Ankara, January 18, 2002

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

Dear Mr. Köhler:

1. **From the outset, Turkey's economic reform program has had two main goals: conquering the chronic and persistent high inflation of the 1990s, and overcoming the associated macroeconomic instability which has constrained our economic growth.** Although the original three-year program initiated in December 1999 has had to be adapted and strengthened in the light of events, including the February 2001 crisis, we have made considerable progress. We have implemented a major fiscal adjustment to help bring about debt sustainability. We have reformed the banking sector through an operational and financial restructuring of public banks, and a strengthening of the regulation and supervision of private banks. We have also pursued disinflation both under the original crawling peg regime and following the float in February 2001. Finally, we have deepened the role of the private sector in the economy, including through reforms to facilitate privatization.

2. **Our revised program, adopted in May 2001, was beginning to achieve its aim of restoring investor confidence in the wake of the two crises, when the events of September 11 hit.** From early August onward, as confidence began to return, interest rates started to fall, and the Turkish lira stabilized. The events of September 11, however, hit Turkey particularly hard, given our debt situation and our location. This severe external shock is affecting the Turkish economy through several channels: weaker demand in industrial countries, lower tourism receipts, reduced access to international financial markets, and poorer privatization and foreign direct investment prospects. This has resulted in a projected external financing gap of US$10 billion in 2002, and weaker short-term economic growth prospects.

3. **We have responded to the fallout of September 11 and Turkey's ongoing economic problems by deepening and extending our economic program, building on our earlier reforms.** The Turkish economy is entering 2002 with greater strength thanks to the reforms carried out so far, but is still facing very important challenges. Chief among them is the reduction of inflation to the targeted 35 percent, the resumption of growth which should continue to be export led, and the more rapid extension of the benefits of growth to the lower-income groups. We are determined to build on the positive results that have emerged at the end of 2001 thanks to the success of our fiscal policies, the competitive exchange rate, and the enactment of many important structural reforms. Despite the progress made, Turkey continues to face difficult macroeconomic and structural policy challenges,

including a substantial public debt burden, high inflation, banking sector difficulties, and extensive state involvement in the economy. To tackle these problems, while addressing the repercussions of September 11, we have decided to adopt a strengthened medium-term economic program.

4. **This letter lays out in detail our economic program for 2002–04, and requests a new stand-by arrangement in its support.** Based on our balance of payments needs, and our strengthened policies described below, we request the approval of a new stand-by arrangement in an amount equivalent to SDR 12,821.2 million for the period January 2002 through December 2004. The current stand-by arrangement (2000–02) will be cancelled upon approval of the new arrangement. We will use the equivalent of SDR 4,916.4 million of what becomes available upon approval to repay outstanding resources under the Supplemental Reserve Facility. Annex A summarizes the main macroeconomic indicators under our program.

5. **The program will be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural performance criteria and structural benchmarks.** The reviews will be held bimonthly in March, May, and July 2002, and quarterly thereafter (starting in October 2002) for the duration of the arrangement. Annex B summarizes the quantitative performance criteria and indicative targets, while the structural conditions are listed in Annex C.

Objectives and strategy for 2002–04

6. **Our program aims to insure the economy against future crises and lay the basis for sustained noninflationary growth.** First, the program will improve the economy's resilience to shocks and reduce its vulnerability to future economic crises, by (i) maintaining the exchange rate float and using inflation targeting to deliver a significant reduction in inflation, (ii) pressing ahead with bank restructuring, and (iii) ensuring a viable government debt position. Second, the program will involve fundamental structural reforms aimed at raising Turkey's growth potential. Achieving these objectives will also help move Turkey closer to the goal of EU membership.

7. **For 2002, our priority will be to restore financial and macroeconomic stability, and to further progress in structural reforms.** To this end, we will ensure that our ambitious public sector primary surplus target of 6½ percent of GNP will be met. This, together with our active and flexible debt management strategy, should ease government debt rollover. We are also determined to deepen our structural reforms to build on the important results achieved so far. While in 2001 the sharp devaluation after the float of the Turkish lira in February and the September 11 shock raised CPI inflation to 68.5 percent, in 2002 monetary policy will be consistent with our 35 percent inflation target. Although real GNP is estimated to have declined by 8½ percent in 2001, a moderate economic recovery started in the third quarter, and is expected to continue in 2002. In light of the negative impact of the recent events on exports and tourism and our commitment to disinflation, we project real GNP growth in 2002 conservatively at 3 percent. We believe, however, that this projection

has upside potential. As regards the external current account, we expect the September 11 shock, the economic recovery, and a modest rebound in the real exchange rate to result in a deficit of about US$2 billion in 2002, following an estimated surplus of a similar size in 2001.

8. **For 2003–04 and beyond, our key objectives are sustainable growth, together with continued disinflation and a viable debt position.** Continued implementation of prudent financial policies and structural reforms will lay the basis for higher growth of at least 5 percent annually in 2003 and beyond. The move to an inflation targeting framework will underpin our disinflation efforts. Recovery in world demand and the impact of structural reform on the competitiveness of our economy will support the current account. In this context, we expect government debt to show a marked declining trend relative to GNP, and the external current account position to be fully financed, with foreign exchange reserves at safe levels.

9. **In support of these objectives, we will pursue a multi-pronged economic policy agenda in 2002–04:**

- **Continued sizeable public sector primary surpluses** to strengthen our debt position and rebuild market confidence. In 2003, we will maintain the primary surplus at the targeted 2002 level of 6½ percent of GNP, and will lower the target in subsequent years only if the debt-to-GNP ratio falls substantially faster than currently envisaged. To achieve these targets, we will introduce fundamental reforms of the expenditure and taxation systems, while ensuring that spending in social areas remains adequate.

