REPUBLIC OF TURKEY
PRIME MINISTRY

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

Dear Mr. Köhler:

1. **The new Government is determined to strengthen and implement the ongoing economic reform program of Turkey.** After the November 3rd elections, Turkey's 58th Government won the vote of confidence in Parliament and took office on November 28, 2002. Financial markets reacted favorably to the election of a strong single-party government, helping to reinforce trust in Turkey's economic prospects. The decision of the European Union leaders at the Copenhagen Summit in December also provided impetus to stabilization and reform efforts on the way to full membership of the European Union. In the early part of 2003, the 58th Government established the main policy framework for the completion of the fourth review under the Stand-By Arrangement. Building on this progress, the reshuffled Government which won the vote of confidence in Parliament on March 23, 2003 will expeditiously continue with program implementation.

2. **The objective of our Government is to unleash Turkey's development potential by providing a stable macroeconomic environment and implementing fundamental structural reforms.** The Government's main goals are disinflation, debt reduction, and lasting rapid growth. We are committed to sustaining the reduction in inflation and we will continue with our disinflation policy to further enhance the prospects for rapid growth in the economy. Our public sector primary surplus target of 6.5 percent of GNP for 2003 is of paramount importance both to fuel confidence in our program and to reduce the high net public debt to GNP ratio. For 2004, and over the medium term, we remain committed to our 6.5 percent primary surplus target. Should prospects for debt reduction change significantly we would be prepared to adjust the target, in close consultation with the Fund, provided that this is consistent with our goal of reducing the public debt ratio to levels specified in the Maastricht Treaty. We also attach special importance to increasing the private sector's role in the economy. We believe that a well-functioning market mechanism and private sector led economy are the main pillars that will underpin sustainable growth. Accordingly, our Government will particularly focus on a renewed privatization effort, measures to attract foreign direct investment, fighting corruption, and improving corporate governance and transparency in the public sector. We

also believe that sustainable growth requires adequate safety nets to prevent exclusion of those parts of the society that are most vulnerable to the externalities of a market based economy and globalization.

3. **The program strategy and macroeconomic targets of the Stand-By Arrangement covering 2002–04 are sound and feasible.** The economic performance of 2002 has demonstrated the Turkish economy's ability to recover quickly and the responsiveness of the economy to sound policies. The original macroeconomic objectives for 2002 have been well exceeded. End-year consumer price inflation fell to 29.7 percent, well below the original program target of 35 percent. The Central Bank's independence played an important role in reaching the inflation target, and the Government will continue to ensure the Central Bank's independence and support its goal of price stability. In 2002 economic activity also picked up strongly, with GNP growth reaching 7.8 percent, well above the original target of 3 percent and even the revised target of 6.5 percent. Our balance of payments position was also comfortable, with gross international reserves rising substantially and the external current account deficit limited to 1 percent of GNP. The net public debt to GNP ratio is estimated to have fallen to below 80 percent at end-2002 from more than 90 percent at end-2001.

4. **Although the general framework of the program has been kept in place, over the past several months fiscal policy has been weaker than envisaged** (Annex A)**.** On the monetary policy front, the monetary aggregates have been within program limits, as end-September and end-December performance criteria for base money and net international reserves have been met. However, on the fiscal front the end-December performance criterion for the primary surplus of the consolidated government sector was missed. This was largely due to the increased spending and weaker than expected revenues in the budget arising from declining tax compliance in the months surrounding the early elections. The divergence from the originally agreed fiscal framework for 2002 could not be compensated by our Government's actions in the little time left before year-end. Under these circumstances, the Government concentrated its efforts on improving the fiscal balances in the period to come. As the first step, the Government passed the interim budget for 2003—covering the first three months—on December 27, 2002, which kept real expenditures constant relative to the corresponding period last year. This Letter describes our subsequent efforts and commitments to get fiscal policy back on track.

5. **Progress has continued in structural reform, although falling short of fully meeting program conditionality** (Annex B)**:**

- In line with program commitments, the Central Bank of Turkey (CBT) met the structural performance criterion on reorganizing its internal audit unit. The prior actions on adoption of a privatization plan for the tobacco and alcohol company TEKEL and passage by Parliament's budget commission of direct tax reform legislation have also been met.

