



International Monetary Fund

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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.

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Ankara, December 9, 1999

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Camdessus:

1. The economic program of the government formed after the April 1999 elections centers on an ambitious goal: freeing Turkey from inflation and enhancing the prospects for growth and for a better standard of living for all parts of society.
2. Over the last 25 years, inflation has weakened Turkey's economic performance in different ways. The most apparent is the instability of economic growth, as periods of rapid economic expansion have alternated with periods of equally rapid decline in economic activity. But the economic and social effects of inflation have been much more far reaching. Growth has not only been volatile, but has also been well below the average of the most successful emerging markets. Higher growth rates must be sustained over time, if the existing income gap with respect to European Union (EU) countries is to be closed.
3. By undermining confidence in the Turkish lira, inflation has also resulted in high and unstable nominal and real interest rates, with dramatic consequences for the society. Speculative and arbitrage activities have attracted more and more resources, and have distorted the working of financial markets and institutions. When the government has to pay on its debt real interest rates of 30 percent or more, private capital moves away from job-creating activities into financial investment. When banks have to charge even higher real interest rates on their loans, the credit process is disrupted and enterprises that have limited access to external capital suffer.
4. Moreover, these high real interest rates, together with a weak fiscal primary position, have pushed public finances onto an unsustainable path. Public sector debt--including the so-called *duty losses* of state banks and the net asset position of the central bank--is

projected to increase from 44 percent of GNP at end-1998 to 58 percent of GNP at end-1999. This leaves Turkey vulnerable to swings in international financial markets' confidence.

5. Ultimately, those who suffer most from a high inflation environment, high real interest rates, and unstable growth are the weaker segments of the population, those who cannot invest in high yielding assets, and who have to rely on their work to earn an income. Reducing inflation and lowering real interest rates would not only raise Turkey's growth prospects in the long run, but also lead to a more equitable and efficient distribution of economic resources.

The goals of our disinflation program and the overall disinflation strategy

6. In setting our disinflation goals for 2000-02, of paramount importance has been balancing the need to signal a clear break away from the past, against the difficulty of bringing inflation down to lower single digits abruptly, given the inertial component that inflation has in Turkey. In our view our inflation target for 2000--lowering the 12-month CPI inflation rate to 25 percent by end-December 2000 (20 percent for WPI inflation)--clearly signals a break from the past (CPI inflation averaged close to 80 percent over the last ten years and is projected at about 65 percent at end-1999), while allowing for some gradualism in the pace of disinflation. Our inflation targets for 2000 also provide a good starting point for lowering both WPI and CPI inflation to 10-12 percent by end-2001, and finally to move to lower single digits (about 5-7 percent) by end-2002.

7. Our program rests on three pillars: up-front fiscal adjustment, structural reform, and a firm exchange rate commitment supported by consistent incomes policies. Up-front fiscal adjustment is necessary because the weakness of public accounts is the ultimate factor behind high inflation. Structural reform is needed to make the fiscal adjustment sustainable, improve economic efficiency, and, through increased privatization receipts, facilitate the decline of public debt. A firm exchange rate commitment and consistent incomes policies are needed to lead inflation and interest rates down more rapidly, particularly in the first phase of disinflation.

8. The strength of our program enhances the credibility of our disinflation goals, and will in this way make it possible to achieve disinflation and growth at the same time. While the primary fiscal position of the public sector will be tightened, growth will be spurred by increased confidence related to the decline in inflation, the expected fall in real interest rates, the revitalization of the private credit market, sizable interest payments that will still continue to accrue to the private sector on the stock of public debt in circulation, and the improvement in the external economic environment, as economic recovery is expected to strengthen in Europe and tourism receipts return to more normal levels. We project GNP growth in the range of 5-5½ percent in 2000, partly reflecting the rebound from the negative growth of 2 percent projected in 1999 (growth within the year is likely to be lower). GNP growth is expected to remain in the range of 5-6 percent in 2001-02.

9. As economic activity picks up, the external current account deficit is projected to increase from ½ percent of GNP in 1999, to 1½-2 percent of GNP in 2000, with deficits of the same order of magnitude expected in 2001 and 2002. Such deficits are appropriate for a country like Turkey that needs to rely on external savings to support investment and growth. They are also sustainable, with the net external debt-to-GNP ratio projected to decline slightly over the next three years (from about 34 percent of GNP in 1999).

10. In support of our disinflation program, we request a three-year stand-by arrangement in the amount of SDR 2,892 million (300 percent of quota). These resources will raise our international reserves available for balance of payments needs, provide a tangible sign of confidence in our adjustment program, and catalyze support from public and private international investors. Performance will be monitored through quarterly reviews during the first year of the program, and biannual reviews thereafter.

Fiscal policy

11. Inflation can only be eradicated if public finances are moved to a sustainable path and there is no more recourse to the inflation tax. This requires shifting the primary balance of the public sector into a sizable surplus, while at the same time accelerating privatization, so as to retire public debt.

