REPUBLIC OF TURKEY
PRIME MINISTRY

Ref: B.02.1.HM.0.DEİ.02.00/500/ Ankara, July 25, 2003

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

Dear Mr. Köhler:

1. **Our economic program, supported by a stand-by arrangement with the Fund, is producing results.** Following the completion of the fourth review on April 18 and the end of hostilities in Iraq, market confidence has improved. Since end-March, benchmark bond rates have fallen by 15 percentage points and the Turkish lira has appreciated by 16.5 percent against a trade-weighted U.S. dollar and euro basket. This more benign environment has also been reflected in improved expectations for growth and disinflation in recent surveys, and should help in achieving our macroeconomic targets for 2003.

2. **We have achieved these successes through our strong policy implementation.** All monetary performance criteria and indicative targets for end-April and end-June have been met. The performance criterion on the consolidated government sector primary balance for end-April has also been met, but the end-June performance criterion may have been missed by a small margin. We have also made good progress in structural reform, in spite of a heavy parliamentary agenda. We met a structural performance criterion on April 9, when Parliament approved direct tax reform legislation. We have also met several structural benchmarks, by: (i) putting in place a general government and state economic enterprise (SEE) employment monitoring system; (ii) preparing an action plan to reduce banking sector intermediation costs; (iii) announcing the sale of an SDIF loan portfolio with a total face value of US$250 million; (iv) enacting a new law on FDI; (v) completing an internal CBT audit of foreign exchange management and program data as of end-2002; (vi) preparing legislation to strengthen the BRSA's effectiveness; and (vii) enacting reforms to the Execution and Bankruptcy Act.

3. **We are also taking steps to complete a number of structural reforms which have faced delays.** Although the end-June performance criterion on reductions in redundant positions in state economic enterprises (SEEs) was missed (since SEE workers delayed their decision to retire pending the outcome of the ongoing wage negotiations, which will entail higher retirement payments). We are taking steps to ensure that we are back on track toward meeting the end-September and end-December targets. There have been delays in other elements of our structural reform agenda. Accordingly, we have rephased a number of

structural benchmarks, including (i) adoption of a privatization plan for Türk Telekom; (ii) passage of a second phase of direct tax reform; (iii) passage of the Public Financial Management and Control Law; (iv) passage of legislation improving state enterprise governance; and (v) improving the public sector personnel system, including establishing an ethical code of conduct for civil servants. Details are given below and are summarized in Annex A.

4. **On this basis, we request completion of the fifth review under the Stand-By Arrangement.** We request waivers for the nonobservance of the end-June performance criteria on reductions in SEE positions and the primary balance of the consolidated government sector. As prior actions for the fifth review we are: (i) taking measures to ensure that the budget will remain on course to achieve the 6.5 percent public sector primary surplus target for 2003; (ii) passing social security legislation in July. We have also approved the draft of the Public Financial Management and Control Law at a Ministerial meeting (another prior action) on July 17, taking into account Bank/Fund comments. We are also taking action to accelerate the reduction of redundant SEE positions. Finally, we are introducing a continuous performance criterion on refraining from any amnesty for public receivables.

5. **In light of the delay in completing the fifth review and the rephasing of some policy actions, we propose a number of technical revisions to the program.** First, we request that the schedule of program reviews be revised as set out in Annex B. Consistent with this revised schedule, the ceilings and floors for the quantitative performance criteria and indicative targets under the arrangement will be set for the respective test dates through December 31, 2003 as shown in Annex C. Except for the cumulative primary balance of the consolidated government, these levels correspond to the indicative targets in our April 5, 2003 Letter of Intent. As described in paragraph 9 below, for this criterion we propose a broader and more transparent definition and revised targets which remain consistent with our public sector primary surplus target of 6.5 percent of GNP.

Macroeconomic framework

6. **With external uncertainties now much reduced, we believe that through continued strong program implementation we can achieve our main macroeconomic objectives in 2003.** The short duration of the military conflict in Iraq, strong performance of industrial production and exports in the first five months, and buoyant demand for consumer durables and intermediate goods in recent months suggest that 5 percent GNP growth in 2003 is readily achievable.