- We have also met several structural benchmarks: (i) direct tax reform legislation was submitted to Parliament; (ii) the primary dealers system for government paper was reintroduced; (iii) a communiqué defining the responsibilities of the Treasury's middle office and a new debt management committee that will oversee the development of risk and debt management policy was published in the Official Gazette; (iv) a package of comprehensive reforms of the Execution and Bankruptcy Act was prepared; (v) the Bank Resolution and Supervision Agency (BRSA) continued with the reform of the banking sector and revoked the license of Toprak, a medium-size insolvent bank; (vi) the BRSA also completed a reorganization study to enhance its supervisory capacity; (vii) the Saving Deposit Insurance Fund (SDIF) announced a detailed strategy for the disposal of assets held by its Collection Department; and (viii) the Council of Ministers issued a decree setting the earmarking of SCT proceeds at zero, starting with the 2003 budget.

- Also, in the context of a draft budget for 2003 that the previous government submitted to Parliament in October, we met the structural benchmarks on including resources to raise the number of tax auditors by 400, incorporating revenue and expenditures under Law 3418, and extending accounting and coding reforms to all consolidated budget agencies (and to general government units on a pilot basis). However, at the time of the elections this draft budget was automatically withdrawn. To make these provisions effective, we included them in the 2003 budget that was passed by Parliament on March 29.

6. **Several structural commitments were missed due to early elections, legal proceedings, or else due to the time constraints faced by the Government.** These include the structural performance criterion on eliminating two thirds of the remaining redundant state economic enterprise (SEE) positions by end-October, and structural benchmarks relating to (i) resolving Pamuk bank and ownership in Yapı Kredi Bank, (ii) announcing the sale of part of the SDIF's loan portfolio, (iii) various elements of the tax administration reform, (iv) adopting a privatization plan for Türk Telekom, (v) passing legislation to establish a code of ethics for civil servants and public administrators, (vi) submitting to Parliament legislation to improve state enterprise governance, (vii) enacting comprehensive reforms of the Execution and Bankruptcy Act, (viii) including net lending as an appropriation in the draft 2003 budget (which was met only in part), and (ix) putting in place an integrated quarterly monitoring system of general government and SEE employment. Nevertheless, we remain committed to the structural reform agenda, and seek rapid progress in this area in the period ahead.

7. **With this Letter of Intent, we provide the details of our action plan to strengthen and speed up the adjustment and reform process, and thereby request the completion of the fourth review under the Stand-By Arrangement.** In support of our request for completion, we have formulated a macroeconomic framework and a structural agenda for 2003. The related monetary, fiscal, and external conditionality for 2003 is

presented in Annexes C–M, and the new structural conditionality in support of our reform agenda is included in Annex B.

8. **We also request waivers of nonobservance for the performance criteria on (i) the cumulative primary balance of the consolidated government sector for end-December 2002, and (ii) eliminating two thirds of redundant positions in SEEs by end-October 2002.** As explained below, we are taking strong measures to bring fiscal policy back on track, including through adopting an annual budget for 2003 consistent with our public sector primary surplus target of 6.5 percent of GNP and supported by front-loaded measures. This will underpin the achievement of disinflation, debt reduction, and sustainable rapid growth. With respect to the elimination of redundant positions in SEEs, as of end-October, 17,801 redundant positions had been eliminated mainly through voluntary retirement. This performance fell short of the target set for end-October by 12,727 positions. Early elections, reluctance of workers to retire (in anticipation of January wage increases), delays in the privatization program and inadequate financing for the Privatization Administration (PA) were the main contributing factors to the shortfall. As of end-January 2003, 20,718 positions have been eliminated. We will meet program conditionality to eliminate all redundant positions—originally scheduled for end-June 2003—by end-2003, on the basis of our strengthened plan described in paragraph 22.

9. **In addition, we request a rephasing of the purchases outstanding over the remainder of the program** (Annex N)**.** Our gross reserves position is stronger than envisaged under the original program, and now stands at about US$28 billion. At the same time, we have faced delays and difficulties in meeting some program commitments, as described above. Both these factors call for a rephasing of the remaining purchases that is better tailored to Turkey's financing needs.

10. **While committed to disinflation and stabilization, the Government recognizes the vital importance of social protection of the most vulnerable segments of the population for the successful continuation of the reforms.** To this end, we will strictly remain within the budgeted fiscal framework, while increasing the impact of social spending by better targeting the social support programs and channeling more of the available resources to the most vulnerable parts of the society.

