP for 2001 was exceeded by an estimated 0.4 percent of GNP, and in January the consolidated government sector exceeded its primary surplus target comfortably. Solid progress has also been made in meeting the program's structural conditionality.

Executive Board Assessment

Executive Directors welcomed the Turkish authorities' decisive efforts to address the problems of the past and implement an ambitious economic reform program to lay the basis for sustainable growth. In the past, financial indiscipline and structural weaknesses had prevented Turkey from realizing its economic potential, and had created an environment of highly volatile growth and inflation spanning several decades. These problems had their roots in fiscal laxity, deficiencies in governance, lack of a nominal anchor, and inefficiencies and nontransparencies in the public sector, and were evident in barriers to private sector development and a banking sector damaged by the two recent crises. Directors welcomed the Turkish authorities' progress in addressing these weaknesses and reduce the vulnerability of the economy to shocks through their bold three-year program. They noted that the program represents a further decisive step away from the interventionist policies of the past, and that it would lay the groundwork for a stronger performance in the future.

In this regard, Directors commended the authorities for maintaining the positive momentum of macroeconomic adjustment and structural reform established in response to the events of September 11. Macroeconomic policies have remained prudent; and the government has continued to press ahead with structural reform, notably with respect to the identification of public sector staffing redundancies and the adoption of the legislative basis for improved public debt management. The authorities' efforts have been rewarded by a substantial decline in interest rates, a strong balance of payments position with an associated appreciation of the Turkish lira, and a drop in inflation and in inflation expectations.

Directors noted that, while these positive results should help lay the basis for sustainable growth, there are downside risks. In particular, they emphasized that the strength and timing of the recovery in output are uncertain, and that financial markets have remained alert to the possibility of further shocks. Directors expressed concern that prolonged slow economic growth would have an adverse impact on Turkey's debt sustainability. To boost growth, they emphasized the importance of structural reforms to raise private investment and productivity and to lower real interest rates. Directors stressed that successful program implementation in the months ahead will require the undivided support of the government coalition.

Directors stressed that, although fiscal developments remain on track, strict budget implementation must continue in order to ensure a sustainable debt position. While commending the authorities' commitment to the target of a public sector primary surplus of 6.5 percent of GNP in 2002, they stressed the need to remain mindful of possible downside risks, and urged the authorities to stand ready to take further offsetting measures to safeguard the primary surplus target and maintain external debt sustainability.

Directors noted that, to be sustainable, the achievement of the overall budget targets will need to be underpinned by decisive reforms. They were encouraged by the government's efforts to improve expenditure management, streamline tax policy, and strengthen revenue administration. On the tax side, they stressed the importance of simplifying the tax code. On the expenditure side, they noted the importance of moving expeditiously with the much-needed downsizing of the state economic enterprises and civil service reform.

Directors noted the increasing scope for monetary policy to promote disinflation and enhance confidence. In this regard, Directors were encouraged by the recent decline in current and expected inflation. The introduction of inflation targeting will further anchor inflation expectations. While a number of Directors noted that, with strong efforts by the CBT and the government, the preconditions for introducing formal inflation targeting could be in place by midyear, some other Directors considered that a longer track record on disinflation would be needed for such a framework to be credible. Regarding reserve management, they urged the CBT to continue to make use of the better-than-expected balance of payments developments to build up foreign exchange reserves, which should further improve confidence, and welcomed the authorities' recent move to pre-announced foreign exchange purchase auctions. They urged further development of the money and foreign exchange markets to help ensure a smoother functioning of the floating exchange rate regime, and welcomed the authorities' plans to lower distortionary taxes and reform the system of reserve requirements. They also stressed the need to closely monitor Turkey's external competitiveness in light of the recent appreciation of the Turkish lira.

Directors welcomed the progress in banking sector reform, including the implementation of the bank recapitalization plan, but called for further rapid movement on corporate debt restructuring. Moving forward, Directors stressed the importance of preserving the integrity and transparency of the bank recapitalization process, and of sticking to its announced timetable. They also underlined the need to maintain the independence of Turkey's regulatory institutions. Directors urged the authorities to accelerate privatization now that market conditions are more favorable, noting that inefficiencies in state economic enterprises are a core factor behind Turkey's disappointing growth performance in the last decade. Similarly, Directors urged the government to be forceful in demonstrating its commitment to dealing with deficiencies in the investment environment and promoting transparency and efficiency of public administration both at the central and local levels. Directors welcomed the measures taken to combat money laundering and the financing of terrorism.

Directors commended recent moves to improve transparency and data provision. Although some deficiencies remain in fiscal statistics, they welcomed the recent extensive improvements in fiscal transparency.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Table 1. Turkey: Selected Indicators, 1999-2004

