International Monetary Fund

Turkey and the IMF

Press Release:
IMF Executive Board Completes Seventh and Final Review Under the Stand-By Arrangement for Turkey and Approves US$3.65 Billion Disbursement
May 9, 2008

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Turkey: Letter of Intent

April 28, 2008

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. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Ankara, April 28, 2008

Dear Mr. Strauss-Kahn,

1. The Turkish economy continues to perform well overall, showing resilience in the face of severe turbulence in global financial markets—a testament to our prudent policies of the past five years. Growth is moderating, in line with global trends, but remains solid. The non-energy current account deficit has broadly stabilized as a percent of GDP, although record-high oil prices are widening the overall deficit. Headline inflation has remained above target, largely reflecting the global surge in energy and food prices, but core inflation has fallen markedly over the last twelve months. And, while the 2007 primary surplus outturn fell short of target, net public debt has dropped below 30 percent of GDP,[1] well ahead of the program's original objectives.

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

- *Quantitative performance criteria and inflation consultation clause* (Annex A). We met all the applicable external debt and net international reserve targets for end-August and end-December. Inflation at both end-June and end-September 2007 was within the outer bands, although it exceeded the inner bands, while end-December inflation exceeded the outer band. The central bank has discussed the reasons for the June and September results with Fund staff and reaffirmed its commitment to policies that will gradually reduce inflation to target levels. It has written a letter to the Government explaining the December deviation and its policy response, and it forwarded this letter to the Fund in accordance with the inflation consultation clause (Annex D of our May 1, 2007 Letter of Intent). The fiscal targets for end-April, end-August, and end-December were missed, as an acceleration of central government spending proved difficult to reverse, pension and health spending (especially at private hospitals) increased more than expected, and consumption-based tax revenue suffered from weak demand for some goods (notably autos and cigarettes). In addition, tax arrears from a large energy state economic enterprise (SEE) and some decline in compliance adversely affected the revenue outturn.

[1] All references to GDP are based on the revised national accounts data released on March 8, 2008.

- *Structural benchmarks.* The structural benchmarks on hiring in SEEs and the civil service were observed for June, September, and December 2007. The new insurance law was passed on June 3, 2007 (structural benchmark). The end-June structural benchmark on the creation of a legal framework for large employers to pay salaries through bank accounts was missed due to the early dissolution of Parliament, but this legislation was passed in April, 2008. The end-June structural benchmark associated with the publication of a report quantifying existing tax expenditure was met with a delay (the report was published on October 10), due to difficulties in compiling necessary data from related institutions. The end-December structural benchmark to introduce a risk-based audit system for VAT refunds was met with a delay (in April 2008, paragraph 17). The end-December structural benchmark to put in place a unified tax declaration form for taxes and social security contributions has not been met, but the relevant legislation was passed in April 2008 and is expected to be implemented by end-2008 (paragraph 16). The structural benchmark to extend the family medicine program to 22 regions by end-December was partially met with a delay, due to technical difficulties, with the program being extended to 20 regions by April 2008 (paragraph 13).

- *New policies*. We recently took a number of strong policy measures. In particular, we

  - adopted a prudent fiscal stance for 2008 that targets a public sector primary surplus of 3.5 percent GDP (paragraph 10);

  - passed a revised social security reform that will contribute decisively to fiscal sustainability (paragraph 15);

  - took several steps to strengthen tax administration (paragraph 17);

  - significantly raised average end-user electricity prices (the first increase in over five years) as part of our plan to bolster the energy sector (paragraph 19); and

  - strengthened bank provisioning requirements in line with international norms (paragraph 21).

3. In light of this recent progress, we request completion of the Seventh Review under the Stand-By Arrangement. In view of the corrective measures being taken (paragraphs 9–20), we request waivers for the end-December 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. This will be the final review under the current Stand-By Arrangement, which ends on May 10, 2008, and will enable Turkey to draw all remaining purchases under the current arrangement (SDR 2.25 billion, or about US$3.7 billion).

