

ANNEX 1: DEVELOPMENTS IN STRUCTURAL REFORMS

Even though significant improvements were observed in Turkey's economic and institutional structures in the 1990s, chronic and high inflation persisted in this period, while the rate of growth followed an unstable course. Financing of high level of budget deficits through domestic borrowing led to persistence of high real interest rates and worsening of domestic debt problem. On the other hand, high real interest rates had unfavorable impact on economic activities.

It became evident that permanent reforms rather than short-term solutions could ensure the reestablishment of stability in economic activities and rate of growth as well. With this purpose, "Disinflation and Economic Stability Program" was introduced as of the beginning of 2000, which was supported by the IMF as well. In this period, despite the decisive steps taken in structural reforms and monetary & fiscal policies, both delays in privatization process of the SEEs and expansion in current account deficit due to sharp increase in energy prices stemmed from oil prices and overvaluation of the Turkish lira plus weak structure of banking sector have led to the November 2000 and February 2001 crises. In this context, efforts towards structural reforms have been intensified with the "Strengthening the Turkish Economy-Turkey's Transition Program" that aims to reduce public deficits in the short-term and to establish permanent stability in financial structure in the long run. In the program, structural reforms are grouped under various titles, and considerable progress was made in these reforms.

1. The Banking Sector Reform

Drastic steps were made both in the resolution of problems of state and SDIF banks and in strengthening of private sector banks.

In the past, financial conditions of state banks, which provided significant resources for accomplishment of public duties, have been deteriorated due to duty losses

that have accumulated as a consequence of these practices. Moreover, excess daily liquidity needs of state banks had a negative impact on overall banking system. With law No. 4603 dated November 25, 2000 as an initial resolution to this problem, charging state banks with new duties without making prior allocation in the budget was avoided. With the Council of Ministers' decision dated April 30, 2001, the decrees on existing duty losses were annulled, and the duty losses of state banks were completely eliminated as of the end of June by extending cash and bills. Short-term liabilities of state banks amounting to TL 8.5 quadrillion on March 16, 2001, apart from those to the Central Bank, were reduced to zero by May 2001. Their short-term liabilities to the Central Bank have been significantly decreased as well. Transfer of resources that is required in the reinforcement of capital structures of state banks was made via securities and cash. On the other hand, the law that was introduced on November 25, 2000 excluded state banks from the scope of Decree No.233 on the SEEs. Hence, these banks will be subject only to the provisions of Banking Law and Commerce Law like all other banks.

With the purpose of operational restructuring, Emlak Bank was transferred to Ziraat Bank as of July 6, 2001, inefficient branches of state banks were closed and number of employees was reduced. An agreement was signed with an independent auditing firm for the external audit of state banks. Besides, outside advisors were appointed to guide operational restructuring of these banks. Rapid progress was made in both internal audit and risk management, and an internal financial control unit was established in Ziraat Bank for this duty. The State Banks' Joint Management Board that will make necessary arrangements to privatize Ziraat Bank and Halk Bank within three years has been established in April, and the newly bank management team was appointed in May.

With respect to resolution of the SDIF banks, merge and sale methods were employed. In this framework, Egebank, Yurtbank, T. Tutunculer Bank (Yasarbank), Bank Kapital and Ulusal Bank were merged with Sümerbank while Interbank and Esbank merged with

Etibank. Bank Ekspres, Sumerbank and Demirbank were sold whereas the sale process for Etibank, Sitebank and Kentbank is still ongoing. Turk Ticaret Bank was closed on July 1, 2001, via the BRSA decision published on June 15, 2001.¹ On the other hand, Toprakbank has been transferred to the Fund on November 30, 2001 in order to keep stability and confidence in financial markets. Overnight obligations of Fund banks, except those with the Central Bank, was eliminated, the short-term liabilities with the Central Bank were considerably reduced. In order to strengthen their financial structures, deposit and capital supports were provided to Fund banks from the SDIF resources. The bills that they had already purchased through auctions were replaced with the bills conforming to market conditions. Bad assets of Fund banks are still being transferred to the SDIF Collection Department. Furthermore, a joint management board was established for Fund banks with the purpose of operational restructuring as in state banks, and their branches and employees were significantly reduced.