11. **We believe that the policies and measures described in this letter are adequate to achieve the objectives of the program.** We will consult periodically with the Fund, in accordance with the Fund's policies on such consultations, about the progress being made in implementing the policies supported under the Stand-By Arrangement, and in advance of any revision to these policies. We will provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with our progress in achieving the objectives and policies set forth in this Letter.

12. **The recently started military conflict in neighboring Iraq will not derail achievement of our key macroeconomic and structural reform objectives.** In the event of a swift conclusion to hostilities we believe our macroeconomic framework and

objectives for 2003 will remain viable. At the same time, we recognize that there are uncertainties, reflected in our financial markets, as to the magnitude and duration of the economic impact of the conflict. Accordingly, we are taking fiscal actions to promote a smooth rollover of government debt, by blocking central government budgetary appropriations for discretionary spending (except defense) until further notice. We are prepared to continue this blockage, with annual savings of at least 1 percent of GNP, as long as is required by our budget financing program. Moreover, if prior to the Fifth Review developments point to significant changes to the macroeconomic framework or in financing prospects, we stand ready, in close consultation with the Fund, to (i) revise the program's macroeconomic projections, (ii) adopt on a timely basis additional fiscal and other measures necessary to safeguard our program objectives, and (iii) agree to revised program modalities.

13. **Any use of additional bilateral financing will be fully in line with our program commitments.** The U.S. government has proposed economic support for Turkey in the grant-equivalent amount of US$1 billion that could be converted into loans of up to US$8.5 billion. Should this or other bilateral assistance materialize, we will use it primarily to strengthen our debt reduction strategy through lengthening maturities and lowering interest rates. Additional spending to address temporary costs arising from the Iraq conflict will be financed by grants or by taking offsetting fiscal measures, thereby preserving our primary surplus objective.

Macroeconomic framework

14. **The better-than-expected outcomes for 2002 are clear evidence that our targets for 2003 of 5 percent growth and 20 percent inflation are appropriate and feasible with the strict implementation of our program strategy described in this Letter.** The strong recovery in 2002 bodes well for growth in 2003, which we continue to project at 5 percent, in light of strong performance in the early months of the year for industrial production and notwithstanding downside risks resulting from the war in Iraq. On the inflation front, the CPI inflation rate declined to 29.7 percent in 2002 from 68.5 percent in 2001, suggesting that our 2003 target of 20 percent remains feasible. In 2002, the main source of growth was stock building. However, in 2003 we expect growth to be driven by private fixed investment and consumption. The low base for private consumption and steadily increasing capacity utilization rates in private industry support these expectations. But regaining consumer and investor confidence with strict program implementation will be the most crucial factor in fostering final domestic demand.

15. **In support of these targets, we will continue to pursue our strategy of fiscal discipline, gearing monetary policy to achieve the inflation target, and instituting deep structural reforms.** We remain resolute to maintain a tight fiscal stance, including prudent public sector wage and employment policies and fitting any additional spending program within the public sector primary surplus target of 6.5 percent of GNP for 2003 and beyond. This underscores our strong commitment to maintaining sound debt dynamics. A move to formal inflation targeting will further strengthen the monetary

policy framework, while implementation of our comprehensive structural reform agenda will enhance medium-term prospects for economic growth and employment.

Fiscal policy and public sector reform

16. **Our 2003 public sector fiscal program is designed to yield a public sector primary surplus of 6.5 percent of GNP.** Given the policy slippage in 2002, this implies fiscal adjustment equivalent to about 2½ percent of GNP from the outturn of 2002. In the interim budget covering the first quarter, we held discretionary spending constant in real terms. We have since specified a number of measures, totaling 4.9 percent of GNP, to bring us to a position consistent with our full-year target (see Annex C for a more detailed discussion). Key measures include increases in tobacco and alcohol excises (already implemented), increases in motor vehicles and property taxes, rationalization of the public investment program, tight wage restraint, and steps to limit expenditure growth through efficiency gains in health care and social security. On March 3, we submitted to Parliament a central government budget consistent with our primary surplus target. Prior to passage, we identified and incorporated into the budget further expenditure cuts needed to meet our World Bank supported targets for Direct Income Support and social aid transfers. On March 29, Parliament passed the budget, which is consistent with the primary surplus target, meeting a **prior action for the review**.

17. **Our fiscal program for 2003 will fully protect social spending.** We have already provided pensioners with an additional support payment for 2003 (amounting to 0.9 percent of GNP). Overall, social spending (comprising health, education, and social protection) will show an increase to 17.9 percent of GNP in 2003 from 17.5 percent of GNP in 2002. As discussed below, we will also reform social security with a view to improving the efficiency of administration and targeting of benefits.