Macroeconomic framework for 2008

4. GDP growth in 2007 came in at 4½ percent, one-half percentage point below our original target. Economic activity has slowed on account of a drought-related shortfall of agricultural production and a weakening of net exports. Looking ahead, we expect activity to remain resilient to the global economic and financial headwinds. At the same time, we are mindful that the worsening global environment has increased uncertainty and reduced prospects for global growth. In this light, we have slightly revised downward our growth target for this year, to around 4½ percent.

5. On the external side, despite a strengthening of the exchange rate, export volumes grew by 10.9 percent in 2007, supported by robust growth in our main trading partners. Import growth accelerated during the course of 2007, reaching 11.1 percent for the year as a whole. Still, the current account deficit declined to 5.7 percent of GDP, from 6.0 percent of GDP in 2006. For 2008, in turn, the current account deficit is expected to increase slightly back to around 6½ percent of GDP, mainly on account of surging oil prices. Meanwhile, external financing remained favorable in 2007, with foreign direct investment covering more than half of the current account deficit (driven mainly by strong private merger and acquisition activity). Foreign direct investment is expected to exceed one-fourth of the current account deficit in 2008, supported by ongoing mergers and acquisitions and the resumption of privatization activity. In light of the recent credit crunch and repricing of risk in global markets, we are monitoring current and capital account developments closely and are prepared to adjust policies as needed.

Monetary policy

6. Low and stable inflation is a key foundation for sustained high growth. The tight monetary policy implemented by the central bank since the mid-2006 turbulence has allowed a marked decline in core inflation from early 2007, despite a recent pick-up in headline numbers, which largely reflects surging global commodity prices as well as necessary domestic price and tax adjustments. In particular, the November adjustment of specific excises on petroleum products and tobacco and the January increase in end-user energy prices to reflect higher input costs (paragraph 19) have exerted some temporary upward pressure on headline inflation. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy supply. Meanwhile, the continued easing of core inflation since early 2007 allowed a gradual reduction in interest rates during September 2007 to February 2008. In the period ahead, we expect macroeconomic policies to remain supportive of further disinflation, while volatile energy and food prices as well as the uncertainties related to international financial markets pose upward risks to the inflation outlook. Against this backdrop, the central bank's policy will be geared toward containing second-round effects of recent price increases and bringing inflation down to the official target by being more responsive to adverse developments than favorable developments to the inflation outlook.

7. We remain committed to the floating exchange rate system, which helps to avoid undue build-up of risks in the financial system and provides flexibility to adjust to external developments. At the same time, accumulating international reserves for prudential reasons remains a key objective of the program. In light of increased volatility in global markets, we have recently reduced the daily minimum purchase amount to US$15 million (from the US$30 million announced in the central bank's yearly program for 2008), with the option for banks to sell up to US$30 million in additional foreign exchange to the central bank. As in the past, we retain the option to change the daily auction/optional selling amounts in either direction depending on market conditions, and to temporarily suspend the auctions in extreme circumstances. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

Fiscal policy

8. The high primary surpluses of the past several years have been the key force allowing the declines in the debt-to-GDP ratio, inflation, and real interest rates. Our public finances are now much stronger as a result. This provides us with latitude to replace the primary surplus target of 6.5 percent of (pre-revision) GNP, which has so far acted as a key guide to fiscal policy, with an explicit medium-term fiscal framework. The framework will be anchored to a debt reduction objective and include a strengthened institutional arrangement for achieving the desired expenditure restraint (paragraph 12). Expenditure restraint and improved tax administration are needed to make room to ease the tax burden on labor and financial transactions over time. In the short term, however, fiscal policy will continue to be geared toward supporting the central bank's disinflation efforts and reducing pressures on the external current account.

