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Turkey: Eighth Review Under the Stand-By Arrangement—Staff Report; Staff Statement; and News Brief on the Executive Board Discussion

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

- the staff report for the Eighth Review Under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **June 11, 2001,** with the officials of Turkey on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 26, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **July 12,** updating information on recent economic developments.
- a New Brief summarizing the **views of the Executive Board as expressed during its July 12 discussion of the staff report that completed the review.**

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

Letter of Intent by the authorities of the member country*

*May also be included in Staff Report.

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

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INTERNATIONAL MONETARY FUND

TURKEY

Eighth Review Under the Stand-By Arrangement

Prepared by European I Department in consultation with other departments

Approved by Susan Schadler and G. Russell Kincaid

June 26, 2001

- A staff team—Messrs. Kähkönen (head), Aitken, and Piñerúa (all EU1), Mr. Mottu (FAD), Mr. Josefsson and Mmes. Basu and Cebotari (MAE), and Ms. Lim and Messrs. McGettigan and Rossi (PDR)—visited Ankara during June 1–11, 2001 to conduct discussions for the eighth review under the Stand-by Arrangement (SBA) with Turkey. The mission was assisted by Mr. Brekk, senior resident representative, and it cooperated closely with World Bank staff on structural issues.

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

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

I. Introduction

1. **In the attached letter, the authorities report on progress made and the next steps under their strengthened economic program, and request the completion of the eighth review under the SBA.** They also request modification of the ceilings for the performance criterion on the cumulative primary expenditure of the central government for the last two test dates in 2001. The modified criteria are in line with the supplementary budget adopted on June 14, which in turn is consistent with the program's targets for the public sector primary balance.

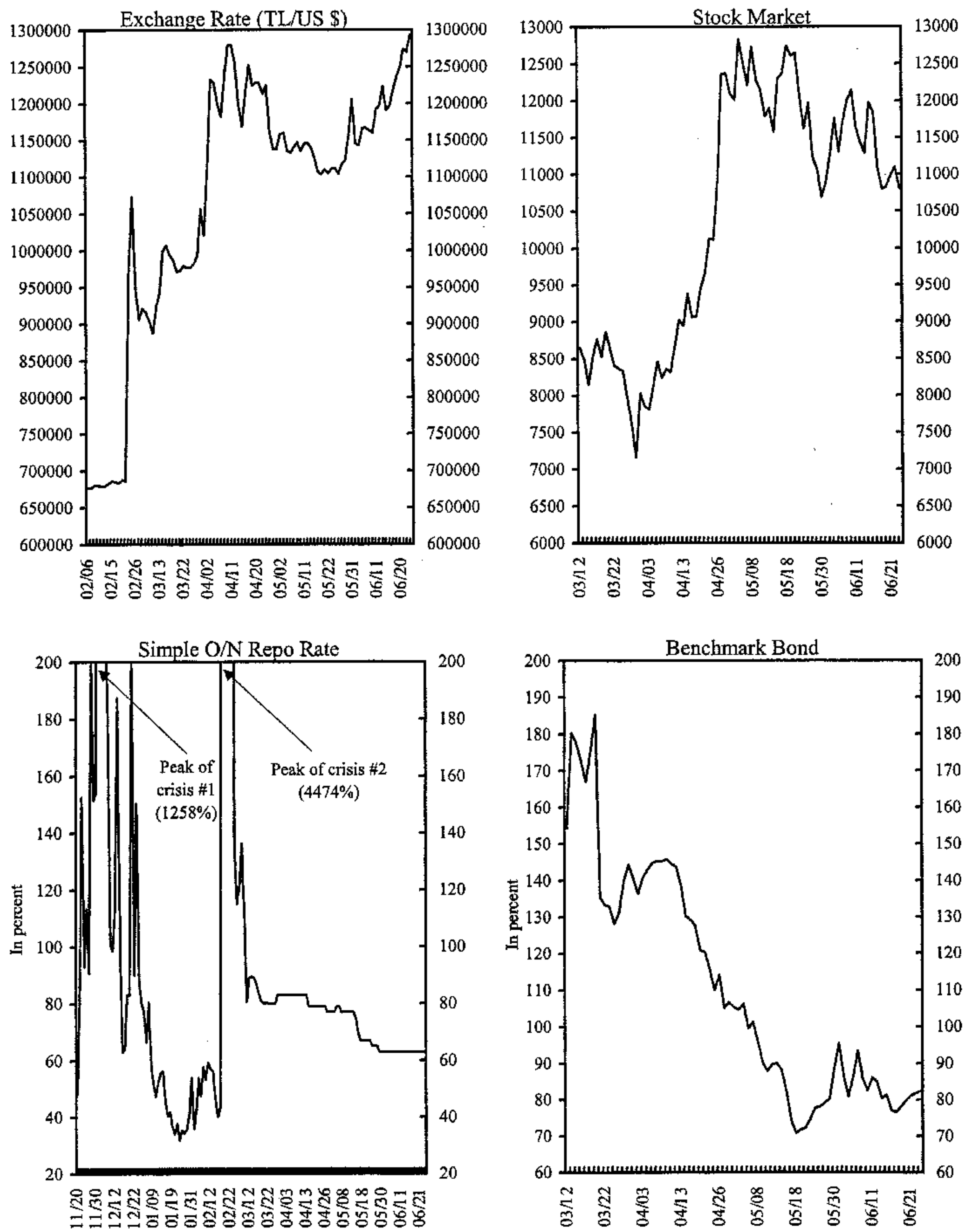
2. **The Fund supports Turkey's economic program under an SBA covering 2000–02** (Table 1). The arrangement was augmented with resources provided under the Supplemental Reserve Facility in December 2000 following the November crisis, and again in May 2001 with resources under the credit tranches in the aftermath of the February crisis. The next purchase of SDR 1.2015 billion is contingent on the completion of this review. The World Bank's Executive Board is expected to discuss in early July a proposed US$1.1 billion Programmatic Financial and Public Sector Adjustment Loan in support of the authorities' program.

II. Performance Under the Program

3. **While the initial market response to the strengthened program approved on May 15 was favorable, the rally proved short lived** (Figures 1 and 2). Within three days after the Board meeting, the benchmark treasury bill rate declined by 17 percentage points (to 71 percent, half the rate only eight weeks before), the stock market rallied, the Turkish lira appreciated slightly (having lost two-thirds of its value in local currency terms between the start of the float on February 22 and mid-May), and the spread on Turkish eurobonds declined by 60 basis points. The initial gains were soon reversed, however. By end-May, the benchmark interest rate had edged up to the 80–90 percent range where it remained through mid-June.

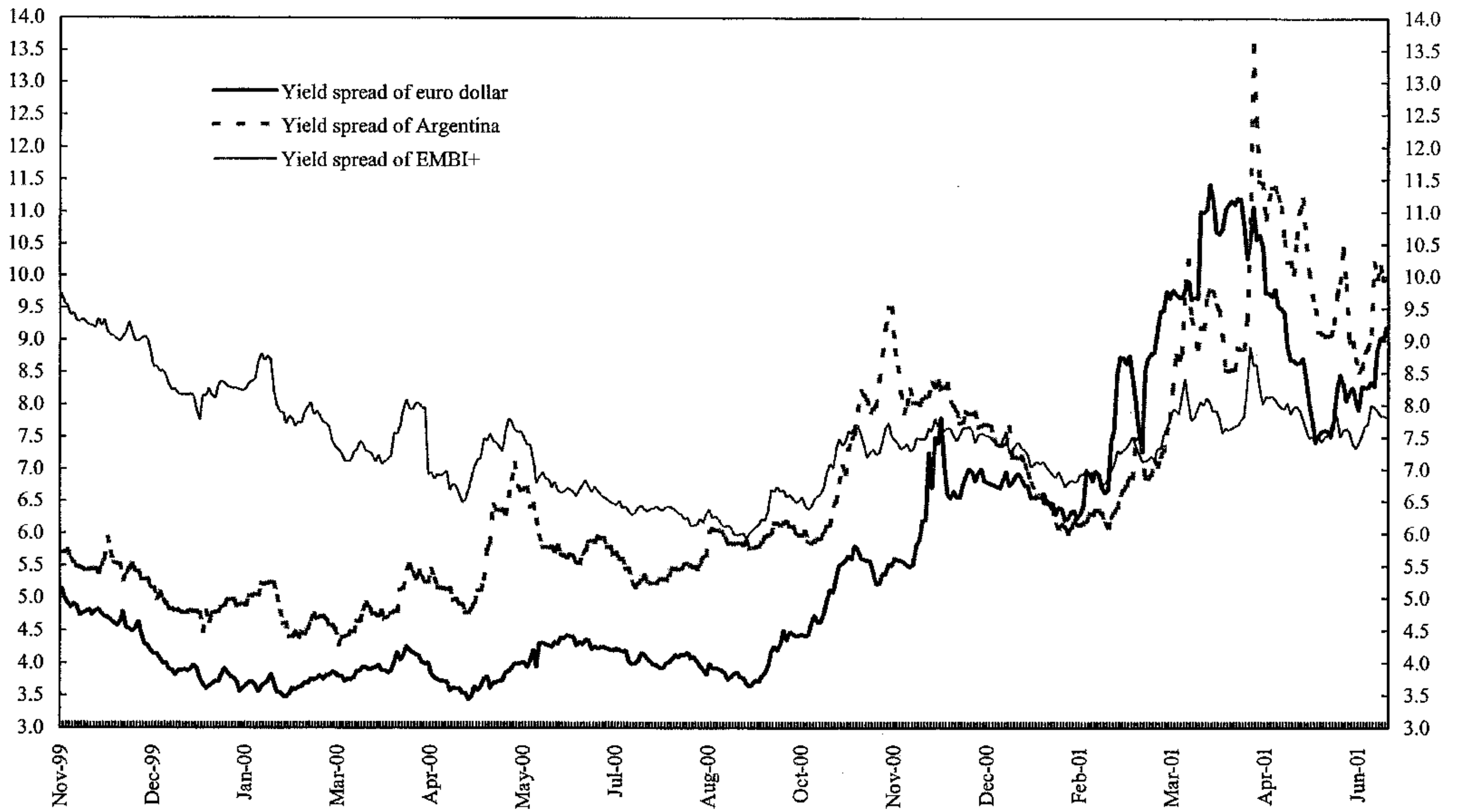
4. **The persistence of high interest rates results from three main factors.** First, frequent public political battles over key measures have fueled **concerns about the coalition's unity and support** for the program. Second, two **policy slippages** in late May caught the markets' attention. The wage settlement for public sector workers and the support price increase for wheat farmers were both more generous than envisaged under the program (see paragraph 8 below). These slippages, together with the concern about political cohesion, cast doubt on the authorities' ability and will to implement the program's ambitious agenda and to achieve debt sustainability. Third, there was **uncertainty about the domestic debt swap** and, related to this, concern about the domestic debt roll-over risk. While the mid-June swap was perceived as successful by the markets, interest rates declined only marginally given political uncertainties.

Figure 1. Turkey: Financial Indicators, 2000-01



Source: Data from the Turkish authorities.

Figure 2. Turkey: Bond Spreads, 1999-2001



Source: Bloomberg.

5. **Except for interest rates, macroeconomic developments over the past month have been broadly as programmed** (Table 2):

- Regarding **growth**, available indicators—industrial production, private sector credit, and capacity utilization—all confirm a decline in economic activity in the early part of the year (Figure 3). For example, in January–April industrial production (adjusted for working days) was 5.4 percent below the level in the corresponding period last year. Surveys indicate, however, that business sentiment may have bottomed out in March, and leading indicators for exports and tourism suggest that the program target of limiting the decline in GNP to 3 percent for the year is still attainable.

- Following sharp increases in the previous two months associated with the large depreciation, **inflation** moderated in May (Figure 4). While the monthly CPI and WPI increases of 5.1 and 6.3 percent were below market expectations and close to program projections, the more telling test will be whether the deceleration expected for June is achieved.

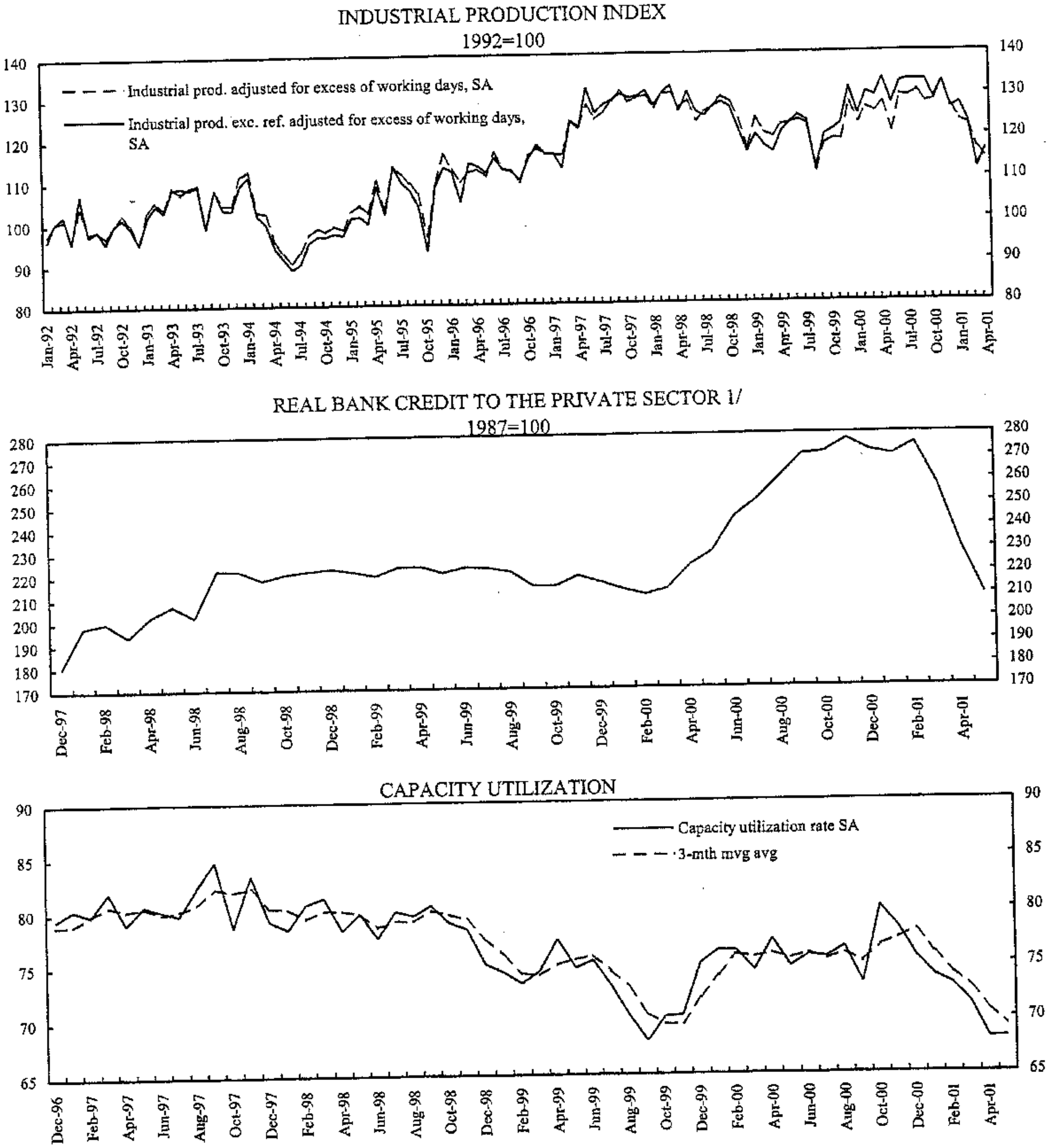
- The external **current account** in the seasonally weak first quarter showed a deficit of US$0.6 billion, in line with the programmed broad balance for the full year (Table 3 and Figure 5). The outcome reflected a sharply depreciated real exchange rate (Figure 6) and weak domestic demand. Preliminary data suggest a possibly stronger turnaround in the current account in the second quarter.

6. **The monetary program appears to be on track.** While exhibiting wide intra-month fluctuations, monetary aggregates have been within program parameters (Table 4 and Figure 7). The end-May indicative ceiling for base money and the end-May performance criteria on NDA and NIR were all observed (Table 1 of the attached Letter of Intent). Subsequently, NDA and NIR have been on track to meet the end-June performance criteria. While base money rose significantly around mid-month, it is expected to fall below the indicative ceiling by the end of the month in line with past monthly patterns.

7. **The fiscal program also appears to have been well on track through May.** The consolidated central government primary surplus through April was ¼ percent of GNP above program projections, reflecting mainly higher revenue on interest income but also lower primary expenditure than envisaged. Preliminary data indicate that the overperformance was even stronger in May, with several revenue categories above projected levels, suggesting that the original projections were conservative.

