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**Turkey:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 1, 2007

The following item is a Letter of Intent of the government of Turkey, which describes the policies that Turkey intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Turkey, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, DC 20431  
U.S.A.

Ankara, May 1, 2007

Dear Mr. de Rato,

1. Economic performance continues to be good. Growth remains close to the levels anticipated under the program, although it has softened from the pace of recent years following last year's financial market turbulence, which necessitated higher interest rates and reduced credit growth. Slowing import growth and strong exports have helped to stabilize the current account deficit, while external financing remains ample, led by continued large inflows of foreign direct investment. Inflation remains above target, but is expected to slow, supported by the tight policy stance of the central bank. Meanwhile, the primary surplus in 2006 exceeded the 6.5 percent of GNP target by a small margin—notwithstanding higher-than-programmed expenditure—and net public sector debt fell further to below 50 percent of GNP.

2. Economic fundamentals and balance sheets have strengthened considerably in recent years, making the economy much more resilient to adverse shocks. And, although recent political uncertainty has increased the risk of financial market volatility, our commitment to persevere with strong policies is unwavering.

3. Regarding program implementation, compliance with targets was as follows:

- *Quantitative performance criteria and inflation consultation clauses (Annex A).* We met the applicable external debt and net international reserve targets. End-December 2006 inflation, however, exceeded the outer band. The central bank has explained the reasons for the deviation and its policy response in a letter to the Government, which was also forwarded to the Fund in accordance with the inflation consultation clause (Annex D). End-March 2007 inflation was within the outer bands, although it exceeded the inner bands. The central bank has discussed the reasons for this with Fund staff and reaffirmed its commitment to policies that will gradually reduce inflation to target levels. With regard to the end-December 2006 fiscal program, we met the targets for the primary surplus of the consolidated government sector and the floor on the overall balance of the social security institutions. However, the ceiling on primary expenditure was missed largely due to higher-than-anticipated investment expenditures. Although data are not yet available, the adjusted end-April 2007 primary surplus, expenditure and social security balance targets are expected to have been missed, mainly due to a combination of lower-than-expected revenues and spending brought forward.

- *Structural reforms* (Annex B). The structural benchmark on state enterprise hiring was observed, and that on civil service hiring is expected to be observed. However, the continuous structural benchmark regarding excise taxes and SEE prices was not met, as adjustments in SEE prices fell short of program assumptions. Parliament passed personal income tax reform legislation on March 1, just missing the end-February 2007 deadline (structural performance criterion), although the approved law omitted one anticipated element (see paragraph 17). The law came into force on April 4. A Large Taxpayers Unit established within the Revenue Administration was operational by end-December 2006 (structural benchmark). Parliament approved legislation authorizing the Social Security Institutions to alter copayments for medical treatments and pharmaceuticals by the end-December 2006 deadline (structural performance criterion), but this was later invalidated by a Constitutional Court ruling on social security reform legislation. Finally, the privatization of Halkbank has been launched, with an IPO of at least 20 percent of its shares expected to be completed by May 15, 2007 (prior action).

4. In light of this performance and our continued commitment to the program, as further elaborated in this letter, we request completion of the Sixth Review under the Stand-By arrangement. We also request a waiver for the small delay in the passage of personal income tax reform legislation and the omission of expected provisions that would have enhanced the tax administration's powers to cross-check income and expenditure. We expect to include similar provisions in future legislation broadening the powers of the Revenue Administration. We also request waivers of applicability for the end-April performance criteria on external debt, as relevant data are not yet available and we expect these targets to be met. In light of corrective measures being taken (see paragraph 11), we also request waivers for nonobservance of end-April performance criteria on the primary surplus of the consolidated government sector, the primary surplus of the consolidated government sector excluding SEEs, the primary spending of the central government and social security institutions, and the balance of the social security institutions, which we expect to have been missed. Quantitative and structural performance criteria through end-December 2007 are set out in Annexes A and B of the attached Technical Memorandum of Understandings, respectively.

5. We are confident that the policies contained in the April 26, 2005 Memorandum of Economic and Financial Policy and supplementary Letters of Intent are adequate to achieve the objectives of our program, and we stand ready to take further measures that may become appropriate for this purpose. We will continue to consult the Fund on the adoption of these measures and in advance of revisions to policies contained in this letter in accordance with the Fund's policies on such consultation.

### **Macroeconomic framework for 2007**

6. The economy grew by 6 percent in 2006, down from the 7.5 percent pace of previous years, as high interest rates and slowing credit growth dampened domestic demand. We

expect growth at 5 percent in 2007, supported by stable economic conditions, gradually falling inflation, and a stronger contribution from the external sector.

7. On the external side, the current account deficit reached almost 8 percent of GNP last year—higher than in 2005 but somewhat below the level anticipated under the program. We expect the deficit to fall to 7¼ percent of GNP this year, as the recent trend of slowing imports and strong exports is supported by robust growth in Turkey’s trading partners, slowing domestic demand, and more stable oil prices. The outlook for external financing remains favorable and the continued high foreign direct investment, driven by strong private sector merger and acquisition activity, is expected to cover half of the current account gap. We will monitor current and financial account developments closely and are prepared to adjust policies as needed.