18. **In 2003, we will pursue a prudent incomes policy, to help both our fiscal adjustment and disinflation efforts.** Civil service wages were increased moderately in January. Any further increase later in the year will be in line with the initial budget appropriation. For public workers, we expect the ongoing negotiations to result in an agreement that reduces the difference between the public workers' wages and civil servant salaries, the ratio of which is currently around 2. Moreover, civil servant salaries and public worker wages will not be subject to backward-looking indexation. More generally, the Economic and Social Council will be instrumental in conveying the government's commitment to breaking the cycle of backward-looking indexation to all parties involved in wage setting in the economy. The Council will next meet in April 2003.

19. **In the context of the 2003 budget, we are taking several measures to ensure that the budget is implemented as specified, without expenditure overshooting and revenue underperformance as in 2002:**

- The budget abolishes the authority for line agencies to spend above budgeted appropriations for some items, such as personnel expenditures, transfers to social security institutions, and green card health spending. All legitimate tax rebates will, however, continue to be paid.

- We will eliminate all special appropriations in the context of passage of the Public Financial Management and Financial Control Law by end June. We will also prepare and pass legislation by end-June to eliminate the accounts and give authority to the Ministry of Finance to collect the revenues.

- The new Public Finance and Debt Management Law strictly controls revisions to foreign-financed investments, including by incorporating for the first time foreign project credits disbursed in-kind into initial investment appropriations.

- The use of general contingent appropriations will be limited to exceptional circumstances, and transfers from investment acceleration appropriations will be restricted to a small amount for each investment project. Shifting appropriations within institutional budget items or investment projects will be restricted to 10 percent of the total initial appropriation of the line item to which the resources have been transferred.

- We will continue with our policy of surveying for expenditure overcommitments every 6 months (the last such survey, at end-2002, revealed only a small amount of payment arrears, mainly on utilities, related to either insufficient appropriations or ongoing disputes with suppliers regarding the amount billed). By end-2003, we will have adapted our accounting system to record expenditure commitments, so that a more systematic approach to monitoring can be taken in 2004.

- We will improve collection enforcement of public receivables, and provide collection administrations with the necessary tools to deal with arrears on their own initiative. To support these efforts, the Prime Minister has announced that there will be no future amnesty for or generalized rescheduling of tax arrears or any other public receivables.

- Finally, to better monitor fiscal performance in 2003, we propose to expand the coverage of the performance criterion on the primary balance of the consolidated government sector to include the extrabudgetary Social Aid Fund and two more SEEs, Türk Telekom and TPAO (Annex D). Since these three were previously the main components of an indicative target for the primary balance of other entities, we propose dropping that indicative target.

20. **To support medium-term fiscal target of a continued 6.5 percent of GNP public sector primary surplus, we will pursue reforms to raise the efficiency of the public sector.** As outlined in the Government's Action Plan, we will focus on two key issues:

- **We will overhaul the administrative and institutional framework for managing social security.** By end-April 2003 we will enact legislation for SSK, İş-Kur, and Bağ-Kur which establishes the administrative mechanisms to support earlier pension reforms, and provides firm legal grounds to implement our 2003 social security measures (a **new structural benchmark**). By end-2003, we will enact new framework legislation with the aim to include all three pension institutions under one organization (the legislation would also enact any necessary parametric reforms to ensure the medium-term solvency of each individual fund). Health insurance and non-pension transfers (for example, for social services) would each be transferred to separate institutions.

- **We will reform public administration.** In particular, we will complete a functional review of government by July 2003. The primary objectives of this review are to restructure the public management in a citizen and sector oriented manner, accelerate the decision-making process by simplifying public organizational structure, and reduce public expenditures. To follow up on this, by end-2003, the Council of Ministers will adopt a civil service reform strategy. This strategy will include: establishment of norms for personnel positions; introduction of objective recruitment and promotion criteria; streamlining of the job ladder; and simplification of the compensation system.

21. **With a view to strengthen our medium-term fiscal planning, we will also improve our management of contingent liabilities in the energy sector.** By end-April 2003, we expect to have prepared a detailed estimate of contingent liabilities arising from BOT (build, operate, and transfer), BO (build and operate), and TOOR (transfer of operating rights) contracts and the contracts for the mobile plants. Based on the findings of this report, the electricity BO, BOT, and TOOR contracts and natural gas take or pay contracts will be reviewed with the relevant parties to reduce the medium- and long-term financial impact of these contingent liabilities.