8. **Recently, however, some policy actions have deviated from program understandings, with a total effect on the primary balance of the public sector estimated at 0.6 percent of GNP in the remainder of 2001. (As discussed in Section III below, compensatory measures have since been taken.)** First, on May 22, following protracted negotiations, the authorities agreed with trade unions on a wage contract for public sector workers (half a million blue-collar employees in state enterprises and the central government)

Figure 3. Turkey: Output and Demand, 1992-2001

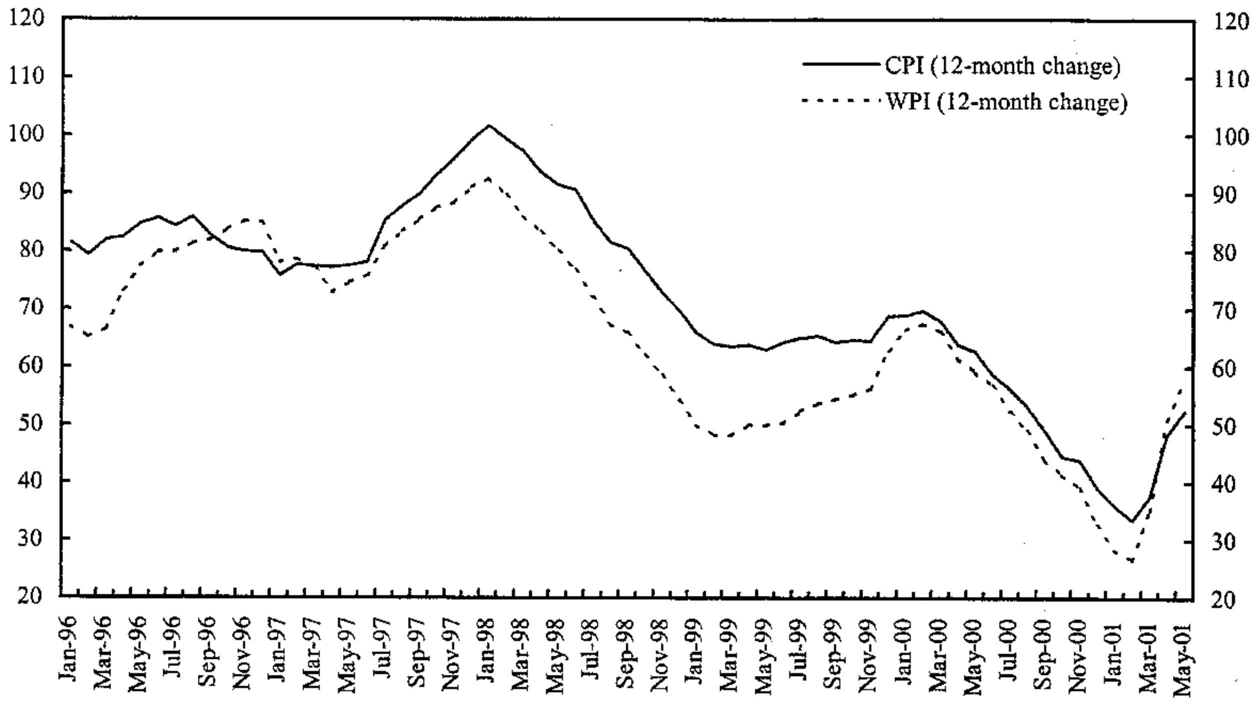


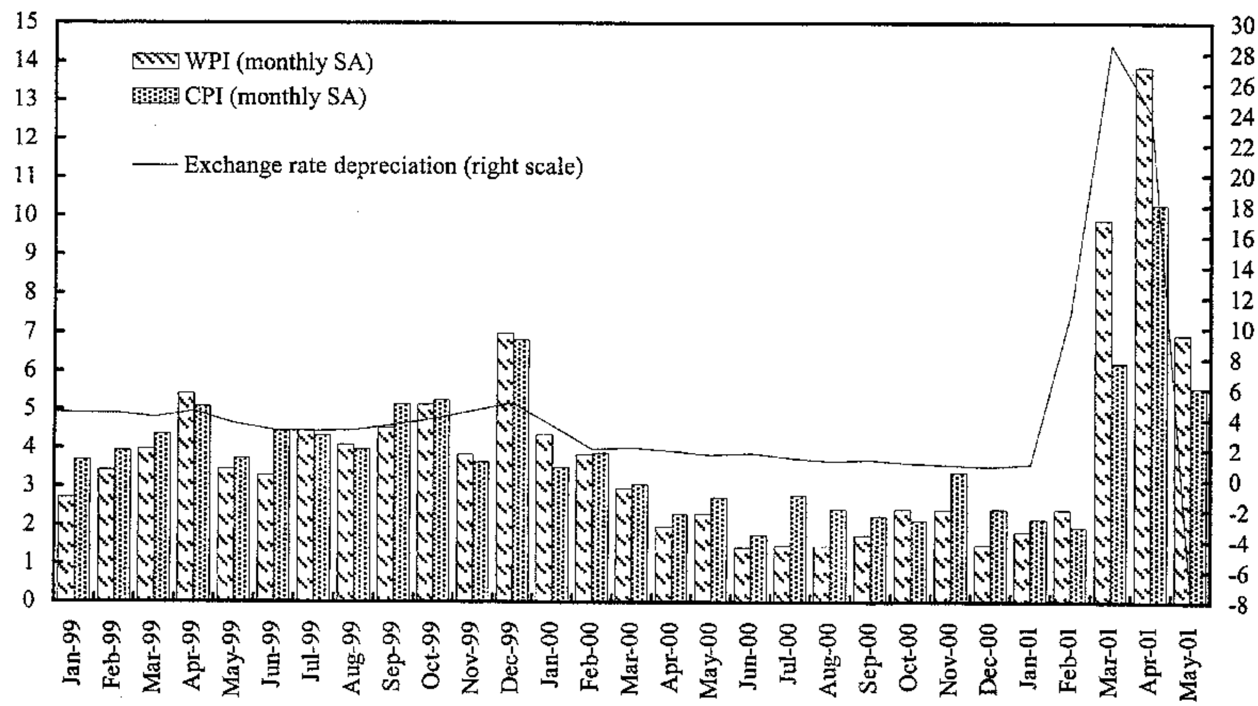
Source: Data provided by the Turkish authorities.

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

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

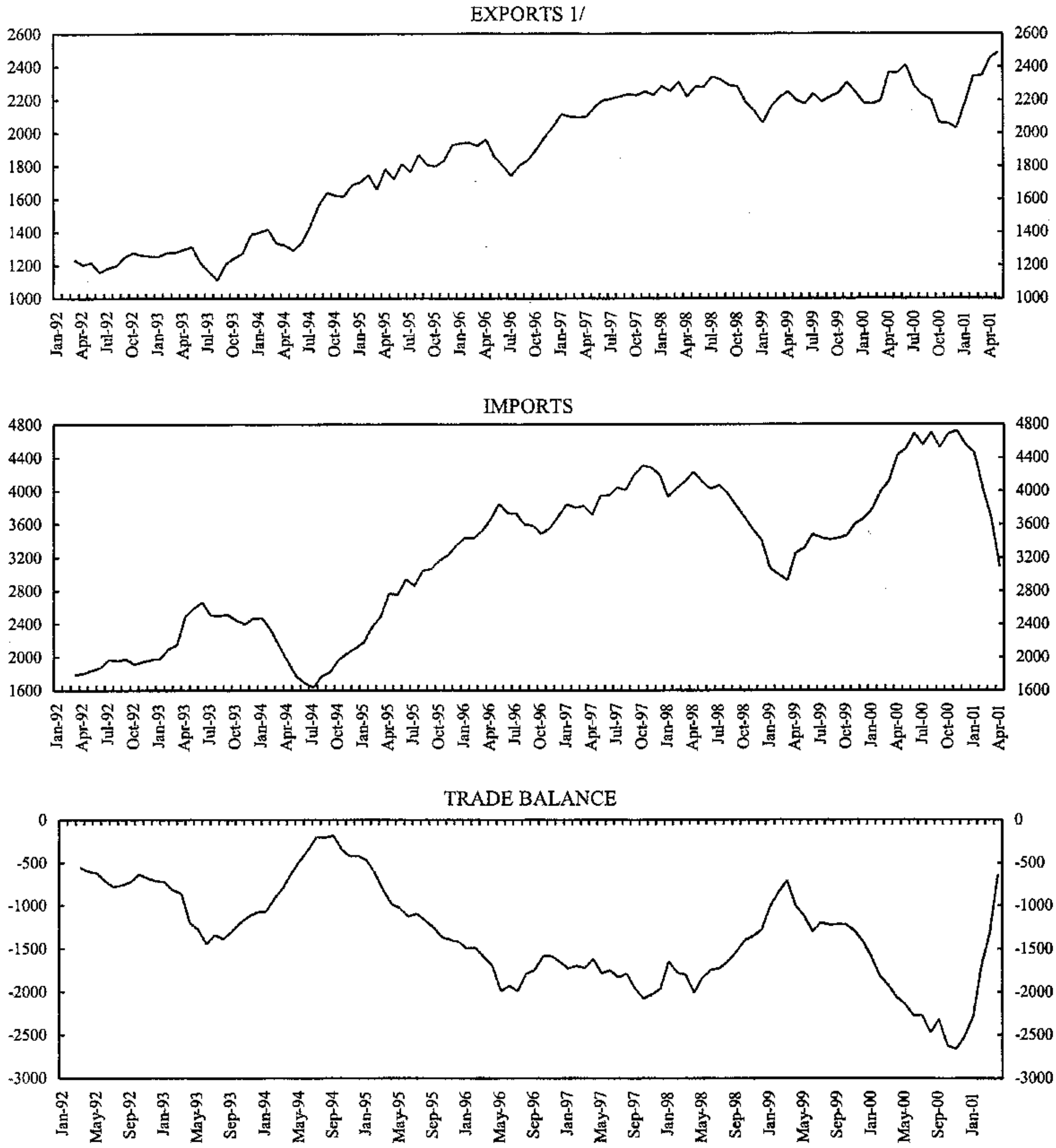
Figure 4. Turkey: Inflation, 1996-2001





Source: Data provided by the Turkish authorities.

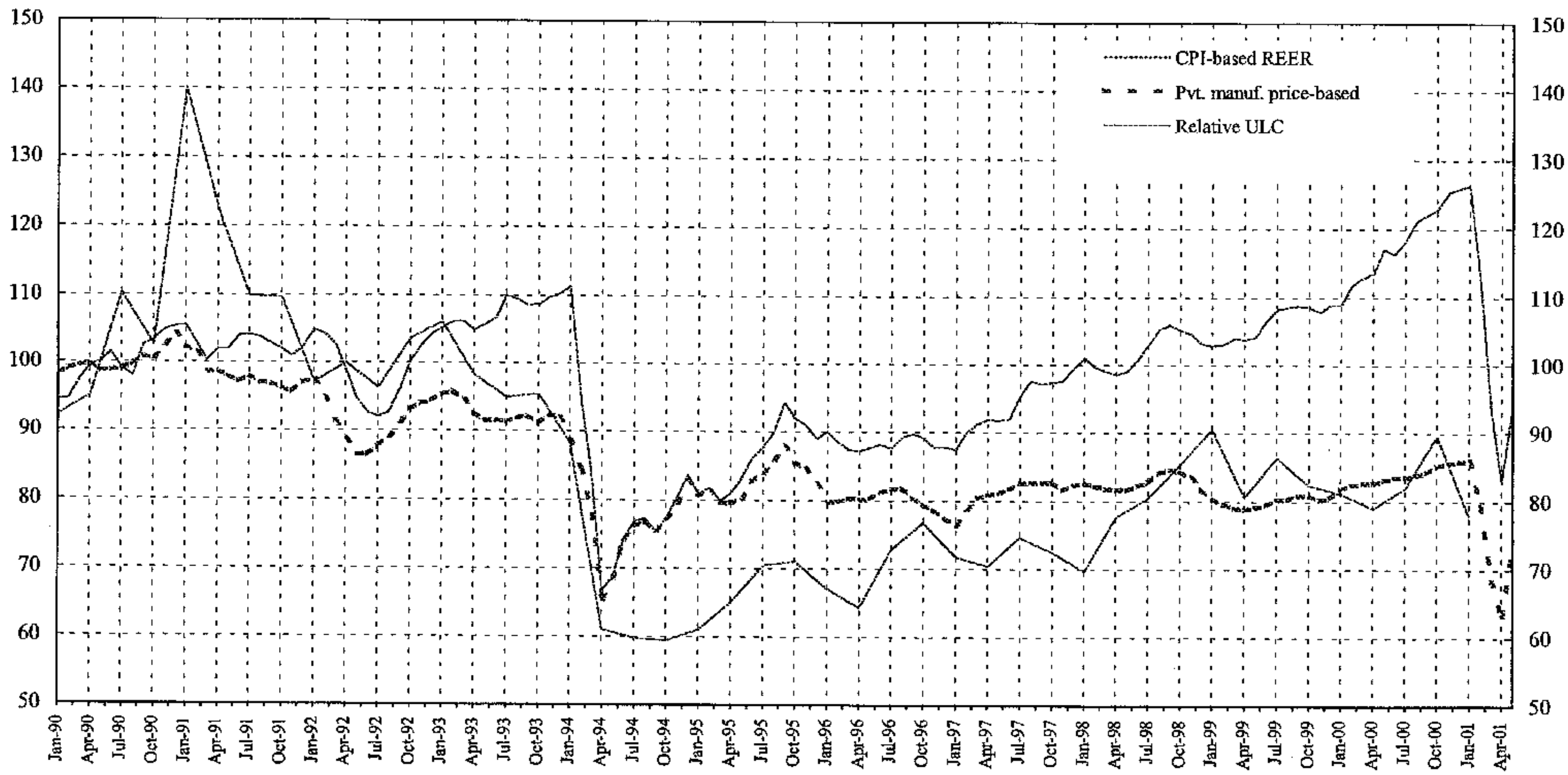
Figure 5. Turkey: Trade Developments, 1992-2001
(In millions of U.S. dollars; seasonally adjusted three-month moving averages)



Source: Data provided by the Turkish authorities.

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

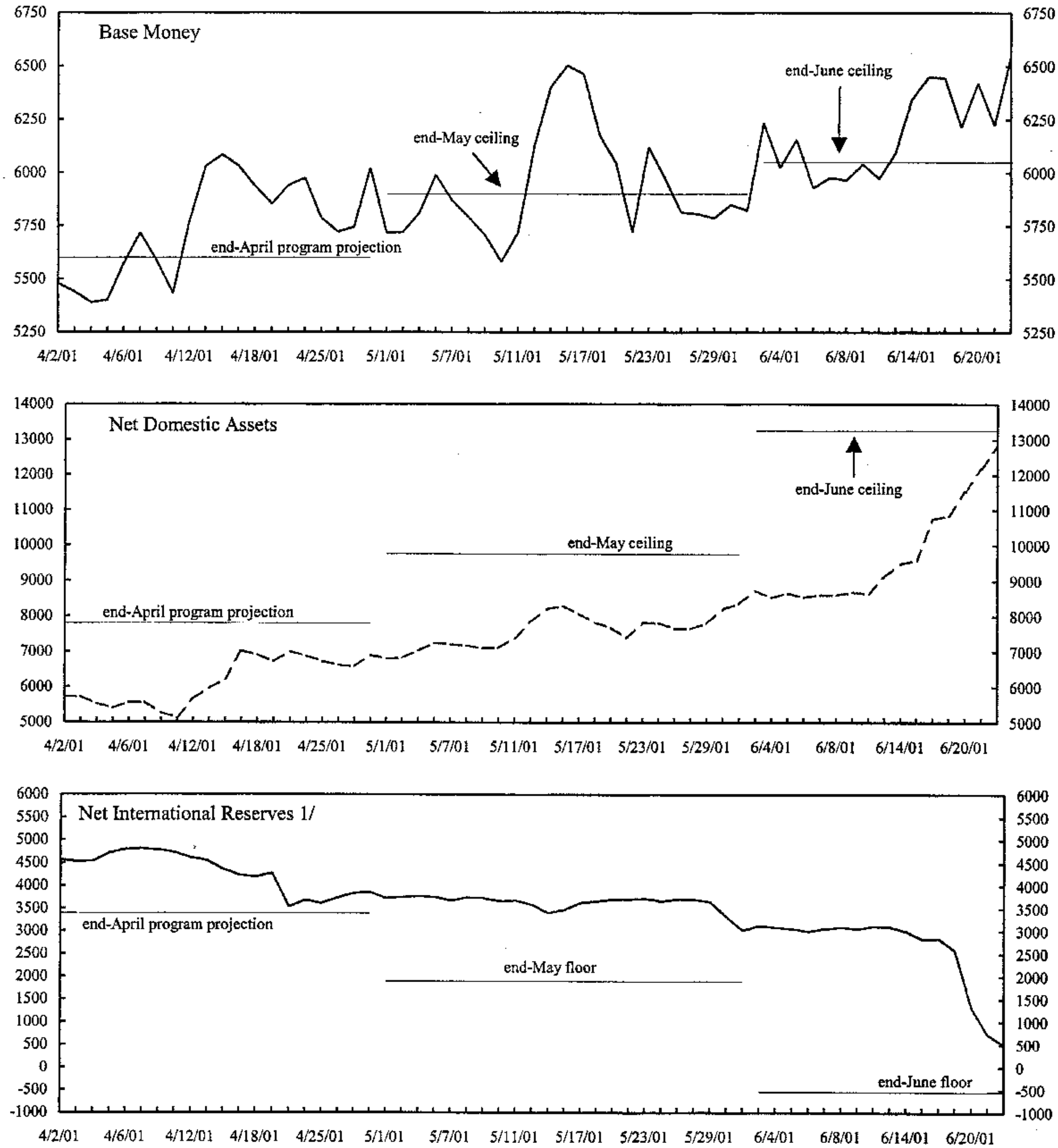
Figure 6. Turkey: Competitiveness Indicators, 1990-2000 1/
(1990=100)



Sources: Turkish authorities; and Fund staff estimates and projections.