### **Monetary policy**

8. We are committed to reducing inflation to the 4 percent target to provide a foundation for high and stable growth. Commodity price and exchange rate shocks contributed to a significant overshooting of inflation last year. As those effects fade and the impact of last year’s monetary policy tightening takes hold, we expect inflation to converge gradually toward target during 2007, with a noticeable fall in yearly inflation rates starting in the second quarter. However, inertia in services inflation, unprocessed food price shocks, and the slow decline in inflation expectations remain challenges to the disinflation process. We will therefore conduct monetary policy with a tightening bias in the period ahead, meaning that monetary policy will be more responsive to adverse developments than favorable developments to the inflation outlook. This approach reflects our commitment to achieving the medium term inflation target.

9. Building international reserves for prudential reasons remains a key objective of the program. We are, therefore, committed to continuing our daily reserve purchase auctions, with the daily minimum purchase amount fixed at US\$15 million and an option for banks to sell up to US\$30 million in additional foreign exchange to the CBT, with provisions to allow temporary suspension of auctions in extreme circumstances. To provide predictability to the auction mechanism, we announced a yearly program for 2007. However, if market conditions are favorable, we will consider increasing the daily auction amounts to accelerate our build-up of reserves. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

### **Fiscal policy**

10. Disciplined fiscal policy has been the cornerstone of the program, allowing declining debt ratios, facilitating disinflation, and reducing real interest rates. Notwithstanding recent deviations from program targets, we remain committed to prudent budgetary policies in the period ahead. In particular, achieving a high primary surplus target through tight spending control will help with disinflation and further ease the debt burden, thereby creating the fiscal

space necessary to implement future reforms aimed at easing the tax burden on labor and financial transactions.

11. Last year, primary spending was higher than programmed owing to a combination of factors, including higher-than-planned capital spending and faster-than-expected growth in health expenditures. As foreshadowed in the program, spending overruns (0.3 percent of GNP) recorded at end-December 2006 will be offset in 2007. Several initiatives—including the expansion of the regional incentives program, the conversion of temporary public sector workers to permanent status, and higher-than-expected increases in pensions—also require offsetting adjustments in spending plans. To this end, we have implemented the following measures:

- The Finance Ministry has issued instructions to block some 0.6 percent of GNP in spending on lower priority current and capital spending and transfers. The bulk of this spending was originally planned for the first half of 2007.
- To offset the weaker-than-programmed contribution of the SEEs to the overall primary surplus target for 2007, we have cut state enterprise investment spending by 0.1 percent of GNP and also blocked some central government spending (including those mentioned above).
- We have established safeguards to ensure that health spending developments do not jeopardize the achievement of this year's budget targets. In particular, we have stepped up monitoring of spending (both on accrual and cash basis) to ensure corrective actions can be taken promptly. We have also significantly strengthened control over public hospital expenditures by (i) setting hospital-by-hospital quarterly budgetary targets beginning with the second quarter of 2007; (ii) putting in place the legal framework necessary to audit and settle hospital invoices so as to enforce hospital budget constraints; and (iii) capping this year's aggregate bonus payments at the 2006 level. All accumulated obligations to public hospitals, as of end-March 2007, have been resolved, leaving no residual claims.

We will also maintain excise taxes and SEE prices, including energy prices, in line with program assumptions (continuous structural benchmark). With these measures in place, we are confident that spending will stay below the (adjusted) program targets for the remainder of the year, thus enabling achievement of a 6.7 percent of GNP primary surplus in 2007. If necessary, we stand ready to take additional measures to ensure our fiscal targets are met.

12. To ensure medium-term efficiency gains in the provision of health services, but without compromising its quality, we have taken measures to improve the IT control mechanisms, including on hospital services, eligibility for contribution-free provision of health services, and pharmaceuticals. We will also introduce new procurement procedures for inpatient pharmaceuticals and medical devices that allow hospitals to generate savings by

jointly negotiating contracts. To promote efficiency, copayments for outpatient services will be included in the social security reform at differentiated rates for primary, secondary, and tertiary levels. The family medicine program will be expanded to 22 regions by end-2007 (structural benchmark). In the event health spending exceeds program targets, we stand ready to take offsetting spending cuts elsewhere in the budget.

13. To support our fiscal objectives, we will continue to replace no more than 50 percent of civil servants leaving through attrition (quarterly structural benchmark, expected to be observed in the first quarter of 2007) and 10 percent of employees leaving state economic enterprises (continuous structural benchmark). We will refrain from introducing new initiatives or sectoral tax cuts that would undermine the tax base, and we will avoid rate reductions or exemptions that would undermine the structure of the VAT. We also expect to implement a broad-ranging reform of the civil service sector in early 2008, which is aimed at rationalizing the wage structure (see November 27, 2006 LOI for details).

### **Structural fiscal reforms**

14. The Constitutional Court ruled in December that many key provisions of the social security reform passed in April 2006 were unconstitutional, including (i) all aspects of the pension reform pertaining to civil servants, where most of the medium-term savings were to be generated; (ii) changes in the valorization formulas for all workers; and (iii) the introduction of medical copayments for civil servants. Excluding these elements would significantly reduce the reform's long-term savings. We have thus postponed implementation of the reform, but remain firmly committed to formulating revised legislation that meets the court's objections while preserving to the maximum extent possible the reform's benefits, in order to ensure the long-term financial sustainability of the social security system. To ensure the broadest possible consensus around this important reform, we will soon issue a white paper explaining the principles of this reform and alternative options for the new pension parameters. We intend to submit revised legislation soon after opening of the new parliamentary session with the view to putting it in place within six months of its submission to parliament. In the interim period before the new law comes into force, we will ensure that civil service pension increases are consistent with the indexation parameters in the new legislation.