Turkey: Main Macroeconomic Indicators, 2002-03

	Projection	
	2002	2003
	(In percent)	
Real GNP growth rate	7.8	5.0
CPI inflation (12-month, end-of-period)	29.7	20.0
	(In percent)	
Central government primary balance	2.4	5.0
Consolidated public sector primary balance	4.0	6.5
Net debt of public sector	80.0	69.6
Gross external debt	72.4	58.7
GNP (in quadrillions of Turkish lira)	273.5	359.4

As we expect private consumption and fixed investment to replace stock building as the main source of growth this year, fostering consumer and investor confidence with strict program implementation will be key to realizing our growth objective. Owing to prospects for stronger private demand and the effect of the Iraq war on tourism receipts, we have raised our projection of the external current account deficit to about 3 percent of GNP from the original 1.9 percent of GNP. On inflation, although exceptional food price increases earlier in the year resulted in consumer price inflation somewhat above projections, the improved outlook for oil prices, the stronger lira, and the unclosed output gap should all contribute to keeping CPI inflation within our end-year target of 20 percent.

7. **We will use prospective bilateral financing to reinforce our debt reduction strategy of lowering interest rates and lengthening debt maturities.** We expect our discussions with the United States on the terms of assistance, the grant-equivalent of US$1 billion convertible into loans of up to US$8.5 billion, to conclude shortly. The presence of these funds would further boost market confidence, allowing the Treasury to lengthen debt maturities and lower interest rates on domestic debt. As we are determined to adhere to our primary surplus targets, additional bilateral assistance will not be used to finance additional government spending.

Fiscal policy

8. **We are taking steps to keep our fiscal program on track.** We expect that the fiscal performance criteria for end-June was missed by a small margin. Delays in implementing some measures, higher-than-expected tax rebates and wage increases, shortfalls in social security contributions, and our plans for higher transfers to agriculture have opened a fiscal gap relative to our full-year public sector primary surplus target of 6.5 percent of GNP. Moreover, while gross payments under the Tax Peace Plan have exceeded expectations, the plan has led to additional tax refund claims. To preserve our fiscal target, as **a prior action** we are taking measures to close this gap, equivalent to about 0.7 percent of GNP. These measures include:

- Cuts in current, transfer, and investment spending of TL 1.2 quadrillion, while safeguarding health and education spending;

- Writing over of TL 0.5 quadrillion in special revenues to the budget, thus preventing the issuance of additional appropriations; and

- An increase in tobacco and alcohol prices yielding TL 0.25 quadrillion.

We stand ready to implement additional measures if needed to attain the 6½ percent of GNP primary surplus target.

9. **To improve transparency, we propose to modify the program definition of the primary surplus.** Annex D sets targets through end-year under the new definition, which includes both special revenues and special expenditures. The new targets are fundamentally the same as the previous ones (which excluded both), but the new definition will help outside observers to better follow our fiscal performance relative to the program. In addition, consistent with the 2002 Public Finance and Debt Management Law, data are not available. Therefore, we propose to exclude foreign-financed in-kind military spending from the definition of the primary surplus performance criterion. Debt stock data include such spending. We will make every effort to improve the coverage of the primary surplus data. The definition will also cap the contribution to revenue of land sales at TL 500 trillion, since these transactions are akin to financing. Owing to the change in the primary surplus targets, we are also proposing corresponding changes in our indicative targets for the overall balance (Annex E).

10. **We are also taking steps to ensure that next year's primary surplus target is on a sound footing.** To offset the expiration of some one-off measures and to ensure no increase in the overall tax burden, we will need to tightly restrict expenditure growth in 2004. To this end, in our budget call for 2004, we have provided indicative ceilings which restrict overall non-interest expenditure growth to zero in real terms. In addition, pending further rationalization of the investment program, we will not introduce new investment projects, except in a limited number of cases including emergencies. These steps will help us formulate a budget consistent with next year's 6.5 percent of GNP primary surplus target in time for submission to Parliament in mid-October.

Labor market policies

11. **Our labor market policies aim at ensuring a competitive economy.** To improve the flexibility of labor markets, on May 22 Parliament passed a new Labor Law. To improve flexibility and increase job creation in the economy, the new law allows for differentiation of labor contracts by introducing provisions for part-time and temporary employment. The new law also improves workers' rights, including through requiring employers to prove that the termination of employment is based on a valid reason as set forth in the law.