1/ Indices based on seasonally adjusted prices, and on constant cross-exchange rates (at end-1999 values).

Figure 7. Turkey: Monetary Developments, 2001
(In trillions of TL)



Source: Data from the Turkish authorities.

1/ In millions of U.S. dollars.

that adds an estimated 0.4 percent of GNP to this year's public sector primary spending relative to program assumptions. Having received a cumulative real gross wage increase of 40 percent in the previous two years, public sector workers will experience only a moderate real wage cut of 13 percent this year before regaining most of that decrease next year. Second, also in late May, the authorities announced a support price increase for wheat, which at 63½ percent was higher than targeted inflation, implying additional fiscal cost of 0.1 percent of GNP. Third, in early June the authorities saw a need for the equivalent of 0.1 percent of GNP to cover the additional civil service wage bill arising from higher-than-projected CPI increases earlier this year and increased direct income support to farmers as recommended by the World Bank.

9. **Structural reforms have continued, following their acceleration ahead of the May Board meeting.** To meet the conditions for the completion of the sixth and seventh reviews, the authorities took decisive actions to fundamentally reform the ailing banking sector (Table 2 of the attached Letter of Intent). Since mid-May, the authorities have taken several follow-up actions. In particular, by end-May they had reduced the stock of repos of the state and SDIF banks (intervened banks under the control of the Saving Deposit Insurance Fund) with the central bank to below TL 7 quadrillion, and by mid-June they had eliminated the remaining overnight position of these banks—both conditions for the completion of the eighth review. Work on improving transparency and efficiency of public management has also continued. A tax regulation extending the use of tax identification numbers in the financial sector has been adopted (another condition for the completion of the eighth review), and steps have been taken to improve budget classification and reporting, and public sector governance.

10. **Nevertheless, some structural measures have lagged behind schedule.** Notably, delays have been experienced in the closing of Emlak bank (the third state bank) and the passage of the Tobacco Law, both actions slated for completion by end-May. While the Tobacco Law was passed by parliament on June 20 and the closing of Emlak is in its final stages, these delays have added to the tensions in the market. In addition, until the appointment of a new professional board for the Bank Regulation and Supervision Agency (BRSA) on June 12, several key actions in the banking sector were on hold. Some actions have since been taken (including the decision to liquidate or merge into a second transition bank the four SDIF banks that cannot be sold, paving the way to meeting a condition for completing the eighth review), and others are expected to be taken shortly (including issuing the connected lending regulation, the institutional strengthening of the collection department of the SDIF, and concluding the sale of Bank Ekspres.)

III. Report on the Discussions

11. **The discussions focused on policy measures needed to restore market confidence and lower interest rates to more sustainable levels.** The staff noted that the program was a very strong one, but to convince markets it had to be implemented flawlessly. Concurring with this view, the authorities indicated their preparedness to take strong corrective action

and to implement in full the existing comprehensive set of program measures (¶3).[1] They also noted that to address markets' political concerns the coalition leaders had recently issued statements reaffirming their support to the program. Finally, the authorities expected the debt swap operation, together with the availability of Fund resources under the program, to help allay markets' roll-over risk concerns.

A. Macroeconomic Framework and Incomes Policy

12. **Despite the risks, the authorities and the staff agreed that the program's macroeconomic targets remained within reach, provided program policies were executed in full.** Having been broadly in line with program projections, macroeconomic developments did not warrant a revision in targets at this point. Hence, the growth assumption of -3 percent and the CPI inflation projection of 52.5 percent (with monthly inflation at about 2 percent in the last quarter) were appropriate for formulating the supplementary budget. However, the authorities shared the staff's view that the risks for growth were on the downside (reflecting in large part the impact of higher-than-projected interest rates) and for inflation on the upside (owing to the higher-than-envisaged increases in public sector wages and the wheat support price).[2] Accordingly, it was agreed to reassess the appropriateness of the macroeconomic targets during future program reviews. As for interest rates, the higher-than-projected rates in June did not alter interest payment projections significantly, as the borrowing need for this month proved to be modest. It was understood, however, that continuation of high real interest rates would weaken prospects for the program, and that an assessment of debt sustainability would remain a focus of future program reviews. On policies, there was agreement that, to help ensure the expected recovery in activity in the second half of 2001, it was important to address market concerns and to restore confidence through flawless implementation of program policies. To help achieve the targeted disinflation, monetary policy needed to keep base money within the programmed path, so as not to accommodate the price impulse from the recent wage and price decisions (the direct impact was estimated to be relatively small), and incomes policy needed to play a role as a supporting nominal anchor.

13. **As part of the effort to bring the program back on track, the authorities indicated their commitment to address the adverse effects of the public sector wage settlement through offsetting fiscal measures and strengthened social dialogue** (¶4, 7). The staff noted that the wage settlement had weakened not only the fiscal accounts but also the role of incomes policy as a nominal anchor. Hence, compensating action should involve measures in both areas. The authorities indicated that they would take immediate measures to

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

[2] The latest consensus forecasts by market analysts (for May) are for a GNP decline of 4.8 percent and CPI inflation of 57.7 percent in 2001.

fully compensate for the fiscal cost of the wage settlement and other slippages (see next paragraph). As for incomes policy, the authorities reiterated their earlier commitment to using the quarterly meetings of the Economic and Social Council as a forum to encourage forward-looking price and wage behavior consistent with the disinflation objective. While welcoming the further fiscal action, the staff observed that against the backdrop of higher-than-projected public sector wage and price increases it would now be more difficult to gather the support of social partners for effective incomes policies. The authorities did not underestimate the difficulties created by the public sector decisions for disinflation, but noted that in future Council meetings they would attempt to foster consensus on wage and price guidelines for the private sector. Moreover, Minister Derviş intended to redouble his already strong outreach efforts to social partners.

B. Fiscal Policy and Debt Management

14. **The authorities agreed to take immediate measures to offset the fiscal cost of the recent policy slippages estimated at 0.6 percent of GNP** (¶5–7). They argued, however, that the substantially better than expected revenue performance in April and May would justify raising the full-year estimate of central government revenue by 0.3 percent of GNP, covering one half of the gap. The staff concurred that the original revenue estimates could indeed be conservative, and advocated a balanced set of new measures, both on the expenditure and revenue side, to fill the remaining gap. Noting that the program already incorporated drastic cuts in real government spending and that further significant cuts would require fundamental changes in underlying policies, the authorities decided to focus on revenue measures. By June 20, they had put in place measures estimated to fill the remaining gap of 0.3 percent of GNP: the petroleum consumption taxes were raised in May and June by more than originally planned; the government decided to increase electricity and gas prices more than earlier envisaged; cigarette and alcohol prices were raised substantially; and the costs of the grain agency were reduced through widening the margin between its sale and purchase price. The staff concurred that with all these measures the public sector primary surplus would be back on track to meet the target of 5.5 percent of GNP in 2001, provided that government spending was kept under control and that the program measures to improve state enterprise finances continued to be implemented (Table 5).

15. **The supplementary budget approved by parliament on June 14 incorporates the new measures and is consistent with program objectives** (Tables 6–7). The original budget for 2001 approved last December was based on pre-crisis macroeconomic assumptions, including substantially lower inflation than now projected. The supplementary budget includes higher nominal revenue and expenditure estimates, while taking into account the measures in the strengthened program approved in May, as well as the subsequent policy slippages and the offsetting measures. It targets a consolidated central government primary surplus of 5.2 percent of GNP—slightly higher than the 5.1 percent in the May program, as the impact of the slippages was felt in both the central government and in the state enterprise sector, while the compensating measures are being taken mainly by the central government. To accommodate the increased spending relative to the May program, the authorities request

modification of the performance criteria for primary expenditure in the consolidated central government for September and December 2001. This request is justified, as the proposed increase in the ceilings is small and as the higher revenue estimates make it possible to achieve the primary surplus target. [3] While real spending will decline substantially overall, the authorities are committed to protecting expenditure in health, education, and social areas.

16. **To further reduce the government's borrowing need and to address the debt roll-over problem, besides intending to use available external financing, the authorities are relying on voluntary private sector involvement (PSI)** (¶9). On the domestic side, the recent debt swap (see Box 1), alongside continued strong fiscal policy and the ongoing use of external assistance, should keep the Treasury's domestic borrowing need well below redemptions during the second half of 2001. Regarding foreign PSI, in mid-June the authorities recently secured a voluntary commitment from foreign commercial bank creditors to maintain their interbank and trade credit lines to Turkish banks, with a view to rebuilding their exposure as the program is implemented.

C. Monetary Policy

17. **With the monetary program on track, discussions with the Central Bank of Turkey (CBT) focused on clarifying how to conduct monetary and exchange rate policy geared toward disinflation in the present circumstances** (¶10). The May 3 Memorandum on Economic Policies had laid out the present framework in broad terms—targeting base money (the program's main nominal anchor) in the presence of substantial CBT lending of foreign exchange to help finance the budget. The staff and CBT officials noted that market participants still appeared confused about how this framework was being implemented in practice. The role of sales of foreign exchange appeared most in need of clarification. To make the policy more transparent, the updated Letter of Intent spells out the framework in greater detail. In a nutshell, while the Treasury is expected to make full use of the room provided by the central bank's strong foreign exchange position to reduce its domestic borrowing needs, it is up to the CBT to mop up any resulting increase in liquidity through sales of foreign exchange to keep base money close to the target. Thus, in months when the Treasury does not have major external debt service payments, the CBT is expected to sell large amounts of foreign exchange in the market to keep liquidity in check, and this is not intervention to target the exchange rate. The CBT agreed to holding preannounced auctions for this purpose, starting in July. Any other intervention in the foreign exchange market would be strictly limited to the smoothing of short-term fluctuations. As for the short-term interest rates controlled by the CBT, to support disinflation these should be adjusted to

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[3] Even with the expenditure overruns associated with the slippages, real central government spending is estimated to decline by as much as 6½ percent in 2001, compared with the May program estimate of 8 percent.

Box 1. The Government Debt Swap

The aim of the debt swap undertaken in mid-June was to reduce rollover risk of government debt, facilitate a decline in interest rates, and help banks close their open foreign exchange positions. Prior to the swap, about 40 percent of domestic currency debt (US$30 billion), maturing between June 2001 and August 2002, was due in June–August 2001; by lengthening the maturity of the debt, the swap would ease the heavy debt service burden of the government in the near term. The swap was also designed to facilitate a decline in interest rates over time by reducing the future issuance of Turkish lira denominated bonds and demand for foreign exchange. Finally, the swap would offer banks a transparent means of closing their on-balance open foreign exchange positions. Although these positions were partly covered by forward hedges (bringing the net open position close to zero), many observers believe that these hedges were of dubious quality.

The authorities were advised on the operation by two international investment banks, and received comments on their proposal from the Fund staff. In discussions prior to the swap, the staff urged that a modest minimum size of the operation be set so as to contain the potential cost of the operation and, within that constraint, encouraged the authorities to maximize the reduction in financing requirements over the next three months so as to achieve as large a reduction in rollover risk as possible.

The swap involved the exchange of domestic treasury bills and longer-dated fixed and floating rate bonds for a package of U.S. dollar indexed bonds and Turkish lira bonds. All existing domestic lira denominated securities were eligible, and were grouped into two categories: 15 securities that mature in 2001, and 8 securities that mature in 2002. Securities maturing in 2001 were exchanged for a package consisting of three securities, each having a weight of 1/3 in the total package: (i) three-year dollar indexed bonds with floating rate coupons; (ii) five-year dollar indexed bonds with floating rate coupons; and (iii) one-year Turkish lira denominated floating rate notes. For eligible securities maturing in 2002, the package was similar, but with two-year Turkish lira floating rate notes rather than one-year. The swap was conducted by modified Dutch auction, with applicants bidding a price for the three-year dollar indexed bond, and all other price components of the package fixed in advance. Noncompetitive bids were allowed, and the swap was based on a preannounced exchange rate of TL/US$ 1,160,000.

The swap offer was well received by the markets. The bids received exceeded the auction's minimum size of US$2.6 billion by almost US$7 billion, and the implied average yield of 14.9 percent (about 300 basis points above Turkey's dollar-denominated Eurobonds) was close to the expected yield of 15–16 percent. After adjusting for the depreciation of the Turkish lira between the time of the preannounced exchange rate and the time of the auction, the effective cost of the swap was 350 basis points above Eurobond yields. All in all, the authorities accepted US$7.7 billion of the total US$9.5 billion received in bids, and issued US$8.6 billion in new securities in exchange (the average market price of the new securities was lower than the average market price of those securities which were received). In response to strong investor demand for the new securities, the authorities on June 18 offered to exchange a further US$0.7 billion at a yield 0.5 percentage points lower than in the auction.

The swap generated substantial cash flow savings, and thereby improved the government's debt service profile. By extending the debt service profile from an average of 5.3 months for the old exchanged bonds to 37.2 months for the new bonds, the swap will generate cash flow savings estimated at US$4.8 billion in June–December 2001, with about US$2 billion alone for the next three months, and US$0.6 billion for 2002. As a result, the swap is expected to reduce the gross domestic borrowing need of the central budget for June–December 2001 from TL 5.7 quadrillion per month to TL 4.5 quadrillion. Although noteworthy, the swap's success in reducing rollover risk in the near term is limited by the fact that only about 20 percent of the securities accepted for exchange were to fall due between June and August 2001. In addition to reducing gross borrowing needs, lower interest rates on the new bonds will reduce interest payments in the remainder of 2001 by about TL 2 quadrillion. Although the swap initially increases the public debt ratio in 2001 by about ¾ percent of GNP as the volume of new debt issued in the swap exceeds the exchanged debt, this effect is reversed in 2002 by lower interest payments, with the resulting debt stock in that year about ½ percent of GNP below the baseline.

The swap reduced the banks' open foreign exchange position significantly, while increasing the government's foreign exchange exposure only moderately. Prior to the swap, the on-balance open foreign exchange position of private banks amounted to $7.6 billion. As these banks bought the bulk of the new dollar indexed bonds, the swap led to a substantial reduction in the on-balance open position. The increase in exposure of the government to foreign exchange risk was relatively limited, as the swap raised the stock of public sector debt denominated in, or indexed to, foreign exchange by only some 13 percent.

achieve the base money target rather than address perceived financial market tensions (such as fluctuations in treasury bill rates and the exchange rate). Money market rates should also be raised even if base money is close to its target, if other inflation indicators (such as the exchange rate) suggest that the disinflation process is in jeopardy.

18. **The staff also reviewed progress made by the CBT in moving toward inflation targeting** (¶11). The CBT had made further preparations for a move to a full-fledged inflation-targeting framework, through strengthening communications and improving the information base and institutional capacity. It was agreed, however, that the precise timing of the move could not yet be decided, given the demanding analytical and empirical requirements for such a framework, and the need to first bring inflation down to more moderate levels.

