REPUBLIC OF TURKEY
PRIME MINISTRY

Ref: B.02.1.HM.0.DEİ.02.00/500/63930 Ankara, November 24, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington DC 20431
U.S.A.

Dear Mr. de Rato,

1. Economic performance under our program remains strong. Inflation is in single digits and growth, though moderating, remains robust. Financial markets have performed well, supported by favorable global credit conditions, the timely start of EU accession negotiations, and successful privatization of key state economic enterprises. Benefiting from these developments and from continued fiscal discipline, the overall fiscal deficit has dropped below the 3 percent of GNP Maastricht criterion and net public debt has fallen below 60 percent of GNP.

2. These achievements reflect confidence in Turkey's economic prospects as well as strong policy implementation under our program (Annexes A and B).

- With respect to the *quantitative performance criteria*, the end-September targets for external debt and net international reserves were met. And while there was an overrun in the overall balance of the social security institutions, the primary surplus target of the consolidated government sector (excluding SEEs) was met by a small margin. Given continued increases in currency demand and further financial deepening, the end-September base money ceiling was exceeded.

- As regards *fiscal reforms* envisaged in the program, we have submitted to Parliament a budget for 2006 consistent with a public sector primary surplus target of more than 6½ percent of GNP, a linchpin of the program. However, approval of legislation introducing universal health insurance and making parametric changes to the pension formula across occupational groups faced a significant delay, mainly because of the summer recess of Parliament and the need to extend the consultation process to ensure its broad support. We also recently submitted to Parliament legislation improving social security contribution collections. To further improve fiscal control, a quantitative framework was developed for monitoring health expenditures and secondary legislation required under the Public Financial Management and Control Law is expected to be put in place shortly. However, legislation strengthening state enterprise governance could not yet be submitted to Parliament as more time is needed to find consensus on a draft law.

- In the area of *financial sector reforms*, Parliament has re-approved legislation that will bring the supervisory framework more closely in line with EU standards, and the BRSA has published, with a small delay, planned reforms to strengthen its organizational and governance structures. We have also recently adopted a restructuring and privatization strategy for state banks, and are expecting to adopt soon a timetable for phasing out the special privileges and obligations of these banks.

3. In light of this performance, we request the completion of the First and Second Reviews under the Stand-By Arrangement. On the basis of our strong disinflation performance, we are requesting a waiver of the end-September base money performance criterion. We are also requesting a waiver of nonobservance for the end-September target on the primary balance of the consolidated government sector including SEEs, given that through August the cumulative surplus of state enterprises was below programmed levels (we remain on track to meet the end-year targets). We are also requesting waivers for the end-June performance criteria for the banking law (passed with a slight delay on July 2) and the pension reform law, which is now expected to be approved by mid-February (structural performance criterion).

4. We are confident that the policies set out in the April 26, 2005 Memorandum of Economic and Financial Policies and this supplementary Letter of Intent are adequate to achieve the objectives of our program, and we stand ready to take further measures that may become appropriate for this purpose. We will continue to consult the Fund on the adoption of these measures and in advance of revisions to policies contained in this letter in accordance with the Fund's policies on such consultation.

Macroeconomic framework 2005–06

5. The economy is on track to grow by 5 percent this year and next and inflation is likely to come in somewhat below the 8 percent end-2005 target. As expected, growth has been moderating this year, but remains well supported by investment and construction activity. Non-agricultural employment has also picked up, with over 1 million new jobs created in the last 12 months, notwithstanding continued productivity increases. Inflation remains firmly under control—with both consumer and producer price inflation in single digits—though possible second round effects from high oil prices and stickiness in non-tradable prices will require continued vigilance in order to achieve next year's target.

6. The current account deficit has continued to widen and is now projected to reach 6 percent of GNP this year and to drop to 5.8 percent next year. Although this partly reflects outside factors—notably higher oil prices and the lifting of international quota restrictions on textiles—buoyant capital inflows and the resulting strong lira have also played a role. Importantly, the quality of external financing is improving, aided by successful privatization of state-owned enterprises, increased foreign direct investment, and borrowing at longer maturities. At the same time, the floating exchange rate will continue to serve as an important safety valve, and continued foreign exchange purchases by the central bank will allow a further build-up in international reserves. We will continue to review current account developments during the year and adjust policies as needed. The ¼ percent of GNP tightening embedded in the 2006 fiscal program goes in this direction.

Monetary policy

7. We will continue to pursue a prudent monetary policy, guided by our inflation targets. While inflation has fallen in line with expectations, base money growth has been stronger than expected, owing to declining interest rates and growing confidence in the lira. To reflect these developments, and since inflation remains under control, we are proposing base money targets for end-December that are slightly higher than the indicative targets envisaged at the outset of the program. To help improve our reserve coverage ratios, we also propose to lock in the much higher than programmed reserve build-up, and request that the floors for net international reserves be raised accordingly. We will continue to build reserves through the daily foreign exchange purchase auctions and we retain the option of using discretionary sterilized intervention to prevent excessive exchange rate volatility.

