REPUBLIC OF TURKEY
PRIME MINISTRY

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

Dear Mr. Köhler:

1. **Our economic program for 2002–04, which the IMF supports under a stand-by arrangement approved in February, is off to a good start.** The last five months have marked an important turning point for the Turkish economy. Since late October 2001, the confidence that returned to financial markets is reflected in the Turkish lira gaining value, interest rates declining, and the stock market recovering.

2. **The positive developments reflect our continued strong policy efforts.** We have met the end-January performance criterion for the consolidated government sector surplus, and the end-February performance criteria for base money and net international reserves (Annex A). We have also continued to make progress in structural areas, including several structural benchmarks (Annex B). Moreover, we expect to complete shortly the two prior actions for the first review, namely passing the Law on Public Debt Management and issuing supporting regulations, and identifying redundancies in state enterprises and eliminating unfilled positions. The latter measures are an important part of our strategy of pursuing state enterprise reforms aimed at increasing efficiency and eliminating the burden imposed on employment and growth in the rest of the economy by excess costs and staffing in the state sector.

3. **On this basis, we request that the first review under the stand-by arrangement be completed.** Our targets and policies remain as set out in the January 18 Letter of Intent. This letter updates on policy developments and describes additional steps we plan to take to achieve the program targets.

4. **The key challenge now is to steer the right course that will allow Turkey to realize both the 3 percent growth target and the 35 percent inflation target set for 2002.** Both targets are equally important. An economic recovery has to take hold so that we start

generating employment again, so that hope in the future can gain momentum, and so that financial markets evaluate positively not only short-term prospects but also the medium-term outlook for the Turkish economy. At the same time, we must and will use the opportunity offered by current circumstances to decisively break inflation expectations and secure the realization of our inflation target. The February outcome shows that we are at a turning point. Inflation is at the root of most of the problems suffered by the otherwise very dynamic Turkish economy. We must reduce inflation to 35 percent this year and to single digits in the medium term. This is an essential condition for rapid, equitable, and truly sustainable growth.

Fiscal policy and debt management

5. **Our fiscal policy remains firmly geared to achieving a public sector primary surplus of 6.5 percent of GNP in 2002.** We estimate the 2001 outcome at 5.9 percent of GNP, above the target of 5.5 percent of GNP. Building on this strong performance, and with tax revenue exceeding projections and spending restraint continuing in January, we comfortably met the end-January 2002 performance criterion on the consolidated government sector primary surplus (which is cumulative from January 1, 2001). Further, we are close to meeting the structural benchmark on completing the remaining measures from the fall fiscal package: most state economic enterprises (SEEs) have approved budgets in line with cost reductions mandated, and we have instructed the others (which had already approved their budgets before the savings measures were defined) to correct their budgets; and we are finalizing the identification of savings from closing regional administrations and other line agency offices. For the latter measure, broad budget appropriations have already been blocked, and implementation of closures is expected by end-June. To offset the lower-than-expected petroleum consumption tax revenue so far this year and the government's recent decision to support job creation (through delaying half of the increase in the social security contribution base by three months, and introducing limited tax incentives), we are taking additional measures. In particular, we will keep investment expenditure in one of our social security institutions (SSK) at the level originally planned in the investment program for 2002, which will entail a saving of TL 195 trillion, and we will implement a generic drug purchase program in another (Emekli Sandığı) by end-April. In addition, we now expect a dividend of TL 180 trillion from the state-owned Ziraat bank, whereas the budget assumed no profit transfer from state banks this year. We are confident that the measures we have taken will be sufficient to enable us to meet our fiscal targets. However, should signs of deviations emerge, we will not hesitate to take decisive and timely action to safeguard these targets.

6. **We are taking further steps to strengthen government debt management.** With the re-introduction of floating rate note issues in January, the maturity of newly auctioned debt has increased sharply. In addition, parliament has passed the Law on Public Debt Management, and we expect the supporting regulations to be in place shortly. In line with international practice, this law will establish a Treasury office covering the presently dispersed responsibilities for formulating overall public debt strategy and assessing risk management, and should allow closer coordination in managing the domestic and international debt portfolios. Details on the operations of this office will be spelled out in a government communiqué to be issued in June. Further organizational and, if needed,

legislative improvements will be made based on the recommendations of a comprehensive study on debt strategy and risk management, which will be undertaken by Treasury with the contributions of external consultants and completed by June 2002.

Monetary and exchange rate policy

7. **The Central Bank of Turkey (CBT) will continue to focus its policies on keeping inflation within the targeted 35 percent for 2002.** While ensuring that our base money and net international reserves (NIR) targets continue to be met, we are preparing for the introduction of inflation targeting, and expect that the pre-conditions will be met by mid-year.