Fiscal goals for 1999

12. While the fiscal stance was relaxed significantly in the first half of 1999, the new government has managed to contain the deterioration of the fiscal primary balance. Developments in the second half of 1999 have been in line with the targets set under the Staff-Monitored Program (SMP), excluding earthquake-related fiscal costs. In order to strengthen fiscal developments during the rest of 1999, expenditure cuts in investment and other current spending, amounting to about 0.4 percent of GNP, have been decided. This, together with the effect of the tax package approved on November 26, 1999 (see below), will allow the primary surplus of the *consolidated central budget* not to fall below TL 1,000 trillion (1.2 percent of GNP) in 1999 (a performance criterion; [Annex A](#)). Excluding earthquake costs (about 0.8 percent of GNP), this target is consistent with the one set under the SMP in early July.

The 2000 fiscal program

13. Our key fiscal goal for 2000 is to raise the primary surplus of the public sector (which includes the consolidated central budget, the extrabudgetary funds (EBFs), the local government, the nonfinancial state enterprises, the central bank, and the so-called duty losses of state banks) from -2.8 percent of GNP in 1999 to 3.7 percent of GNP in 2000 (the latter figure excludes the expenses related to the earthquake, which are estimated at about 1½ percent of GNP in 2000). This level of the primary surplus would be more than sufficient to stabilize the net public debt-to-GNP ratio over the medium term. However, the disinflation will bring about a temporary rise in the burden of interest payments with respect to GNP, as real interest payments on the securities issued at fixed interest rates in the past will increase as inflation falls. Thus, in 2000, sizable privatization receipts will also be needed to limit the growth of the public debt ratio.

14. The attainment of these fiscal goals will be monitored through a set of performance criteria and indicative targets:

- A quarterly performance criterion will be set on the primary surplus of the consolidated government sector (which includes the consolidated central budget, four key EBFs, eight state economic enterprises, the unemployment insurance fund and the three social security institutions), excluding privatization receipts. The floor for end-year will be TL 4,500 trillion (3.6 percent of GNP), with a front-loaded quarterly distribution of the fiscal adjustment ([Annex B](#)).

- As privatization receipts will play a key role in our macroeconomic program, a separate annual performance criterion will be set on the primary surplus inclusive of privatization receipts, with quarterly indicative targets (Annex B).
- An indicative ceiling will be set on the overall deficit of the consolidated government sector, excluding privatization receipts, so as to monitor the developments not only of the primary balance, but also of interest payments. The overall deficit in 2000, which includes the temporary rise in the burden of interest payments on government securities in circulation resulting from the disinflation process, is expected not to exceed TL 18,750 trillion (15 percent of GNP) corresponding to an operational deficit (that is, the deficit adjusted for inflation) of 7.4 percent of GNP.

15. The above figures do not include earthquake-related fiscal expenditures. These expenditures will be monitored through a special reporting system and will be accommodated under the fiscal performance criteria up to 1.1 percent of GNP. Taking into account the earthquake-related fiscal costs that cannot be monitored separately (mostly tax revenue losses amounting to about 0.2 percentage points of GNP), the additional burden for the primary balance of the consolidated government sector related to the earthquake will be about 1¼ percent of GNP in 2000 (which excludes an additional ¼ percent of GNP channeled through the social solidarity fund). This ceiling may be revised, in case external official financing in excess to the existing US\$1.8 billion becomes available in 2000, during one of the program's reviews, taking into account overall macroeconomic developments. These expenses will be targeted in the most effective way. In this respect, the cost of the credit subsidy scheme introduced soon after the earthquake will be limited to the TL 50 trillion allocated in the 2000 budget.

16. The tax package approved by parliament on November 26 will facilitate the attainment of these objectives. This package includes additional personal income and corporate tax payments; an additional payment of the annual motor vehicle and property taxes; a tax on mobile phone bills; and an increase in the remittances of surpluses generated by regulatory boards (such as the Istanbul Stock Exchange, Capital Markets Board, etc). In addition, we have introduced measures allowing individuals to reduce the duration of military service against payment of a fee. Finally, a withholding tax on government securities issued before December 1, 1999 has been introduced to reduce the windfall gain accruing to securities holders from the reduction in inflation and interest rates in 2000. These measures will raise revenues by about 2 percent of GNP in 2000. In addition, the following revenue measures will be introduced:

- An amount equivalent to 0.3 percent of GNP will be generated from direct taxes, by increasing the withholding tax on income from fixed assets and on the self-employed from 15 to 20 percent, increasing the withholding tax on interest income from deposits and repos by 2 percentage points, and limiting the increase in tax brackets and the special exemption for wage and salary earners to the targeted inflation rate;
- With respect to indirect taxes, the standard VAT rate, which at 15 percent is significantly lower than in other European countries, will be increased by 2 percentage points, with the goal of generating 0.5 percent of GNP. In addition, during 2000, Treasury approval will be required for the setting of oil prices, with oil price levies adjusted automatically depending on movements in oil prices so as to allow the attainment of the targeted savings in the budget (about 0.4 percent of GNP) regardless of the behavior of oil prices.