22. **To support the fiscal program in 2003, we will pursue fiscal-structural reforms vigorously:**

- **The second phase of our ongoing tax policy reforms, involving direct tax reform, will soon be completed.** The direct tax reform legislation was submitted to Parliament on March 25, 2003. Consistent with our tax strategy, this legislation will, among other things: (i) harmonize taxes on financial investment income at the declaration stage; (ii) reduce investment allowances and eliminate the withholding tax applied on them; (iii) eliminate the current double taxation of corporate earnings and dividends; and (iv) reform the system of credits against income tax. This legislation was approved by the Parliament's budget commission on April 2, 2003 (meeting a **prior action for this review**), and we expect it to be passed by the whole Parliament by end-April 2003 **(a new structural performance criterion)**. Subsequently, we will further rationalize direct taxation by submitting to Parliament by end-May legislation to minimize geographical, sectoral, and other investment incentives (including, in line with earlier commitments, the progressive reduction of benefits in Free Trade Zones). We expect that this legislation will be approved by Parliament by end-June 2003 (**a new structural benchmark**). Also, by end-June 2003 we will develop and implement through government decree proposals to harmonize taxation of financial income at the withholding stage, with due regard to financial sector stability. To improve the transparency of future tax policy, and help preserve the benefits of the direct tax reform, beginning with the 2004 budget we will publish details (including estimated costs) of remaining tax exemptions and incentives.

- **We attach particular importance to improving taxpayer compliance.** Our Tax Peace plan, which restructured tax arrears, is the last such benefit taxpayers will receive. There will be no tax amnesties or restructurings, and in support of this aim, we intend to fundamentally reform the tax administration. Drawing on OECD experience, and maintaining the accountability of the General Directorate of Revenues (GDR) to the Minister of Finance, we will by end-year upgrade its operational efficiency. We also expect to complete the functional reorganization of the GDR by end-June 2003 and will begin to extend this structure to the local level. During this process we will establish direct vertical lines of accountability and upgrade the taxpayer service function to devote more attention to taxpayer types. We have already taken steps to strengthen tax administration operations this year. The budget for 2003 includes resources to employ 400 new tax auditors, and in January our new audit coordination unit completed an audit coordination plan which targets audit resources to high-risk areas. Our ongoing automation project will enable us to make better use of taxpayer identification numbers during audits. During the 2004 budget cycle we will further increase IT and human resources devoted to audit.

- **We are taking steps to bring our program of eliminating redundant positions in state enterprises back on track.** As of end-January 2003, we were some 10,000 short of the end-October 2002 target of 30,600. We have now developed a strengthened plan to first catch up with this interim target and then reach our revised goal of eliminating all the identified 45,800 redundant positions by end-December 2003. On March 26, 2003, the Government adopted a regulation lifting existing restrictions on retirement of public sector workers (as laid out in Prime Ministry Circulars No. 1996/16 dated March 25, 1996 and No. 2001/51 dated December 3, 2001), enabling SEE managers to address the redundancy problem in their enterprises. We believe this will result in a cumulative reduction in the number of redundant positions, starting from end-January 2003, by 9,900 by end-June 2003, 19,400 by end-September 2003, and 25,074 by end-December 2003. The number of eligible retirees exceeds the number of redundant positions in some companies and falls short in others (the mismatch amounts to 5,025 workers). To achieve our target in each state enterprise, we will transfer redundant workers ineligible for retirement into state enterprises which have open positions due to excess retirements (subject to the transferees having matching qualifications). The regulatory change and the intention to complete the elimination of redundant positions by end-2003 will be announced publicly. The adoption of the government regulation and the public announcement will be **prior actions** for the fourth review, while the quantitative targets listed above will be **structural performance criteria**. To ensure that our steps will achieve lasting reductions in public employment, open redundant positions will be permanently eliminated. To help enforce this, we will fully implement a quarterly monitoring system for general government employment by mid-May 2003, meeting a structural benchmark with delay. Since we are extinguishing a public sector liability, the net costs of retrenchment will again in 2003 be excluded from the calculation of the public sector primary balance for program purposes up to TL 500 trillion.