15. In the meantime, we will press ahead with measures to improve the collection of social security contributions, including (i) putting in place by end-June 2007 a legal framework requiring large employers to pay salaries through bank accounts (structural benchmark), (ii) strengthening and expanding the Large Employer Office, and (iii) modernizing debt collection techniques. Milestones have been drawn up to guide these reforms. We will also establish by end-May a committee to enhance cooperation between the SSI and the Revenue Administration and strengthen information sharing. In this context, we plan to put in place a unified tax declaration form by end-2007 (structural benchmark).

16. The Large Taxpayer Unit within the Revenue Administration became operational on January 1, 2007 (structural benchmark). To make the LTU more effective, we are committed to raising the number of auditors assigned to the LTU to 35 as a prior action for this review. We plan to raise the number of auditors further over time commensurate with the work load of the LTU. We also intend to eventually reduce fragmentation in tax administration functions. Also in the area of tax administration, we plan to address VAT refund fraud by introducing a risk-based audit system by end-2007 (structural benchmark) and raising audit staff levels from 5 to 10 percent of total resources over the medium term.

17. Parliament passed second-stage personal income tax reform on March 1, 2007 (end-February performance criterion). As expected, this law rationalizes the system by replacing VAT expenditure rebates with standard family credits, and broadens the tax base by lengthening the holding period defining long-term real estate capital gains.

18. We are committed to improving the efficiency and financial performance of the SEEs. The finances of some of these companies have deteriorated as a result of increases in input costs and unpaid bills. In the electricity sector, our strategy for the privatization of the regional distribution companies—and, subsequently, generation companies—provides the best and most durable solution to these problems. We intend to proceed with this process, beginning with the sale of the first three distribution companies in 2008. In support of this plan, and to safeguard the finances of the SEEs, we are considering ways to ensure full and continuous cost recovery, and will adopt measures to that effect. In the meantime, we have issued strict instructions for prompt settlement of bills by public institutions. It is also our intention to initiate action by the time of the next review to improve collection of companies' receivables from local administrations and to extend the use of prepayment requirements for other users of public utilities.

19. Improved fiscal transparency is key to preserving the credibility of our fiscal policies and market confidence. To that end, on March 30, 2007, we published previous years' fiscal figures in the new "central government budget" format, which facilitates comparability across years (prior action). We have also made progress on improving the accounting and reporting systems of local administrations. On April 11, we published end-2006 local budget realization figures and plan to publish future budget realization figures on a quarterly basis. We remain committed to publishing a report that quantifies existing tax expenditures by end-June 2007 (structural benchmark). Finally, we are continuing to work on a public-private partnership (PPP) law that would lay out a framework for the management and accounting of such projects across all sectors.

### **Financial sector reform**

20. We remain committed to the privatization of state-owned banks, as indicated in previous Letters of Intent. In line with this, we have revised our strategy for the privatization of Halkbank, which now envisages, as a first step, an IPO for at least 20 percent of its shares.

Completion of the IPO is expected by no later than May 15, 2007 (prior action). To this end, we have obtained the approval of the Capital Markets Board (CMB) for the IPO, and began a road show to major capitals in late April 2007. We also remain committed to preparing a strategy for Ziraat, drawing on the experience of Halkbank.

21. Parliament passed landmark mortgage legislation in February 2007. This law lays the legal foundations for a more efficient and financially stable mortgage lending system, including by allowing mortgage finance institutions, securitization of housing loans, and variable rate mortgages. The law also includes tight norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value. The BRSA will be in charge of supervising primary lending by banks, leasing companies, and consumer finance companies, while the CMB will be in charge of supervising securitization of housing loans as well as Mortgage Finance Companies (MFCs). By end-June 2007, the CMB will issue regulations on operational requirements for MFCs, as well as for mortgage-backed securities and mortgage-covered bonds, while BRSA will determine the requirements to obtain mortgage licenses for leasing companies and consumer finance companies.

22. We remain committed to maintaining an adequate regulatory and supervisory framework for our banking system. Drawing upon the findings of the recent Financial Sector Assessment Program, we aim to pass the insurance law before end-June 2007 (structural benchmark). The committee looking into the merits of a further consolidation of supervisory functions presented its report in December 2006 and the government is reviewing its findings.

23. SDIF will have disposed of all its assets taken over from intervened banks as planned by end-2007, thus allowing it to focus exclusively on its role as a deposit insurance agency. At that point, Treasury will resolve its receivables arising from earlier bank restructurings.

### **Investment climate**

24. Ongoing efforts to improve our investment climate were rewarded with a record level of FDI in 2006, which at US\$20 billion exceeded the cumulative total of the previous five years. We expect FDI this year to be almost as high, driven by ongoing merger and acquisition activity in the banking and other sectors and by investment across several sectors including communications, energy, manufacturing, and real estate. Although the sale of electricity distribution and generation companies, Tekel tobacco, and state shares in several other companies have met with delays, we remain committed to the full privatization of these and other entities in the Privatization Agency portfolio in the 2007 to 2009 timeframe, and we are continuing to lay the necessary groundwork. Meanwhile, we are proceeding with plans to privatize Petkim petrochemicals company in the coming months.