- Other measures, including an increase in the additional VAT on tobacco and alcoholic beverages, education levies, and fees and charges is expected to yield 0.4 percent of GNP.
- Finally, the Council of Ministers, during the first quarter of 2000, will use the authority granted to it by Law 4444, Article 2, paragraph 2, effective July 1, 2000 (with an expected yield of 0.4 percent of GNP).

17. Tax revenues will also be boosted (generating around 1.1 percent of GNP) by the revision of the method of computing taxable profits for corporate holders of government bonds with the expiration of the implementation delay in Article 279 of the Tax Procedure Law in the 1999 budget. Finally, the tax benefits granted for the areas affected by the Marmara region earthquake will be extended beyond December 31, 1999, only for the regions hit by the most recent aftershocks (Bolu and Sakarya).

18. Savings of 0.3 percent of GNP will be generated through cuts in noninvestment public expenditures, including savings from a reduction in personnel expenditure in 2000 and cuts in other current expenditures (including outlays covered by Article 54 of the budget law).

19. Fiscal developments in 2000 will also benefit from the pension reform passed in September (see below)--which is expected to improve the balances of the social security funds by 0.5 percent of GNP in 2000 with respect to the trend before the reform--as well as from the incomes and agricultural policies discussed below. Finally, the Ministry of Finance will issue in January 2000 a directive that will cut all primary spending (excluding personnel and transfers to the social security funds) by 2 percent in 2000 with respect to the budgetary allocations.

20. Many of the measures in the 2000 fiscal package are of a one-off nature. This has been necessary given the magnitude of the adjustment with respect to the trend. Further measures of a permanent nature will be introduced in 2001, when we also expect a stronger contribution from the structural reforms discussed below.

21. The introduction of the measures indicated in paragraphs 16-18 (with the exception of the last bullet point in paragraph 16), as well as approval by the parliamentary budget commission of the 2000 budget will be prior actions for the presentation to the IMF Executive Board of our request for a stand-by arrangement.

22. The above fiscal targets will be strictly pursued, if needed, through the introduction of corrective fiscal measures during 2000. Additional measures would also be introduced, in consultation with the IMF staff, to strengthen the disinflation effort and support the exchange rate commitment, if needed.

Privatization receipts and public debt management in 2000

23. The fiscal adjustment will be complemented by a more active and diversified debt management policy and through the acceleration of privatization, so as to contain the burden of interest payments. In order to limit the domestic borrowing requirement of the public sector, we intend to raise privatization receipts for the public sector in 2000 to at least 3½ percent of GNP (US\$7.6 billion), through the steps indicated below. The privatization receipts arising in the telecommunication and energy sectors (US\$4½-5½ billion) will be transferred directly to the treasury. Of the cash privatization receipts of the Privatization Authority (US\$3.1 billion), about US\$0.9 billion will be used for interest

payments, operational costs, and transfers to SEEs. The balance (US\$2.2 billion) will be transferred to the public participation fund (PPF) to be used to finance the investment of EBFs (US\$400 million) and the remaining US\$1.8 billion will be used to reduce the liability of the PPF toward the treasury. Any additional privatization receipts from whatever source will be transferred to the treasury for debt reduction. To achieve these targets, privatization will be accelerated through the legislative changes indicated below.

24. Moreover, net external borrowing for the public sector will amount to at least 2½ percent of GNP (US\$5¼ billion), including external support for earthquake expenditure, but excluding IMF resources. As we regard the composition of public sector debt as excessively biased toward domestic sources, compared with other emerging markets, we will endeavor to increase external borrowing above the indicated amount, within the overall ceilings (performance criteria) indicated in Annexes F and G.

25. Regarding domestic debt management, we will continue to rely on the more diversified debt management policy initiated in 1999 with the issue of floating rate notes, so as to reduce the reliance on longer term fixed-rate securities--the yield of which would, ex post, be very high in a disinflation environment--and improve the smoothing over time of interest payments.

26. Altogether, we project the net public debt-to-GNP ratio to remain broadly stable in 2000 with respect to end-1999 (about 58 percent of GNP). We regard this as an upper bound, and we will endeavor to bring about a reduction in the public debt ratio.