9. As pertains to 2007, a combination of higher-than-planned spending and weaker-than-expected revenue has resulted in a lower-than-targeted primary surplus. To strengthen public finances going forward, we have focused on making permanent improvements to tax administration (paragraph 17), including stepped-up collection efforts that have already begun to yield a recovery in revenue in late 2007 and early 2008.

10. Our revised 2008 budget targets a primary surplus of no less than 3½ percent of GDP, in line with the 2007 outturn. Against the backdrop of a slowing economy, the revisions were needed to accommodate an acceleration of labor market reforms (previously planned for 2009) and some priority investment projects, cumulatively amounting to no more than ½ percent of GDP in 2008. To promote achievement of this target:

- We have taken measures to boost revenue, including adjusting specific excises on petroleum products and tobacco, and strengthened tax administration. And, although we are confident that our revenue targets will be met, we stand ready to implement additional measures if revenues fall short of our baseline projections or if other assumptions underpinning the budget, including on state enterprise pricing, do not materialize.

- Expenditure as a share of GDP is expected to be slightly lower than in 2007. We have maintained hiring caps (limiting the replacement of civil servants leaving to attrition to 50 percent) to contain the wage bill.

- To help contain the Social Security Institution (SSI) deficit, we are implementing measures to improve health spending efficiency (paragraph 13).

- The recent price increases for electricity (paragraph 19) and natural gas are expected to improve SEEs' 2008 income by 0.4 percent of GDP (relative to what it would have been otherwise).

11. We have designed and plan to adopt soon a comprehensive reform package to reduce labor market rigidities and the financial burden on employment, which contribute to low employment ratios and a large informal sector, ultimately reducing growth. The package: (i) reduces nonfinancial burdens, including by easing special hiring and licensing requirements for private companies; (ii) expands active labor market programs; (iii) eases restrictions on temporary employment; and (iv) reduces employers' social security contributions by 5 percentage points, with additional targeted incentives for youth employment. We have ensured that the cost to this year's budget is contained to less than ¼ percent of GDP.

12. We plan to strengthen significantly our medium-term fiscal framework. For the time being, as a prior action for the review, we will soon announce a revised medium-term fiscal plan, including a debt reduction target (to 30 percent of GDP in gross terms as per the Maastricht definition by 2012) and a path for the primary surplus and primary spending consistent with meeting this target (details to be posted on www.hazine.gov.tr). We will preserve our primary surplus target in the near term (2009) even if debt falls below our projections. We will study alternative options to institutionalize this framework, with a view to taking a decision before the 2009 budget. To facilitate the monitoring of fiscal targets and to enhance fiscal transparency, we have started releasing fiscal statistics in line with a preannounced release calendar and publishing more data on sectors outside the central government, including the social security institution, SEEs, and revolving funds. We will also publish accounts that consolidate the central government and social security institution.

13. We are committed to improving the health system, enhancing its efficiency over time, and ensuring the system is adequately financed. We are confident that the budget for health spending in 2008 is sufficient and have adopted safeguards to ensure the spending overruns of the last several years are not repeated. Specific measures include the following: (i) we have adopted tight global caps for state hospitals' 2008 budgets on a quarterly basis; (ii) we have used the "discount" system to legally settle all 2007 invoices and renewed this authority in March with a view to applying the same system in 2008; and (iii) we will shortly announce

differentiated copayments for outpatient services with payments increasing with the level of service. Copayments will be between 0 and 2 YTL for primary care, between 5 and 10 YTL for secondary care, and between 8 and 10 YTL for tertiary care services, with a 100 percent discount for secondary and tertiary care with a physician referral. Technical preparations are now being made to put in place a referral system and facilitate the early adoption of differentiated copayments. To promote medium-term efficiency, we plan to publish an actuarial report on health finances by end-June 2008. We are also expanding the family medicine system, which was extended to 20 regions by April 2008.