8. To further support disinflation, the CBT continues to prepare carefully for its move to formal inflation targeting in January 2006, including by improving its forecasting and policy analysis model and making the necessary organizational changes. The CBT recently hosted a regional workshop on inflation targeting and will make a detailed announcement on the operational framework in December. With the planned move to formal inflation targeting, the CBT plans to replace base money and net domestic asset ceilings—though these will continue to be monitored carefully—with an inflation consultation clause (Annex D).

Fiscal policy

9. Fiscal policy has remained prudent in 2005. Central government revenues are projected to be somewhat better than programmed, though expenditures have been under pressure mainly on account of additional transfers to the social security institutions (SSIs). These reflect the greater than expected costs of expanded access to drugs and medical services, administrative complications related to hospital and pharmacy reform, and contribution shortfalls linked to earlier rumors about an amnesty. Both of these latter effects we view as transitional and likely to subside over time. Thus, while the 4½ percent of GNP indicative ceiling on the SSI deficit is likely to be breached this year, we are confident that it is achievable in 2006. In addition, we remain committed to achieving the 6.5 percent of GNP

primary surplus target in 2005 and, if needed, we will adjust budget allocations to ensure this target is met.

10. Looking ahead, fiscal discipline remains a cornerstone of the program and is essential to underpin our medium-term debt reduction targets, reduce Treasury's rollover rates, and ease pressure on the external current account deficit. Our 2006 budget, submitted to Parliament in mid-October, is fully consistent with these objectives. The consolidated budget and extrabudgetary funds are expected to deliver a combined primary surplus of 5.3 percent of GNP, which corresponds to a tightening of the fiscal stance when compared to this year's expected outturn of 5.0 percent of GNP. This adjustment will allow the government to maintain the primary surplus target for the public sector at just over 6½ percent of GNP, notwithstanding the privatization of Türk Telekom and TÜPRAŞ, which will reduce the contribution of the state enterprise sector to the overall primary target. The overall public sector deficit (program definition) is expected to improve further by ½ percentage point next year, falling to around 1 percent of GNP, helped by lower interest rates and a declining debt burden.

11. Our fiscal program for 2006 also includes a number of steps aimed at improving the composition of revenues and expenditures. On the revenue side, these include: (i) initiating reforms of the personal and corporate income taxes; (ii) harmonizing the withholding tax regime for financial investment income; and (iii) permitting a real decline in petroleum excises. In terms of expenditures (relative to GNP), the budget: (i) reduces social security transfers, both by controlling health costs and by improving collections; and (ii) allows investment spending and capital transfers to increase over 2005 levels.

12. During the year, we will monitor closely macroeconomic developments and the implementation of our fiscal program. In the event that strong economic performance allows higher than expected revenue collection, we intend to spend additional revenues on high priority investment projects, provided that the overall primary surplus, the social security deficit, and the external current account position are evolving in line with program projections. Revenue overperformance will otherwise be saved.

13. Achieving the objectives of the 2006 budget depends crucially on our ability to contain the social security deficit. Consequently, we propose to replace the indicative targets on the social security deficit with semiannual performance criteria.

- To gain greater control over health spending, we have prepared a realistic annual lump-sum budget for the state hospitals under which each hospital will be expected to finance all of its patient expenditures. This lump-sum budget will be granted at the beginning of the year and it will be set as an upper limit for the total payments of social security institutions to public hospitals. At the same time, we plan to strengthen the auditing and payment mechanisms of the social security institutions as well as the management of public hospitals to preserve the amount and quality of services provided. We are conscious that containing health spending is key to preserving a sound budgetary position. To this end, we intend to monitor closely developments in this area and, if overruns emerge early next year, we stand ready to take additional measures.

- We are also introducing a new framework to strengthen social security contribution collections and provide a permanent solution to the problem of past arrears. These reforms include the following key components: (i) introducing a uniform statute of limitations of five years for all arrears; (ii) requiring recipients of government subsidies to be current on their tax and social security obligations; (iii) improving collection through prioritizing arrears by age and size and substantially increasing the number of employees in Bağ-Kur and SSK dedicated to collections; (iv) outsourcing collection of arrears on a commission basis, starting no later than June 2006; (v) reforming the penalty and interest regime so as better to discourage late filing and payment; and (vi) introducing an installment payment facility to clear the existing stock of arrears.