Fiscal policy in 2001-02

27. Fiscal policy in 2001-02 will be geared to at least stabilizing the domestic debt-to-GNP ratio of the public sector, thus consolidating the fiscal results achieved in 2000. Taking into account privatization receipts (see below), and our current expectations about interest rate developments, stabilizing the domestic debt ratio in 2001-02 will require maintaining the primary position of the public sector, excluding privatization receipts, interest receipts, and the transfer of profits from the central bank, at the same level of 2000, net of the earthquake related costs (that is at about 3.7 percent of GNP). These targets will be achieved as the earthquake-related costs are phased out, and the temporary measures introduced in 2000 are replaced by permanent measures.

28. The total debt-to-GNP ratio is expected to decline slightly from a projected 58 percent of GNP at end-2000 to 56½ percent of GNP in 2001 and to 54¾ percent of GNP in 2002.

29. Privatization will continue with the goal of reaching privatization receipts of at least ¾ percent of GNP in 2001 and 2 percent of GNP in 2002 (see below).

Monetary and exchange rate policy

30. Our monetary and exchange rate policies will be guided by two considerations. First, disinflation and a rapid decline in interest rates require that monetary and exchange rate developments become more predictable, so as to reduce the uncertainty on the value of financial investment for both residents and nonresidents. This requires a shift to a more forward-looking commitment on exchange rate policy. The strengthening of fiscal policy under the program, our level of international reserves, coupled with the financial support from the international community, make the introduction of such a commitment feasible.

Second, there is a need to avoid to be locked into a monetary and exchange rate framework that--while appropriate for disinflation--may lead to unnecessary rigidities in the long run, a problem that has affected many emerging markets in recent years. Hence, there is a need for a transparent and pre-announced exit strategy from this exchange rate regime.

31. The monetary and exchange rate framework under the program will conform to these requirements. More specifically, the exchange rate framework will have the following features:

- A pre-announced exchange rate path with respect to the existing basket will be introduced before the IMF Executive Board meeting (a prior action). The exchange rate path will be announced for the period January 1, 2000-December 31, 2000. During this period, the depreciation rate will be 20 percent, equal to the target for WPI inflation, according to the schedule reported in Attachment I. Within each month, the daily exchange rate adjustment shall remain constant. After the introduction of the new exchange rate system, the depreciation rate for the rest of December 1999 will be the same as in the first part of the month.
- At the end of each quarter, the exchange rate schedule will be extended by three additional months, without changing the part of the exchange rate path already announced. The devaluation rate for the additional three months may differ from the announced rate in the preceding period with a view to furthering the disinflation process.
- There will be no band around the exchange rate path for the first 18 months following the introduction of this regime. A gradual shift toward a more flexible exchange rate regime will begin on July 1, 2001 when a symmetric, progressively widening band about the central exchange rate path will be introduced. This band will widen at a rate of 15 percentage points per annum, measured from edge to edge. The total width of the band will thus reach 7½ percent by end-December 2001, 15 percent by end-June 2002, and 22½ percent by end-December 2002.

32. During the first 18 months of the stand-by arrangement--that is the period during which there will not be an exchange rate band around the central path--monetary policy will be based on the following rules:

- The stock of net domestic assets (NDA) of the central bank at the end of each quarter will not exceed the December 1999 level (adjusted for valuation changes), a performance criterion (Annex D).
- During each quarter, and with the exclusion of the fortnights centered on religious holidays (January 8-10, March 16-19, and December 27-29), NDA will remain broadly constant, while allowing some limited flexibility during the quarter to avoid excessive volatility in overnight rates, and without prejudice to the NDA ceilings specified in Annex D. Accordingly, we intend to keep the NDA stock broadly constant at its December 1999 level, but allow short-run fluctuations around that level equivalent to about ±5 percent of total base money at the end of the preceding quarter. Finally, in order to increase the flexibility of the domestic money market, the reserve requirement coefficient applying to the stock of Turkish lira deposits shall be reduced from 8.0 percent to 6.0 percent and a liquidity requirement of 2 percent on Turkish lira deposits will be imposed. This new liquidity requirement may be met on the average of daily data for the reserve requirement period,

rather than on a continuous basis. Changes in the new liquidity requirement, and the reserve requirement on Turkish lira deposits, and changes in the reserve requirement on foreign exchange deposits will be done only in consultation with IMF staff. The total of the new liquidity requirement and reserve requirement imposed on Turkish lira deposits shall not be changed during 2000.

33. Within this context, other than for short-term fluctuations, all base money will be created through the balance of payments and domestic interest rates will be fully market determined. Capital inflows will not be sterilized, allowing a rapid decline in interest rates and avoiding an excessively large interest rate differential, which would perpetuate the inflows. In the same vein, capital outflows will not be sterilized, so as to lead to a prompt increase in money market interest rates, which will help ensure that the floor on net international reserves (Annex E) is observed should pressures on the exchange rate arise. The interbank interest rates posted by the central bank will be adjusted daily in line with the movements of the overnight money market rates.

34. During the second half of 2001, as a gradually widening band is introduced around the pre-announced exchange rate path, more flexibility will also be given to NDA policy, so as to allow a gradual shift from a monetary framework entirely centered on the exchange rate to one that allows greater flexibility in pursuing the inflation target.