14. To support our fiscal objectives, we will continue to replace no more than 10 percent of employees leaving SEEs and will maintain excise taxes and SEE prices (including energy prices) in line with program assumptions, or promptly take corrective measures. We will refrain from (i) introducing sectoral tax cuts that would undermine the structure of the VAT or income tax or (ii) creating any extrabudgetary fund that would prejudice fiscal transparency and financial discipline.

Structural fiscal reforms

15. Parliament has adopted a revised social security reform law, which addresses the objections raised by the Constitutional Court to Law 5510 while retaining most of the latter's savings. The reform will contribute enormously to entrenching fiscal sustainability over the medium and long run. The revised law also establishes a new universal health insurance framework. To promote efficiency in this area, the law authorizes the Social Security Institution to set copayment rates for outpatient services that are differentiated between primary, secondary, and tertiary levels. We expect to implement the law in its entirety starting from October 2008. In the interim period before the new law comes into force, we will ensure that pension increases do not exceed the growth rates implied by the indexation parameters in the new law.

16. In the meantime, we continue to press ahead with measures to improve the collection of social security contributions. In the context of the social security reform, we have adopted a legal framework requiring large employers to pay salaries through bank accounts (prior action), which had been delayed by the early dissolution of the previous parliament. In addition, we are strengthening and modernizing premium collection techniques. In this respect, we have established special departments focused on debt collection issues within the Social Security Institution, and we are working on establishing a separate subdivision within the Department of Premium Collection in Social Security Institution to deal with large employers. We are also working on operationalizing Large Employer Offices in Istanbul, Ankara, and Izmir, which we expect to start operations by end-September 2008. We have also passed legislation enabling a unified tax declaration form, which we intend to implement by end-2008.

17. Continued progress in tax administration is essential to our objective of enabling lower taxes over the medium term without jeopardizing our fiscal objectives. We have expanded the number of auditors assigned to the Large Taxpayer Unit to 50 and will add more as we identify highly-qualified suitable candidates. To guard against VAT refund fraud, we (i) have eliminated the ability to offset third-party tax liabilities (thus limiting offsets to the claimant's own liabilities); (ii) introduced a risk-based audit system for VAT cash refunds with the introduction of a pilot system (prior action) that, with positive results, will be expanded by end-2008 to include more taxpayers; in the interim, post-refund audits of offsets will be introduced; (iii) will soon introduce monthly cross-matching of purchase and sales invoices for larger taxpayers; and (iv) will raise audit staff levels from 5 to 10 percent of total resources over the medium term. To improve compliance, we (i) will review the penalties for serious fraud and evasion with the goal of strengthening sanctions by end-2008; (ii) will remove the option to pay a fine to avoid custodial sentences by end-2008; and (iii) will enhance cash teams by introducing test purchasing backed up by verification.

18. We remain committed to reforming the civil service in such a way as to improve efficiency (through greater flexibility, better incentives for performance, and added emphasis on human capital development), eliminate discrepancies between pay for equal work (by consolidating the legal framework governing salary setting), and contain the weight of personnel costs in total public expenditure (through strengthened monitoring of employment and pay policy changes).

19. We have formulated a comprehensive plan to attain lasting financial viability of the SEEs operating in the energy sector. Our plan combines four key elements: (i) an upfront adjustment of end-user electricity tariffs; (ii) implementation of a reliable, automatic pass-through mechanism; (iii) a resolution of the nonpayment by municipalities; and (iv) a swift resumption of our sectoral privatization strategy. An upfront 16½ percent increase in average end-user tariffs for electricity was implemented on January 1, 2008. Consistent with our commitment to achieve the 2008 primary surplus target for the SEE sector, we have adopted, effective July 1, 2008, an automatic price adjustment mechanism that will ensure full pass-through and thus create a reliable basis for future private investment in the sector.