A number of measures were taken in order to allow healthier functioning of the banking sector. The BRSA requested commitment letters from the capital deficient banks to improve their conditions. Those that failed to fulfill their capital increase commitments were transferred to the Fund. Thank to domestic debt swap performed by the Treasury on June 15, 2001, private banks whose foreign exchange positions suffered from the February crisis were extensively recovered. With the regulation published by the BRSA in February 2001, provisions related to banks' internal auditing and risk management systems were declared to the banks. The sub-arrangements pertaining to the mentioned regulation are to be completed by the year-end. Legal changes that encourage bank mergers were effected under Regulation on Bank Mergers and Transfer published in June as well as the tax advantages introduced in July. The works for improving investment environment and increasing foreign capital inflows by clearing the bureaucratic obstacles and other

impediment to capital inflows of foreign banks are moving ahead. Legal changes that encourage increase in capital resources in the banking sector were made in July. Moreover, the Central Bank introduced an intensive monitoring system in May in order to obtain weekly data on deposit interest rates applied by banks. This system, by combining these data and the daily data of the banks, aims at receiving an early warning particularly about liquidity pressures and thus, taking necessary measures to prevent it. With the circular published on September 22, 2001, the Central Bank has been empowered to request and collect information on foreign exchange, gold and Turkish lira transactions directly from any and all types of finance institutions, and to make relevant examinations in these institutions. In order to reduce financial costs of banks and to encourage Turkish lira deposits, as of August 8, 2001, the Central Bank started to apply interest on required reserves allocated for Turkish lira deposits.

On the other hand, the BRSA made considerable progress with regard to the supervision of banks' branches abroad as well as offshore banks. In this context, the BRSA signed bilateral agreements with the Central Bank of the Turkish Republic of Northern Cyprus on September 17, 2001 and the Central Bank of Albania on October 19, 2001, and started negotiations with other relevant countries.

2. The Budget Reform

In the Turkish budget system, the unity of budget deteriorated as a consequence of increase in extra budgetary expenditures due to practices such as extra budgetary funds and duty losses in the past. In the course of time, the budget has lost its adequacy and efficiency. With weakening correlation between resources and expenditures, the budget system has gradually become inadequate to provide information to decision-makers and the general public. Moreover, limitations imposed on the auditing scope of the Exchequer and Audit Department (Sayistay) in the course of time reduced the efficiency of the supervision of the budget as well.

¹ The banking license of Turk Ticaret Bank was revoked as of July 1, 2001. However, the legal process is still continuing because of the Council of State's (Danistay) decision to suspend the enforcement.

With the Program, important progresses have been made in eliminating impediments and delays in the management of public expenditures, and rapid progress has been made in providing budgetary discipline. The budgetary funds except the Support Price Stabilization Fund (DFIF) that is essential for the World Bank loans, and extra budgetary funds excluding the Social Aid and Solidarity Fund, the Defense Fund, the SDIF, the Privatization Fund, and the Promotion and Publicity Fund were abolished. A decision was taken not to establish any further fund. These are radical reforms that have been made toward achieving of budget discipline and its transparency. Outstanding steps were taken toward adopting a budget code system confirming international standards in 6 pilot institutions included in the general budget. The spread of this system will allow clear and rapid pursuit of the amount and nature of expenditures of all institutions. A considerable progress has been made by the Ministry of Finance in the web based Say2000i Accountancy Automation Project that will allow monitoring daily operations of accountancies nationwide from a single center. This project aims at on-line following of account and cash movements of state institutions between main unit and the provinces on a basis of a standard accounting system. The Treasury started to systematically announce the payments related to the Treasury guarantees in order to provide transparency. To pursue the Treasury's payments within the scope of guaranteed debts and repayments to the Treasury by the related administrations, a "lending minus repayment" item was included to the Treasury's monthly reports. Additionally, regulations that will expand the range of application of tax identification number were put into force as of September.