Monetary policy

12. **The CBT's monetary policy will continue to focus on reaching this year's 20 percent inflation target.** Consistent with this goal, we met all monetary performance criteria and indicative targets for end-April and end-June. With our main macroeconomic targets unchanged, we are retaining the monetary targets set out at the last review. Although

inflation in the opening months of this year was somewhat higher than projected, the decline in world oil prices and the strengthening of the Turkish lira have already helped bring about a marked reduction in the inflation rate. This decline has resulted in the recent decline in private expectations of future inflation. In light of these favorable developments, the CBT lowered its interest rates in April and June, and again in mid-July.

13. **We are determined to build up a strong record of program implementation before introducing inflation targeting.** With the new fiscal measures identified in this Letter of Intent, we believe that we will soon be able to demonstrate a track record of meeting our primary surplus targets, and establish a reputation for fiscal discipline. We are also directing our incomes policy towards supporting our inflation objective. While these efforts to fulfill the preconditions for inflation targeting continue, we are advancing our technical preparedness, including making further refinements to our modeling and forecasting of inflation.

14. **We remain committed to the floating exchange rate regime.** We demonstrated this commitment during the external tensions associated with the war in Iraq, when we made only modest foreign exchange lending operations, and the market soon stabilized. Following the end of the hostilities, in light of the increased supply of foreign exchange as evidenced by the reversal of currency substitution, on May 6 we reintroduced our daily foreign exchange purchase auctions, consistent with our long-stated objective of strengthening our international reserve position. We have also intervened, on a few occasions, to dampen excessive exchange rate volatility. However, such discretionary intervention will be strictly limited.

Fiscal reforms

15. **We remain committed to implementing key fiscal structural reforms in the period ahead:**

- Preparation of the second phase of **direct tax reform** is facing delay. We are still working towards a consensus on the general principles guiding the draft laws in this area (progressive reduction of benefits in free trade zones, and minimizing geographical, sectoral, and other investment incentives). We were therefore unable to meet the end-June structural benchmark to pass this legislation. Accordingly, we will complete the draft laws after a process of consultation, drawing on international practice. Preparation of the legislation will be a **prior action** for the sixth review. We intend to pass this legislation by end-November 2003 (**prior action** for the seventh review).

- While we missed the objective of eliminating 9,900 **redundant SEE positions** between end-January and end-June (structural performance criterion) by some 2,500 positions, we expect the process to gain speed as more employees seek early retirement following the completion of wage negotiations. Going forward, we will continue to rely on voluntary retirements, supplemented by implementation of the regulation adopted March 26, 2003 which lifted restrictions on retirement of public sector workers. To help ensure that the targets are met, we are intensifying our monitoring and enforcement of the reduction of redundant position at the level of individual SEEs. Our public employment monitoring system was put in place in late May (meeting a structural benchmark), and it shows that our retrenchment and attrition program has reduced state enterprise staffing by 36, 796 employees during January 2002–March 2003.

- We have finalized the draft **Public Financial Management and Control law** for submission to Parliament. Although Parliament's heavy workload has meant that it has been unable to pass this law (missing a structural benchmark for end-June), we now expect Parliament to do so by end-October (as a **prior action** for the sixth review). The law sets out a comprehensive framework for budget preparation, execution, and control. It consolidates into the central government budget, under a common classification, revolving and extra budgetary funds, annexed institutions, and all regulatory agencies, bringing the latter under parliament's oversight while preserving their financial and administrative autonomy. It also eliminates earmarking mechanisms (separate legislation to bring the existing earmarked revenues on budget will be passed this year). The bill clarifies the roles and responsibilities of the key institutions involved in fiscal management, with the Ministry of Finance responsible for the budget and for setting standards for accounting, financial control, and reporting throughout the general government. The law also expands the coverage of Turkish Court of Accounts (TCA) external audits to all of general government and brings internal audit to EU standards. Finally, as we no longer see a role for TCA in budget execution, internal audit and ex-ante control functions will shift to line ministries.