8. **While adhering to the floating exchange rate regime, the CBT will use the improvement in the balance of payments and reverse currency substitution to build up its foreign exchange reserves.** As interest rates have declined, the CBT has been in a stronger position to offset any use of the Treasury's foreign exchange receipts for domestic payments through money market operations, rather than foreign exchange auctions. Accordingly, NIR is now well above the program floor. If the balance of payments were to strengthen further, and reverse currency substitution to continue, we would consider making foreign exchange purchases in a transparent manner to further bolster our reserve position. We therefore expect to be able to preserve our improved international reserve position and stay well above the formal target. From a medium-term perspective, reserve accumulation will enhance market confidence and enable Turkey to better withstand external shocks. As before, discretionary intervention in the foreign exchange market will be strictly limited, though the CBT stands ready to intervene to dampen excessive volatility in the foreign exchange market.

9. **We will take steps to develop deeper and more liquid foreign exchange and money markets.** The CBT has already announced a program to phase out its intermediary role as a "blind broker", beginning in March 2002, which will promote interbank markets. To encourage the development of futures markets, the Ministry of Finance has clarified that profits taxes will not be levied on daily mark-to-market profits, but on profits when the contract is closed. To encourage development of the foreign currency market, we will eliminate stamp duties on forward contracts and remove the tax on interbank foreign exchange transactions by end-May, 2002. Also by end-May, we will require withholding for interest earned through transactions intermediated by Takasbank, with a view to reducing segmentation in the interbank market. To rationalize the system of reserve requirements, the CBT has announced, effective from May 2002, increases in (i) the scope and length of the averaging of reserve requirements, and (ii) the remuneration of both Turkish lira and foreign currency reserves, linking remuneration to market rates. Remuneration will take place at less than market rates, since these are riskless assets. Many of these initiatives have been developed by a multi-agency working group, which will continue to identify measures to ensure the successful development of money and foreign exchange markets.

Financial sector reform

10. **Implementation of the recapitalization scheme for private banks is proceeding as envisaged.** Since the amended banking law took effect on February 1, the Bank Regulation and Supervision Agency (BRSA) has issued regulations and guidelines, and briefed banks and auditors about the details of the scheme. The banks' external auditors are expected to complete the targeted assessments of the banks' capital needs by end-March as scheduled. The BRSA has started the selection of third-party audit firms to carry out the second reviews, designed to verify auditor compliance with regulations and guidelines in estimating the capital needs. We expect the BRSA to appoint the auditing firms within a week (allowing us to meet an end-March structural benchmark with minimal delay). To clarify the conditions for government support, the BRSA is preparing prototype contracts to be signed between the Saving Deposit Insurance Fund (SDIF) and the majority shareholders on the pledging of shares, share buy-backs, and the conversion of Tier–2 capital into Tier–1 capital.

11. **The operational restructuring of state banks in preparation for privatization is also moving ahead after the passage in January of the required legislation and decree.** The Joint Board of Ziraat and Halk has already taken the initial steps leading to the closure by mid-year of 827 branches (458 in Ziraat and 369 in Halk): as of March 7, 119 branches had been closed. As regards the privatization of Vakif Bank, five potential bidders have expressed interest and are conducting due diligence. Bids are expected in May.

12. **The SDIF is committed to resolving the remaining intervened banks and to ensuring transparency in its operations.** It is taking steps toward resolving the four intervened banks still under its ownership. Three potential bidders are carrying out due diligence on one of them (Toprak) and are expected to present their bids by April 9. A second bank (Bayindir) is acting as a bridge bank, and once the resolution process has been completed a decision will be made whether to sell or liquidate the bank. The resolution of the remaining two banks (Taris and Türk Ticaret) has been temporarily halted by court decisions. To promote transparency, an auditing firm has been appointed to carry out the annual audit of the SDIF, which we expect to be completed by end-April (meeting a structural benchmark), by which date the SDIF will also start presenting monthly balance sheets.

13. **To complement bank rehabilitation, we are taking steps to promote corporate debt restructuring.** The voluntary market-based framework introduced in January 2002 (the "Istanbul Approach") will facilitate restructuring of the debts of large borrowers. In support of this, a framework agreement to be jointly signed by the creditors and used as the basis for the debt workouts has been finalized, but has yet to be signed. The Production and Finance Committee, chaired by the Treasury, and with high-level representatives from government agencies and the business and banking communities, is meeting regularly. To accelerate the restructuring process, we will establish a secretariat to this committee in April. The committee will complement existing incentives by developing further measures, consistent with preserving the transparency and integrity of the bank recapitalization exercise, to catalyze banks' and corporates' participation in the "Istanbul Approach". This committee will also work with the relevant government agencies to establish by June 2002 a database to

monitor corporate debt. In addition, the SDIF has announced that a private asset management company will be set up by end-August 2002, with the SDIF owning a minority share.