- **Inflation targeting under a floating exchange rate regime**, featuring a pre-announced medium-term disinflation path. The Central Bank of Turkey (CBT) will direct monetary policy to keep inflation within 35 percent in 2002, 20 percent in 2003, and 12 percent in 2004. To facilitate the achievement of these targets, the government will make determined efforts to remove the widespread backward indexation of wages and prices during the program period.

- **Completion of banking sector restructuring**, to underpin financial stability and help orient credit flows to their most efficient uses. This will include a strengthening of the private banking sector, efficient resolution of intervened banks, continuation of the operational restructuring of state banks—with their privatization the ultimate objective—and further improvement of regulation and supervision.

- **Enhancing the role of the private sector in the economy** by accelerating privatization, facilitating corporate debt restructuring, improving the business climate (including through the creation of an Investor Council), and encouraging foreign direct and domestic investment. By the end of the program period, we expect all large state economic enterprises (SEEs) to have been restructured, and most of them privatized.

- **Public sector reform** aimed at a lasting improvement in public resource management and efficiency. Our main focus in this area will be on reforming the civil service, further consolidating the fiscal accounts, and improving fiscal reporting and transparency.

10. **Within this overall framework, economic policy will respond flexibly to unforeseen developments.** Economic prospects and the balance of payments will depend on the duration and effects of the September 11 shock, and on the restoration of investor confidence. If the balance of payments outturn were better than predicted, we would in the first instance allow a build-up of foreign exchange reserves and adjust monetary policy to safeguard the inflation target. Should the overperformance be large and persist, with the overall debt position better than expected, we would also be prepared to make repayments of Fund resources ahead of schedule, or refrain from drawing scheduled disbursements. In the event developments are less favorable than anticipated, the program's prudent fiscal and monetary stance and strong reform agenda should help reassure markets and thus insulate Turkey. Nevertheless, we would further strengthen fiscal policy as needed to ensure that the debt situation remains manageable should the circumstances deteriorate markedly and market confidence be slow to return. We believe that the policies and measures described in this letter are adequate to achieve the objectives of the program, but we stand ready to take additional measures if necessary to keep our program on track, in close consultation with the Fund. We will also consult with the Fund on its balance of payments policies after the expiration of the arrangement, in line with the Fund's policies on such consultations, while we have outstanding purchases in the upper credit tranches.

The program for 2002

Fiscal policy

11. **We are putting in place a fiscal framework to increase the public sector primary surplus from the targeted 5.5 percent of GNP in 2001 to 6.5 percent of GNP in 2002.** Even under the difficult economic conditions, we met all of our primary surplus targets through end-September with considerable margins, and expect to have met our full-year target as well. We will continue with this strong implementation in 2002, in view of our need to achieve a more sustainable debt situation. We have made some minor and neutral changes to our fiscal framework for 2002, due to changes in the macroframework. We expect much weaker-than-programmed oil prices and projections for a stronger-than-programmed currency to lift the primary surplus in our energy SEEs, which are large importers. The primary surplus, however, is now expected to be lower for the consolidated budget, since a higher price level will feed fully through to indexed wages and pensions, but in the case of revenues, be partially offset in impact by lower growth.

12. **In support of our fiscal target for 2002, we have specified about 2 percent of GNP in new measures (detailed in Annex G of our letter of November 20), and have already implemented many of them.** On the revenue side, we have passed a Finance Bill implementing changes in specific excises, raised the petroleum consumption tax (PCT) and

extended it to natural gas, doubled property tax rates in metropolitan areas, amended the Construction Law (to allow our electricity metering program to proceed), and raised prices and eliminated discounts and exemptions in key SEEs. We have also passed a budget law reflecting most central government expenditure measures, and issued circulars to implement tighter cost controls in the health sector. Finally, we have instructed SEEs in the Annual Investment and Financing Decree and in three circulars to implement all cost savings measures in their budgets. Treasury auditors will monitor SEEs' compliance with these measures on a quarterly basis.

13. **We will also implement as prior actions a number of additional measures to help achieve the 6.5 percent of GNP primary surplus target.** On the revenue side, the Council of Ministers will approve a reduction in the share of central government tax revenues accruing to metropolitan municipalities to 4.1 percent. On the expenditure side, we will issue a circular to implement our attrition rules, and the Minister of Finance will approve a reallocation of spending to ensure adequate funding for Direct Income Support (DIS) for small-scale farmers. The reallocation is needed, because the budget approved by parliament did not reduce agricultural premia and increase DIS to the extent intended, and it involves reducing transfers to the sugar and electricity companies to fund an increase in it.

14. **A few measures will be done later in the year, because they require more time.** In early February, we will increase the PCT (on items excluding natural gas) by 1 percent in real terms. By end-March 2002 (as a **structural benchmark**), the Minister of Finance will identify savings from closing regional administrations and other regional line agency offices, and block relevant budget appropriations in the budget, and SEEs will approve budgets in line with the cost reductions mandated. Throughout the year, to safeguard government revenues we will refrain from introducing any new tax exemptions or incentives, except those specified in our tax reform plan (discussed below). Moreover, to safeguard SEE revenues, we will refrain from introducing any new discounts or exemptions for SEEs, except those pursued for commercial reasons by enterprises' managements.