25. We also remain committed to further deregulation, reduction of administrative barriers, increased efficiency of the judicial process, and enhanced corporate governance—which are needed to raise investment and put Turkey on a higher long-term growth path. We



plan to hold the annual Investment Advisory Council meeting in June, where we will report on progress over the past year and identify new reform priorities. We have established a new agency to foster investments, the Turkish Investment and Support Promotion Agency, which will become fully operational by the end of 2007. We also aim to obtain approval of a new Commercial Code. This legislation will introduce, among other things, a requirement for firms to prepare financial statements in accordance with International Financial Accounting Standards.

26. We intend to introduce reforms to reduce labor market rigidities and financial burdens on employment, which contribute to low employment ratios and a large informal sector and which ultimately reduce growth. A reform package is being prepared that will reduce nonfinancial and financial burdens on formal employment. Our guiding objectives will be to increase labor market flexibility while preserving essential worker rights, and reduce informality. Any reform in this area will stay within the constraints of the fiscal program framework and be prepared in close consultation with stakeholders and the Fund.

Very truly yours,

/s/

Ali Babacan

Minister of State for Economic Affairs

/s/

Durmuş Yılmaz

Governor of the Central Bank of Turkey

Annexes

Annex A: Quantitative Performance Criteria and Indicative Targets for 2006–07

(Millions of new Turkish lira, unless otherwise indicated)

	Mar. 31, 2006		Jun. 30, 2006		Sep. 30, 2006		Dec. 31, 2006		Apr. 30, 2007		Aug. 31, 2007	Dec. 31, 2007
	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Outcome	Ceiling/ Floor	Ceiling/ Floor
<b>I. Quantitative Performance Criteria 1/</b>												
1. Floor on the cumulative primary balance of the consolidated government sector 2/	7,771	10,603	17,366	25,042	29,684	33,272	34,490	36,159	12,338	...	32,338	39,738
2. Floor on the cumulative primary balance of the consolidated government excluding SEEs sector 2/	7,471	8,403	16,414	22,095	28,052	31,417	31,796	34,646	11,738	...	31,138	37,238
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/					124,046	124,859	173,084	174,972	56,362	...	119,000	190,600
4. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US\$)	8,500	4,196	14,000	4,806	18,000	6,829	21,500	10,853	9,000	...	15,000	22,000
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US\$)	1,000	0	1,000	0	1,000	0	1,000	0	1,000	...	1,000	1,000
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US\$)	19.7	32.4	24.3	31.0	25.7	31.0	28.7	32.6	28.7	40.6	31.3	31.8
7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/	-6,100	-6,634	-12,000	-10,554	-18,400	-16,481	-24,300	-22,001	-5,000	...	-16,300	-24,200
<b>II. Indicative Targets</b>												
1. Floor on the cumulative overall balance of the consolidated government sector 2/	-3,429	1,202	-3,934	7,133	-5,466	2,080	-6,460	-1,168	-6,612	...	-3,612	-6,512
2. Privatization Proceeds (in millions of US\$)	1,900	4,579	2,800	7,970	3,200	8,008	4,200	8,010	N/A		N/A	N/A
<b>III. Inflation Consultation Bands (12-month change, in percent) 4/</b>												
									Mar. 31, 2007		Jun. 30, 2007	Sep. 30, 2007
									Target	Outcome		
Outer Band (upper limit)	9.4		8.5		7.8		7.0		11.2		8.7	7.3
Inner Band (upper limit)	8.4		7.5		6.8		6.0		10.2		7.7	6.3
Central Point	7.4	8.2	6.5	10.1	5.8	10.5	5.0	9.7	9.2	10.9	6.7	5.3
Inner Band (lower limit)	6.4		5.5		4.8		4.0		8.2		5.7	4.3
Outer Band (lower limit)	5.4		4.5		3.8		3.0		7.2		4.7	3.3

1/ Cumulative targets are set from January 1, 2006 for targets within 2006 and from January 1, 2007 for targets within 2007.

2/ After being adjusted for program adjusters. Coverage from June 2006 onwards expanded, to account for new institutions now covered under the Central Government Budget.

3/ Indicative target for March 2006, performance criteria from June 2006 through December 31, 2007.

4/ Test dates for inflation consultation bands are kept at a quarterly frequency throughout 2007 and are thus reported separately in Annex D of the TMU.