Other structural reforms

14. **The government is supporting growth and the reduction of inflation through major structural reforms.** In addition to our prudent fiscal policies, our efforts to restructure the banking system, reduce overstaffing in the public sector, increase the role of the private sector in the economy, and improve the business environment will promote growth and enhance price competition. The government will also undertake reforms to de-index the economy, and lessen inflation expectations. In the ongoing negotiations on new two-year private sector wage contracts the government will, in its role as an intermediary, stress to labor unions and employers the need to reduce backward indexation. Moreover, in the first of a planned series of meetings, the Treasury, the State Planning Organization, and the CBT met in February with labor unions and employers' associations to discuss wage and price policies consistent with the 35 percent inflation target.

15. **Important steps to strengthen government finances and public sector efficiency are being taken as planned.** A more efficient public sector and a more equitable and efficient tax system are essential to pave the way for rapid growth and new productive employment creation throughout the economy. The steps we are taking include the following:

- To **rationalize employment in the public sector**, we have eliminated all open unfilled redundant positions at state economic enterprises (SEEs), and we have tentatively identified the number of redundant public workers in SEEs to be in the range of 40,000–60,000 positions. By end-April we will determine how best to meet our target of reducing the identified redundancies by one third by end-June. In parallel, we will sharpen the tentative estimate, based on aggregate analysis, by using company-specific information, and will by end-May produce final estimates. Our aim remains to reduce the redundancies by two thirds by end-October 2002 (a structural performance criterion), and to eliminate them altogether by end-June 2003. For the central government, the Ministry of Finance and the Treasury are in the process of completing an evaluation of redundancies, and will by end-September 2002 formulate an action plan to address them. The process aiming at improved public sector efficiency has been underway since last September, and good progress has been possible through voluntary retirement of workers receiving the severance payments they are entitled to. We will continue with this strategy, and will rely on layoffs only when necessary.

- The first phase of **tax reform**, focusing on simplifying indirect taxation, will soon be fully in place. This phase will also include initial steps to reduce distortions associated with the taxation of interest income, and rationalize taxes on financial transactions. In particular, we will reduce disparities among the withholding tax rates on deposits. We are preparing the necessary draft legislation, and expect parliament to adopt the legislation in April. Further steps to rationalize the taxation of financial transactions will be taken in the second phase of our tax reform program this fall.

- We have identified key actions to be taken during 2002 to **reform the revenue administration**. By end-July, we will institute an audit coordination unit in the Ministry of Finance, and require that it produce a coordinated audit plan for the following year by end-November (completion of the first such plan by November 2002 is a new **structural benchmark**). By end-September, the Minister of Finance will adopt a strategy to strengthen the collection of outstanding public sector tax arrears (a new **structural benchmark**). In the budget for 2003, we will provide resources to increase the number of auditors by 400 to move toward OECD standards (inclusion of such resources in the draft budget submitted to parliament is a new **structural benchmark** for October 17). Finally, to help overhaul our revenue administration in the medium term, we will implement a functional reorganization, beginning at end-June.

- To **strengthen expenditure management**, we have consolidated revolving funds, reducing their number by 589, and completed our survey of end-2001 expenditure commitments in excess of appropriations (with these actions, we have met two structural benchmarks). To enable us to monitor and address commitments on a regular and timely basis, we will from now on conduct such surveys twice a year (as of end-June and end-December), with the aim of having the results available within six weeks after the end of each period. We have also completed all the preparatory work to establish an independent procurement agency (an end-March structural benchmark), and expect the board of the agency to be appointed shortly, following the issuance of an enabling regulation.