15. **We have expanded our monitoring to additional elements of the public sector for 2002.** In addition to a performance criterion on the primary surplus of the consolidated government sector (Annex D), the program will include a semiannual indicative target on the primary balance of other elements of the public sector (Annex E). For 2002, this new target covers the social aid and solidarity fund, 10 SEEs, all revolving funds in education and health, special provincial administrations, and a municipal development bank. For 2003, it will also cover 10 more SEEs, and municipalities with a population of over 50,000. The program will also include an indicative target on the overall balance of the consolidated government sector (Annex F). A baseline for net lending has been specified (Annex G), below which amounts will not be counted toward our primary balance performance criterion. In 2003, all net lending will be counted toward our target.

Public debt management

16. **In the last few months, the Treasury has been able to lengthen the maturity of domestic debt issuance and widen the range of investor participation, notwithstanding the turbulent conditions in world markets.** We lengthened the average maturity of Treasury bill issuance to nearly 6 months in November, the longest since May, which illustrates growing market confidence. Retail investors augmented their securities holdings, spurred by the recent increase in the tax exemption threshold and improving domestic market conditions. With demand from insurance companies and foreign investors also on the rise, this diversified the investor base. Meanwhile, the Treasury issued US$1.5 billion in international bonds during the final quarter of the year, exceeding expectations under difficult international market conditions.

17. **For 2002, we expect that additional external financing and the strong financial position of state banks will limit the domestic borrowing needs from the private sector to comfortable levels, facilitating a smooth rollover of the government's domestic debt.** With stable growth in the state banks' deposit base expected to continue in 2002, these banks will be able to eliminate any remaining short-term liabilities, and at the same time contribute toward meeting the domestic financing needs of the budget through the swapping into longer maturities of the bonds held by the state banks. Available external financing will further reduce domestic borrowing from the private sector. Our borrowing program is based on a conservative assumption of US$2½ billion in international bond issues in 2002, augmented by the use of some US$7 billion in external support from the Fund (prudent external debt limits will be monitored through the performance criteria outlined in Annexes H and I). The residual financing needs, while large, are expected to be well within the ability of the domestic private sector to absorb. Taking all the above into account, we estimate the required private sector rollover ratio in 2002 to be a manageable 85 percent.

18. **Beyond this, we will take several new debt management initiatives in 2002 to improve the robustness of the debt program to periods of market weakness, reduce remaining market concerns about the rollover, and diversify the investor base.** In Treasury bill auctions and public offerings, we will continue to lengthen average maturity to the extent demand allows and to encourage a diverse range of investors. This should further reduce the gross borrowing requirement from the market, and hence the private banks' rollover ratio. We will also provide instruments and a market structure which seek to ensure that banks continue to play a major role in the funding of government debt. Accordingly, in issuing new domestic debt we will pay particular attention to the need to allow banks to match their foreign exchange and interest rate exposures.

19. **Specifically, our new initiatives will include the following:**

- In January 2002, we will resume the program of **Floating Rate Note** (FRN) auctions which had halted in November 2000. By further increasing the maturity of the Treasury's debt, this program will allow a reduction in the Treasury's gross borrowing requirement, while providing an instrument which meets banks' needs concerning interest rate risk and liquidity. To improve the liquidity of the FRN market, before the first issue a revised standard method of price and yield calculations, in line with international practice, will be publicized by the Treasury for use in the primary and secondary markets, and by the CBT and the Istanbul Stock Exchange for use in their collateral valuation. For their part, the Treasury and the Banking Regulation and Supervision Agency (BRSA) will ensure that banks fully understand the appropriate interest rate risk treatment.

- To further enhance the liquidity of domestic debt, we will **reintroduce a primary dealer program** by end-September 2002 (**structural benchmark**). Discussions with candidate primary dealers are currently taking place. Under the program, primary dealers will commit to minimum levels of purchases at auctions, and to make markets in Treasury bills and domestic government bonds, both for outright transactions and for the lending of securities. The Treasury will also provide a facility to swap other bills into benchmark bills, at its own discretion, to relieve any securities settlement shortages which might occur.

- Liquidity in the government securities market will be helped by **liquidity in other financial instrument markets**. Therefore, the deepening of the interbank money market and creation of a Turkish Interbank Offer Rate described in paragraph 25 will be helpful for debt management.

- We will continue to issue, subject to market conditions, **domestic fx-denominated and fx-indexed bonds, as well as international bonds**, to further lower the gross domestic borrowing requirement while maintaining a diverse investor base and mix of instruments.

- The Treasury will conduct a study on its operational mechanism, procedures, and structure to improve its **risk and debt management**, including through closer coordination between domestic and international borrowing. The recommendations of this study will be implemented by mid-2002. This will allow joint decisions to be made on the borrowing approach in these two markets, to reflect the overall borrowing needs of the Treasury and the reality that international and domestic investors alike participate in these markets.

- The Treasury will also develop its **cash management operations**, acting in coordination with the CBT.

- The Treasury will intensify its **dialogue with the full range of investors**, including bilateral contacts and group discussions with institutional investors and intermediaries, and enhanced retail outreach.

Monetary policy

20. **The main goal of monetary policy will be to reduce inflation to 35 percent by end-2002.** The CBT will achieve this goal by initially using base money targets and later, as the preconditions are met, through the introduction of formal inflation targeting. To achieve this goal, we have developed a monetary program that sets performance criteria on the level of base money. Through 2002, we will target base money growth of 40 percent, in line with projected 3 percent real output growth and our target of 35 percent inflation. However, as the experience in 2001 has shown, the demand for base money is difficult to predict. Thus, during program reviews an assessment of base money demand will be a focus area, with targets for base money adjusted should money demand show signs of deviating markedly from program projections. In such assessments, indicators such as dollarization of deposits, velocity and currency movements, and yield curve indicators will be monitored closely.