20. We are preparing a detailed action paper to resolve the issue of nonpayment by municipalities, including for street lighting, and reduce technical losses and theft, which weigh on the financial performance of the electricity sector. Moreover, we are committed to taking expeditious steps toward our strategic objective of increased private sector participation in both distribution and generation. In particular, we are soon launching the tender process for the privatization of four regional electricity distribution companies (prior action). In this context, we will review carefully the possible need to adjust some of the performance targets and investment obligations for distribution companies stipulated under the original timetable. We also remain committed to privatizing generation companies in due course.

Financial sector reforms

21. We are continuing our efforts, most recently acknowledged in the Financial System Stability Assessment, toward ensuring that our supervisory and regulatory practices are fully in line with international best practices. To this end, the BRSA has recently tightened liquidity requirements and issued a new regulation setting specific provisioning rules for special mention loans in accordance with good prudential practices. As part of its examination of risk management in banks, the BRSA will further emphasize to banks their responsibilities to comprehensively monitor foreign exchange risks. In addition, the central bank has launched a new survey of corporate sector foreign exchange exposure to improve its oversight of these risks from the viewpoint of financial stability. The results will be published by end-2008. With respect to Basel II, the BRSA has postponed full implementation of the new rules until early 2009. To give banks sufficient time to prepare for the new capital requirements, however, the BRSA will soon announce risk weightings for banks' various assets.

22. Banks' prudent assessment of risks depends crucially on the availability of accurate and timely information about their borrowers' financial position. With this in mind, we are committed to ensure the parliamentary adoption of the new Commercial Code during 2008. The Commercial Code will require that corporate financial statements be prepared in line with International Financial Reporting Standards, thus ensuring a much improved coverage and timeliness.

23. We are also committed to completing all the requirements for an efficient and financially stable mortgage lending system. The Capital Markets Board (CMB) has already issued several important implementing regulations for the landmark February 2007 Mortgage Law. A draft regulation on asset-backed securities was recently disclosed for public comments and a draft regulation on mortgage finance corporations will be disclosed for public comments shortly. Both of these regulations will be issued in final form by end-June 2008. The BRSA plans to take appropriate measures for monitoring implementation of the new mortgage regulations by banks and their affiliates. Such supervisory actions would include requiring banks to have proper systems in place to identify all risks related to mortgage lending.

24. The initial public offering of 25 percent of Halkbank shares in May 2007 was highly successful. We are now making preparations for a secondary equity offering (SEO) of another 24 percent of shares in the period ahead, and depending on market conditions. This step could be followed by further block sale of the majority shares. We also remain committed to preparing a privatization strategy for Ziraat, once Halkbank is fully privatized.

25. The SDIF is now in a better position to focus on its role as a deposit insurance agency. It has recently taken a decision on the design of risk-based premiums that will further improve the functioning of the deposit insurance scheme. To assist the SDIF with its mission,

we will continue to ensure high-quality cooperation and sharing of information among all relevant regulatory and supervisory agencies.

Investment climate

26. Foreign direct investment reached a new record in 2007, with net inflows of US$20 billion surpassing the previous year's record level of US$19 billion. Ongoing merger and acquisition activity across a range of sectors and the renewed privatization drive should continue to support foreign direct investment inflows this year and over the medium term. The main elements in the privatization agenda for 2008 include Tekel tobacco (tender completed in February), Türk Telecom (IPO for 15 percent) electricity distribution and generation, sugar refineries, toll roads and bridges, the national lottery, and the Halkbank share offering. We are committed to passing revised legislation as necessary to preserve the rights of foreign investors to own real estate in Turkey, as this is needed to ensure that Turkey continues to benefit from a robust flow of foreign direct investment.

27. We are committed to redoubling our efforts to improve Turkey's investment climate and continue to work closely with the private sector to identify and implement investment-friendly reforms. Notable areas of recent progress include the streamlining of business license requirements, and simplification of customs procedures. We expect parliamentary passage of the Commercial Code in the coming period (paragraph 22), which will strengthen corporate governance and transparency.