D. Structural Reform[4]

19. **Banking issues were subject to much discussion** (¶12). In reviewing recent progress, the staff welcomed the major steps taken over the past few months, noting in particular that the state and SDIF banks had been recapitalized to the agreed levels (Box 3). The staff observed, however, that the financial condition of private banks had deteriorated significantly during the first quarter of 2001 as a result of the slowdown in economic activity and the high real interest rates (Box 4). Regarding the present situation and the next steps, the highlights of the discussion were as follows:

- While the strengthening of the two large **state banks** (Ziraat and Halk) was progressing well, the closing of the third state bank, Emlak (a condition for completing the eighth review), was facing delays. Because of anticipated legal problems, the authorities had abandoned the original strategy of merging Emlak with Ziraat. Instead, they devised a strategy that involves legislation to facilitate the closure of Emlak, but allows the revocation of its license and the transfer of liabilities and assets to the two large state banks only after the President signs the law. The staff agreed with this strategy, but noted that going through the legislative route would lengthen the closure process. The authorities indicated that they were making preparations to be in a position to close the bank in a matter of days after the law becomes effective.

- On **SDIF banks**, the authorities were in the process of finalizing the sale of three banks (including the first transition bank) and initiating the sale of a fourth one. The

[4] Box 2 provides a summary of the coverage and status of structural conditionality in the strengthened program, areas covered by World Bank lending and conditionality, and structural conditions not included in the program.

Box 2. Structural Conditionality

Coverage of structural conditionality in the strengthened program approved in May 2001

To address the structural weaknesses that contributed to the recent economic crises and the abandonment of the crawling peg in February, the program approved in May 2001 places a heavy emphasis on several reform areas. (The program's structural conditionality is set out in Table 2 of the May 3 MEP and Annex B of the Letter of Intent attached to this staff report.) The areas covered by the program's structural conditionality 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 include measures to strengthen fiscal transparency and management and to increase the role of the private sector in the economy. Since the problem in Turkey remains largely a confidence crisis, which in part reflects structural weaknesses in the economy, the credibility of the program depends in part on the strength of the structural effort. Hence, structural conditionality is crucial for the program to meet its objectives.

Status of structural conditionality from the strengthened program approved in May 2001

Many of the key structural conditions were prior actions for Board approval of the program, involving in particular fundamental reform of the banking sector. Following the May Board meeting, structural reforms have continued in the areas of banking, privatization, and fiscal transparency. Although some structural measures have lagged behind schedule, it is expected that all structural program conditionality for the present review (mostly prior actions) will be met before the Board meeting. Since the May Board meeting, structural conditionality relating to the banking system has been strengthened further, with the addition of a prior action for the completion of the eighth review requiring all private banks identified as financially weak to sign commitment letters for capital strengthening. This condition, deemed important to improve the financial position of private banks and avert a further deterioration of confidence, is expected to be met by the time of the Board meeting.

Structural areas covered by World Bank lending and conditionality

Much of the World Bank program lending in 2001 is to be delivered through a proposed Public Sector and Financial Sector Adjustment Loan (PSFSAL I) focusing on banking reforms and other key public finance measures, with conditionality closely paralleling Fund prior actions for completion of the eighth review, and scheduled for approval in early July. A second Economic Reform Loan (ERL) will cover energy reform, agricultural reform, and privatization. In addition, an Agricultural Reform Implementation Loan (ARIP) will cover the ongoing moves to a direct income support payment system for farmers.

Other relevant structural conditions not included

The May program contains conditions on preparing enterprises for privatization, but in contrast to some previous programs with Turkey there is no structural conditionality related to actual sales of enterprises. Fund and Bank staffs regard this as appropriate given the unfavorable current market conditions for many of the enterprises to be privatized. Instead, Fund and Bank conditionality is aimed at preparing the ground for rapid privatization once market conditions improve.

Box 3. Update on Public Bank Recapitalization

The process of recapitalizing the public (state-owned and SDIF) banks has been completed. As a result, these banks, which had a large negative net worth at end-March 2001, have been recapitalized to the agreed levels. By end-May 2001, the two large state banks (Ziraat and Halk) reported capital adequacy ratios (CARs) somewhat above the 8 percent regulatory minimum, implying an adequate capital cushion against any future operational and loan losses, as well as off-balance sheet risk, which may not have yet been fully reflected in the banks' balance sheets. The third state-owned bank (Emlak), which will be absorbed by Ziraat and Halk, was recapitalized to a CAR of just above 8 percent. By end-May 2001, the SDIF banks also reported a positive net worth (with a CAR above 0 percent). In addition, the overnight position of the state-owned and SDIF banks has been eliminated, and the stock of repurchase agreements with the CBT was brought to below TL 7 quadrillion.

The recapitalization program was funded through the issuance of treasury securities totaling TL 44 quadrillion (24 percent of GNP). This amount of securities is in line with the previously estimated cost to the public sector (Table 5 of the MEP of May 3, 2001). As about half of this debt was already included in the estimate of public debt at end-2000, the total increase during 2001 amounts to TL 22 quadrillion.

- Securities issued since 1999 to recapitalize the state-owned banks amounted to TL 27.3 quadrillion, while TL 6.3 quadrillion of securities were issued to recapitalize the SDIF banks.

- In addition, on May 14, the treasury swapped (i) TL 10 quadrillion of CPI-indexed securities in Ziraat and Halk for TL 12.5 quadrillion of floating rate notes, with the difference of TL 2.5 quadrillion attributed to interest accrued on the swapped securities; and (ii) TL 3.7 quadrillion of auctioned securities (face value) in the SDIF banks for TL 3.4 quadrillion of floating rate notes.

The tabulation below presents a breakdown of the recapitalization costs by bank:

Recapitalization costs incurred as of end-May, 2001
(In TL quadrillions; excluding accrued interest on swapped securities)

State banks	27.3
Ziraat	14.0
Halk	12.6
Emlak	0.7
SDIF banks	16.3
Total	43.6

Box 4. Update on the Condition of Private Banks

Many banks were hard hit by the recent crisis. Turkey's 27 domestic, private commercial banks[1] (the "private banks") account for roughly one-half of the banking sector's assets, with the four largest private banks controlling about 28 percent of assets. For many (but not all) private banks, the sharp devaluation of the Turkish lira in February 2001, together with the increase in interest rates and higher credit risk associated with the economic downturn, resulted in significant FX and interest rate related losses, as well as some loan losses due to corporate sector distress. The combined effect of these factors weakened the solvency, liquidity, and profitability of private banks as a group.

The effects of the crisis are apparent in weaker profits and a decline in the average capital adequacy ratio. For the first quarter of 2001, the private banks reported an average return on assets (ROA) of 0.3 percent, and an average return on equity (ROE) of 2.3 percent. These profits—albeit modest and significantly lower than in previous quarters in the pre-crisis period—were made possible by high earnings for some of the larger banks (that acted as lenders in the interbank market where interest rates were high), which more than covered FX losses arising from the currency devaluation. Nevertheless, the average CAR for the private banks as a group fell by three percentage points, from 18 percent at end-2000 to 15 percent by end-March 2001. This decline in the CAR mainly reflected losses arising from tighter provisioning for connected party lending, higher provisioning for nonperforming loans (NPLs), and higher capital charges for banks' foreign financial subsidiaries as a result of the February devaluation. NPLs have so far remained low (at 3.8 percent of total loans) on average. However, they have inched upward (from 3.5 percent at end-2000), and all banks continue to face the prospect of increasing credit losses as a result of a slowdown in economic activity, in part due to unsustainably high real interest rates. (Table 8 presents selected banking system indicators).

Notwithstanding a weakening of their financial condition during the first quarter of 2001, the four largest banks remained liquid and profitable. At end-March 2001, these banks had an average CAR of 19 percent. The substantial FX losses for these banks (totaling about TL 1 quadrillion) arising from the currency devaluation were compensated by income gains from the higher interest rates (totaling about TL 1.2 quadrillion). However, the average CAR for the four banks fell from 23 percent at end-2000 to 19 percent at end-March 2001, mainly due to higher provisioning, and deductions from the capital base for foreign subsidiaries after the devaluation.

The performance of the remaining 23 small- and medium-sized private banks (accounting for a little over 20 percent of system assets) has been significantly weakened by the crisis. For this group, FX losses in the aftermath of the devaluation exceeded gains from the higher interest rates, and the group as a whole reported net losses of about TL 60 trillion. Between end-2000 and March 2001, CARs (before provisioning for connected lending) declined for 21 (of the 23) banks.

To deal with this deteriorating situation, the BRSA has strengthened its enforcement of capital adequacy rules. Recognizing that the solvency position of several private banks was deteriorating, and that the banks would likely become more vulnerable to credit losses and other shocks, the BRSA has adopted a strategy for the recapitalization of banks, involving (i) the application of strict rules for banks to recognize their capital deficiencies and (ii) maximum pressure on banks' owners to recapitalize them—together with a clear message that failure to recapitalize would result in takeover by SDIF. Commitment letters requiring bank management to strengthen the financial condition of their banks and ensure adequate capitalization, by specific dates, are expected to be signed with all banks identified as undercapitalized. Three banks have already made capital injections, and eight banks have indicated to the BRSA their plans to raise additional capital during June. This will be followed by capital augmentation steps until year-end 2001, by which date the CARs of all banks are expected to be in full compliance with the regulatory requirements. Failure to do so will result in SDIF takeover.

1/ This includes a bank, which was earlier classified as a "foreign bank."

SDIF had so far had limited success in selling intervened banks. This was partly the result of macroeconomic conditions, but could also be attributed to a protracted sale process. The staff noted that since a bank's franchise value is lost quickly, especially if it stays too long as an intervened bank with limited operations, the SDIF should seek the assistance of outside financial advisors to avoid undue delays in the sale process.

- On **private banks**, the authorities accepted as a new condition for completing the eighth review the signing of commitment letters for capital strengthening by all private banks identified as financially weak. These letters commit each bank's management to strengthen the financial condition of the bank and to ensure adequate capitalization through phased capital increases to be completed by end-2001. To provide early warning of problems in private banks, the CBT had put in place an enhanced monitoring system that provides weekly bank-by-bank interest rate data. To facilitate further consolidation in the banking sector, in mid-June parliament approved a law designed to eliminate the remaining tax obstacles for mergers.

20. **In other structural areas, the discussions focused on steps to be taken before the review can be completed, and actions to ensure that the structural program for the remainder of the year remains on track.** In the area of privatization, the authorities expected a new professional board and management team for Türk Telekom to be put in place before end-June, meeting a condition for completing the eighth review. In addition, the Privatization Agency was moving ahead with the preparation for sale of a number of assets in its portfolio (¶13). While the authorities recognized that market conditions might not be ideal at present for sale of Türk Telekom and Turkish Airlines, they were confident that proceeds from the sale of other assets in the Agency's portfolio would be sufficient to yield the targeted US$1 billion for the year. With regard to improving the business climate, the law implementing the constitutional amendment on international arbitration was passed in late June, and a study on administrative barriers was expected to be completed by end-June (¶14). To improve transparency and efficiency of public management, the law providing for the closure of the remaining budget and extrabudgetary funds was approved by parliament in mid-June, meeting a structural benchmark, and the authorities were working in close cooperation with the World Bank on international conferences to be organized later in the year on public expenditure management and anti-corruption (¶15, 16). Finally, the authorities welcomed the preparation of the data module of the Fund's Reports on Observance of Standards and Codes (ROSC), scheduled for fall 2001 (¶17).

IV. Safeguards Assessment

21. **Further progress has been made on the safeguards assessment.** Under the SBA, Turkey is subject to the transitional procedures for safeguard assessments, which require the CBT to publish annual financial statements in accordance with international standards. The first external audit of the accounts of the CBT—covering 2000—was carried out by *Deloitte Touche & Tohmatsu,* and was published in June. The audited financial statements were recently made available to staff, and an assessment of the quality and effectiveness of the

audit will be completed before the next program review. The internal audits for previous years have been published in the CBT's Annual Reports.

V. Staff Appraisal

22. **The momentum in economic reform and disinflation has been largely maintained.** Following up on the strong upfront measures taken ahead of the mid-May Board approval of the new economic program, the authorities have subsequently taken important further actions to restructure the banking sector, prepare for privatization, and improve transparency. Also, budget performance has been in line with the program and the monetary performance criteria met, helping the resumption of disinflation.

23. **Nevertheless, recent developments underscore the need for flawless execution of the economic program buttressed by full and united support by the coalition government.** The wage settlement for public sector workers and the grain price decision were not in line with the program. While compensating fiscal measures have since been taken, these decisions have served to undermine confidence in the government's ability and will to implement the ambitious program. Moreover, the coalition has not always been united in its support for the program. As a result, interest rates have failed to decline to sustainable levels as rapidly as hoped, putting fiscal sustainability and the economic recovery at risk. To help address market concerns, full and undivided political support to ensure strict implementation of the program is essential.

24. **Perseverance in fiscal adjustment is also necessary**. Given the government's debt position, fiscal policy must focus on achieving the program's ambitious primary surplus target. The government's actions to offset the budgetary effects of the wage and agricultural pricing decisions will help in this regard. In the event that additional budget measures are needed, more emphasis should be placed on reducing the spending side of the budget. The further improvements planned in government debt management should also help underpin debt sustainability. The government debt swap provided helpful short-run relief by extending the maturities of government debt.

25. **Monetary policy will be geared toward disinflation under the floating exchange rate framework.** The ultimate goal remains the adoption of full-fledged direct inflation targeting, and the CBT's preparatory work will help facilitate the move in that direction. In the interim, the continued achievement of the program's targets on monetary aggregates would help disinflation, and provide guidance to financial markets. Greater transparency by the CBT about how it conducts its policies would provide further helpful guidance to markets.

26. **Continued efforts in banking reform are needed to address a key vulnerability underlying the recent crises**. The further steps taken to restructure the state banks, resolve the SDIF banks, and put in place precautionary measures for private banks that could potentially face problems are all important steps in the right direction. These steps need to be

supported by vigilance in detecting problems in the banking system and decisive action when such problems surface.

27. **Further impetus in other structural reforms will help lay the basis for economic recovery and increased transparency**. The wide range of measures underway to facilitate privatization and strengthen budget practices will help economic efficiency as well as transparency in economic management. The authorities' request for the preparation of the data module of the Fund's Reports on Observance of Standards and Codes (ROSC) is a welcome step toward further increasing the transparency in economic issues.

28. **Gaining the support of social partners, as well as the international financial community, will be critical for the sustainability and ultimate success of the program.** The renewed emphasis on the Economic and Social Council as a focal point for promoting responsible wage and price policies in line with the program is welcome, although the recent public sector wage and price increases have made achieving consensus more difficult. Regarding social protection, the government's strategy is appropriately designed to shield the more vulnerable segments of the population, through the exemption from cuts of government health, education, and social expenditure as well as targeted relief to those most affected by the crisis. The reinforced efforts to explain the program's objectives and strategy to domestic and international audiences, and to secure commitments from international banks to maintain exposure, should also help underpin its success.

29. **While risks remain, the staff recommends that the Board approve Turkey's request for the completion of the eight review under the stand-by arrangement, and the requested modification of the performance criteria on the primary expenditure of the consolidated central government.** The authorities have made good further progress in putting in place the policies planned under the program. The fiscal impact of the recent slippages has been offset. The program still faces risks, especially the possibility that interest rates will remain above the program assumptions. Under these circumstances, the government will need to demonstrate its commitment to the program by following through fully on all program policies as a way to further restore confidence, reduce interest rates, and achieve the program's ultimate goal of economic recovery and rapid growth.