21. **In May 2001, we took the first crucial step toward inflation targeting, by granting the CBT full operational independence to pursue the goal of price stability.** Throughout the turbulence in financial markets of the past year, we believe that CBT independence has helped stabilize monetary policy, keeping inflation from spiraling out of control. Looking ahead, we will ensure that any new laws or regulations do not undermine the independence enshrined in the CBT law. With confidence now showing signs of improving, the CBT's independence will play a crucial role in delivering a significant and sustained reduction in inflation.

22. **We are taking important steps to fulfill the remaining conditions for the successful launch of inflation targeting.** First, we have sustained our efforts to raise the public sector primary surplus and to improve debt management. This has put the public finances in significantly better shape which, in time, will give monetary policy greater freedom to reduce inflation. Second, we will continue to strengthen the banking system which, as a side benefit, will considerably ease the pressures facing monetary policy. Third, we believe that our strengthened economic program will sustain the recent improvement in financial market conditions, increased confidence in the Turkish lira, and exchange rate stability. Together with our adherence to the program's money supply targets, monthly inflation should soon fall quite sharply and, with it, expectations of inflation for the remainder of the year. Fourth, we will continue our technical preparations for the introduction of inflation targeting, including improved modeling and forecasting of inflation, highlighted in the CBT's inaugural Monetary Policy Report of November 2001—the forerunner to a quarterly Inflation Report. We believe that these four steps will play an important role in meeting all of the pre-conditions for successful inflation targeting by mid-year.

23. **In support of the early introduction of inflation targeting, we are strengthening incomes policy and taking steps to reduce backward indexation in the economy.** We recognize the need to move to a system of wage and salary determination that focuses increasingly on productivity and profitability rather than inflation. To this end, we will seek a significant reduction of the ex-post indexation element contained in current contracts during

the next public worker collective bargaining round and civil service salary adjustment, and will use the Economic and Social Council as a forum for incomes policy discussions with the private sector. We will also consider the possibility of reducing backward indexation of administered prices, without compromising SEEs' financial conditions.

24. **We will maintain the floating exchange rate regime, which is central to our monetary policy and the sustained reduction of inflation.** Since the beginning of August, the CBT has almost completely refrained from discretionary foreign exchange intervention, limiting itself to pre-announced auctions, which in recent months have been daily. We will continue to strictly limit discretionary intervention outside the pre-announced auctions. In December, reflecting the lack of need for sales in that month, the CBT discontinued these auctions, a move well received by markets. However, significant external assistance to the budget will continue in 2002, and we will still need at times to make foreign exchange sales to convert this assistance into Turkish lira as needed for domestic payments. As in 2001, any such sales (or any purchases which may be needed to build up reserves) will be conducted in an orderly and predictable way, and not used to defend a particular level of the exchange rate. Specifically, any such sales will be effected through pre-announced auctions.

25. **We are also introducing reforms to improve the working of the money and foreign exchange markets:**

- **Developing the money market.** Under the floating exchange rate, interest rate volatility has decreased significantly. As a result, conditions are now in place for deepening the interbank money market, and for creating a Turkish Interbank Offer Rate (TIBOR). This can play a key role in the pricing of credit, as well as for other financial instruments (including forwards and swaps). We will encourage a successful conclusion by end-February 2002 of banks' discussions to establish interbank borrowing reference rates in Turkish lira out to at least three-month maturity to enhance money market liquidity and transparency, and to provide accurate reference rates for financial instruments. In addition, with most SDIF banks resolved and the measures taken to strengthen the private banking system, the CBT has already announced that during 2002 it will gradually end its practice of acting as a blind broker (for example, borrowing on behalf of banks).

- **Developing forward and futures markets.** By reducing uncertainty, forward and futures markets are an essential part of a successful floating exchange rate regime. We have established a working group, chaired by the CBT and with representatives from the Treasury, Ministry of Finance, BRSA, Capital Markets Board, Istanbul Stock Exchange, and the Turkish Bankers' Association, charged with facilitating the development of these markets, as well as the creation of an interest rate futures market. The working group will identify concrete actions by end-January 2002 in the areas of taxation (including exemption of daily revaluations of open positions from transaction taxes), accounting, and regulation. The first measures will be put in place by end-February 2002. In addition, banks will be allowed to deal in these markets electronically, rather than being required to be physically present at the futures exchange. Progress toward establishing and deepening these forward and futures markets will be monitored closely in program reviews.

- **Currency transactions of state economic enterprises.** Consistent with the change to floating exchange rates, in January 2002 the Privatization Agency will authorize companies in its portfolio to transact their foreign exchange business not at the CBT official rate, but at the market rate. The oil and gas companies (TÜPRAŞ and BOTAŞ) will work with state banks to improve their foreign exchange practices, to minimize lumpy transactions in the foreign exchange market. In this connection, the Treasury has already issued BOTAŞ this instruction, and has ended the practice of requiring this company to seek market quotations (and, in so doing, revealing its foreign exchange needs) from major market participants.