16. **As market conditions have improved, we will give privatization new impetus.** In March, we completed the second public offering of shares in POAŞ (petroleum distribution company)on schedule, raising US$167 million for 16.5 percent of the shares in the company. We are also preparing for the third equity offering of TÜPRAŞ (petroleum refinery), aiming to close this deal by end-June depending on market conditions. We plan to offer a minimum 16 percent stake, which would bring TÜPRAŞ under majority private ownership. In addition, restructuring and corporatization studies regarding TEKEL's tobacco and alcohol entities and the determination of SEKER's (sugar company) privatization strategy are underway. A privatization plan for Türk Telekom will be adopted by the Council of Ministers in April as planned. Following the Constitutional Court decision regarding the pending transfer of operating rights (TOOR) contracts, we will determine which, if any, investors are eligible for Treasury guarantees and inform by end-June 2002 those eligible of the amendments needed to bring the contracts in compliance with the license regulations of the Energy Market Regulation Agency and the Electricity Markets Law. With the exception of these eligible projects, the government will transfer all state-owned thermal generation and electricity distribution assets under the scope of privatization by end-July 2002. Moreover, the eligible contracts for which the financial arrangements have not been finalized by end-January 2003 will be cancelled, and the related assets transferred under the scope of privatization by end-

February 2003. As regards pre-privatization restructuring, the Privatization Administration has merged two maritime companies under its portfolio and decided to merge another four companies with Sumerholding. Moreover, one tourism company will be liquidated shortly. As a result of these steps, we expect significant savings in operating and overhead costs.

17. **We are continuing efforts to improve the business environment.** We have prepared legislation reducing the number of documents needed to obtain investment incentives, implemented an employee code of ethical conduct for customs, and submitted to the Council of Ministers legal amendments to strengthen the Turkish Patent Institute. Also, we have started the preparation of a new Law on Foreign Direct Investment and legal documents facilitating hiring, including of foreign personnel. Moreover, an Investor Relations Office was set up within the Treasury in February, and this office will open an interactive website in April. Finally, to promote Turkey as an investment destination and learn from international perspectives we have scheduled the inaugural meeting of the Investor Council for July 2002. Once established, we foresee that the Council, consisting of top-level officials of major international corporations, will meet annually.

18. **Transparency in the public sector will be improved through a phased implementation of our action plan.** On February 13, the Council of Ministers adopted a decree spelling out an action plan to enhance transparency and good governance. This plan is part of a broader public sector reform effort, encompassing also public expenditure management and civil service reform. To oversee the implementation of this plan, a Ministerial Steering Group for public sector reform, as well as a subcommittee to provide support to the Steering Group in implementing the action plan to enhance transparency and good governance, will be established by end-April 2002 (a new **structural benchmark**). We will accelerate the ongoing work in public administration reform and define additional conditionality in this area in later program reviews. In the meantime, we have defined the following steps to improve transparency:

- publication of (i) the above-mentioned action plan to enhance transparency and good governance, and (ii) the Report on the Observance of Standards and Codes (ROSC) on the quality of economic data, carried out in consultation with the IMF;

- improvement of the public sector personnel system, including passage of legislation to establish a code of ethical conduct for civil servants and public administrators by end-2002 (a new **structural benchmark**); and

- increase in access to information, through the preparation of an Information Act, defining the rights of citizens to request information and the obligation of public organizations to provide information by end-2002.

19. **In the context of an IMF safeguards assessment, which is required for new Fund-supported programs, we have formulated a plan that will further improve the**

transparency and effectiveness of the CBT's control, accounting, reporting, and auditing systems. With effect from 2001 financial statements, the CBT will publish audited financial statements consistent with IAS. Starting with the 2002 financial statements, the CBT will clarify disclosures of the Fund position and the relationship with the Treasury, and limit the amount of profits available for distribution to realized profit, less unrealized losses. The CBT will expand the role of its existing audit committee, and from now on, when mandating an external audit firm, will include among the duties of the external auditor to issue a report reviewing the consistency between the program data reported to the IMF (specifically covering base money, net international reserves, and net domestic assets) and the audited financial statements. In this regard, by May 15, 2002 the CBT will ask the existing audit firm to prepare such a report, and will issue it by July 15, 2002 (a new **structural performance criterion**). Also by May 15, 2002, the CBT and Treasury will issue a Memorandum of Understanding to clarify the Treasury/CBT relationship with the Fund. Moreover, the CBT will reorganize by end-2002 the internal audit function. To this end, it will (i) adopt a new charter, which will detail the mission, scope, accountability, independence, responsibility, and authority of the audit function in line with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors. The CBT will also (ii) formulate an implementation plan identifying staffing levels, reporting lines, scope of audits, risk assessment methodologies, and developing an internal audit manual and training programs (measures (i) and (ii) constitute a new **structural performance criterion**). For the purposes of the safeguards assessment, an internal audit of foreign exchange management and program data as of end-2002 will be conducted by May 15, 2003 (a new **structural benchmark**).

20. **Finally, we continue to receive support for the structural and social components of our program from the World Bank.**

Very truly yours,

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

ANNEX A
ANNEX B