Incomes policy

35. Incomes policy will be essential to support disinflation and our exchange rate policy, and in particular to guide the private sector to set wage and price increases in line with the inflation target. To this end, salary increases for civil servants will be set in line with targeted CPI inflation (25 percent during 2000, of which 15 percent on January 1, and the remainder on July 1). We believe these increases will be sufficient to protect civil servants from erosion in their purchasing power. However, should CPI inflation during the first six months of 2000 exceed 15 percent, in July there will be an additional increase in civil servants' salaries equal to the difference between the CPI inflation rate during the first six months and 15 percent.

36. Minimum wage increases are determined by the Minimum Wage Commission, consisting of representatives of the government, the trade unions, and the employers. However, the government will endeavor to ensure that the minimum wage increase in 2000 will be in line with targeted inflation.

37. Incomes policy will continue to play an important role in 2001 and 2002, when we expect civil servants wages to be increased in real terms, based on targeted inflation and budgetary considerations.

Structural reform

38. Our structural reform program aims at making sustainable over the medium term the fiscal adjustment implemented in 2000, lowering the burden of interest payments on public sector debt, improving transparency and economic efficiency, and reducing the contingent liabilities of the public sector. All these are essential to create an environment where high growth rates could be sustained in a low inflation environment. Structural benchmarks for the first year of the program are identified below. Other benchmarks will be identified

during the program's reviews.

Structural reform of the fiscal sector

39. Structural reform in the fiscal area will aim at strengthening public finances, providing better services to the population over the medium term, reducing inequalities in the tax burden, and reducing waste in public expenditure. To this end, our efforts will initially focus on four key areas: agricultural reform, pension reform, fiscal management and transparency, and tax policy and administration.

Agricultural policies

40. Present agricultural support policies are not the most cost-effective way of providing support to poor farmers. They distort resource allocation by distorting market price signals, tend to benefit rich farmers more than poor ones, and lack coherence--given the fragmentation of the policy making process in this field among several ministries and public institutions. Above all, they have become quite onerous to the taxpayers with an average cost of about 3 percent of GNP in recent years. The medium-term objective of our reform programs to phase out existing support policies and replace them with a direct income support system targeted to poor farmers. This will first be done by setting up a pilot program for the crop year 2000, and, based on the results of that pilot, we will extend the direct support system nationwide in 2001 and we expect to complete it by end-2002. This system would be based on a farmers registration system that would be completed by March 2001.

41. In the interim, agricultural policies will be rationalized. In this regard, the government will announce the following set of principles that will govern the present support policies in 2000 and, if the direct support system is not yet fully implemented, in 2001:

- The support prices for cereals in 2000 will be set such that the spread between support prices and the projected world market prices is no more than 35 percent of the projected c.i.f. world price, and reduced further in 2001. The support price will not be below US\$150 per ton. Import tariffs will be adjusted such that the tariff-inclusive import price is higher than the support price, as determined above. The projected world price will be determined based on the price of the USA2HRW as quoted in the Chicago Board of Trade. In order to reduce the volume of purchases of cereal done by TMO and stem the losses of this company arising from the build up of large stocks, the government will announce that TMO domestic sale prices will be no less than the lower of (i) the purchase price of TMO plus storage costs incurred up to the date of sale (including imputed interest charges on stocks) or (ii) the tariff-inclusive import parity price for cereal of equivalent quality.
- For sugar beet, quotas have already been allocated for 2000. The support price of sugar beet will be increased in line with targeted inflation but the increase will be no less than 75 percent of the 12-month CPI inflation up to August 2000 when the support price is announced. In 2001-02 TSFAS will operate the support for sugar beet production in such a way that its losses do not exceed a fixed amount set by the government in light of budgetary considerations. This will allow TSFAS factories to operate on a more commercial basis with greater freedom in setting prices and quantities in contracts with growers. If quotas are used, they will be set consistently with this targeted loss.
- Regarding support purchases of industrial crops done on behalf of the government by the

agricultural sales cooperatives and their unions (ASCUs), the draft law granting ASCUs full autonomy will be passed by parliament by March 2000 (a structural benchmark for the completion of the first review) and an amount of TL 410 trillion will be given to ASCUs to help defray some of the costs of their restructuring, including paying arrears to farmers for last year's crop.