The Draft Law on Public Financing and Debt Management, which has been formulated to improve effectiveness in debt management by gathering the provisions related to debt management that take place in various legal texts under a single law and by centralizing the debt management, has been submitted to the Parliament. This draft that brings in clear borrowing rules and limitations, aims at including the

Treasury's on-lending credit and debt guarantees into the budget coverage as well.

Amendments to Decision No.32 on the Protection of the Value of the Turkish Lira that have been adopted to ensure the pursuit of external debt records of private sector more soundly were introduced on October 1, 2001. These amendments allow the Central Bank to monitor all external borrowings of the private sector. Hence, a significant step has been taken towards efficiency in gathering data on external borrowings of private sector.

3. Reforms toward Competition and Efficiency in the Economy, and Foreign Direct Investments

Reforms aiming to increase the role of private sector in the economy and also in privatization have great importance for improving effectiveness and efficiency in the economy. In the medium-term, it is targeted to attract foreign direct investments in order to ensure financing of accumulated debt stock and sound operating of economy. Considerable progress has been made in the last period.

A strong private sector reform and increasing competition depend on amendments made within the legal framework. Principles and procedures in the production, pricing and marketing of sugar and sugar beet were re-determined by the Sugar Law introduced in April 2001. With this regulation, the state has withdrawn itself from the pricing process in order to bring competition in the market and thus paving the way for privatization of sugar factories. The Natural Gas Law that aims at offering natural gas to the market under competitive conditions, and Telecom Law that targets to increase the efficiency in telecommunication sector and prepare Turk Telecom to privatization have been published in May. The Turkish Civil Aviation Law that allows free pricing of domestic lines was introduced in April while the Electricity Market Law in July. Thanks to these legal studies, drastic steps were taken for the structural reforms about establishing competitive environment and attracting foreign direct investments to the country, and the necessary legal

framework for this aim has been, to a large extent, established.

Another progress made toward attracting foreign capital is the approval of the Law on International Arbitration. With the law enacted in July, conflicts arising from specifications and contract privileges related to public services, where any foreign element is involved, shall be settled through international arbitration, paving the way of foreign-capital direct investments. On the other hand, the work is moving ahead in order to reduce administrative barriers to investments. A study and report on Project on Detecting Administrative Barriers to Investments, prepared by International Finance Corporation (IFC) of the World Bank and Foreign Investment Advisory Service (FIAS), was submitted at a conference held in September to which various international institutions and civil society organizations attended to the conference. Studies on the action plan for removing administrative barriers to investments are still continuing.

4. The Social Solidarity and Social Security Reform

Reforms that have been made in social security in order to strengthen social solidarity and to resolve existing problems at present and in medium-term were put into effect as of 1999.

At the first stage, a Law on Social Security Reform was enacted in September 1999. Accordingly, pensions were made possible to increase by the amount of paid premium. Retirement age has been progressively raised. Moreover, preserving purchasing power of pensions has been ensured by the application of inflation indexation system. Subsequently, by introducing

Unemployment Insurance system, a drastic step has been taken for avoiding unemployed persons to suffer.

At the second stage of the reform aiming at the institutional restructuring, Social Security Institution was established within the structure of the Ministry on Labor and Social Security by the Council of Ministers decision dated August 24, 2000, in order to establish standardization among insurance programs implemented by the insurance companies and to monitor financial positions of these companies. Radical reforms were affected in the social security system via amendments in laws governing SSK, Bağ-Kur, Turkish-İş and Individual Retirement Savings & Investment System. On the other hand, Law on Foundation, Working Principles and Operation Methods of Economic and Social Council was introduced on April 21, 2001. The Council aims at providing reconciliation and cooperation among social groups in formulating economic and social policies. Furthermore, the studies on initiating automation project in SSK and Bağ-Kur, establishing a central database in coordination of social security institutions and forming an extensive information system, setting up a common accounting system and achieving standardization in the health services are still continuing at present.

In order to socially support the low-income group that may suffer due to the implementation of the Economic Program, the Government and the World Bank have drawn up the Social Risk Reduction Project. Under the agreement signed between the government and World Bank on August 13, 2001, the Japanese government has donated US\$ 580 thousand through the World Bank. Moreover, the World Bank made a decision on providing US\$ 500 million credit for this purpose on September 13, 2001.