Table 1. Turkey: Schedule of Purchases Under the SBA/SRF, 1999-2002
(SBA augmentation at 660 percent of quota)

Date	Purchases under SBA		Purchases under SRF		Purchases under the Augmentation to SBA		Combined Purchases under SBA/ SRF		Conditions
	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	In millions of SDR	As a percent of quota (%)	
Actual Purchases	**1,330.3**	**138.0**	**4,048.8**	**420.0**	**1,554.0**	**161.2**	**6,933.1**	**719.2**	
1999	221.7	23.0	-	-	-	-	221.7	23.0	
December 22, 1999	221.7	23.0	-	-	-	-	221.7	23.0	Board approval of SBA
2000	886.9	92.0	1,735.2	180.0	-	-	2,622.1	272.0	
April 29, 2000	221.7	23.0	0.00	-	-	-	221.7	23.0	First review; and end-Dec. 1999 performance criteria
July 6, 2000	221.7	23.0	0.00	-	-	-	221.7	23.0	Second review; and end-Mar. 2000 performance criteria
December 22, 2000	443.4	46.0	1,735.2	180.0	-	-	2,178.6	226.0	Third and fourth reviews; and end-Sept. 2000 performance criteria
2001 (Jan-May)	221.7	23.0	2313.6	240.0	1554.0	161.2	4089.3	424.2	
February 5, 2001	221.7	23.0	867.6	90.0	-	-	1,089.3	113.0	Fifth review; and end-Dec. 2000 performance criteria
May 15, 2001	-	-	1,446.0	150.0	1,554.0	161.2	3,000.0	311.2	Sixth and seventh reviews; end-Mar. 2001 performance criteria
Scheduled Purchases	**1,561.7**	**162.0**	**1,735.2**	**180.0**	**4,808.4**	**498.8**	**8,105.3**	**840.8**	
2001 (June-Dec)	665.2	69.0	1,735.2	180.0	4,808.4	498.8	7,208.8	747.8	
July 3, 2001	221.7	23.0	578.4	60.0	401.3	41.6	1201.5	124.6	Eighth review; and relevant performance criteria 1/
July 25, 2001	221.7	23.0	578.4	60.0	401.3	41.6	1201.5	124.6	Ninth review; and relevant performance criteria 2/
September 20, 2001	-	-	578.4	60.0	1,824.5	189.3	2,402.9	249.3	Tenth review; and relevant performance criteria 3/
November 15, 2001	221.7	23.0	-	-	2,181.2	226.3	2,402.9	249.3	Eleventh review; and relevant performance criteria 4/
2002	896.5	93.0	-	-	-	-	896.5	93.0	
February 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Twelfth review; and end-Dec. 2001 performance criteria
May 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Thirteenth review; and end-Mar. 2002 performance criteria
August 15, 2002	221.7	23.0	-	-	-	-	221.7	23.0	Fourteenth review; and end-June 2002 performance criteria
November 15, 2002	231.4	24.0	-	-	-	-	231.4	24.0	End-Sept. 2002 performance criteria
Total	**2,892.0**	**300.0**	**5,784.0**	**600.0**	**6,362.4**	**660.0**	**15,038.4**	**1,560.0**	
Memorandum items									
2001	886.9	92.0	4,048.8	420.0	6,362.4	660.0	11,298.1	1,172.0	
Quota	964.0	100.0							

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

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

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

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

Table 2. Turkey: Selected Indicators, 2000-03

	Prel.	Proj.		
	2000	2001	2002	2003
Real Sector				
GNP growth rate	6.1	-3.0	5.0	6.0
GNP deflator (in percent)	51.6	49.4	28.3	16.6
WPI (12-month, end-of-period)	32.7	57.5	16.6	12.5
CPI (12-month, end-of period)	39.0	52.6	20.0	15.0
Average nominal T-bill interest rate	38.0	81.0	40.6	32.6
Average ex post T-bill real interest rate 1/	-11.4	23.7	6.9	13.2
Average ex ante real interest rate 2/	-6.5	36.4	20.0	18.0
Central government's budget (in percent of GNP)				
Primary balance 3/	4.6	5.2	5.6	5.6
Net interest payments 4/	15.8	21.0	16.8	13.7
Budget balance	-11.2	-15.8	-11.2	-8.1
Consolidated public sector (in percent of GNP)				
Primary balance of public sector	2.8	5.5	6.5	6.5
Net interest payments 5/	21.9	23.5	14.3	11.7
PSBR (incl. CBT profits)	19.1	18.0	7.8	5.2
Net debt of the public sector (in percent of GNP)	**57.4**	**79.7**	**69.5**	**62.5**
Net external	18.3	30.5	24.8	20.2
Net domestic	39.1	49.2	44.7	42.3
Of which: Gross domestic debt of the central government	40.9	62.5	56.7	54.0
Auctioned debt	23.4	23.2	25.9	28.1
Bank recapitalization	17.4	31.4	24.1	20.0
External sector				
Current account balance (in percent of GNP)	-4.8	-0.5	-0.7	-0.5
Gross external debt (in percent of GNP)	56.6	68.7	61.9	58.9
Net external debt (in percent of GNP)	37.0	45.7	40.5	37.2
Monetary aggregates				
Seignorage 6/	1.8	1.5	1.0	0.7
Nominal growth rate of broad liquidity	39.9	59.5	29.7	17.3
Privatization proceeds (in millions of US$)	3,273	3,110	3,500	3,500
Net external financing of public sector (in millions of US$)				
Amortization	6,199	8,535	6,927	8,438
Gross borrowing	10,333	8,244	8,700	7,500
Of which: Eurobond issues	7,500	2,500	4,700	4,500
GNP (in trillions of lira)	125,971	182,445	245,741	303,555

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

1/ Average of monthly T-bill interest rate divided by 12-month past inflation.
2/ Average of monthly nominal interest rate divided by 12-month ahead CPI inflation.
3/ On a commitment basis, excluding profit transfers from the CBT, interest receipts, and privatization proceeds.
4/ Interest payments minus interest receipts plus profit transfers from the central bank.
5/ Interest payments minus interest receipts plus CBT profits before transfers to the government.
6/ Change in reserve money in percent of GNP, where reserve money is defined as currency issued plus reserve requirements.

Table 3. Turkey: Balance of Payments, 1998-2003
(In billions of U.S. dollars)

	1998	1999	2000	2001 Q1	2001 Q2-Q4	2001 Total	2002	2003
Current account balance	**2.0**	**-1.4**	**-9.8**	**-0.6**	**-0.3**	**-0.9**	**-1.7**	**-1.2**
Trade balance	-14.2	-10.4	-22.3	-2.2	-10.6	-12.8	-13.6	-14.5
Exports (fob)	31.2	29.3	31.2	8.1	26.0	34.1	36.5	39.3
Exports (fob) in trade returns	27.0	26.6	27.3	7.2	22.7	29.9	31.9	34.4
Shuttle trade	3.7	2.3	2.9	0.8	2.5	3.2	3.4	3.7
Imports (fob)	-45.4	-39.8	-53.6	-10.3	-36.6	-47.0	-50.1	-53.8
Imports (cif)	-45.9	-40.7	-54.0	-10.6	-36.5	-47.1	-50.3	-54.0
Energy imports (cif)	-4.5	-5.3	-9.3	-2.0	-6.1	-8.1	-7.5	-7.1
Services (net)	10.5	3.9	7.4	0.5	6.3	6.8	6.5	7.5
Services (credit)	25.8	18.7	22.3	3.8	18.9	22.8	24.0	25.6
Of which: Interest	2.5	2.4	2.8	0.8	2.1	2.9	3.1	3.2
Tourism receipts	7.2	5.2	7.6	0.8	7.6	8.3	8.6	9.1
Other receipts 1/	10.5	7.1	7.9	1.4	6.3	7.7	8.3	8.9
Services (debit)	-15.3	-14.8	-15.0	-3.3	-12.7	-16.0	-17.5	-18.0
Interest	-4.8	-5.5	-6.3	-1.8	-6.1	-7.9	-8.5	-8.2
Private transfers (net)	5.6	4.8	5.0	1.1	3.9	4.9	5.2	5.4
Workers remittances	5.4	4.5	4.6	0.9	3.6	4.5	4.7	4.9
Official transfers (net)	0.2	0.4	0.2	0.0	0.2	0.3	0.3	0.3
Capital account balance	**0.4**	**4.7**	**9.4**	**-2.0**	**-9.0**	**-11.1**	**6.7**	**4.8**
(including errors and omissions)	-1.5	6.6	6.8	-4.0	-10.0	-14.0	6.7	4.8
Direct investment 2/	0.6	0.1	0.1	1.6	-0.1	1.4	1.6	1.6
Portfolio investment in securities 2/	-6.1	0.2	-5.2	-2.9	-0.7	-3.6	1.5	1.5
Public sector (central & local governments & EBFs)	-1.9	1.2	6.2	0.0	-0.6	-0.5	2.6	-0.1
Bonds (net)	-0.3	3.1	6.1	0.4	0.0	0.4	2.3	0.6
Disbursements	2.7	5.0	7.5	0.7	1.8	2.5	4.7	4.5
Repayments	-3.0	-1.9	-1.4	-0.2	-1.9	-2.1	-2.4	-3.9
Loans (net)	-1.7	-1.9	0.1	-0.4	-0.5	-0.9	0.2	-0.7
Disbursements	1.2	1.0	3.7	0.3	4.1	4.4	4.0	3.0
Repayments	-2.8	-2.9	-3.6	-0.7	-4.6	-5.4	-3.8	-3.7
Central Bank of Turkey (net)	0.7	-0.2	0.7	0.0	0.2	0.2	0.9	1.0
Domestic money banks (net)	1.9	0.5	2.1	-0.4	-4.0	-4.4	0.1	0.5
Domestic money banks (FX deposits abroad - accumulation)	-0.8	-1.8	-1.9	1.5	-3.4	-1.9	-0.5	-0.5
Domestic money banks (other, net)	2.7	2.4	4.0	-2.0	-0.6	-2.5	0.6	1.0
Domestic money banks (medium and long term, net)	0.5	0.2	-0.2	-0.3	-0.4	-0.7	0.1	0.3
Domestic money banks (short term, net)	2.2	2.2	4.2	-1.6	-0.2	-1.8	0.5	0.7
Other private sector (net)	5.3	2.8	5.6	-0.2	-3.8	-4.1	0.1	0.5
Other private sector (medium and long term, net)	4.2	2.3	4.9	0.3	-3.2	-2.9	-0.8	-0.5
Other private sector (short term, net)	1.1	0.5	0.6	-0.5	-0.7	-1.2	0.9	1.0
Errors and omissions	-2.0	1.9	-2.7	-2.0	-1.0	-3.0	0.0	0.0
Overall balance	**0.4**	**5.2**	**-3.0**	**-4.6**	**-10.3**	**-14.9**	**5.0**	**3.6**
Change in central bank gross reserves	0.2	5.9	0.3	-3.1	1.7	-1.4	0.6	2.4
IMF (net)	-0.2	0.7	3.3	1.4	12.1	13.5	-4.5	-1.2
Purchases	0.0	0.8	3.4	1.4	13.2	14.6	1.2	0.0
Repurchases	-0.2	-0.1	-0.1	0.0	-1.1	-1.1	-5.6	-1.2

Table 3. Turkey: Balance of Payments, 1998-2003
(In billions of U.S. dollars)
(continued)

	1998	1999	2000	2001	2002	2003
Memorandum items						
Trade in goods and services						
As percent of GNP						
Current account balance, incl. shuttle trade	1.0	-0.7	-4.8	-0.5	-0.9	-0.6
Trade account balance, incl. shuttle trade	-6.9	-5.6	-11.1	-7.3	-7.0	-7.0
Exports of goods and nonfactor services	26.5	24.4	25.1	30.6	29.4	29.8
Imports of goods and nonfactor services	27.2	26.2	30.8	31.2	30.3	30.7
Percent change						
Value growth in exports of goods (incl. shuttle trade)	-4.4	-6.1	6.4	9.4	6.8	7.8
Value growth in exports of goods (excl. shuttle trade)	2.7	-1.7	4.4	9.4	6.8	7.8
Value growth in imports of goods	-5.3	-12.5	34.7	-12.3	6.7	7.4
Volume growth in exports of goods (excl. shuttle trade)	6.4	6.3	11.6	10.4	6.1	6.8
Volume growth in imports of goods	-2.5	-1.2	35.2	-10.4	9.0	7.4
Terms of trade	6.1	-6.6	-8.9	2.6	2.0	0.0
Reserve and debt indicators						
Gross foreign reserves (Central Bank of Turkey)						
US$ billion	20.9	24.3	23.2	21.8	22.3	24.7
Months of goods & NFS imports	4.1	5.3	4.1	4.2	4.0	4.1
External debt (end of period)						
US$ billion	96.9	103.0	114.3	121.2	120.9	122.0
Percent of GNP	47.1	55.0	56.6	68.7	61.9	58.9
Percent of exports of goods & NFS	177.7	225.3	225.5	224.5	210.7	197.9
Net external debt (end of period) 3/						
US$ billion	62.5	63.6	74.7	80.7	79.3	77.5
Percent of GNP	30.4	34.0	37.0	45.7	40.6	37.4
Short-term debt (end of period)						
US$ billion	21.2	23.5	28.9	25.3	26.7	28.5
Ratio to foreign reserves	101.6	96.7	124.6	116.0	119.6	115.4
Short-term debt plus MLT repayments						
US$ billion	32.7	36.1	44.5	43.9	42.8	46.0
Ratio to foreign reserves	156.5	148.5	191.6	201.7	191.4	186.1
Debt service ratio 4/	26.0	34.1	37.3	43.0	37.3	36.5
Other						
NFA of CBT	-0.2	5.4	-3.7	-15.0	4.2	2.6
NFA of DMBs	-1.9	-0.5	-2.1	4.4	-0.1	-0.5
NFA of the banking system	-2.2	4.9	-5.8	-10.6	4.1	2.2

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

1/ The decline in other receipts between 1998 and 2000 partly reflects a methodological change in the compilation of this item.
2/ Including privatization receipts.
3/ Nonbank external debt less the NFA of the banking system.
4/ Interest plus medium- and long-term debt repayments as percent of current account receipts (excluding official transfers).

Table 4. Turkey: Central Bank Balance Sheet, 2001-03
(End-of-period stocks, in trillions of Turkish liras) 1/

	2001						2002	2003
	Q1	May	May	Q2	Q3	Q4		
	Act.	Prog.	Act.	Prog.	Prog.	Prog.	Prog.	Prog.
Net foreign assets	**9,014**	**6,675**	**7,336**	**3,393**	**425**	**-2,679**	**3,752**	**9,900**
Net international reserves	14,454	12,937	13,199	9,686	6,781	3,928	11,495	18,595
Other foreign liabilities (net)	5,441	6,262	5,863	6,293	6,356	6,607	7,743	8,695
							30.3	17.5
Banks deposits in foreign currency	**7,858**	**9,024**	**8,374**	**9,069**	**9,160**	**9,522**	**12,407**	**14,578**
Required reserves	3,647	3,885	4,067	3,904	3,943	4,099	5,341	6,276
Free reserves	4,212	5,139	4,307	5,165	5,217	5,423	7,066	8,302
Net domestic assets	**4,422**	**8,203**	**6,860**	**11,704**	**15,272**	**19,483**	**17,488**	**14,795**
Net domestic assets (excluding devaluation account) 2/	*5,803*	*9,749*	*8,357*	*13,248*	*16,809*	*20,994*	*19,293*	*17,471*
Claims on central government (net)	**-557**	**15,849**	**13,023**	**19,173**	**22,225**	**25,665**	**27,645**	**29,306**
Claims on other public sector (net)	**-542**	**-542**	**-630**	**-542**	**-542**	**-542**	**-542**	**-542**
Claims on banks	**10,532**	**-692**	**-131**	**101**	**2,161**	**4,565**	**8,008**	**11,521**
Other items (net)	**-5,010**	**-6,412**	**-5,402**	**-7,027**	**-8,572**	**-10,205**	**-17,622**	**-25,489**
Other	-3,630	-4,865	-4,180	-5,483	-7,035	-8,694	-15,817	-22,813
Devaluation account	-1,380	-1,547	-1,222	-1,544	-1,537	-1,511	-1,805	-2,676
Securitizations	0			0	0	0	0	0
Base money	**5,578**	**5,854**	**5,822**	**6,029**	**6,537**	**7,282**	**8,833**	**10,117**
Currency issued	3,587	3,797	3,964	3,898	4,190	4,715	5,489	6,187
Bank deposits in liras	1,991	2,057	1,858	2,130	2,347	2,567	3,345	3,930
Required reserves	1,162	1,273	1,206	1,318	1,452	1,588	2,070	2,432
Free reserves	829	784	652	812	895	979	1,275	1,499

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

1/ All foreign currency aggregates are valued at current exchange rates.
2/ Includes also any monetization of the devaluation account since end-March 2001.