- We will also prepare new **state enterprise governance legislation**, with appropriate transparency and fiscal control arrangements. Owing in part to a legislative backlog, this legislation could not be passed by end-June as originally planned. We now expect Parliament to pass this legislation by end-2003 (accordingly, the structural benchmark for end-June 2003 has been rescheduled to end-December 2003).

- As a result of an extensive inter-agency consultation process, and in close collaboration with the World Bank, we have drafted a series of amendments to bring the **Public Procurement Law** in line with international standards. We expect these amendments to be passed by Parliament by end-July.

- Finally, we are preparing **legislation on public administration reform,** to create a more favorable legal and institutional environment for the efficient, transparent, and participatory provision of public services. As a first stage, a framework law will set out principles of governance and clarify the division of labor between central agencies and local governments. Informed by a forthcoming functional review of government, adjustments will be made in ministry laws and a new regulatory board law will be prepared to set standards and increase accountability (while preserving the financial and administrative autonomy of regulatory boards). New laws to regulate local governments will refine their budget systems, and ensure strict control of their borrowing.

16. **We are striving to upgrade our revenue collection administrations, to improve taxpayer compliance and provide a lasting solution to our arrears problem**:

- As a **prior action for the fifth review**, we expect Parliament to pass social security administrative reform legislation for Is-Kur, Bag-Kur and SSK (which was a structural benchmark for end-April). This legislation provides the legal basis for improved collection enforcement and, reflecting our commitment in the Letter of Intent of April 5, does not include any elements of amnesty of arrears. The legislation introduces a new system of penalties and interest in line with the best international practice (e.g. penalty interest at the government's borrowing cost). While the past stock of arrears remains unchanged, to ease the application of the new system those who are in arrears will be offered the opportunity to restructure. Payments will be in line with capacity to pay, as measured by gross sales or social security premia base.

- In parallel with the second phase of direct tax reform, we expect Parliament to pass legislation to reform tax administration by end-2003. The legislation will provide for reorganizing along functional lines, upgrading the status of the General Directorate of Revenues (GDR) within the Ministry of Finance, and establish clear vertical lines of accountability (to the local level) within the GDR. This, and information from the Tax Peace Plan, will help us to better target our audit program.

- To underline our commitment not to introduce any further amnesties, we are making this a **continuous structural performance criterion**. An amnesty will be understood as a reduction in the net present value of a public receivable, without any reference to individual ability to pay, or attempt to enforce individual payment. A public receivable will be understood as an obligation to general government (GFS definition) or to a state economic enterprise or state bank.

Financial sector reform

17. **We are continuing to strengthen the banking system.** Progress is being made in resolving Yapi Kredi and Pamuk banks, and in selling the assets held by the Collection Department of the Savings Deposit Insurance Fund (SDIF). We remain committed to privatizing the state banks, and to sustaining the financial and operational independence of the Banking Regulation and Supervision Agency (BRSA).

18. **Yapı Kredi's financial position has stabilized, with the integrity of its operations preserved.** The special oversight committee created in February will soon present its first quarterly report to the BRSA and SDIF Board, and a summary of its findings will be published. The bank's financial performance has been in line with that of its peers. Its management, with the assistance of an advisory firm, is developing a restructuring plan that will facilitate the eventual divestiture of shares both held and represented by the SDIF.

19. **The SDIF is completing the resolution of the remaining three intervened banks still under its portfolio.** The sales process of Pamukbank has been extended but is in its final stages. The three potential investors have completed or are in the process of conducting due diligence with bids to be submitted by July 31. The strategy for Bayindirbank will be

evaluated once the sale of Pamukbank is concluded. Voluntary liquidation of Türk Ticaret is still delayed by a court injunction in favor of the minority owner. On July 3, the BRSA revoked the license of Imar, a medium sized-bank. The BRSA took this action after uncertainties increased about the financial condition of the bank, and depositors started to withdraw their funds.

20. **The BRSA's financial and operational independence is being strengthened.** Draft legislation setting out clear grounds and time limits for legal appeal of BRSA decisions has been prepared (meeting a structural benchmark) and is being reviewed by government agencies. Amendments will be made to the Administrative Procedures Law and the Banks Act to achieve the goals outlined in our Letter of Intent of April 5, 2003. We expect Parliament to pass these laws by end-October 2003 (a structural performance criterion). The Government will also ensure the BRSA's **financial independence** by providing for direct submission to Parliament of its budget in the new Public Financial Management and Control Law. The Government would also consider favorably requests by BRSA to ease restrictions on its spending decisions in carrying out its operations.