## ANNEX B: STRUCTURAL CONDITIONALITY, 2006–07 1/

Action	PC/SB
<p><b>Prior Actions</b></p> <p>1. Raise the number of auditors assigned to the Large Taxpayer Unit to 35 (¶16)</p> <p>2. Publish historical fiscal data in the new “central government budget” format (¶19)</p> <p>3. Complete IPO of at least 20 percent of Halkbank shares (¶20)</p>	<p>5 days before Board meeting</p> <p>Done</p> <p>5 days before Board meeting</p>
<p><b>Fiscal measures</b></p> <p>4. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19, MEP April 26, 2005)</p> <p>5. At most 10 percent of those leaving through attrition in each state enterprise will be replaced, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (¶17, MEP April 26, 2005)</p> <p>6. Replace no more than 50 percent of civil servants leaving through attrition (¶14, LOI November 27, 2006)</p> <p>7. Maintain excise taxes and SEE prices in line with 2006-07 program assumptions (¶14, LOI November 27, 2006)</p> <p>8. Publish report that quantifies existing tax expenditures (¶17, LOI November 27, 2006)</p> <p>9. Extend family medicine program to 22 regions (¶12)</p> <p>10. Put in place a unified tax declaration form for SSI and Revenue Administration (¶15)</p> <p>11. Put in place a legal framework requiring large employers to pay salaries through bank accounts (¶15)</p> <p>12. Introduce a risk-based audit system for VAT refunds (¶16)</p>	<p>Continuous PC</p> <p>Continuous SB</p> <p>Quarterly SB</p> <p>Continuous SB</p> <p>SB. End-June 2007</p> <p>SB. End-December 2007</p> <p>SB. End-December 2007</p> <p>SB. End-June 2007</p> <p>SB. End-December 2007</p>
<p><b>Financial Sector Measures</b></p> <p>13. Secure parliamentary approval of the insurance law (¶22)</p>	<p>SB. End-June 2007</p>

1/ PC=structural performance criterion, SB=structural benchmark. Paragraph numbers refer to the May 1, 2007 supplementary Letter of Intent.

**ANNEX C: PURCHASES AND PROPOSED SCHEDULE OF PURCHASES, 2005–08**

	SDR Millions	Percent of Quota	Test Date 1/	Earliest Possible Purchase Date	Date of Board Approval
Approval	555.2	57.6			11-May-05
<b>2005</b>					
1st & 2nd Reviews	1,110.3	115.2	30-Sep-05		9-Dec-05
<b>2006</b>					
3rd Review 2/	624.6	64.8	31-Dec-05	1-Mar-06	28-Jul-06
4th Review 2/	624.6	64.8	31-Mar-06	1-Jun-06	28-Jul-06
5th Review	749.5	62.9	30-Sep-06	1-Dec-06	13-Dec-06
<b>2007</b>					
6th Review	749.5	62.9	31-Dec-06	22-May-07	
7th Review	749.5	62.9	30-Apr-07	1-Jul-07	
8th Review	749.5	62.9	31-Aug-07	1-Dec-07	
<b>2008</b>					
9th Review	749.5	62.9	31-Dec-07	1-Mar-08	
Total 3/	6,662.0	559.2			

Source: IMF staff.

1/ All test dates for the inflation consultation bands are quarterly.

2/ The third and fourth reviews were combined.

3/ Quota was increased from SDR 964 million to SDR 1,191 million, effective November 1, 2006. Each purchase expressed as a share of current quota; total purchases as share of final quota.

### ANNEX D: INFLATION CONSULTATION BANDS

1. The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Turkish Statistical Institute), are specified as follows:

	2007			
	March	June	September	December
Outer band (upper limit)	11.2	8.7	7.3	6.0
Inner band (upper limit)	10.2	7.7	6.3	5.0
Central point	9.2	6.7	5.3	4.0
Inner band (lower limit)	8.2	5.7	4.3	3.0
Outer band (lower limit)	7.2	4.7	3.3	2.0

2. Inflation prospects will be an important part of each review under the arrangement. In line with our accountability principles, we are committed to report to the public the reasons for any breach of the outer bands, and our policy response. In this vein, should the observed year-on-year rate of CPI inflation for the quarter preceding a purchase fall outside the outer bands specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the CBT will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

**ANNEX E: TARGETS FOR NET INTERNATIONAL RESERVES**Table 1. Turkey: Performance Criteria on the Level of  
Net International Reserves

(In billions of U.S. dollars)

	Floor on level of NIR	Floor Adjusted for Privatization Outcome	Actual	Memo item: NIR of the CBT
Outstanding stock as of September 30, 2005:			13.2	28.6
December 31, 2005	14.0	15.9	22.4	37.5
March 31, 2006	17.2	19.7	32.4	45.7
June 30, 2006	19.9	24.3	31.0	42.4
September 30, 2006	20.3	25.7	31.0	42.6
December 31, 2006	22.6	28.7	32.6	43.2
April 30, 2007	28.0	28.7	40.6	48.3
August 31, 2007	31.3			
December 30, 2007	31.8			

1. For program purposes, net international reserves is defined as net international reserves of the CBT minus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.
2. Net international reserves of the CBT comprise its gross foreign assets excluding encumbered reserves less its gross international reserve liabilities plus the net forward position of the central bank, denominated in U.S. dollars. Encumbered reserves are reserves that are not readily available.
3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the September 30, 2004 average London fixing market price of US\$414 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US\$0.31 billion on December 29, 2006). Reserve assets as of December 29, 2006 amounted to US\$59.9 billion (evaluated at program exchange rates).
4. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL/YTL-denominated liabilities indexed to any exchange rate) to residents and non-residents with an original maturity of up to and including one year (including reserves against foreign currency deposits of the banking sector), claims from central bank letters of credit, overdraft obligations of the central bank, and central bank liabilities arising from

balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On December 29, 2006 reserve liabilities thus defined amounted to US\$16.7 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of December 29, 2006 these amounts were zero.