26. **Implementation of the monetary program will be monitored through performance criteria on the monetary base and net international reserves (NIR), and indicative limits on net domestic assets (NDA).** As outlined above, until the introduction of inflation targeting the main anchor of the monetary program will be the monetary base. Performance criteria on base money and indicative targets for NDA are presented in Annex J. In addition, performance criteria for NIR are designed to allow the use of US$7 billion out of the US$10 billion external financing under the program to ease pressures in financial markets (Annex K). Developments in this area, including the behavior of interest rates, NDA and NIR, will be monitored in close cooperation with the Fund, between and during the reviews, to ensure that program objectives are achieved.

Banking reform

27. **The program aims to continue the strengthening of the banking system and oversight framework that has been underway since 1999.** The focus is on measures to strengthen private banks, resolve intervened banks (those under the control of the Saving Deposit Insurance Fund, or SDIF), further improve the efficiency of state banks (with privatization the final goal), put in place frameworks for dealing with nonperforming bank loans, and further improve prudential regulation and supervision.

28. **In 2001 we completed the financial restructuring of state banks, and for 2002 our objective is to conclude their operational restructuring.** We have recapitalized Ziraat and Halk banks and reorganized them under new professional management. We expect them both to resume normal lending to the real sector and to be profitable in 2002. We will also pass the necessary legal amendments and issue a Council of Ministers' decree for staff reductions to continue the operational restructuring that is already underway (**prior actions**). By end-June 2002, we will reduce the number of branches by 800 (**structural performance criterion**). In this context, we will also reduce staffing correspondingly. For Vakif Bank, a privatization advisor is doing due diligence analysis, and we have invited potential investors to indicate their interest in the bank and submit bids in May.

29. **We are introducing a comprehensive plan to further strengthen the private banking system so that it can perform its crucial role of financial intermediation to the real sector.** In the first stage, we took over the weakest banks in the system. However, continued financial market turbulence has caused market losses and weakening economic conditions are causing loan losses, worsening the financial position of many banks. The capital-strengthening program implemented in 2001 brought in substantial amounts of private capital, but will not be sufficient. We have therefore initiated a strategy to ensure the soundness of the Turkish banking system, which we see as a precondition for banks to resume normal lending to the economy. The strategy will start with a rigorous and targeted evaluation of banks' loan portfolios and other counterparty risks. This will be accompanied by a public support scheme, which allows the SDIF to make equity and subordinated debt investments in viable private banks, provided that their owners meet certain capitalization targets. The scheme seeks to maximize private capital contributions, minimize the cost to the government, and bring about further rationalization of the banking sector. Once banking sector soundness has been restored, the general guarantee can be lifted with due prior notice.

30. **The rigorous evaluation of banks' loan portfolios is an essential element of the new support scheme, providing a clear basis for investors and the government to inject necessary new capital into the banking system.** In January 2002, the BRSA will issue guidelines to be applied in the evaluation, including the use of uniform criteria (**prior action**). The targeted evaluation of loan portfolios, collaterals, and certain other exposures will be performed by banks' existing external auditors, and will be completed by end-March 2002. Third-party auditing firms will be appointed by the BRSA by end-March 2002 to verify that the guidelines have been followed, and to ensure the integrity of the process (**structural benchmark**). The BRSA will complete the final interpretation of the evaluations by end-April 2002, and by May 15, 2002 will send letters to banks stipulating required actions on the basis of this interpretation (the latter is a **prior action for the second review**). Any losses identified in the evaluation will be fully absorbed by writing down existing shares. The evaluation results will be incorporated into banks' end-June 2002 financial statements.

31. **Public capital support will be provided to solvent private banks whose owners are prepared to raise equity to certain thresholds.** The support will be provided on a one-time basis. Owners of solvent banks can have their Tier-1 equity contributions matched by equity provided by the SDIF. Capital contributions in cash in 2001 will be counted as owners' contributions, except for amounts needed to cover negative net worth. SDIF equity contributions will be against a pledge of shares from banks' majority shareholders. In addition, banks that participate in the scheme will give the SDIF board representation and selective veto rights, and will adhere to restrictions on the distribution of profits as long as the SDIF remains an owner. To qualify for SDIF support, a bank or group of banks to be merged must have a market share of at least 1 percent of total banking system assets. In case there are banks that are insolvent or severely undercapitalized and unable to raise sufficient capital to participate in the scheme, they will be taken over and resolved by the BRSA and the SDIF. In addition to equity support, banks with a Tier-1 capital adequacy ratio (CAR) of at least 5 percent may qualify for convertible subordinated debt (Tier-2 capital) contributions

from the SDIF, up to a CAR of 9 percent. The scheme will be administered by BRSA jointly with SDIF, which must receive applications for participation in the scheme before end-May 2002. Banks will make preparations for their participation in the scheme while the valuation assessments are going on, and the scheme will be completed before end-June 2002.

32. **We expect that the legal framework for the scheme described above and related regulations will become effective in January 2002 (prior actions).** On January 10, 2002, parliament passed the relevant legal amendments. Once effective, the amendments will create fast track procedures for calling shareholders' general assemblies, writing down existing capital, and raising new capital; assign a special commercial court to deal with all issues related to the support scheme; and limit the scope for shareholders and other parties from interfering in the implementation of the scheme. The amendments will also make more precise the conditions for the BRSA to intervene in, and SDIF take control of, chronically and severely undercapitalized banks before they become insolvent, to facilitate least cost solutions for the government. Details of the scheme, including the SDIF's rights as shareholder as well as the terms for the SDIF's exit from the scheme, will be regulated by the BRSA and announced in January 2002. Given the complexity of the legal issues involved, the BRSA will undertake legal consultations, as necessary, to ensure implementation of the public capital support scheme as planned.