- To benefit from the installment payment facility, and to ensure that payments under the scheme are not diverted from other obligations, participants must remain current on their tax and social security obligations. The length of repayments will be linked to the age of the debt, and the size of repayments to contributors' ability to pay (at least in the case of large SSK debtors, whose capacity to pay is feasible to assess). To ensure fairness and transparency, this facility will not apply to payment arrears accumulated since end-March 2005. We recently submitted supporting legislative and regulatory frameworks to Parliament. Implementation will begin immediately following enactment of the supporting legislation and will be closely monitored under the program.

- Pending the implementation of the new pension law, we will ensure that pension increases and any changes to tax rebates to pensioners will be consistent with the inflation objective and the social security envelope provided for in the 2006 budget.

Structural fiscal reforms

14. We are making further progress in the area of tax policy reform, with the stage set for important changes that will simplify the tax structure, broaden the tax base and align tax policy more closely with EU practices.

- The *corporate income tax* will be overhauled by lowering the tax rate and phasing out exemptions and allowances, including to remove a significant anti-employment bias in the tax code. The reduction in the headline rate will make Turkey more competitive with its neighbors, while weakening taxpayers' motivation to engage in tax avoidance schemes. We believe that in the long run this reform will be revenue neutral but we have already identified expenditure savings that will be immediately put in place in case shortfalls emerge in the near term. We stand ready to take additional policy measures to ensure that the budget targets are preserved. We aim to make effective the proposed changes to the corporate income tax for fiscal year 2006. To this end, legislation will be submitted to Parliament soon.

- The *personal income tax* will be reformed in two steps: (i) by end-December 2005, legislative changes will be adopted to streamline the structure of the tax by unifying the schedules for wage and nonwage income and reducing the number of tax brackets, (structural benchmark). These changes are expected to be revenue neutral. (ii) We are planning to introduce additional reforms later in 2006 aimed at broadening the base and increasing the efficiency of the personal income tax. To this end, we are considering streamlining existing allowances and exemptions and reforming the existing system of consumption credits to make the tax structure more progressive. Any changes will be designed so as to increase—or at least, leave unchanged—the overall revenue yield. As these reforms are far-reaching and technical preparations are at an early stage, their introduction has been phased as follows: legislation will be submitted to cabinet by end-April 2006 and to Parliament by end-May 2006 (structural performance criterion). With extensive lead time needed for taxpayer education, parliamentary approval of the law is expected by end-September 2006 (structural performance criterion).

- We remain committed to phasing out the financial transaction taxes during the program period, starting with the *Banking and Insurance Transaction Tax* by end-2006 as budgetary conditions permit.

- Finally, from January 1, 2006, interest and capital gains—including on government securities—will be subject to a flat 15 percent final *withholding tax*, helping to further harmonize, simplify, and broaden the base of the income tax system.

15. To strengthen tax administration, we plan to: (i) establish a tax policy unit in the Ministry of Finance by end-December 2005 (structural benchmark); (ii) complete the functional restructuring of the newly established Revenue Administration by end-April 2006 (structural benchmark); and (iii) establish a large taxpayer unit, although this will now be possible only by end-June 2006 (structural benchmark). We are also improving coordination between the new Revenue Administration and the social security institutions (Bağ-Kur and SSK), in line with our intention to give increasing responsibility for social security contribution collection to the Revenue Administration.

16. To support these tax reforms, and in line with program objectives, we will refrain from introducing targeted incentives and sectoral tax cuts. In particular, we will continue to

preserve the structure of the VAT and avoid introducing exemptions. To assist poorer (registered) farmers, we have, however, introduced subsidies on diesel fuel, fertilizer and on grain, resulting in a net overrun in the agricultural budget of less than 0.1 percent of GNP. We remain committed to controlling strictly the overall envelope for agricultural subsidies.

17. Passage of the pension reform law had to be delayed to ensure additional consultations with social partners and is now expected to be approved by mid-February (structural performance criterion). Submission to Parliament of the social security administrative reform law is expected by end-November (prior action), with passage by end-January 2006 (structural performance criterion).

18. A key fiscal objective in the area of decentralization is to improve spending efficiency and accountability, while ensuring strict financial discipline and local government fiscal sustainability. Sustainability of municipal finances going forward will be ensured by adherence to the newly established legal limits on personnel spending, borrowing, and debt stocks, improved financial management and accountability and, where needed, additional revenue or spending measures. We are mindful that the devolution of spending and the provision of transfers and revenue authority must proceed in tandem to avoid fiscal imbalances. Debt restructuring of municipalities is underway, although progress has been slower than expected, and a comprehensive report of municipalities' restructured debts will be made available by end-June 2006.

19. We have drafted legislation on governance of the state economic enterprises, but further consultations with stakeholders are needed to garner the necessary consensus before the draft law can be submitted to Parliament.

20. We are in the process of amending the Public Financial Management and Control Law to define internal audit and internal control requirements adequately and consistently with EU requirements. These amendments—which are consistent with our commitment to respect budget appropriations—have been submitted to Parliament and implementing regulations are expected to be adopted by year-end (structural benchmark). Finally, the

comprehensive review of civil service wage and employment structure is on track to be completed by end-2005 (structural benchmark).