Table 5. Turkey: Public Sector Primary Balances, 2000-02

	2000	2001			2002
	Est.	May Prog.	Rev. Est.	Diff.	May Prog.
			(In trillions of TL)		
Public Sector	**3,531**	**9,964**	**9,964**	**0**	**16,062**
Central government 1/	**5,830**	**9,283**	**9,563**	**290**	**13,850**
Total revenue	31,978	45,561	46,411	850	62,191
Tax revenue	26,514	37,150	38,000	850	50,883
Nontax revenue 1/	5,463	8,411	8,411	0	11,307
Noninterest expenditure	26,148	36,278	36,838	560	48,341
Personnel	9,982	14,300	14,650	350	19,267
Other current	3,520	4,800	4,800	0	6,467
Transfers (excl. credit subsidies) 2/	10,250	13,028	13,238	210	17,554
Credit subsidies	145	400	400	0	0
Investment	2,251	3,750	3,750	0	5,053
Rest of the public sector	**-2,299**	**681**	**391**	**-290**	**2,212**
EBFs	-678	-506	-506	0	-246
Unemployment insurance fund	334	1,151	1,151	0	1,475
Local governments	-107	-215	-215	0	-246
SEEs	-1,848	251	-39	-290	1,229
Social insurance institutions	0	0	0	0	0
			(In percent of GNP)		
Public Sector	**2.8**	**5.5**	**5.5**	**0.0**	**6.5**
Central government 1/	**4.6**	**5.1**	**5.2**	**0.2**	**5.6**
Total revenue	25.4	25.0	25.4	0.5	25.3
Tax revenue	21.0	20.4	20.8	0.5	20.7
Nontax revenue 1/	4.3	4.6	4.6	0.0	4.6
Noninterest expenditure	20.8	19.9	20.2	0.3	19.7
Personnel	7.9	7.8	8.0	0.2	7.8
Other current	2.8	2.6	2.6	0.0	2.6
Transfers (excl. credit subsidies) 2/	8.1	7.1	7.3	0.1	7.1
Credit subsidies	0.1	0.2	0.2	0.0	0.0
Investment	1.8	2.1	2.1	0.0	2.1
Rest of the public sector	**-1.8**	**0.4**	**0.2**	**-0.2**	**0.9**
EBFs	-0.5	-0.3	-0.3	0.0	-0.1
Unemployment insurance fund	0.3	0.6	0.6	0.0	0.6
Local governments	-0.1	-0.1	-0.1	0.0	-0.1
SEEs	-1.5	0.1	0.0	-0.2	0.5
Social insurance institutions	0.0	0.0	0.0	0.0	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.

Table 6. Turkey: Central Government Primary Budget, 2000-01
(In trillions of Turkish liras)

	2000	2001		
	Est.	May Prog.	Rev. Est.	Diff.
Total revenue	**32,592**	**46,448**	**47,298**	**850**
Tax Revenue	**26,514**	**37,150**	**38,000**	**850**
Direct	10,849	12,891	13,291	400
Personal income	6,308	9,936	10,236	300
Corporate income	2,554	2,100	2,200	100
Motor vehicle and wealth	347	400	400	0
Windfall gains tax	1,641	455	455	0
Indirect	15,665	24,259	24,709	450
VAT	8,380	13,143	13,143	0
Domestic transactions	4,488	7,220	7,220	0
Foreign transactions	3,892	5,923	5,923	0
Petroleum excises	3,269	5,400	5,650	250
Foreign trade (excluding VAT)	398	551	551	0
Other indirect, incl. excises	3,619	5,165	5,365	200
Nontax revenue	**6,078**	**9,298**	**9,298**	**0**
Budgetary funds	2,206	3,084	3,084	0
Education levies	513	800	800	0
Revenue from state property 1/	1,157	1,783	1,783	0
Other nontax revenue	2,052	3,091	3,091	0
Of which: Interest receipts	332	415	415	0
CBT profits	229	472	472	0
Annexed budget	151	540	540	0
Noninterest expenditure	**26,148**	**36,278**	**36,838**	**560**
Personnel	9,982	14,300	14,650	350
Civil servants	8,274	12,100	12,180	80
Public workers	1,708	2,200	2,470	270
Other current	3,520	4,800	4,800	0
Transfers	10,001	13,428	13,638	210
Social security, incl unempl. fund	3,321	5,112	5,092	-20
Budgetary funds	1,995	866	866	0
Price Stabilization Fund	574	281	281	0
Other funds	1,421	585	585	0
Agricultural subsidies	359	1,060	1,060	0
State participation (capital transfers) 2/	248	65	65	0
Transfers to SEEs	886	1,000	1,100	100
Banks' credit subsidies	145	400	400	0
Tax rebates	1,632	2,050	2,050	0
Other transfers	1,415	2,875	3,005	130
Investment	2,251	3,750	3,750	0
Unallocated earthquake expenditures	395		0	
Primary balance (authorities' definition) 1/	6,444	10,170	10,460	290
Primary balance (IMF staff definition) 1/	**5,830**	**9,283**	**9,573**	**290**
Memorandum items				
Monitorable earthquake costs	1,343	650	650	0
Primary expenditure excl. tax rebates	24,516	34,228	34,788	560
Total revenue (IMF staff definition) 1/	31,978	45,561	46,401	850

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

1/ Excluding privatization proceeds, CBT profits, and interest receipts.
2/ Excluding recapitalization of state banks.

Table 7. Turkey: Central Government Primary Budget, 2000-01
(In percent of GNP)

	2000	2001		
	Est.	May Prog.	Rev. Est.	Diff.
Total revenue	**25.9**	**25.5**	**25.9**	**0.5**
Tax revenue	**21.0**	**20.4**	**20.8**	**0.5**
Direct	8.6	7.1	7.3	0.2
Personal income	5.0	5.4	5.7	0.2
Corporate income	2.0	1.2	1.2	0.0
Motor vehicle and wealth	0.3	0.2	0.2	0.0
Windfall gains tax	1.3	0.2	0.2	0.0
Indirect	12.4	13.3	13.5	0.2
VAT	6.7	7.2	7.2	0.0
Domestic transactions	3.6	4.0	4.0	0.0
Foreign transactions	3.1	3.2	3.2	0.0
Petroleum excises	2.6	3.0	3.1	0.1
Foreign trade (excluding VAT)	0.3	0.3	0.3	0.0
Other indirect, incl. excises	2.9	2.8	2.9	0.1
Nontax revenue	**4.8**	**5.1**	**5.1**	**0.0**
Budgetary funds	1.8	1.7	1.7	0.0
Education levies	0.4	0.4	0.4	0.0
Revenue from state property 1/	0.9	1.0	1.0	0.0
Other nontax revenue	1.6	1.7	1.7	0.0
Of which: Interest receipts	0.3	0.2	0.2	0.0
CBT profits	0.2	0.3	0.3	0.0
Annexed budget	0.1	0.3	0.3	0.0
Noninterest expenditure	**20.8**	**19.9**	**20.2**	**0.3**
Personnel	7.9	7.8	8.0	0.2
Civil servants	6.6	6.6	6.7	0.0
Public workers	1.4	1.2	1.4	0.1
Other current	2.8	2.6	2.6	0.0
Transfers	7.9	7.4	7.5	0.1
Social security, incl unempl. fund	2.6	2.8	2.8	0.0
Budgetary funds	1.6	0.5	0.5	0.0
Agricultural subsidies	0.3	0.6	0.6	0.0
State participation (capital transfers) 2/	0.2	0.0	0.0	0.0
Transfers to SEEs	0.7	0.5	0.6	0.1
Banks' duty losses/credit subsidies	0.1	0.2	0.2	0.0
Tax rebates	1.3	1.1	1.1	0.0
Other transfers	1.1	1.6	1.6	0.1
Investment	1.8	2.1	2.1	0.0
Unallocated earthquake expenditures	0.3			
Primary balance (authorities' definition) 1/	5.1	5.6	5.7	0.2
Primary balance (IMF staff definition) 3/	**4.6**	**5.1**	**5.2**	**0.2**
Memorandum items				
GNP (TL trillion)	125,971	182,439	182,439	
Monitorable earthquake expenditures	1.1	0.4	0.4	0.0
Total revenue (IMF staff definition) 3/	25.4	25.0	25.4	0.5

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

1/ Excluding privatization proceeds.
2/ Excluding recapitalization of state banks.
3/ Excluding privatization proceeds, CBT profits, and interest receipts.

Table 8. Turkey: Banking System - Selected Indicators, 1997-2001 1/
(In trillions of Turkish liras)

	December				Mar.
	1997	1998	1999	2000	2001
			Banking System		
Total assets	**22,759**	**41,969**	**82,371**	**119,202**	**131,448**
Cash and claims on CBT	1,495	2,665	5,097	6,235	7,667
Claims on other banks	2,679	4,414	9,070	14,376	14,602
Securities portfolio	5,857	10,179	23,344	32,027	34,433
T-bills and bonds	5,163	8,864	18,314	22,327	18,201
Other securities	694	1,314	5,030	9,700	16,233
Loans, net	8,873	14,689	22,601	35,789	40,614
Other assets	3,855	10,024	22,258	30,775	34,133
Total liabilities	**22,759**	**41,969**	**82,371**	**119,202**	**131,448**
Deposits	12,571	24,194	48,272	68,143	78,835
Borrowing from banks	2,556	4,663	10,070	15,996	20,786
Repos	3,139	4,644	8,950	13,620	11,128
Other liabilities	2,743	5,179	10,844	12,983	15,428
Shareholders' equity (incl. profits)	1,749	3,290	4,235	8,461	5,271
Memorandum items					
NPLs (%) total loans	2.1	6.7	9.7	9.2	8.5
ROA (%)	2.1	1.8	-0.4	-0.7	-3.3
ROE (%)	27.4	23.1	-7.2	-10.5	-83.0
Share in assets (%)	100	100	100	100	100
Share in deposits and repos (%)	100	100	100	100	100
			Private Banks 2/		
Total assets	**10,361**	**18,826**	**37,170**	**54,978**	**68,353**
Cash and claims on CBT	708	1,248	2,445	3,247	4,574
Claims on other banks	1,346	2,714	5,882	10,181	10,859
Securities portfolio	3,000	4,688	11,138	12,854	14,414
T-bills and bonds	2,635	3,768	7,613	6,414	4,439
Other securities	366	920	3,525	6,439	9,975
Loans, net	3,884	7,009	11,408	19,199	22,696
Other assets	1,422	3,167	6,297	9,498	15,809
Total liabilities	**10,361**	**18,826**	**37,170**	**54,978**	**68,353**
Deposits	5,331	10,489	20,694	29,865	40,490
Borrowing from banks	1,421	2,492	5,716	9,708	12,750
Repos	1,600	1,646	2,761	3,581	1,708
Other liabilities	983	1,940	3,585	3,930	5,715
Shareholders' equity (incl. profits)	1,025	2,259	4,414	7,894	7,690
Memorandum items					
NPLs (%) total loans	1.3	2.2	3.6	3.5	3.8
ROA (%)	3.8	4.3	3.9	2.6	0.3
ROE (%)	38.6	35.9	33.1	18.0	2.3
Share in assets (%)	45.5	44.9	45.1	46.1	52.0
Share in deposits and repos (%)	44.1	42.1	41.0	40.9	46.9

Table 8. Turkey: Banking System - Selected Indicators, 1997-2001 1/
(In trillions of Turkish liras)

	December				Mar.
	1997	1998	1999	2000	2001
	Public (state and SDIF) banks 3/				
Total assets	**10,733**	**20,472**	**39,250**	**55,877**	**53,047**
Cash and claims on CBT	751	1,341	2,510	2,806	2,743
Claims on other banks	948	1,116	1,638	2,316	2,114
Securities portfolio	2,673	5,244	11,214	17,903	19,008
T-bills and bonds	2,374	4,873	9,960	15,048	13,226
Other securities	299	371	1,255	2,855	5,782
Loans, net	4,126	6,209	8,610	12,946	13,065
Other assets	2,236	6,562	15,278	19,907	16,118
Total liabilities	**10,733**	**20,472**	**39,250**	**55,877**	**53,047**
Deposits	7,042	13,447	27,033	37,396	37,138
Borrowing from banks	416	911	1,685	2,495	3,691
Repos	1,469	2,940	6,077	9,834	9,318
Other liabilities	1,299	2,582	5,572	7,115	7,077
Shareholders' equity (incl. profits)	507	592	-1,116	-963	-4,177
Memorandum items					
NPLs (%) total loans	2.9	12.6	19.0	18.8	18.0
Net profit (loss) before tax	80	-89	-1,795	-2,555	-4,790
ROE (%) 4/	5.9	-33.8	...	...	...
Share in assets (%)	47.2	48.8	47.7	46.9	40.4
Share in deposits and repos (%)	54.2	56.8	57.9	57.8	51.6
	Foreign and Investment Banks				
Total assets	**1,665**	**2,672**	**5,951**	**8,346**	**10,049**
Cash and claims on CBT	36	75	143	182	350
Claims on other banks	385	584	1,550	1,878	1,629
Securities portfolio	183	247	992	1,271	1,011
T-bills and bonds	154	223	741	865	536
Other securities	29	24	251	406	475
Loans, net	864	1,471	2,583	3,645	4,853
Other assets	197	295	683	1,370	2,206
Total liabilities	**1,665**	**2,672**	**5,951**	**8,346**	**10,049**
Deposits	197	258	546	882	1,207
Borrowing from banks	719	1,259	2,670	3,792	4,345
Repos	70	58	111	205	103
Other liabilities	462	657	1,687	1,938	2,636
Shareholders' equity (incl. profits)	217	439	937	1,529	1,758
Memorandum items					
NPLs (%) total loans	1.8	2.1	2.1	1.8	2.1
Net profit (loss) before tax	79	212	496	489	310
ROE (%)	25.1	34.1	36.3	21.4	13.2
Share in assets (%)	7.3	6.4	7.2	7.0	7.6
Share in deposits and repos (%)	1.7	1.1	1.1	1.3	1.5

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

1/ Includes off-balance sheet repos and reverse repos.
2/ Domestic, commercial banks.
3/ These include 4 state banks and 13 SDIF banks (6 of these have now been merged into Sumerbank, 3 are under under negotiation for sale, another 3 are to be merged into a second transition bank, and 1 is to be liquidated) through the entire period.
4/ ROE is not reported when aggregate equity position is negative.

TURKEY: FUND RELATIONS
(As of May 31, 2001)

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

II. **General Resources Account**:

	SDR Million	% Quota
Quota	964.00	100.0
Fund holdings of currency	8,145.85	845.0
Reserve position in Fund	112.77	11.7

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	112.31	100.0
Holdings	4.85	4.3

IV. **Outstanding Purchases and Loans**:

	SDR Million	% Quota
Stand-by Arrangements	6,933.12	719.2
First credit tranche	361.50	37.5

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	12/22/99	12/21/02	15,038.40	6,933.12
Stand-by	7/08/94	3/07/96	610.50	460.50
Stand-by	4/04/84	4/03/85	225.00	168.75

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

	Overdue	Forthcoming				
	5/31/01	2001	2002	2003	2004	2005
Principal		867.6	3,181.2	1,068.1	1,622.9	554.8
Charges/Interest		217.4	324.8	140.2	75.7	14.7
Total		1,085.0	3,506.0	1,208.3	1,698.6	569.5

VII. Exchange Rate Arrangement:

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

VIII. Article IV Consultations:

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

IX. Technical Assistance: (1993–present)

Department	**Timing**	**Purpose**
MAE	July 1994	Banking sector reform
MAE	July 1995	Inflation accounting
FAD	September 1995	Taxation of petroleum products
FAD	October 1995	Assistance to IBRD-supported Public Financial Management Project; eight FAD missions since 1994, assignment of five resident experts, mainly focused on customs modernization.
STA	February 1997	Balance of payments compilation
PDR/EU1/MAE	December 1998	Short-term debt monitoring
MAE	June 1999	Basel Core Principles
MAE	August 1999	Debt management policies
MAE	October 1999	Banking sector reform

MAE	March 2000	Banking sector reform
FAD	April 2000	Fiscal transparency
FAD	April 2000	Tax policy
MAE	April 2000	Banking sector reform
MAE	May 2000	Banking sector reform
MAE	July 2000	Inflation targeting
STA	September 2000	BOP statistics
MAE	Sept. 2000-April 2001	Banking sector reform
FAD/STA	May 2001	Fiscal accounting and reporting

Ankara, June 26, 2001

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

Dear Mr. Köhler:

1. **We have continued to make good progress in implementing the ambitious agenda spelled out in the Memorandum on Economic Policies (MEP) attached to our letter dated May 3, 2001.** In that letter, we presented our strategy for overcoming the recent crises and putting Turkey on a path to sustainable growth. This strategy relies on strong structural reforms, prudent fiscal and monetary policies under a floating exchange rate regime, and an enhanced social dialogue. Following the completion of the sixth and seventh reviews on May 15, we have maintained a good record in implementing our program. The quantitative performance criteria for end-May were observed with large margins, and we have taken further steps in banking and other structural areas (Annexes A and B). Indeed, since May 3 parliament has continued to work with extreme speed. It has approved all the laws and legal amendments foreseen in the program, providing an impressive record of structural reform. On this basis, we request completion of the eighth review under the stand-by arrangement. We also request modification of the ceilings for the performance criterion on the cumulative primary expenditure of the central government for the remainder of 2001, in line with the supplementary budget adopted by parliament on June 14 (Annex C).