Stock-taking

28. As the current Stand-By Arrangement comes to an end, we consider that most of the key objectives set at the outset of the program have been achieved. First and foremost, continued discipline in fiscal and monetary policies (in the context of the recently adopted inflation targeting framework) has consolidated macroeconomic stability, affording three more years of strong and steady growth with comparatively low inflation, sharply rising FDI, and strengthened public balance sheets. These advances have allowed our economy to withstand even serious external shocks, including repeated bouts of financial market turbulence. Simultaneously, we have made important progress in a number of structural areas, notably on social security, tax administration, and banking supervision, as well as state bank restructuring and privatization.

29. Reflecting the success of the program, Turkey has expanded significantly its trade and investment links with the rest of the world, converged further to the economies of the European Union, strengthened its international reserve position, and reduced it reliance on Fund financial support. We intend to build on this economic success by persevering in the period ahead with disciplined macroeconomic policies and structural reforms to secure even greater economic prosperity.

Very truly yours

Mehmet Şimşek /s/	Durmuş Yılmaz /s/
Minister of State for Economic Affairs	Governor of the Central Bank of Turkey

Annex A. Turkey: 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	Outcome			Ceiling/ Floor	Outcome
I. Quantitative Performance Criteria 1/																
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	9,358	32,338	23,066			40,738	29,183
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	7,327	31,138	19,845			38,238	26,665
3. Ceiling on consolidated primary spending of central government budget and social security institutions (SSK, BK and ES) 2/	n.a.	n.a.	n.a.	n.a.	124,046	124,859	173,084	174,972	56,485	59,690	118,593	125,003			190,795	195,988
4. Ceiling on contracting or guaranteeing of new external public debt with original maturities of more than one year (in millions of US$)	8,500	4,196	14,000	4,806	18,000	6,829	21,500	10,853	9,000	4,247	15,000	8,175			22,000	10,263
5. Ceiling on the stock of external public debt with original maturities of up to and including one year (in millions of US$)	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0	1,000	0			1,000	0
6. Floor on level of net international reserves of CBT and Treasury combined (in billions of US$)	19.7	32.4	24.3	31.0	25.7	31.0	28.7	32.6	28.7	40.6	34.2	44.0			31.8	43.7
7. Floor on the cumulative overall balance (before transfers) of the social security institutions (SSK, BK, and ES) 3/	-6,100	-6,634	-12,000	-10,554	-18,400	-16,481	-24,300	-22,001	-5,000	-8,976	-16,300	-17,549			-24,200	-25,041
II. Indicative Targets																
1. Floor on the cumulative overall balance of the consolidated government sector 2/	-3,429	1,202	-3,934	7,133	-5,466	2,080	-6,460	-1,168	-6,612	-6,580	-3,612	-6,512			-5,512	-9,972
2. Privatization Proceeds (in millions of US$)	1,900	4,579	2,800	7,970	3,200	8,008	4,200	8,010	n.a.	n.a.	n.a.	n.a.			n.a.	n.a.
III. Inflation Consultation Bands (12-month change, in percent) 4/																
									Mar. 31, 2007		Jun. 30, 2007		Sep. 30, 2007		Dec. 31, 2007	
									Target	Outcome	Target	Outcome	Target	Outcome	Target	Outcome
Outer Band (upper limit)	9.4		8.5		7.8		7.0		11.2		8.7		7.3		6.0	
Inner Band (upper limit)	8.4		7.5		6.8		6.0		10.2		7.7		6.3		5.0	
Central Point	7.4	8.2	6.5	10.1	5.8	10.5	5.0	9.7	9.2	10.9	6.7	8.6	5.3	7.1	4.0	8.4
Inner Band (lower limit)	6.4		5.5		4.8		4.0		8.2		5.7		4.3		3.0	
Outer Band (lower limit)	5.4		4.5		3.8		3.0		7.2		4.7		3.3		2.0	

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 thus reported separately in Annex D of the TMU (EBS/07/47).