33. **We remain committed to the speedy resolution of banks taken over by the SDIF.** With the exception of two banks, whose resolution has been halted by courts, all SDIF banks taken over before November 2001 were resolved by end-2001 (meeting a **prior action**). Their deposits, together with matching government securities, were successfully auctioned off to other banks. Most interbank liabilities with matching government securities were transferred to Ziraat. The SDIF will, however, retain one small bank with a small staff and branch network as a bridge bank with its operations strictly limited to asset management purposes; this bank will not accept deposits. The bank will be funded through the SDIF. Remaining assets and liabilities have been transferred to the Collection Department of the SDIF. The medium-size bank taken over in November 2001 is for sale; its final resolution method will be determined and initiated by February 2002.

34. **The SDIF will make strong efforts to deal with nonperforming loans and collaterals.** The SDIF is developing a strategy and procedures for dealing with these assets with the assistance of a consulting firm, and is recruiting additional staff to deal with the large volume of problem assets. Transparency of SDIF's operations is essential, given the complexity of its transactions and the large funding it receives from the Treasury. Accordingly, the SDIF will prepare a monthly balance sheet starting end-March 2002 and become subject to annual external audits. The external audit for 2001 will be completed by end-April 2002 (**structural benchmark**).

35. **We will take a number of measures to further strengthen the legal and regulatory framework:**

- Laws and regulations regarding loan classification, loan loss provisioning, and collateral valuation will be amended as necessary following the portfolio reviews by end-June 2002. As a first step, we will pass as a **prior action** a legal amendment in January 2002 to eliminate with immediate effect the existing four-year transition rule for loan loss provisioning.

- As of January 1, 2002, two important regulations became effective: including in CAR calculations capital charges for market risks on a solo basis; and monitoring of internal control and risk management systems. Moreover, trial implementation of a new accounting system in line with International Accounting Standards (IAS) will begin in January 2002 (**prior action**). The inclusion of off-balance sheet repos in banks' balance sheets was announced in December 2001, and will take effect as of February 1, 2002. Effective July 1, 2002, capital charges for market risks will be included on a consolidated basis when calculating the CAR. Moreover, following the trial implementation the BRSA will evaluate the experience and issue by end-June 2002 a revised regulation on the new accounting standards to ensure that banks' end-2002 balance sheets comply with IAS (**structural performance criterion** for end-June 2002).

- Reporting requirements will be improved based on the findings of the independent assessments, and the quality and timeliness of the reporting will be strictly enforced as of end-June 2002.

Corporate debt restructuring

36. **We are strengthening the framework for corporate debt restructuring to complement the restructuring of the banking sector.** The existing legal, judicial, and institutional frameworks are inadequate for the scale of restructuring that is needed. As a first step, in January 2002 we will introduce a voluntary market-based framework (the "Istanbul Approach") for dealing case-by-case with multicreditor exposures to large and medium-size borrowers. A Technical Secretariat has been established under the Bankers' Association to monitor progress and an Arbitration Panel to resolve disputes. For its part, Halk Bank is renegotiating with and extending credit to small and medium-size enterprises, both at market terms. Given the need to accelerate the debt restructuring process, we will in early 2002 create a multiagency Coordination Committee with private sector participation under the Treasury. This Committee will be responsible for facilitating and monitoring the corporate debt restructuring process, as well as identifying and proposing the removal of impediments that may exist.

37. **To facilitate corporate debt restructuring, we are also undertaking a major review of the bankruptcy and foreclosure frameworks, which will be overhauled as needed.** This will complement our ongoing work of modernizing our Civil and Commercial Codes to conform with EU rules and directives. A World Bank Report on Standards and Codes (ROSC) on Turkey's insolvency regime is expected to be completed in January 2002. The Ministry of Justice will prepare an action plan based on the findings of that report and

existing reform proposals, and form a Commission to prepare necessary amendments to the Bankruptcy Law. We will also support the upgrading administrative procedures in the judiciary to improve the capacity of the courts.

38. **Financial disclosure of companies and especially of large corporate groups will be improved, and corporate governance standards strengthened.** The Capital Markets Board (CMB) will introduce international accounting standards, including inflation accounting provisions, by January 1, 2003. Starting end-March 2002, the CMB will require corporate groups to provide consolidated financial statements, and will set up a dedicated group to monitor their finances. As of the same date, the CMB will also require corporate groups with financial affiliates to provide consolidated group statements and share those statements with the BRSA.

Public sector reform

39. **We will significantly strengthen the central government's underlying fiscal position by implementing our ambitious public sector reform program.** In particular, we will aim to increase expenditure efficiency (allowing more to be done with less), and reform the tax system (to broaden the base and make it more sustainable), and the civil service (to increase efficiency and improve the quality of the public service). To alleviate the impacts of these actions on the most vulnerable members of society, we will enhance and better target our social spending (paragraph 43 below).

40. **Our key reform initiatives for the central government include the following:**

- To strengthen **expenditure efficiency**, we will improve procurement methods and rationalize the public investment program. The Public Procurement Law in line with UN standards (UNCITRAL) was adopted by parliament on January 4, 2002 (meeting a **prior action**). Following its adoption, we will immediately begin the work necessary to allow it to take effect by January 1, 2003, including establishing an independent procurement agency by end-March 2002 (**structural benchmark**), and changing laws and regulations to make them consistent with the new framework. To further improve the transparency and competitiveness of public procurement, we expect parliament to amend the Public Procurement Law by end-May 2002, to (i) bring the real value of the thresholds toward those in line with international best practice and (ii) extend the minimum time period for procurement applicable for cases below the thresholds (**prior actions for the second review**). Public investment has already been rationalized in the 2002 fiscal framework, with 353 (of 5,047) main projects and 649 sub-projects removed from the roster, and a 20 percent reduction in both total costs and the estimated time to completion. Building on this, we will compile a comprehensive list of projects to be phased out in time to make decisions for the 2003 budget.