2. **We have been encouraged by the initial results of our program.** The benchmark treasury bill rate fell by over 50 percentage points between mid-April and mid-June. After the sharp increases in the price level in March and April following the large depreciation, the more modest price increases in May indicate that CPI inflation remains on a path broadly consistent with our initial inflation estimates. While we have not yet moved to formal inflation targeting, which we intend to implement as soon as feasible, we are projecting CPI inflation at 18 percent in the second half of the year, and we aim at bringing inflation down to about 2 percent per month (on a seasonally adjusted basis) in the final quarter. Indicators of economic activity confirm a recession in the early part of the year, but we expect the restoration of confidence, strong export growth and expenditure switching, and record-high tourism activity to help initiate a recovery in the second half of the year, limiting the decline in GNP to the projected 3 percent in 2001. The developments on the external current account in the first quarter of the year are in line with the projected broad balance for the full year.

3. **We remain firmly committed to the unfaltering implementation of the program, with the help of strong international financing support and an open communications policy.** The May 3 letter remains the main document describing our policies for 2001–02,

and is updated in the present letter in a number of areas. To fulfill the program's financing needs, we have secured substantial official and private financing. The recent augmentation of IMF support under the stand-by arrangement and the forthcoming support from the World Bank under the Programmatic Financial and Public Sector Adjustment Loan are the key elements of the official financing package. As for private sector involvement, we recently held meetings with foreign banks in Frankfurt and New York, and have received commitments from these banks to maintain their current exposure to Turkish banks and to seek to rebuild their interbank and trade credit lines as the program is implemented. On our communication policy, we are taking a number of initiatives to better explain the economic program to the investor community and the public at large. We have published the May 3 letter and the MEP and, for the first time, agreed to the publication of the IMF staff report. The Treasury has hired new external communication staff, enhanced the contents and frequency of press releases, and is preparing fact sheets on aspects of the program on its website. The Central Bank of Turkey (CBT) and the Bank Regulation and Supervision Agency (BRSA) have both held meetings with the media and the banking community to explain the program, and have posted information about the program on their respective websites.

Incomes policy

4. **Incomes policy will continue to play an important role in the program.** Wage negotiations for public sector workers were concluded in late May. We estimate that the two-year agreement will lower the ratio of average net salaries of public sector workers and civil servants from 2.6 in 2000 to 2.2 in the first contract year before raising it to 2.3 in the second contract year. While the agreement therefore results in a significant realignment of the relative wage of public sector workers in 2001, the outcome was not fully in line with our objectives. Nevertheless, the unions agreed to postpone payment of the wage increase slated for the first six months of the contract to early 2002, and the agreement involves a substantial decline in real wages in 2001. To offset the additional cost to the public sector of about 0.4 percent of GNP in 2001, we have taken a number of measures to achieve the targeted increase in the public sector primary surplus (see paragraph 7 below). Moreover, we will strengthen the dialogue with social partners to encourage moderate wage and price increases in the private sector. To this end, the Economic and Social Council will meet at least once a quarter and will become more central to the dialogue now that its legal status has been strengthened. In these meetings, the achievements and objectives of the program will be highlighted, and we will encourage forward-looking price- and wage-setting behavior anchored to the program's targets, including through wage and price guidelines for the private sector consistent with the inflation objective. In addition, the Minister of State for Economic Affairs will continue to make a determined outreach effort to labor unions, industrialists, employers, and bankers.

Fiscal policy

5. **Our fiscal efforts in 2001 have been strong.** In the consolidated central government, the primary surplus (excluding privatization proceeds, transfers of profits from the CBT, interest receipts, and the cost of state banks' recapitalization) through April at 1.8 percent of

annual GNP was somewhat above our projections, owing to the strong performance of the withholding tax on interest income in April, and preliminary data for May suggest an even larger, and more broad-based, overperformance. Regarding policy efforts, in May we raised VAT rates as planned, and increased the minimum contribution base relevant for social security payments by 40 percent, while increasing the contribution ceiling from four to five times the minimum contribution. We also raised petroleum consumption taxes by over 20 percent in May and by 16 percent in June, more than originally planned. In the state enterprise sector, we have made substantial progress in implementing the comprehensive set of measures specified in paragraph 32 of the May 3 MEP. With the exception of the public sector wage agreement and the grain support price decision (see next paragraph), all these measures have been implemented as planned.

6. **Nevertheless, there have been some deviations from original plans.** The public sector wage agreement will add TL 250 trillion to the central government wage bill and TL 410 trillion to the wage bill of state enterprises this year. We will also need TL 80 trillion more than originally budgeted to cover the additional civil service wage bill arising from slightly higher-than-projected CPI increases earlier this year. Moreover, the increase in the wheat support price by a weighted average of 63.4 percent exceeded targeted inflation, resulting in an additional cost to the public sector of TL 200 trillion. Finally, in line with World Bank advice, we have increased direct income support to farmers by TL 100 trillion compared with the May program. All in all, these deviations add some TL 1 quadrillion (0.6 percent of GNP) to public expenditure this year.

7. **We have taken offsetting measures to remain on track to meet our public sector primary surplus target of 5.5 percent of GNP in 2001.** Achieving this target is a key part of our strategy to ensure a sustainable debt position. The additional measures we have already put in place are as follows. First, as mentioned above, we raised petroleum consumption taxes in May and June more than originally planned, and in the remainder of the year will increase them monthly at least by WPI inflation. Second, in the state enterprise sector, we have decided to increase electricity and gas prices more than originally planned. Specifically, the average price of electricity sold by TEAS (the electricity generation company) will rise gradually to US$5.1 cents/kwh by the end of the year, so as to achieve an average of US$4.5 cents over the year, the tariffs of TEDAS (the electricity distribution company) will increase accordingly, and the average sale price of BOTAS (the natural gas company) will reflect input costs strictly. Third, on June 11 TEKEL (the tobacco and alcohol company) increased cigarette and alcohol prices by 16–22 percent. Fourth, to increase the activity of private traders in the grain market and to allow TMO (the soil products office) to regulate the market with minimum cost, the government has issued a decree setting the margin between the purchase and sale prices at 18–26 percent, compared with 12–20 percent last year. In total, the above-mentioned measures are estimated to yield 0.3 percent of GNP in the remainder of the year. We believe that these measures, together with the stronger-than-expected revenue performance in April and May (with a full-year effect of 0.3 percent of GNP), will fully compensate for the remaining additional fiscal cost of the deviations mentioned in the previous paragraph.

8. **On June 14, parliament approved a supplementary budget for 2001 consistent with the program objectives, meeting a condition for the completion of the eighth review.** This budget targets the consolidated central government primary surplus at 5.2 percent of GNP (excluding privatization proceeds, transfers from the CBT, interest receipts, and the cost of state banks' recapitalization) and incorporates the impact of all the revenue and expenditure measures described in detail in paragraphs 30–31 of the MEP attached to our letter of May 3. While the supplementary budget provides only an overall envelope for expenditure, we will protect the real value of spending on health, education, and social areas. To ensure that the primary surplus target is reached, the Ministry of Finance stands ready, if necessary, to issue directives to reduce discretionary noninterest expenditure relative to budget allocations during the year.

9. **Supporting measures are being introduced to reduce government borrowing costs and facilitate the placement of government debt.** The Treasury's domestic borrowing program for June is based on the strong primary budget position and the use of external resources, allowing for a sharp reduction in the domestic debt rollover ratio to 47 percent for this month. Strong fiscal policy and the use of additional external assistance are expected to keep the Treasury's domestic borrowing need well below redemptions during the second half of 2001. To reduce this need further and lengthen the maturity on domestic debt, the government has undertaken a voluntary debt swap, prepared with the help of advisors from two international investment banks. The auction held on June 15 was successful, resulting in an exchange of some US$8 billion of short-maturity Turkish lira government paper for a mix of longer-dated Turkish lira and foreign exchange indexed government paper. Other steps to improve debt management are also being taken. A committee of public and private sector representatives will announce in July its proposals to institute a strengthened primary dealer system by end-August. The legal framework for debt management will be provided by a new Law on Public Finance and Debt Management. Preparations are on track for the draft Law to be submitted to parliament by end-June.

Monetary and exchange rate policy

10. **In its pursuit of price stability in the transition toward direct inflation targeting, the CBT will continue to focus on the control of monetary aggregates under the floating exchange rate regime.** Developments through May—base money below (but close to) the program's indicative ceiling, and inflation and growth broadly on the projected path—indicate that there is no need to revise the monetary parameters in the program at this point.[1] Hence, the CBT will aim to keep base money closely in line with the indicative ceilings specified in Annex E of the May 3 MEP. This base money path—designed to be consistent with our inflation and growth projections—will continue to be the key nominal anchor for the

[1] Annex D, which is a revised version of Annex E of the May 3 MEP, clarifies the definition of net domestic assets (NDA) under the program. The NDA ceilings are not affected by the clarification. The clarification involves replacing paragraph 4 of Annex E of the May 3 MEP by two new sentences.

program. The CBT stands ready to raise money market rates even if base money is close to its target, should other inflation indicators suggest that the disinflation process is in jeopardy. Regarding NDA, as indicated in the May 3 MEP, the ceilings specified in the program allow for the bulk of the external financing to be used to reduce the government's borrowing needs, thereby facilitating a decline in interest rates and contributing to the sustainability of the government's debt position. To keep NDA within the targeted path, the CBT will adjust money market interest rates as needed. To offset the expansion of NDA resulting from the use of external financing, the floors on Net International Reserves (NIR) have been set to allow the CBT to mop up this additional liquidity through the sale of foreign exchange. Starting in July, the CBT will announce to the markets the timing and amounts of its auctions to sell foreign exchange tied to the external resources being lent to the government to alleviate its borrowing requirement. These sales of foreign exchange will coincide as much as possible with any creation of domestic liquidity generated by the use of those resources by the government in financing its domestic operations. Any other intervention in the foreign exchange market will be strictly limited to the smoothing of short-term fluctuations, and will be effected primarily through auctions. In this regard, the CBT will also refrain from lending or borrowing foreign exchange in the interbank market.

11. **The CBT is making progress in the preparatory work to move to a direct inflation targeting framework as soon as feasible.** It is enhancing its information base, including through improving its structural and short-term models and preparing new surveys of financial markets' expectations about inflation and other macroeconomic indicators, which will start by September 2001. During the preparatory phase, the CBT will continue to discuss inflation targeting with officials from countries that are implementing such a monetary policy framework, and will seek further technical assistance as needed. The CBT is improving its communication strategy also in this area, to clarify both how monetary policy is being conducted in the transition to inflation targeting, and how it will be carried out once the transition is complete.

Structural policies

Banking

12. **We will make every effort to keep banking reform on track:**

- **The strengthening of state banks is progressing well.** The three state banks with negative net worth (Ziraat, Halk, and Emlak) have been recapitalized to the regulatory levels. The overnight position of these banks (and the banks owned by the Savings Deposit Insurance Fund, SDIF) was eliminated by mid-June, and the stock of repurchase agreements of state and SDIF banks with the CBT was brought to below TL 7 quadrillion by end-May (both are **conditions for completing the eighth review**). A law (see below) has been approved by parliament to facilitate the closing of Emlak (that is, the revocation of its license) and the transfer of all its liabilities and some of its financial assets to Ziraat and Halk (another **condition for completing the eighth review**). Moreover, a reporting system has been put in place to monitor profits/losses, liquidity, and interest rate margins in the state banks. The reports generated by this system indicate that Ziraat and Halk now have positive margins and that deposit withdrawals have so far been limited. Independent outside auditors have also been appointed for each bank. Finally, a law has been passed by parliament to allow the implementation of several key measures in reforming state banks. The law includes provisions to (i) facilitate the closure of Emlak, (ii) promote the operational restructuring of state banks, and (iii) remove the government's power to impose duty losses in the future.

- **Substantial progress has been made in the resolution of SDIF banks.** The SDIF banks have been recapitalized to cover their negative net worth. We are in the process of finalizing the sale process of three banks: Demirbank, Bank Ekspres, and Sümerbank (the first transition bank). The closure of Ulusal has now been completed, with its assets and liabilities having been transferred to Sümerbank for resolution. The process of selling Iktisat will commence once the Sworn Bank Auditors finalize their evaluation of the bank's financial position. On June 15, the BRSA issued a decision to merge three of the remaining four SDIF banks (Etibank, Interbank, and Esbank) into a second transition bank (under Etibank), while the fourth one (Türk Ticaret) would be closed down. Merging these banks into a transition bank or placing them into liquidation is **a condition for completing the eighth review**.

- **The capital bases of private banks are being strengthened.** The BRSA has assessed the financial condition of all 27 private domestic deposit-taking banks, and commitment letters will be signed with all the banks identified as financially weak or undercapitalized (**a condition for completing the eighth review**). In these letters, the managements of individual banks will be required to commit themselves to take action, by specific dates, to strengthen the financial condition of their banks and to ensure appropriate capitalization levels. Initial steps in recapitalizing these banks will be taken immediately, and some capital will already be raised before end-June 2001, followed by additional capital augmentation steps from then until the end of year, by which date all banks are expected to be in full compliance with all prudential regulations. BRSA will promptly impose sanctions prescribed in the Banking Law on any bank that does not fully comply with the commitment letter. These sanctions range from the replacement of managers and board members in less severe cases to full intervention in the case of more serious violations. Assessment of compliance with the commitment letters will be a focus area in the subsequent program reviews.

- **In May, the CBT put in place an enhanced monitoring system to provide weekly data on interest rates offered by individual banks.** Combined with daily bank-by-bank data on interbank transactions, these data provide early warning of liquidity pressures and facilitate early intervention of problem banks.

- **Legislative amendments and the newly-appointed professional BRSA Board will help reinforce the implementation of banking reforms.** The amendments to the Banking Law enacted on May 28 have provided (i) immunity for BRSA staff from prosecution for actions taken while performing their duties; (ii) tax deductibility for specific loan loss provisions; (iii) that a regulation on connected lending in line with EU regulations will be issued by June 28, 2001 (**a structural benchmark**); and (iv) additional powers to the SDIF's Collection Department (COD) in carrying out loan recoveries. Moreover, we are in the process of fully staffing the COD, and preparing operational guidelines for loan recovery. In addition, we will transfer all the nonperforming loans of Sümerbank above TL 75 billion (some 1,200 loan files) to the COD by end-July. Finally, a law to eliminate the remaining tax hurdles for mergers, including in the financial sector, has been approved by parliament.

Enhancing the role of the private sector in the economy

13. **Privatization, including preparations for divestiture of large state-owned assets, is moving apace.** We expect that a new professional board and management team of Türk Telekom will be put in place shortly, meeting **a condition for completing the eighth review**. The immediate priority of the new Telekom Board will be to adopt a plan for corporatization. The Privatization Administration is working on a privatization plan for Türk Telekom in accordance with the new Law, which the Ministry of Transport will present to the Council of Ministers as soon as the plan is finalized. While the timing of sale of individual enterprises will depend on market conditions (which in turn are linked to our progress in implementing the economic program and restoring financial stability), the Privatization Agency is moving ahead with the preparation for privatization of assets in its portfolio. Specifically, advisors have been engaged for the further sale of state participations in TUPRAS (the oil refinery) and POAS (petrol stations), and we expect that the public offering of both companies could be carried out in the fourth quarter of this year. Now that domestic air fares have been liberalized, the public offering for Turkish Airlines is also foreseen for the fourth quarter. Following the adoption of the Sugar Law in April and the new Tobacco Law in June (the latter is **a condition for completing the eighth review**), we will move ahead with the privatization of the sugar and tobacco factories in the context of our agricultural reform program supported by the World Bank. In the steel sector, a major operational restructuring involving the reduction of the workforce is underway, in preparation for the eventual privatization of ERDEMIR through a merger with ISDEMIR. Following a review of obstacles for the sale of state-owned land, legal amendments to facilitate these sales will be submitted to parliament by the summer recess. All in all, we believe that the targeted US$1 billion in privatization proceeds in the remainder of this year is well within reach.

14. **We are also making progress in improving the business climate.** The law to implement the constitutional amendment on international arbitration was approved by parliament on June 21, meeting **a structural benchmark**. A study on administrative barriers to investment by the World Bank's Foreign Investment Advisory Service is expected to be completed in late June. In view of the need to incorporate the views of all relevant agencies, the conference to discuss the conclusions of this study can only be held in early September, and will be followed by the presentation of an action plan to the Council of Ministers shortly thereafter.

Transparency

15. **The work toward improving the transparency and efficiency of public management is moving ahead.** In particular, we have adopted a tax regulation in June that extends the use of tax identification numbers (TINs) in the financial sector starting in September 2001, meeting **a condition for completing the eighth review**. The tax administration will make full use of the information provided by the TINs to broaden the tax base and improve compliance. We also remain committed to improving fiscal accounting and reporting. In May, the Treasury and IMF staff organized a two-day seminar on budget classification and accounting, and held technical discussions on how to move toward accrual accounting. Since then, we have started publishing in the monthly reports of the Treasury a "lending minus repayments" item to monitor the payments by Treasury of called guarantees and the amounts repaid. A new budget classification in line with international standards has been completed, and will be implemented in six pilot budget agencies for the 2002 budget. The law providing for the closure of the remaining 15 budgetary funds (except DFIF) and two extrabudgetary funds was approved by parliament on June 19, meeting an end-June **structural benchmark**.