Financial sector reforms

21. We are further strengthening BRSA's supervision by bringing it closer to best international practices. To this end, Parliament has re-approved the banking law originally passed in early July. Given that more than 50 supporting regulations have to be issued within one year of the passage of the banking law (structural benchmark), the BRSA has prepared an action plan setting out the timetable and priorities for their drafting and implementation, and will publish on its web site a quarterly report on progress made in this area. Taking into account the findings of the Imar inquiry, on October 11 the BRSA published a set of actions to strengthen its organizational structure, including by merging onsite and offsite supervision, creating auditing teams and adopting a number of far-reaching measures to improve transparency and accountability. Implementation of the BRSA's organizational changes envisaged in the banking law will be completed by year-end. The transfer of supervision of non-bank financial institutions from the Treasury to the BRSA will also be completed before end-2005. The committee to assess whether further integration of financial sector supervision is warranted will soon be formed with a view to present its findings by end-March 2006 (structural benchmark).

22. Further progress is being made on preparations for the possible privatization of state banks. On June 30, 2005, bank-specific strategies were adopted by both the government and the boards of the state banks. Terms of reference for the hiring of a financial advisor for Halk were agreed in September and the relevant authorization by the High Privatization Council was obtained in November. The financial advisor will be hired by early January and an announcement setting out a timetable and modalities is expected by end-June 2006 (structural benchmark). In this context, and to take into account the input of the financial advisor, we are delaying to end-March 2006 the adoption of a timetable for phasing out special privileges and obligations of the state banks (structural benchmark). We intend to follow a similar process for Ziraat during 2006. In addition, Vakifbank completed successfully its first IPO in November 2005 (end-December 2005 structural benchmark).

23. SDIF is making good progress on the resolution of assets in its portfolio (end-2005 structural benchmark). The SDIF recently successfully auctioned the remaining non-related-party loans through profit sharing arrangements, which ensure that the recovery rate will be substantially above that achieved in the previous auction. Reflecting asset sales to date, the SDIF has already repaid US$ 2 billion of its debt to the Treasury. Looking forward,

- Following the successful sale of 9 cement factories, and several media companies during September and October, the SDIF is on track to complete the sale of assets seized from the former owner of the failed Imar bank before end-2005.

- By end-2007, the SDIF will dispose through competitive bids its holdings of shares in companies and other assets. A strategy for its operational restructuring will be developed as assets are sold, but no later than end-September 2007.

- The resolution of Bayındırbank will be concluded by end-2007.

- The Treasury will, by end-March 2006, resolve its receivables from the SDIF that arise from the earlier costs of restructuring the banking system.

24. As part of our efforts to strengthen the financial sector and deepen financial intermediation, we plan to introduce new legislation establishing a framework for mortgage lending and securitization. Given the large expected increase in lending resulting from this reform, we plan to phase in gradually the implementation of the law, including by adapting the supervisory framework and prudential regulations as needed. It is envisaged that during a transitional period only banks will be allowed to extend mortgage loans and that loans will be restricted to purchases of dwellings, and a prudent limit for the size of the loan relative to the purchasing price will be set in implementing regulations.

Enhancing the investment climate

25. Our efforts to raise the quality of the investment climate have gained further momentum after the second meeting of the Investment Advisory Council (IAC) on April 29, 2005. We have also made some modifications to the Coordination Council for the Improvement of the Investment Climate (CCIIC) with a view to enable this platform to achieve quick results. To this end, in July 2005 we amended the Law on Municipalities and the Law on Organized Industrial Zones to streamline procedures for certain business permits and, in August 2005, we put in place the regulation on Opening Business and Operating Permits to further simplify and decentralize required procedures. In the period ahead, we intend to continue building on IAC advice to strengthen the investment climate, including in priority areas such as corporate governance and the social security system.

26. We are making good progress in our privatization program. As a result of the sale of 23 state-owned enterprises, US$3.2 billion in privatization revenues has been raised this year, of which US$2.7 billion has been transferred to the Treasury. This includes an initial payment for Türk Telekom (telecommunications), for which the tender process has been completed at a sale price of US$6.55 billion, bringing the total value of privatizations completed in 2005 to US$16 billion. The technical work on TÜPRAŞ (refineries) and Erdemir (steel) has also been concluded, and we expect to finalize these privatizations by early 2006. Looking further ahead, we aim to complete the privatization of the remaining state-owned companies under the portfolio of the Privatization Administration by end-2006.

Very truly yours,

/s/
Ali Babacan
Minister of State for Economic Affairs

/s/
Süreyya Serdengeçti
Governor of the Central Bank of Turkey

Attachments