- We will specify an ambitious three-year plan to **reform the tax system**, which the Council of Ministers will approve in January 2002 (**prior action**). The plan will establish two phases of tax reform to be implemented in 2002. The first phase, to be enacted in a revenue-neutral manner by end-April 2002 (**structural benchmark**), will focus on simplifying the system of indirect taxation and lessening distortions associated with the taxation of nominal interest income. The second phase will deal with reform of direct taxation (to take effect on January 1, 2003). Legislation for the second phase of this reform will be submitted to parliament by end-October 2002 (**structural benchmark**). Our direct tax priorities will be to: (i) harmonize taxes on investment income; (ii) rationalize ad hoc inflation adjustments in the tax system; (iii) rationalize the system of investment incentives; and (iv) reform the system of credits against income tax. The plan will also address tax administration reform (including technical assistance needs). To achieve greater efficiency, we will reorganize the tax administration in line with the study that we have carried out with the World Bank. Conditionality on implementation will be set at the time of the first program review.

- To **reform the civil service**, the Council of Ministers will adopt a civil service reform strategy by end-2002. As part of the preparatory work, by end-March 2002 we will establish a ministerial committee to carry out a functional review of government, which will be completed by end-September 2002. By this time, we will also have in place an integrated system to monitor total general government and SEE employment levels on a quarterly basis (**structural benchmark**).

41. **We expect the biggest improvements in public resource use and the underlying fiscal position to arise from reductions in overstaffing, especially in inefficient SEEs.** This will reduce the necessity for aggressive public sector price increases, thereby supporting disinflation, improve the efficiency of enterprises, and in many cases help to prepare the ground for privatization. Supported by a Prime Minister's circular issued on December 3, 2001, we have already initiated a voluntary retirement scheme for public sector workers. 15,000 individuals will have been retired or notified of their retirement by mid-January 2002 (**prior action**). We have also recently identified (with World Bank assistance) redundant workers in Türk Telekom and in the Privatization Agency portfolio of companies, and we will extend voluntary retirement offers to the individuals occupying them. For those who accept, we will provide payments, and allow them to retire, no later than end-March 2002. Also by end-January 2002, we will (i) identify all redundant workers and positions in SEEs (updating and expanding our earlier analysis); and (ii) eliminate all open, unfilled redundant positions (**prior actions for the first review**). Through voluntary retirement offers, and layoffs only when necessary, we will reduce the number of redundant workers by one-third by end-June, and cumulatively two-thirds by end-October 2002 (the latter being a **structural performance criterion**). By end-June 2003, we will phase out the remaining redundancies. For this well-targeted attrition, we will allow no replacement hiring, and the resulting unfilled positions will be immediately eliminated. We will audit SEE compliance with this program on a quarterly basis. Progress toward meeting the above targets will also be a focus of earlier program reviews. Since we are making long-term financial savings from this action, the net cost of this initiative (severance payments less wage savings) will not be counted toward our primary surplus target, up to a limit of TL 1.25 quadrillion in 2002.

42. **We will enhance aggregate fiscal control, by strengthening the legal framework for fiscal policy, consolidating fiscal institutions, and deepening fiscal transparency reforms:**

- To strengthen the legal framework for fiscal policy, we will (i) pass the Law on Public Debt Management and issue two supporting communiqués (**prior actions for the first review**), and (ii) by end-June 2002, submit to parliament a Law on Financial Management and Internal Control consistent with best international practices (**structural benchmark**). The latter law will cover budgeting, accounting, transparency, and internal and external control.

- To continue the process of consolidating fiscal institutions, we will by end-March 2002, close 548 additional revolving funds (out of 1,981 remaining), to achieve the target we originally set for end-2001 (**structural benchmark**). We will also, in the draft budget for 2003 to be submitted to parliament, incorporate the revenue and expenditures under Law 3418 (**structural benchmark** for October 17, 2002). The earmarking of these revenues, and those under Law 4306 would also be eliminated. We will also improve the transparency of the operations of the remaining extra-budgetary funds (the Social Aid and Solidarity Fund, the Defense Industry Support Fund, the Privatization Fund, and the Promotion Fund). By July 2002, we will amend their governing legislation to require passage of their budgets by parliament, external audit of their accounts (reported to parliament), and monthly reporting of their accounts, on a consolidated basis, with the central government's accounts (**structural benchmark**). Looking forward, we will eliminate the one remaining budgetary fund (the Support Price and Stabilization Fund) in three years, when the World Bank's Agricultural Reform Implementation Project ends.

- To enhance fiscal transparency, in the draft 2003 budget to be submitted to parliament we will (i) include net lending as an appropriation, and (ii) extend accounting and coding reforms to all consolidated budget agencies, and to general government units on a pilot basis (**structural benchmarks** for October 17, 2002). Moreover, by end-March 2002, we will complete a survey of end-2001 commitments in excess of appropriations (**structural benchmark**).

43. **We will enhance and better target our social spending.** Already in 2002, we are increasing social spending substantially in real terms. In addition, we will address the impact of public sector retrenchment through the labor redeployment and reinsertion program (supported under the World Bank's Privatization Social Support Project), and through unemployment insurance, for which benefit payments are set to commence in 2002 (this would protect those workers who are not eligible for adequate severance). Other key priorities will be (i) to increase resources allocated to direct income support for farmers (in support of this, we will eliminate all agricultural premia in the 2003 budget), and (ii) to fully implement the World Bank supported Social Risk Mitigation Project, which seeks to enhance safety net resources available to the poorest households.