6. As of December 29, 2006 the sum of: (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year amounted to US\$10.6 billion.

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

8. The projected Net International Reserves path from the fourth quarter of 2005 to the fourth quarter of 2006 was based, inter alia, on the following projections for foreign exchange receipts resulting from privatization:

	Privatization receipts, in millions of US\$, Cumulative from 2005 Q4
2005 Q4	800
2006 Q1	2,800
2006 Q2	3,700
2006 Q3	4,200
2006 Q4	5,200

9. Privatization receipts are defined in this context as the proceeds from sale or lease of (all or a portion of) entities and properties held by the public sector, including the Privatization Authority and the Savings Deposit and Insurance Fund, that are deposited in foreign exchange at the Central Bank of Turkey, either directly, or through Treasury.

10. In the event that realized foreign exchange receipts resulting from privatization depart from projected receipts, the NIR floor for each quarter was revised upward (downward) by the excess (shortfall) of cumulative realized receipts compared to the projected cumulative receipts in paragraph 8 above.

11. The 2007 targets assumed that privatization receipts would be US\$1.0 billion in the fourth quarter of 2006. In the event that the realized figure departed from that figure, the NIR

floors for April, August, and December 2007 would be adjusted. In this framework, the NIR floors for 2007 will be adjusted upward by US\$0.7 billion, which was the excess of actual fourth quarter 2006 receipts relative to the US\$1 billion assumption.

12. In addition to the adjustment of NIR floors as described in the preceding paragraphs, the NIR floors for August 31 and December 31, 2007 will also be adjusted upward (downward) for any excess (shortfall) of privatization revenues (as defined in paragraph 9 above) in 2007 relative to the following assumptions:

	Privatization receipts, in millions of US\$, Cumulative in 2007
August 31	4,700
December 31	5,000



## ANNEX F: FISCAL TARGETS

## A. Primary Balance of the Consolidated Government Sector

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

	Floor (In millions of YTL)
Cumulative primary balance from January 1, 2006, to: December 31, 2006	34,050
Cumulative primary balance from January 1, 2007, to: April 30, 2007	12,338
August 31, 2007	32,338
December 31, 2007	39,738
Cumulative primary balance (excluding SEEs) from January 1, 2006, to: December 31, 2006	31,350
Cumulative primary balance (excluding SEEs) from January 1, 2007, to: April 30, 2007	11,738
August 31, 2007	31,138
December 31, 2007	37,238

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of: the central government; the 3 extra budgetary funds (EBFs) identified below; the 3 social security institutions (SSIs) identified below (and unified into a single institution as of the beginning of 2007); the unemployment insurance fund; and the 22 state economic enterprises (SEEs) identified below. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

- a) For the central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported accrual-based transfers to the social security institution(s) will be converted to a cash basis.
- b) For the EBFs from above the line on a modified cash basis, counting non-transferred shared tax revenues, to the extent these are not already recorded as reserves by other elements of the CGS.
- c) For the SSI(s) and the unemployment insurance fund from above the line on a cash basis.
- d) For the SEEs, from below the line as described in paragraph 7.

2. For the purposes of the program, the primary revenues will exclude interest receipts of the central government (including on tax arrears, although combined penalty/interest charges associated with tax payments will be counted as primary revenues), SEEs, and of the unemployment insurance fund (UIF), profit transfers of the Central Bank of Turkey (CBT) and net special revenues of the Turkish mint, proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof), and dividend payments from Ziraat Bank. (Dividend payments from Halkbank that are determined not to stem from income derived from recapitalization bonds shall be counted as primary revenues.) Late payment penalties of the UIF will be included as primary revenues. Revenues of the CGS from sales of immovables will be included up to an aggregate cap of YTL 500 million. Interest receipts of EBFs and SSIs will not be excluded. The floor on the primary balance will be adjusted upward for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments.

3. For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. Privatization-related expenditure of the Privatization Fund will not be excluded. Current carryover appropriations are not included as expenditures when constructing the program targets, while spending against such appropriations will count as primary expenditures for the purposes of calculating both primary and overall balances.

4. Net lending of any component of the CGS will be considered as a non-interest expenditure item. (If this net lending is negative, it will be considered as a non-interest revenue item.) Payment of guaranteed debt by treasury on behalf of non-CGS components of the public sector will not be treated as net lending up to the baseline reported in Annex G.

### **Extrabudgetary funds**

5. The three EBFs included in the definition of the performance criterion are the Defense Industry Support Fund, the Privatization Fund, and the Social Aid and Solidarity Incentive Fund.

### **State economic enterprises**

6. The 22 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal), T. ŞEKER FAB (sugar), TMO (soil products office), TEKEL (tobacco), TCDD (railways), BOTAŞ (natural gas), TEDAŞ (electricity distribution), EÜAŞ (electricity generation), TETAŞ (electricity trade), TEİAŞ (electricity transmission), TPAO (petroleum exploration and extraction), ETİ Maden İŞL., MKEK, TKİ, ÇAYKUR, DHMİ, PTT, PETKİM, TİGEM, KIYEM, TDİ, and DMO.