	1999	2000	2001	2002	2003	2004
Real Sector			(In percent)			
Real GNP growth rate	-6.1	6.3	-9.4	3.0	5.0	5.0
GNP deflator	55.8	50.9	57.8	53.2	24.4	13.1
Nominal GNP growth rate	...	60.4	42.9	57.8	30.7	18.8
WPI (12-month, end-of-period)	62.9	32.7	88.6	31.0	16.2	12.0
CPI (12-month, end-of-period)	68.8	39.0	68.5	35.0	20.0	12.0
Average nominal treasury bill interest rate	106.2	38.0	99.1	65.6	46.0	38.1
Average ex-ante real sector interest rate 1/	32.0	-9.5	31.1	30.8	27.5	20.0
Central government budget			(In percent of GNP)			
Primary balance 2/	1.5	4.2	4.6	5.3	5.6	5.6
Net interest payments 3/	13.1	15.8	21.8	19.0	17.3	13.5
Overall balance	-11.6	-11.6	-17.2	-13.7	-11.7	-7.8
Consolidated Public Sector						
Primary balance	-2.0	2.3	5.9	6.5	6.5	6.5
Net Interest Payments 4/	22.1	21.9	23.5	17.6	15.6	12.5
PSBR (including CBT profits)	24.1	19.6	17.6	11.1	9.1	6.0
Operational balance	-12.4	-6.9	-1.2	-3.5	-4.4	-3.0
Net debt of public sector	61.0	57.4	93.3	77.2	69.7	65.7
Net external	20.1	18.3	36.8	33.4	29.2	27.1
Net domestic	40.9	39.1	56.5	43.8	40.6	38.6
Net debt of public sector (in percent of centered GNP) 5/	48.6	51.3	75.7	68.6	65.1	61.7
External sector						
Current account balance	-0.7	-4.9	2.3	-1.2	-1.0	-1.1
Gross external debt	55.1	59.4	80.2	67.5	65.4	61.7
Net external debt	33.7	39.2	54.5	44.4	42.7	39.0
Short-term external debt (by remaining maturity)	20.8	23.0	22.7	18.2	17.5	17.4
Monetary aggregates						
Seignorage 5/	3.2	1.8	1.0	1.0	0.7	...
Nominal growth of M2Y broad money (in percent)	98.7	39.6	88.3	40.2	27.4	17.1
	(In billions of U.S. dollars, unless otherwise indicated)					
Privatization proceeds	0.1	3.3	2.8	1.5	2.5	1.0
Net external financing of central government	1.4	4.1	-3.7	0.0	-1.7	-1.0
Amortization	6.0	6.2	8.2	6.5	8.4	8.0
Gross borrowing	7.4	10.3	4.5	6.5	6.7	7.0
Of which: Eurobond issues	5.0	7.5	2.2	3.0	4.5	4.7
GNP	187.4	201.3	146.5	...	...	...
GNP (in quadrillions of Turkish lira)	78.3	125.6	179.5	283.2	370.1	439.5

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

1/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation. With average maturity of newly issued debt less than one year, and with FRNs paying quarterly coupons, this measure overstates the effective real interest rate when inflation is declining.

2/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds.

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

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

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

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Approves US$1 Billion Tranche to Turkey Under Stand-By Credit

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Turkey's economic performance under the three-year stand-by credit. The decision will enable Turkey to draw up to SDR 867.6 million (about US$1 billion) immediately.

The stand-by credit was approved on February 4, 2002 (see Press Release No. 02/7) in a total amount of SDR 12.8 billion (about US$16 billion). So far, Turkey has drawn SDR 7.3 billion (about US$9 billion).

After the Executive Board discussion on Turkey, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

"The Turkish authorities have made considerable progress in implementing their ambitious economic reform program. In the past, financial indiscipline and structural weaknesses had prevented Turkey from realizing its economic potential, and created an environment of highly volatile growth and inflation over several decades. The program addresses these weaknesses and should reduce the vulnerability of the economy to shocks. It represents a further decisive step away from the interventionist policies of the past, and will lay the groundwork for a more consistent economic performance in the future.

"In this regard, the positive momentum of macroeconomic adjustment and structural reform that the authorities have maintained since last fall has been encouraging. Macroeconomic policies have remained on course, and the government has continued to press ahead with structural reform. The authorities' efforts have been rewarded by a substantial decline in interest rates, a strong balance of payments position and an associated appreciation of the Turkish lira, and a drop in inflation and in inflation expectations. Despite these positive developments, downside risks remain. In particular, the timing and strength of the recovery in output are as yet uncertain, and financial markets remain alert to the possibility of further shocks. Unwavering implementation of the program with the undivided support of the government coalition is needed to bring the Turkish economy onto a sustainable growth path.

"Fiscal developments remain on track, but strict budget implementation must continue to ensure debt sustainability. While the authorities remain firmly committed to the target of a public sector primary surplus of 6.5 percent of GNP for 2002, they need to remain mindful of possible downside implementation risks, and stand ready to take further offsetting measures to safeguard the primary surplus target.

"To be sustainable, the achievement of the overall budget targets will need to be underpinned by decisive reforms in public employment and budget mechanisms. In this regard, efforts to improve expenditure management, streamline tax policy, and strengthen revenue administration are encouraging. On the tax side, it will be important to avoid complicating the tax code with additional incentives. On the expenditure side, credible estimates of overstaffing in state economic enterprises are required to lay the basis for the much-needed downsizing in this sector.

"The scope for monetary policy to promote disinflation and enhance confidence is increasing. One avenue is a move to inflation targeting, which could help further anchor inflation expectations. In this regard, recent inflation developments are encouraging. Regarding reserve management, the authorities' efforts to make use of the better-than-expected balance of payments developments to build up foreign exchange reserves through pre-announced foreign exchange purchase auctions are appropriate, and should further improve confidence. Further development of the money and foreign exchange markets is needed to help ensure a smoother functioning of the floating exchange rate regime. The authorities' plans to lower distortionary taxes and reform the system of reserve requirements are welcome. The Central Bank has made good progress in improving transparency, including through improvements in financial reporting, internal controls and in the external audit process.

"More even progress is needed in the structural areas. The progress in banking sector reform, including the implementation of the bank recapitalization plan, is welcome, but corporate debt restructuring should be accelerated. Moving forward, the integrity and transparency of the bank recapitalization process and the independence of Turkey's regulatory institutions should be maintained.

Renewed impetus should be given to privatization now that market conditions are more favorable, and the government should forcefully demonstrate its commitment to dealing with deficiencies in the investment environment and improving governance," Ms. Krueger said.