- The government will gradually phase out the credit subsidy to farmers. The total cost of credit subsidies sustained by Ziraat Bank and Halk Bank will decline from an estimated 1.2 percent of GNP in 1999 to 0.6 percent of GNP in 2000. To achieve this goal, Ziraat Bank and Halk Bank will introduce (as a prior action) the following mechanism for the determination of its subsidy rate: (i) the subsidized interest rate will not be lowered until it is equal to its "reference rate" (defined as the average 12-month treasury bill auction rate--or the closest maturity--during the preceding three months multiplied by 1.05); (ii) henceforth, the subsidized rate will remain equal to its reference rate; and (iii) should the reference rate start rising, the percentage spread of the reference rate over the subsidized rate will not increase. Borrowers will be given the choice to borrow at a fixed interest rate (the subsidized rate at the time when the loan is contracted) or at a floating rate equal to the prevailing subsidized rate. The increase in subsidized credit granted by Ziraat Bank and Halk Bank will not exceed 55 percent in 2000.
- The fertilizer and other input subsidies will remain constant in nominal terms in 2000 and 2001.

Pension reform

42. The new government has completed the first part of a comprehensive agenda for social security reform. In particular, the reform approved by parliament in September: increases the minimum retirement age for new entrants to 58/60 immediately and to 52/56 for existing contributors over a ten-year transition period; raises the minimum contribution period for entitlement to a pension; reduces the average replacement ratio from 80 percent to 65 percent; extends the reference period for calculating pensions to the lifetime working period; indexes pension benefits to the CPI; and increases the ceiling on contributions. Whereas in the absence of reform, the deficit of the social security system was expected to widen sharply from 3 percent of GNP this year to some 16 percent by 2050, following the reforms this trend will be reversed and, indeed, the deficit is projected to decline steadily in the short to medium term. To facilitate this, government will raise the ceiling on contributions to four times the minimum level on April 1, 2001 and five times the minimum level in April 2002. In the coming months, the government plans to deepen social security reforms by, on the one hand, undertaking administrative reforms to improve coverage, compliance and administrative efficiency and, on the other hand, creating the legal framework for private pension funds with a view to diversifying the sources of long-term savings. Progress in this area will be the subject of future program reviews.

Fiscal management and transparency

43. Fiscal management is the key to the government's stabilization program. To this end, important changes will be required to strengthen budget preparation, execution, and control; to enhance transparency and accountability of fiscal operations; and to improve the tax system and its administration.

44. Changes in the budgetary framework will require broadening the effective coverage of the budget. In this respect, 20 budgetary funds, out of a total of 61 budgetary funds, will be closed by February 2000 (a structural benchmark for the first review); 25 more funds would be closed by August 2000 (a structural benchmark for the third review). The remaining funds will be closed by June 2001. Further progress in this area will be achieved by introducing in 2001 accounting and reporting on a commitment basis for the consolidated central budget. Moreover, in 2001 an integrated financial information system based on a treasury single account and a general ledger will be implemented.

45. Enhancing transparency and accountability in budgetary operations is essential to improve fiscal management. A first step has been the inclusion in the 2000 budget of the cost of credit subsidies of state banks. By end-1999 the government will take stock of existing contingent liabilities, most notably government guarantees and make this information publicly available (a structural benchmark for the first review). By end-2000, the government will establish a public registry of guarantees and set explicit limits to issuance of new guarantees in the 2001 budget (a structural benchmark for the fifth review). As to EBFs, the scope of their activities will be reviewed by end-March 2000 with a view to identifying those that do not fulfill their original purpose. On this basis, we will reach understandings with the IMF staff on the list of EBFs to be eliminated. The elimination of these EBFs by June 2000 will be a structural benchmark for the third review. No new budgetary or EBFs will be created. A fiscal transparency review from the Fiscal Affairs Department of the IMF will be undertaken during 2000, based on the authorities' request. This review--which would raise Turkey's standing in the eyes of lenders and financial markets--would set the basis for further reforms in this area.

Tax policy and administration

46. The government is committed to improve the tax system and strengthen tax enforcement in order to make the tax system more efficient and equitable. A tax system with a broad base and low and predictable marginal tax rates, along with clear laws and regulations, is the best vehicle to stimulate domestic investment and attract foreign investment. The Ministry of Finance has already undertaken several ambitious projects, including the full automation of the tax administration system, that will enhance the effectiveness of the tax administration. During the second review, if the need arises, necessary changes will be identified in the tax system for implementation in 2000/2001. The government is aware that tax amnesties undermine tax compliance, and is committed to avoiding any new amnesty in the future.