21. **On July 17, 2003, Parliament passed amendments to the Execution and Bankruptcy Act,** which are expected to be enacted shortly (meeting an end-May structural benchmark with delay). These amendments will enhance the effective enforcement of creditor rights. In addition, by end-November 2003 we will enact a new section of the Execution and Bankruptcy Act on pre-packaged bankruptcy that incorporates the latest comments of the World Bank and Fund staff. Regulations on the implementation of these pre-packaged bankruptcy provisions will be introduced by December 15, 2003 (**new structural benchmark**). These laws should significantly improve the regime for corporate insolvency and creditor rights in Turkey.

22. **The SDIF asset sales have commenced.** The SDIF on June 30 announced the auction of loan portfolios with face value of at least US$250 million (meeting a structural benchmark), with bids to be submitted by November 20, 2003. After this first sale, we intend to put up new portfolios of loans (except small consumer loans) for sale every four months. The sales process should benefit significantly from our recent reform of the Execution and Bankruptcy Act.

23. **The removal of the general bank guarantee has been announced.** The BRSA announced on July 3 changes in the general guarantee protecting all depositors and other creditors in banks. The guarantee will be effective until July 5, 2004, after which it will be replaced by a limited deposit protection scheme. Until then, the following two schemes will be in place: (i) the general scheme protecting all depositors and creditors in intervened banks, and (ii) a scheme fully protecting individual depositors, but not commercial deposits, in banks being liquidated directly without intervention.

24. **We are also taking necessary measures to further strengthen the regulatory and supervisory framework:**

- We will transfer **the regulation and supervision of nonbank credit institutions** from the Treasury to the BRSA effective January 1, 2004 following passage of the relevant legislation, now postponed until after the Parliamentary recess. In preparation for this transfer, the BRSA has completed a reorganization study to fully integrate supervision of nonbank credit institutions with that of banks.

- The Treasury is working on a new draft law to **regulate insurance companies** in line with applicable EU Insurance Directives. To allow this work to benefit from World Bank technical assistance, the expected date of passage has been delayed until end-2003.

- BRSA is creating a **database** which will standardize, harmonize, and speed up the collection of banking data, and produce timelier and higher quality data. This will also reduce the number of ad hoc and overlapping reporting requirements imposed on banks. With the database up and running, the BRSA expects to reduce the lag in publishing banking data from about four months currently to about one month by end-2003.

- We have introduced an **exemption from value-added tax** for: (i) sales of collaterals of loans which are transferred by banks, special finance houses and other financial institutions to asset management companies established according to the provisions of Act No 4743; (ii) sales of collaterals of loans which are restructured under the Istanbul Approach by financial institutions; and (iii) sales of assets and rights which are transferred to the SDIF according to the provisions of Banks Act. This will promote the disposal of nonperforming loans and the eventual creation of private asset management companies. The revenue impact of this measure was already built into the 2003 budget.

25. **Working with the World Bank, we continue to make progress in reforming the state banks.** We have introduced new safeguards to ensure that state banks only extend credits based on commercial principles, Ziraat has adopted plans to restructure its agricultural loans, and we are proceeding with our plans to prepare Ziraat and Halk, together with Vakif, for privatization:

- The Government will continue to **refrain from interfering in the commercial decisions of state-owned banks.** The Sworn Bank Auditors of the BRSA will complete the first of its new quarterly certifications of the State Banks in August 2003, covering the first six months of this year. Certifications thereafter will be made quarterly, and completed no later than two months after the end of each quarter.

- **Ziraat** is restructuring its nonperforming and fully provisioned agricultural loans in line with the commitments in the April 5 Letter of Intent. The legislation relating to the restructuring was adopted on June 6, and the restructuring process is proceeding as planned. The restructuring applies to such loans extended and fully utilized before January 31, 2002. Of the outstanding debt as of June 11, 2003, within 60 days of enactment of the Law, borrowers have the option of either (i) repaying 10 percent upfront and the remaining amount in three equal installments every October, or (ii) repaying the whole amount, in which case a 30 percent discount will be given.