7. The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing from the banking system (excluding pre-export financing from Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net

advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

8. Net financing from the banking system (excluding pre-export financing from Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2005 the stock of net banking claims on SEEs as defined above stood at YTL 1,243 million, valued at the exchange rates on that day.

9. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2005 the stock of external loans stood at YTL 6,932 million, valued at the exchange rates on that day.

### **Social security institutions**

10. The three social security institutions (SSIs) included in the definition of the performance criterion for end-December 2006 are SSK, Bağ-Kur, and Emekli Sandığı. For the 2007 targets, the object of monitoring is the unified social security institution (SSI), including the activities of SSK, Bağ-Kur, and Emekli Sandığı. The deficits of the SSI(s) will be covered by transfers from the central government budget, and they are thus expected to be in primary balance.

### **Adjusters**

11. The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as the sum of (i) overdue pension payments; (ii) medicine payments overdue by more than 45 days for both imported and domestic medicine (from the date of invoice receipt); (iii) other payments overdue by more than 30 days and payments to hospitals overdue by more than 60 days (from the date of invoice receipt). In the case of Bağ-Kur they exclude the arrears to the common retirement fund. The stock of arrears for Bağ-Kur stood at YTL 0 million; for SSK stood at YTL 0 million; and for Emekli Sandığı stood at YTL 0 million on December 31, 2005. These stocks of arrears will be used for the purpose of calculating the adjustor.

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

- a) For any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;

- b) For any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).
- c) For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 300 million.

13. The floor on the primary surplus of the CGS will be adjusted upward (downward) in line with the projected surplus (deficit) of the primary balance of any fund or entity that is incorporated in the CGS after January 1, 2007.

14. The floor on the primary surplus of the CGS will be adjusted by the primary balance projected at the time of approval of the program for any state economic enterprise (included in the performance criterion) when there is a change of control due to privatizations. The adjustor will be calculated as the difference between the primary surplus generated by the company while in public control and the annual projection. This adjustor does not apply to Türk Telekom or TÜPRAŞ in 2006.

15. The 2007 (end-April, end-August, end-December) floors on the primary surplus of the CGS would be adjusted upward to the extent that the end-2006 target on the primary spending of the central government and the SSIs (section B below) is missed. In this framework, the 2007 floors on the primary surplus of the CGS have been adjusted upward by YTL 1,888 million, which was the excess of primary spending of the central government and the SSIs relative to the end-2006 target.

## **B. Primary Spending of the Central Government and the Social Security Institution(s)**

Table 1. Turkey: Performance Criteria on the Cumulative Consolidated Primary Spending of the Central Government and the Social Security Institution

	Ceiling (In millions of YTL)
Cumulative primary spending from January 1, 2006 to: December 31, 2006	174,000
Cumulative primary spending from January 1, 2007 to:	
April 30, 2007	56,362
August 31, 2007	119,000
December 31, 2007	190,600

16. The December 2006 ceiling in Table 1 is established on the sum of (i) the primary spending of the central government, excluding transfers to social security institutions, measured as in paragraph 1.a of Section A above; and (ii) the primary spending of the social security institutions, measured as in paragraph 1.c of Section A above. The 2007 ceilings relate to the expenditures of the fully consolidated central government and social security

institution. This means that central government transfers and payments of social security contributions are consolidated out, as well as any payments (such as common retirement) between social security institutions.

### Adjusters

17. The ceilings on primary spending will be adjusted symmetrically to compensate for any over- or underperformance in collections of the revenue bases subject to sharing with local governments and extrabudgetary funds.

18. The 2007 (end-April, end-August, end-December) spending ceilings would be adjusted downward to the extent that the end-2006 spending target is missed. In this framework, the 2007 spending ceilings have been adjusted downward by YTL 1,888 million, which was the excess of primary spending relative to the end-2006 target.

### C. Overall Balance of the Consolidated Government Sector

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

	Floor (In millions of YTL)
Cumulative overall balance from January 1, 2006 to: December 31, 2006	-6,900
Cumulative overall balance from January 1, 2007 to: April 30, 2007	-6,612
August 31, 2007	-3,612
December 31, 2007	-6,512

19. The overall balance of the consolidated government sector (CGS), Table 1, comprises: (i) the primary balance of the CGS as previously defined in this annex; (ii) the net interest payments of the central government (excluding in 2006 those combined penalty/interest charges associated with tax payments and already included as primary revenues); the UIF and the SEEs; (iii) the interest payments of SSI(s) and EBFs; (iv) transfers of profits from the CBT and net special revenues of the Turkish Mint to the consolidated central government; (v) Ziraat Bank dividend payments and recapitalization-bond-related dividend payments from Halkbank; and (vi) expenditures under the risk account (net lending).

20. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of this Annex.

21. All definitions and adjusters specified earlier in this Annex to apply to the primary balance of the CGS will also apply to the overall balance of the CGS. In particular, the

overall balance will be adjusted for the overall balance of any new government funds and institutions established after January 1, 2007.