47. Reducing tax arrears, which amounted to about 3 percent of GNP in April 1999 (of which about half within the public sector), will be one of our priorities. To this end, the government will set up a quarterly monitoring system by April 2000 (a structural benchmark for the second review). Targets for the net reduction in arrears during the rest of 2000 will be identified at the time of the second review

Privatization and the capital market

48. Realizing privatization receipts is imperative if domestic interest rates are to decline and economic efficiency is to improve. To this end, in August 1999, parliament passed key constitutional amendments permitting international arbitration in concession contracts, permitting the appropriate legislation to define the scope of state concessions, and clarifying the role of the Danistay in reviewing contracts. Building upon this important step,

legal measures will be introduced to: (i) enable Turk Telekom to act as a private entity by making it subject to the Turkish commercial code and permit it to retain exclusivity on fixed-line operations until at least end-2002; and (ii) establish a regulatory body for the telecom sector. This body will be established within three-six months following the enactment of the law. All receipts from the privatization of Turk Telecom will be transferred to the treasury shortly after the sale. The provisions of the telecommunications law will be consistent with this. Passage by the relevant parliament committees of a telecommunication law in line with the above requirements will be prior action for the program. Passage of such a law by parliament by January 31, 2000 will be a structural performance criterion. Privatization in the energy sector will also be crucial, both to realize receipts through transfer of operating right (TOR) contracts, and to foster investment and efficiency in this sector. Thus, legal amendments will be passed by parliament to define energy as a sector subject to the Turkish commercial code (a prior action). A financial recovery plan for state enterprises in the energy sector will be prepared and wholesale and retail electricity prices shall be raised over time to stem fiscal losses, as necessary.

49. The privatization program for 2000 is ambitious, but we expect to realize some US\$7.6 billion (in cash) over the course of the year. These receipts are expected to come from: (i) the sale of 20 percent of Turk Telekom to a strategic investor, as well as wireless licenses (the latter will take place during the first quarter of 2000), with an additional wireless license to be issued to Turk Telecom; (ii) the TOR for electricity distribution and power plants; and (iii) the sale by the Privatization Agency of the enterprises listed in Attachment II. Based on current procedures which will not be changed, the Privatization Agency will need approval from the Privatization High Council for the enterprises currently in its portfolio, only at the time of completion of the privatization operation.

50. With a view to realizing another US\$6 billion (2¾ percent of GNP) of privatization receipts in 2001, we shall, by the time of the second program review, identify the next set of companies to be privatized, and by end-August, secure passage of the relevant decisions enabling the addition of these companies to the Privatization Agency portfolio (a structural benchmark for the third review). A law establishing the regulatory framework in the electricity and gas sector will be passed in 2000. Privatization receipts in 2002 are expected to amount to about US\$4 billion. These targets for privatization receipts may be revised during the program's reviews in light with developments in the borrowing requirement of the public sector.

51. Domestic debt management will also be improved through the introduction of primary dealers in government securities markets. Primary dealers will be committed to quote two-way prices and participate in government securities auctions. This will bring the Turkish government securities market in line with the practice of most EU countries, and will enhance its liquidity. The introduction of primary dealers will be a structural benchmark for the completion of the second review.

Strengthening the banking system and banking regulation

52. Actions in these areas are an integral part of our program to reduce interest rates and improve economic efficiency. Important initial steps were taken soon after the government took office. In June 1999, parliament approved a new banking law that inter alia created a new supervision authority (the Banking Regulation and Supervision Agency or BRSA) in place of the current split between the treasury and the central bank. Also, in late September the limit on commercial banks' net open foreign position was lowered to 20 percent of

capital. However, some important weaknesses remain in the new act, and amendments are urgently needed in order to place the banking supervision framework on a proper foundation.

53. The *Banks Act* will be amended to increase transparency and independence in the operation of the Agency, strengthen key prudential regulations, and to provide all of the tools needed for the improved resolution of problem banks. The BRSA will be made fully autonomous by removing the involvement of the Council of Ministers from all decisions in the area of supervision, other than the appointment of the members of the Board. In particular, the decisions to license and delicense banks, and to approve provisioning regulations will rest with the Board. The law will also be amended to eliminate the three-year period during which a Board member was prohibited from employment as a senior executive in the banking sector, a provision that had made it difficult to find active professionals to take Board positions. The Board of the BRSA will be named by end-March 2000 (a structural performance criterion), and the BRSA is expected to be in full operation by end-August 2000 (a structural performance criterion).

54. The *Banks Act* will also be amended to strengthen the prudential standards for bank lending to owners and to single or related parties. The ratio of loans to large owners (defined as those with more than 10 percent of equity) shall decline from the current 75 percent of capital to 70 percent by July 1, 2000, and will then decline by 5 percentage points every six months until the ratio of 25 percent is attained. In addition to these amendments to the law, the supervision authority (the Minister for Economic Affairs until the Board is appointed) will issue in December new, more stringent loan loss provisioning regulations in line with international standards to be applied fully to all new loans, including renewal of any existing loans, from January 1, 2000, and will modify the capital adequacy and foreign exchange exposure limit regulations to apply on a consolidated basis. Tax regulations will be amended so as to allow the deductibility of provisions for tax purposes. The implementation of this measure will be discussed in the context of the second review of the program. Banks that have capital adequacy ratios below minimum required levels will be required to present and adhere to time-bound programs for strengthening their capital positions. We are committed to the strict and uniform enforcement of these and other prudential regulations as well as agreed remedial measures and for this purpose, beginning in 2000, the Agency (the treasury until the Agency is established) will prepare a quarterly report for its management on infractions and banks' compliance with remedial measures.