Enhancing the role of the private sector

44. **Our program places a special emphasis on fostering private sector development.** The key elementsXwhich have been developed in close consultation with the World BankXinclude privatizing companies, encouraging domestic and foreign investment, and improving governance and transparency. We will also improve our communications policy, to underline both to the public and to investors that a genuine economic transformation is underway.

45. **Our privatization strategy aims to complete in 2002 the preparatory work for the divestiture of all major companies slated for sale.** Besides selling enterprises for which the technical preparations have already been completed—notably TÜPRAŞ (petroleum refinery) and POAŞ (petroleum distribution)—we are committed to completing in 2002 all preparatory work for the privatization of Türk Telekom, TEKEL (tobacco and spirits), ŞEKER (sugar), THY (airlines), ERDEMIR (steel), EUAŞ (electricity generation), TEDAŞ (electricity distribution), BOTAŞ (natural gas), and state-owned land. Specifically:

- While the specific timing will depend on market conditions, we expect the Privatization Administration (PA) to proceed with the public offerings of POAŞ by end-March 2002 and the public offering of TÜPRAŞ by end-June 2002. This will lower the government's stake in TÜPRAŞ to less than 50 percent. The PA is also ready to launch the initial public offering for THY as soon as market conditions allow.

- The government has in December 2001 appointed a Privatization Tender Committee for Türk Telekom. While it was not possible for the Committee to prepare a revised privatization plan by end-2001, as originally intended, we will ensure that such a plan is adopted by the Council of Ministers in April 2002 (**prior action for the second review**). The corporatization plan now under preparation with the help of international consultants will provide input to the privatization plan.

- On January 3, 2002, parliament passed the Tobacco Law (meeting a **prior action**). As the next step, a privatization plan for TEKEL will be prepared and adopted by the Council of Ministers by end-September (**prior action for the fourth review**).

- We also will proceed with the privatization of ŞEKER, with the first step being the adoption of a privatization plan by May 2002. For both TEKEL and ŞEKER, we recognize that successful privatization needs to be preceded by major operational restructuring, which we are determined to undertake in close cooperation with the World Bank.

- In the electricity sector, in January 2002, subject to legal clarification, we expect the Council of Ministers to adopt a government decree annulling with immediate effect all the projects for which transfer of operating rights (TOOR) contracts are pending. By March 2002, the Ministry of Energy will inform the PA which electricity assets will be privatized, and by April 2002 the prequalification tenders for the distribution companies will be launched.

- We expect to complete the transfer of gas distribution companies to the PA by March 2002.

- The PA is ready to go forward with the divesting of ETI Krom AŞ, ETI Elektrometalurji AŞ, ETI Gümüs AŞ, which are in the PA portfolio, as soon as licenses are transferred from ETI Holdings.

- The PA will continue its divestment of ERDEMIR, and of tourism and fertilizer assets in its portfolio. The PA will also continue divesting its portfolio of small and medium-size companies.

- Finally, we will build on efforts made in 2001 (including legal amendments and simplified procedures) to increase the sale of government land. As constitutional problems made the legal amendments less effective than envisaged, we have initiated a study to evaluate how the remaining obstacles to government land sales could best be removed.

46. **We aim to make Turkey substantially more attractive for domestic and foreign investors.** A list of follow-up actions to a Foreign Investment Advisory Service (FIAS) report finalized in mid-2001 has been sent to the Council of Ministers, and is expected to be adopted in January 2002 (**prior action**). As envisaged under that action plan, we will:

- submit to the parliament by end-May 2002 a new draft Law on Foreign Direct Investment in line with the findings of the FIAS study (**structural benchmark**);

- submit to the parliament by end-March 2002 a draft law on work permits prepared by Ministry of Labor and Social Security, and issue a communiqué by end-April 2002 on the implementation procedures for employing foreign personnel employed by foreign capital companies as soon as the new law is approved by parliament;

- complete by end-February 2002 legislation reducing the number of documents needed to obtain investment incentives;

- establish and implement by end-February 2002 an employee code of ethical conduct for proceedings at customs; and

- submit to the Council of Ministers by end-January 2002 legal amendments to strengthen the Turkish Patent Institute.

47. **We attach the highest importance to improving governance and transparency.** To this end, the Council of Ministers will adopt a strategy for increasing transparency and combating rent-seeking activities by end-January 2002 (**structural benchmark**). Concrete

follow-up actions for the remainder of the 2002–04 program period based on this plan will be defined and included as program conditionality in subsequent program reviews.

48. **Finally, we will further improve our strategy for explaining the goals and policies of the program.** To this end, we will establish an Investor Relations Office by February. This Office will serve as the focal point for two-way communication between the Turkish authorities and the domestic and international investor communities, and will be set up as a permanent structure within the Treasury. Furthermore, we will establish an Investor Council consisting of prominent business representatives from Turkey and abroad. This Council, which is expected to have its first meeting by mid-2002, will advise on issues relevant for the attractiveness of Turkey as an investment destination and will meet with regular intervals. In addition, the recently intensified efforts of the of the Treasury, the CBT, and the BRSA to explain policies under the economic program in their respective areas will be further strengthened, including through the arrangement of regular (bimonthly) press conferences by the Treasury.

Very truly yours,

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