16. **We are also moving ahead with a three-pronged plan to improve governance in the public sector and promote effective government**. First, a Public Expenditure and Institutional Review (PEIR) was completed with a series of intra-governmental workshops in Ankara in May, with the support of the World Bank. An international conference will be held in November to disseminate and discuss the findings of the PEIR study. Second, an international conference on *Promoting Good Governance and Anti-Corruption in Turkey* will be held in early September, also with the support of the World Bank, to diagnose the problem, develop actions, and mobilize political support. Third, to strengthen the code of conduct of government officials, a law to streamline the prosecution of public officials has been forwarded to parliament.

17. **Following up on the fiscal transparency report completed last year, we are requesting the preparation of the data module of the IMF's Reports on Observance of Standards and Codes (ROSC)**. Last summer's ROSC module on fiscal transparency was well received. We believe that the data module will provide a useful assessment of our economic data and dissemination practices, further adding credibility and transparency to our economic data and policies. We expect an IMF team to visit Ankara in October to work with us on this report.

Very truly yours,

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

Table 1. Turkey: Quantitative Performance Criteria and Indicative Targets

	March 31, 2001		May 31, 2001		June 30, 2001		July 31, 2001		September 30, 2001		December 31, 2001
	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor	Outcome	Ceiling/Floor
I. Performance criteria											
1. Floor on the cumulative primary balance of the consolidated government sector (in trillions of Turkish lira)	1,850	2,256	3,250	...	...		4,250		6,200		9,250
2. Ceiling on the stock of net domestic assets of the CBT (in trillions of Turkish lira)	0	5,117	9,750	7,942	13,250		15,850		19,500		21,000
3. Floor on change in net international reserves (in millions of US$) 1/	...	...	-1,500	-837	-2,900		-2,000		-2,600		-600
4. Ceiling on contracting or guaranteeing of new external public debt (in millions of US$)	5,500	1,035	...	...	7,500		...		12,000		1,700
5. Ceiling on the stock of public short-term external debt outstanding (in millions of US$)	1,100	1,000	...	...	2,100		...		2,100		2,100
6. Ceiling on the cumulative primary expenditure of the central government (in trillions of Turkish lira)	5,830	5,480	11,400	...	...		17,450		23,880		34,790
II. Indicative targets											
1. Floor on the cumulative overall balance of the consolidated government sector (in trillions of Turkish lira)	-2,620	-1,945	-4,750	...	...		-11,750		-18,150		-26,450
2. Ceiling on the base money (in trillions of Turkish lira)	...	...	5,900	5,815	6,050		6,300		6,800		7,300

1/ Floors correspond to changes in NIR during the period specified in Annex F of the Memorandum on Economic Policies attached to the May 3, 2001 Letter of Intent.

Table 2. Turkey: Structural Policy Conditionality, 2001

Action	MEP Ref. [1]	Type of Action	Timing	Status, June 25, 2001
Banking Sector Reform				
1. Reduce the SDIF and state banks' overnight position by at least two-thirds from the March 16, 2001 level	¶8	Condition for the completion of the 6th and 7th reviews		Done
2. Eliminate the SDIF and state banks' remaining overnight position	¶8	Condition for the completion of the 8th review		Donc
3. The stock of repos of the SDIF and state banks with the CBT not to exceed TL 7 quadrillion	¶8	Condition for the completion of the 8th review	By end-May 2001	Done
4. Establish a common and politically independent board for Ziraat and Halk reporting to the treasury and appoint new management	¶10	Condition for completion of the 6th and 7th reviews		Done
5. Complete financial restructuring of state banks	¶10	Condition for completion of the 6th and 7th reviews		Done
6. Close Emlak Bank and transfer its liabilities and some of its assets to Ziraat Bank	¶11	Condition for completion of the 8th review	By end-May 2001	
7. The SDIF to recapitalize Sümerbank to cover its negative net worth	¶12	Condition for completion of the 6th and 7th reviews		Done
8. Recapitalize the remaining seven SDIF banks to cover their negative net worth	¶13	Condition for completion of the 6th and 7th reviews		Done
9. Organize in a second transition bank or put into liquidation the four banks for which there arc presently no bidders	¶13	Condition for completion of the 8th review		
10. Sell, put into liquidation, or otherwise resolvc the remaining SDIF banks	¶13	Condition for completion of the 12th review	End-2001	
11. (a) Presentation by all capital-dcficient banks of detailed capital strengthening plans (b) Finalization of commitment letters by the banks on recapitalization plans agreeable to Fund staff	¶15 ¶12[2]	Prior action for 6th and 7th reviews Condition for completion of the 8th review	By end-April 2001	Done

[1] Unless indicated otherwise, this refers to relevant paragraphs in the May 3 Memorandum on Economic Policies (MEP).

[2] Refers to the paragraph in this Letter of Intent.

Action	MEP Ref. [1]	Type of Action	Timing	Status, June 25, 2001
12. Parliamentary approval of amendments to Banking Law	¶16	Condition for completion of the 6th and 7th reviews		Done
13. Adopt connected lending regulation	¶17	Benchmark	Within one month of approval of Banking Law	Expected to be issued by June 28
14. Bring accounting standards for banks in line with international standards	¶17	Benchmark	From the beginning of 2002	
Fiscal Transparency and Management				
15. Close the remaining 15 BFs (except DFIF) and 2 EBFs	¶19	Benchmark	End-June 2001	Done
16. At least halve the number of revolving funds	¶19	Benchmark	End-2001	
17. Submit to parliament a Law on Public Finance and Debt Management	¶19	Benchmark	End-June 2001	
18. Accompany the draft 2002 budget by accounts and financial outlook for EBFs and SSIs, revolving funds, contingent liabilities, SEEs, and local authorities	¶19	Benchmark		
19. Submit to parliament a Public Procurement Law in line with EU standards	¶19	Benchmark	By October 15, 2001	
Increasing the Role of Private Domestic and Foreign Capital in the Turkish Economy				
20. Parliamentary approval of legislation to facilitate Turk Telekom privatization	¶21	Prior action for 6th and 7th reviews		Done
21. Appointment of new professional board and management team for Turk Telekom	¶21	Condition for completion of 8th review		
22. Parliamentary approval of Tobacco Law	¶21	Condition for completion of 8th review	May 2001	Done
23. Passage by parliament of a law fully implementing the constitution amendment on international arbitration	¶22	Benchmark	Before parliament's summer recess	Done
Fiscal Policy and Public Debt Management				
24. Approval of tax measures: (a) increase petroleum consumption tax by 15 percent in early May; (b) increase VAT rates (except the reduced 8 percent rate) by 1 percentage point; and (c) increase, as of April, the minimum contribution base relevant for social security payments in line with the existing regulations	¶30	Prior action for 6th and 7th reviews		Done
25. Approval of supplementary budget in line with program expenditure figures and offsetting budgetary measures listed in ¶6 of the present letter	¶34	Condition for completion of 8th review		Done
26. Enact tax regulation to extend the use of tax identification numbers	¶34	Condition for completion of 8th review	End-May 2001	Done
27. Reduce the stock of private sector tax arrears from the end-2000 level of 2 percent of GNP (including interest and penalties)	¶34	Benchmark	End-2001	

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

	Ceilings (In trillions of TL)
Cumulative primary expenditure from January 1, 2001 through:	
May 31, 2001 (performance criterion)	11,400
July 31, 2001 (performance criterion)	17,450
September 30, 2001 (performance criterion)	23,880
December 31, 2001 (performance criterion)	34,790

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

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

3. The deficits of the social security institutions (SSIs) are covered by transfers from the central government budget. The ceiling on the primary expenditure of the central government (Table 3) will be adjusted downward for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as those payments overdue by more than one month, and in the case of Bag Kur exclude arrears to the common retirement fund. As of December 31, 2000, the stock of arrears of Bag Kur stood at TL 120 trillion, while the two other institutions had no expenditure arrears.

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

Table 4. Turkey: Performance Criteria on the Net Domestic Assets of the Central Bank of Turkey

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

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

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

2. Base money is defined as currency issued by the CBT, plus the banking sector's deposits in Turkish lira with the CBT. Indicative ceilings for base money are shown in Table 4.a below.

3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex F of the May 3 MEP), medium-term and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange. As of March 31, 2001, net foreign assets of the CBT amounted to TL 9,012 trillion.

4. The cumulative net change in the devaluation account from its balance at end-1999 (excluding any distribution of unrealized foreign exchange profits, in cash or through the write-off of government paper held by the CBT, since end-March 2001) will be subtracted from end-period NDA stock as defined above. The balance of the devaluation account at end-March 2001 was TL-1,380 trillion.

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

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

where: R denotes the 4 percent reserve requirement plus the 2 percent liquidity requirement coefficient and ΔB denotes the change in base generated by a change in the definition of the reserve aggregate. The averaging period will not be changed during 2001.

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

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

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

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

Table 4a. Turkey: Indicative Ceilings for Base Money

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

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

Statement by the IMF Staff Representative
July 12, 2001

This statement provides an update on economic and policy developments since the staff report (EBS/01/97, 6/26/01) was issued. It also expresses the staff's views on the request by Messrs. Kiekens and Çakir to waive the applicability of the two quantitative fiscal performance criteria for end-May 2001 and the two external debt performance criteria for end-June 2001. The information provided in this statement does not warrant changes in the thrust of the staff appraisal.

The Board meeting to discuss the eighth program review was postponed from July 3, owing to delays in implementing four of the nine conditions for completing the review. Three of the outstanding conditions were in the area of banking, and the remaining one concerned Türk Telekom. As reported below, the authorities have since made satisfactory progress in meeting these conditions.

Market unease over the implementation of conditions for completing the eighth review has been reflected in interest rates, and to a lesser extent, the exchange rate. The treasury has met its minimum borrowing limit in the last three weekly debt auctions, but at interest rates in the 92–95 percent range. Secondary market rates for the benchmark bond have likewise risen from an average of 82 percent in the last week of June to 94 percent on July 10. The Turkish lira has depreciated by some 4 percent since end-June.

Recently released data give additional support to the assessment in the staff report of moderating inflation and a sharp decline in economic activity. Inflation in June fell in line with program projections to 3.1 percent for the CPI and 2.9 percent for the WPI. National accounts data indicate that real GNP fell in the first quarter of 2001 by 4.2 percent year on year, somewhat more than programmed but less than expected by most market analysts. Industrial production fell further in May, with the average index (adjusted for working days) for the first five months of 2001 some 6 percent below the same period a year earlier.

The monetary program was broadly on track through June. The end-June performance criteria on NDA and NIR were observed. Base money exceeded its indicative ceiling by some 3 percent.

The four structural benchmarks covered by this review have been met. The staff report already indicated that the law providing for the closure of the remaining budgetary and extrabudgetary funds was passed by parliament in mid-June (it was signed into law by the President on July 2). Since then, the law fully implementing the constitutional amendment on international arbitration was passed on June 21 (and signed into law on July 5), the connected lending regulation was issued on June 22, and the law on public finance and debt management was submitted to parliament on July 5.

The Turkish authorities have over the past few days taken several steps toward meeting the four conditions for completing the review that were outstanding when the Board meeting scheduled for July 3 was postponed:

- **Closing Emlak bank.** This condition was met on July 9, when the license of the bank was revoked.

- **Merging or putting into liquidation four unsellable intervened banks.** Three of these were merged into a second transition bank on July 2. While the banking supervision board (BRSA) had decided on June 15 to put the remaining bank (Türk Ticaret) into liquidation in early July, the liquidation is now on hold owing to a court case. The BRSA has appealed the initial court decision against the liquidation, and has devised a strategy to resolve the bank no later than in August even if the appeal is unsuccessful.

- **Signing of commitment letters on capital strengthening plans by financially weak private banks.** This condition was met by July 10 for all but one of the weak banks. By end-June, acceptable commitment letters had been signed by most private banks that had been identified as financially weak. On July 10, the BRSA intervened five private banks. Three of these had not presented any recapitalization plans, and the other two had plans judged not to be credible. In the case of one bank, the authorities have agreed to provide a resolution plan by end-August.

- **Appointing a new professional board and management for Türk Telekom.** In the Fund and World Bank staff's view, the board appointed on June 29 did not meet the program's criteria, namely that: "In order to ensure full commercialization of the company, the members of the new professional board and management team appointed by the general assembly of Türk Telekom will have recognized qualifications and experience. The board and management team will have members with relevant private sector experience" (paragraph 21 of the May 3 Memorandum on Economic Policies). On July 10, the authorities made further changes in Türk Telekom. Specifically, (i) the company's board was expanded by two new members with relevant private sector experience; (ii) the roles of the general manager and chairman of the board were separated; (iii) a new chairman was elected; and (iv) two new deputy general managers were appointed. In addition, the company has decided to hire an international advisor to help it with its corporatization plan, and the authorities have invited the IFC to join the effort, with a mission scheduled to arrive in Ankara shortly.

The staff considers that the authorities have made satisfactory progress in meeting the conditions for completing the eighth review. Five conditions were met in full by end-June. Of the three outstanding actions in the banking area, one has since been fully met. In the case of one of the unsellable intervened banks, the delay in resolution is for reasons beyond the authorities' control, and the staff finds the strategy proposed by the authorities reasonable. The staff also recognizes that the remaining weak private bank for which a commitment letter has not been signed is a particularly complex case, and finds the approach proposed by the authorities acceptable. Regarding Türk Telekom, in the Fund and Bank staff's view the company's new board and management team meet the program's conditions.

The staff reaffirms its recommendation to the Board that the eighth review be completed. In the second half of May and in June, the authorities built upon the strong upfront measures taken ahead of the Executive Board approval of the new economic program by taking important further actions in banking, privatization, and transparency. While higher-than-expected interest rates continue to pose a risk to the success of the program, the progress in July in implementing the remaining conditions for completing the review is further evidence of the authorities' strong efforts to keep their ambitious program on track.

Finally, the staff supports the request to waive the applicability of the two quantitative fiscal performance criteria for end-May 2001 and the two external debt performance criteria for end-June 2001, as the relevant information is not yet available. Based on preliminary information, these performance criteria are expected to have been met.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 01/57
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July 12, 2001

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Approves US$1.5 Billion Tranche Under Stand-By Credit to Turkey

The Executive Board of the International Monetary Fund (IMF) today approved the eighth review of Turkey's economic program supported by the three-year Stand-By Arrangement. The Board's decision will enable Turkey to draw SDR 1.2 billion (about US$1.5 billion) immediately from the IMF.

The stand-by credit was approved in December 1999 for SDR 2.9 billion (about US$4 billion—see Press release 99/66). In December 2000, SDR 5.8 billion (about US$7 billion) in additional financial resources were made available under the Supplemental Reserve Facility (SRF—see Press Release 00/80). On May 15, 2001, the IMF approved the increase of the stand-by credit by SDR 6.4 billion (about US$8 billion), bringing the total available resources from the IMF to SDR 15 billion (about US$19 billion—see Press Release 01/23). So far, Turkey has drawn a total of SDR 6.9 billion (about US$9 billion) from the IMF.

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

"The Fund commends the Turkish authorities' strong and comprehensive efforts to implement their strengthened program, and approves completion of the Eighth Review. Much has been achieved to restructure the economy and improve Turkey's economic fundamentals. However, ambiguities regarding the implementation of certain measures have delayed the full benefits of the program. Looking forward, the Fund urges the strongest possible execution of, and unified political leadership behind, the program. This, together with the Fund's full support, is the best avenue for putting Turkey back on the road to low inflation and sustained growth.

"Progress with financial sector reform has been impressive. Decisive steps have been taken to restructure the state banks and intervened private banks, which will contribute to greater stability in money markets and to enhanced governance. The authorities are determined to continue their efforts to ensure that private banks are adequately capitalized, and to respond to any problems in the financial sector with prompt and decisive action.

"Sustained structural reform is key to the improvement of economic prospects and to reducing the role of the state in the economy. Recent measures to enhance governance and fiscal transparency are most welcome and their continued implementation will lend further credibility to the reform effort.

"Greater transparency in the conduct of monetary policy under the program will help market participants in assessing monetary conditions and guide inflationary expectations. Continued achievement of the program's monetary targets will remain important in the period ahead, while the authorities prepare for the adoption of formal inflation targeting as early as feasible. The impact of the public sector wage settlement and of the wheat price decision will have to be closely monitored, and incomes policy strengthened. Overall, full program implementation should help bring interest rates down from their present high levels and ensure the success of the program," Mr. Köhler said.