### D. Overall Balance (before transfers) of the Social Security Institution

Table 1. Turkey: Performance Criteria on the Cumulative Overall Balance (before transfers) of the Social Security Institution

	Floor (In millions of YTL)
Cumulative overall balance (before transfers) from January 1, 2006 to: December 31, 2006	-24,300
Cumulative overall balance (before transfers) from January 1, 2007 to: April 30, 2007	-5,000
August 31, 2007	-16,300
December 31, 2007	-24,200

22. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı for the end-December 2006 test date, and the balance of the unified social security institution for the 2007 test dates. It excludes additional payments made to pensioners in lieu of phased-out tax rebates (up to YTL 1.772 billion) for 2006. For 2007, these additional payments as well as billed payments are counted as both revenue and expenditure of the SSI.

### E. Amnesties and Public Sector Receivables

23. Amnesties will be understood as a reduction in the net present value of a public receivable, without any reference to individual ability to pay, or attempt to enforce individual payment. A public receivable will be understood as an obligation to general government (GFS definition) or to a state economic enterprise or state bank.

24. This performance criterion will not apply to companies in the Privatization Administration's portfolio.

### F. Structural Benchmark on New Civil Servants Hires

25. A quarterly benchmark will be used to monitor the 50 percent ceiling on the replacement ratio for civil servants as provided for in the 2007 Budget Law. The replacement ratio will be computed as the cumulative number of entries in each quarter in 2007 divided by the total number of attritions in 2006. Attritions comprise retirements, deaths, resignations, and transfers to other agencies; entries comprise appointments and transfers from other agencies. These data will be provided for the total of civil servants, divided into the following sub-categories: general administration, education services, health services, technical services, and other positions. These data will be prepared by the Ministry of Finance (General Directorate of Budget and Fiscal Control) on a quarterly basis and will be submitted to the Fund within 6 weeks of the end of the corresponding quarter.

**ANNEX G: PROGRAM BASELINE FOR TREASURY NET LENDING**

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US\$)	Baseline (In millions of YTL)
Cumulative net lending from January 1, 2006 to: December 31, 2006	335	490
Cumulative net lending from January 1, 2007 to: April 30, 2007	125	185
August 31, 2007	225	335
December 31, 2007	335	500

1. Net lending (risk account) by Treasury to other (non-CGS) components of the public sector is defined as the sum of guarantee payments made by Treasury on behalf of these entities minus repayments obtained by Treasury from them.
2. Other components of the public sector include: extrabudgetary funds not in the CGS, revolving funds, associations or foundations, state economic enterprises not in the CGS, state banks (including Eximbank and Iller bank), special provincial administrations, municipalities, municipal enterprises, build-operate-transfer projects, and build-operate projects.
3. Repayments include those obtained in cash directly from municipalities. Repayments, obtained through claw-back mechanisms, either directly, by withholding of transfers of tax shares from the MoF, or indirectly, via withholding of transfers to be made by Iller Bank, and proceeds from privatization, direct or indirect, are not included as repayments.
4. For the purposes of program monitoring, the flows in U.S. dollars will be converted at the average YTL/US\$ exchange rate between test dates.



**ANNEX H: SHORT-TERM EXTERNAL DEBT CEILINGS**

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

	Ceilings (In millions of US\$)
December 31, 2005	1,000
March 31, 2006	1,000
June 30, 2006	1,000
September 30, 2006	1,000
December 31, 2006	1,000
April 30, 2007	1,000
August 31, 2007	1,000
December 31, 2007	1,000

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

**ANNEX I: MEDIUM- AND LONG-TERM EXTERNAL DEBT CEILINGS**

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

	Limits (In millions of US\$)
Cumulative flows from end-December 2004	
December 31, 2005	16,000
Cumulative flows from end-December 2005	
March 31, 2006	8,500
June 30, 2006	14,000
September 30, 2006	18,000
December 31, 2006	21,500
Cumulative flows from end-December 2006	
April 30, 2007	9,000
August 31, 2007	15,000
December 31, 2007	22,000

1. The limits specified in Table 1 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex F) of new, nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the International Monetary Fund on August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The term “nonconcessional” means containing a grant element of less than 35 percent on the basis of the currency-specific discount rates based on the OECD commercial interest reference rates in place at the time at which the contract is entered into, or guarantee issued.

2. Excluded from this performance criterion are credits extended by the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank of Turkey and sales of treasury bills and bonds denominated in TL/YTL or FX to nonresidents in either the domestic primary market or the secondary market. Also excluded from this performance criterion is debt or the guaranteeing of debt if the proceeds from that debt have been used to retire other debt as part of a liability management operation that results in an improvement of the debt profile, either through a lengthening of maturity or a reduction in net present value of the debt stock; this could include direct swaps of one debt instrument for another and new debt issues whose proceeds are used to retire other debt; to qualify for exclusion from the PC, the debt that has been retired pursuant to such liability management operations must have a maturity date at least one year past the contract date of the new debt that has been undertaken.

3. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

**ANNEX J: PROGRAM EXCHANGE RATES**

Table 1. Cross Exchange Rates for Program Purposes

	TL value	YTL value	U.S. dollars per currency unit
Program exchange rates			
U.S. dollar	1,497,696	1.497696	1.0000
Euro	1,845,162	1.845162	1.2320
Japanese yen	13,469	0.013469	0.0090
Swiss franc	1,186,643	1.186643	0.7936
U.K. pound	2,707,645	2.707645	1.8086

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period May 31, 2005–May 31, 2008. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of September 29, 2004.

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