55. Taking an insolvent bank from its owner is a very important market discipline on the behavior of banks and the prompt intervention by the Agency in the event of insolvency protects the assets available to depositors and other creditors. Therefore, the *Banks Act* will also be amended to require the take over by the Savings Deposits Insurance Fund (SDIF) of all insolvent banks. The new amendments will give the SDIF the authority and responsibility to restructure a problem bank to facilitate its sale in full or in part, or to liquidate the remainder based on existing laws.

56. The SDIF will no longer be permitted to lend or otherwise provide liquidity support to banks other than those under its full control.

57. Approval by parliament of the amendments to the *Banks Act*, in line with paragraphs 53-56, and the actions in the area of prudential regulation mentioned in paragraph 54, will be prior actions for the discussion of the stand-by arrangement request by the IMF Board.

58. The above actions and measures will strengthen public confidence in the banking sector and remove upward pressure on interest rates resulting from distress borrowing (and excessively high deposit rates) by these banks. However, the state banks are another important source of such distortions. We are addressing the long standing problems of these banks by strengthening their oversight, while pursuing actions to begin the commercialization of Ziraat Bank and Halk Bank with an eventual privatization goal, through development of strategic corporate plans, operational restructuring, and financial and capital restructuring plans with phased-in timetables, which will be initiated in year 2000. In the interim, in order to impose financial discipline on the operations of these banks, while improving their cash management, cash transfers to cover losses on subsidized lending have been specified in the 2000 budget. Moreover, as in 1999, 15 percent of the unpaid duty losses at end-1999 will be converted into securities earning an interest linked to CPI inflation, to be serviced in cash. The yield on the stock of unpaid duty losses at end-1999, excluding the part converted in securities, will be computed quarterly based on the average of monthly treasury bill rates plus a spread of 35 percent for Ziraat Bank and 21 percent for Halk Bank. This spread will also remunerate state banks for nonremunerated services provided to the government; these services will be more properly priced in the future. Management of state banks will be expected to maintain the profitability of state banks under this tighter budget constraint.

59. The success of our strategy for strengthening the banking sector depends in part on the public correctly understanding it. We intend to communicate all aspects of our policies and actions in this area to the public.

60. In the coming year, we will take important additional steps in the area of prudential regulation and supervision. Appropriate prudential requirements in line with international standards and best practices will be taken in the areas of: (i) accounting standards applicable to banks for prudential reporting and financial disclosure purposes, (ii) capital adequacy, including market risk, and (iii) improved internal risk management procedures. These changes will allow for better asset valuation of banks and for more meaningful financial statements, facilitate earlier corrective actions against banks based on more realistic asset valuations, and introduce the necessary discipline in banks' lending policies.

61. In particular, by end-April 2000 we will amend accounting rules to require consolidated accounting and proper valuation of securities (a structural benchmark for the completion of the second review). We also intend to fully implement by end-June 2000 (a structural performance criterion) capital adequacy and foreign exposure limits rules mentioned in paragraph 54. In addition, in order to assure the strictest compliance with these regulations by end-June 2000, we will introduce penalties (a performance criterion) for foreign exchange positions in excess of prudential limits (100 percent reserve requirement). The existing penalties will continue to apply for noncompliance with connected lending limits. Finally, we intend to issue by end-June 2000 regulations on internal risk management systems and amend capital adequacy rules to take into account market risks (structural benchmark for the completion of the third review).

Other areas

62. In the area of trade policy, parliament has recently passed a law bringing Turkey's customs regulations in line with the EU's Customs Code. Another law has established the Turkish National Accreditation Council--a vital step in the implementation of the EU's legislation on the removal of technical barriers to trade. On tariff rates applied to third

countries, the higher rates applied by Turkey on the list of "sensitive items" (some 290 products at the 12-digit level) will be reduced to the EU's common external tariff rates by January 1, 2001.

63. Turkey has accepted the obligations of Article VIII of the Fund's Articles of Agreement and its exchange system is free of restrictions on the making of payments for current international transactions. During the period of the stand-by arrangement, the government will not impose any restrictions on payments or transfers for current international transactions or impose or intensify restrictions on imports for balance of payments purposes, introduce or modify multiple currency practices, conclude bilateral payments agreements which are inconsistent with Article VIII, or incur external arrears.

64. The Government of Turkey believes that the policies and measures described herein are adequate to achieve the objectives of our program, but it stands ready to take additional measures, if necessary, to keep the program on track, consulting regularly with the Fund.

Very truly yours,

/s/

/s/

Mr. Recep Önal
Minister of State for Economic Affairs

Mr. Gazi Erçel
Governor of the Central Bank

Use the free [Adobe Acrobat Reader](#) to view [Attachments and Annexes](#).