Borrowers participating in the scheme will not be eligible for new loans from Ziraat until they have paid the rescheduled amounts in full.

- A strategic study by independent consultants for the privatization of **Halk** will be completed by end-September 2003. We intend to put Halk up for sale by end-2003, with Ziraat following in 2004.

- On **Vakif,** the proposal to sell part of the bank to its pension fund proved unworkable. Alternative approaches to divesting the bank are now being considered in close consultation with the World Bank.

26. **We also intend to reduce intermediation costs to facilitate credit extension by the banking system to the real sector.** The inter-agency working committee to reduce intermediation costs has met regularly since its inception. It has already prepared and published a quantitative assessment of the intermediation cost burden. On July 15, 2003 it completed an action plan with specific initiatives for tackling such costs in the near future (meeting an end-May structural benchmark with delay). As part of this plan, the BRSA/SDIF have reduced deposit insurance premia, the BRSA has reduced the fee charged to institutions under its supervision, and the Capital Markets Board has reduced registration and listing fees. With the Ministry of Finance in the lead, and drawing on technical assistance from the Fund, the committee is now preparing more precise estimates of the economic and fiscal impact of each intermediation cost. Based on this work, by mid-October 2003, the Ministry of Finance will issue a detailed schedule of the phased implementation of the plan through end-2004 and beyond.

Enhancing the role of the private sector

27. **We have given privatization renewed impetus, making all tender announcements for the first half of 2003 as planned, although the actual sales of most of the large companies are still some time away:**

- The winning bid for PETKIM (petrochemicals) was announced on June 6 and approved by the Privatization High Council.

- In June we made tender announcements for the privatization of TEKEL (tobacco and alcohol) and TÜPRAŞ (petroleum refinery). In light of the strong interest shown by both domestic and international investors, we are confident of completing the sale of the two companies by end-2003.

- A comprehensive privatization strategy for ŞEKER (sugar) was adopted by the Privatization High Council (PHC) on June 26, 2003. It envisages putting some plants up for sale in early 2004.

- While the end-April benchmark relating to the privatization plan for Türk Telekom was missed, we have built on the Council of Ministers' principle decision of April 30, 2003 and have agreed with the World Bank on the next steps that need to be taken. We expect that the Council of Ministers will adopt the privatization plan by end-

October 2003 (the structural benchmark will be moved accordingly, from end-April to end-October).

- In the electricity sector, the PHC approved the transfer of 19 distribution entities, three portfolios of multiple generation plants and 55 hydropower plants under the scope of privatization.
- Along with the work on all these larger privatizations, we have also completed the sale of a number of smaller companies. As regards privatization revenue, cash proceeds in the first half were about US$50 million, below our indicative target. However, given the tender announcements already made, we are still confident that we will meet our US$2.1 billion end-year target.

28. **We are also moving ahead with the planned actions to promote foreign investment, improve the business climate, and address corruption.** The Foreign Direct Investment Law has been enacted, meeting a structural benchmark. Also, the new legislation establishing the Investment Promotion Agency, developed in collaboration with the World Bank, is expected to be enacted after the Parliamentary recess. After the postponement last year owing to political uncertainty, we have decided to hold the inaugural Investor Advisory Council meeting late this year or early in 2004. We are also making progress in introducing the numerous other initiatives to improve the business climate, which were detailed in the April 5 Letter of Intent. We were unable to pass legislation establishing a code of conduct for civil servants and public administrators (missing a structural benchmark for end-July), but intend to do this by year-end (revised structural benchmark).

Safeguards assessment

29. **We have further strengthened the CBT's internal control, accounting, and audit functions.** On May 15, 2003 the newly established Internal Audit Department completed the audit of foreign exchange management and program data as of end-2002, meeting a structural benchmark. With this, the CBT has completed all the actions under program conditionality in the context of the safeguards assessment, which is required for all new Fund arrangements.

Very truly yours,

Ali Babacan	Süreyya Serdengeçti
Minister of State for Economic Affairs	Governor of the Central Bank of Turkey