- Forthcoming **public expenditure management reforms** will further consolidate the improvements we have made in the area of fiscal transparency. The 2003 budget will incorporate the revenues and expenditures under Law 3418 and an appropriation for the risk account, and extend budget classification and coding reforms to general government on a pilot basis. However, owing to the delay of the budget debate until March, it will take a little longer than originally envisaged to pass the new Public Financial Management and Financial Control Law (a structural benchmark for end-March). In fact, some time will be needed to iron out inconsistencies with other legislation (including the recent public debt and procurement laws, and audit legislation) and the distribution of responsibility and accountability across the three key institutions involved with budget management. The balance between the independence and fiscal accountability of regulatory boards also needs to be improved, and provisions giving rise to on- and off-budget earmarking mechanisms corrected. To allow the law to become effective in time for the 2004 budget cycle, we will pass it by end-June 2003 (a **new structural benchmark**).

- **We will steadfastly implement the new Public Procurement Law, which became effective on January 1, 2003.** The new procurement framework is an important signal of the government's commitment to fiscal reform and fighting corruption. It is broadly in line with international standards. It has been prepared after wide consultation with the World Bank and the EU. We will monitor the implementation of the new system under the law. If improvements are deemed necessary, we will consult with World Bank and IMF staff on possible amendments.

- **We will strengthen the governance framework for state enterprises.** It did not prove possible to submit to parliament amendments to the existing governance law by end-2002 (a structural benchmark) due to elections and the need to focus on more pressing budgetary matters. In any event, we have now decided to expand the scope of this reform, and completely overhaul the existing legislation, to help prepare the ground for privatization. We intend to clarify state enterprise goals (including financial targets), set new accountability standards, and enhance management autonomy and internal governance. Accounting, reporting, and audit arrangements will be reviewed. We expect parliament to pass this legislation by June 2003 (a **new structural benchmark**).

Debt management

23. **We continue to make progress in improving debt management:**

- In September 2002, **we introduced a strengthened primary dealer system** that deepened the market for government debt, with all participating banks meeting their obligations.

- To reduce risks and improve the financing picture for 2003, **we will continue our policy of building a deposit buffer at the CBT** through borrowing in excess of redemptions when market conditions allow. In addition, we seek to develop a cash management mechanism to borrow and lend short term as provided for in the new Debt Management Law.

- **We have developed a risk-based debt management strategy.** In September 2002, the communiqué on coordination of debt and risk management was published. It was subsequently strengthened in January 2003 by defining the risk control functions of the middle office. In November, an internal circular, defining the operational procedures of the debt management committee, was introduced.

- **Capacity building efforts continued throughout 2002, and we expect the middle office to become fully operational by end-2003.** Studies on the formulation of a strategy for public liability portfolio, valuation of contingent liabilities, definition of simple strategic benchmarks, and development of risk management system were carried in consultation with the international advisors. The simple strategic benchmarks for 2003, as mentioned in the Letter of Intent dated July 30, 2002, were introduced in January 2003. The performance of the debt portfolio will be reviewed against the strategic benchmarks on a quarterly basis.

- In addition, **we will submit quarterly Debt Management Reports to Parliament** to increase the transparency of debt management operations and public awareness on the management of public liability portfolio, starting from April 2003.

Financial sector reform

24. **Progress has been achieved in all four main pillars of the BRSA's banking restructuring strategy.** The private banking sector is further strengthened, efforts are continuing on the resolution of the SDIF banks and disposal of the assets held by its Collection Department, restructuring and privatization of the state banks is progressing, and the regulatory and supervisory framework is being strengthened.

25. **The soundness of the private banking sector is improving with increases in capital adequacy ratios and reductions in risk exposures.** The average capital adequacy ratio of private banks has increased to 16.4 percent as of September 2002. Banks are further reducing their vulnerability to risks as open foreign exchange positions remain well below the regulatory limits and interest rate risk is declining due to the issuance of floating rate notes by the Treasury. In addition, the recapitalization program and the three-stage audit process have ensured that non-performing loans are properly provisioned for.

26. **We will also be taking the following measures to support the rapid resolution of the overhang of nonperforming assets of the banking sector:**

- The Ministry of Justice has prepared a package of comprehensive **reforms of the Execution and Bankruptcy Act**. These reforms are aimed at creating an effective bankruptcy system that will provide appropriate incentives for voluntary workouts in good faith. The early elections prevented us from meeting the structural benchmark on enacting these reforms by end-January 2003. The Ministry of Justice has since reviewed the comments received on the package, and the Government submitted the package to Parliament on March 25, 2003. We expect Parliament to pass the reforms by end-May 2003, meeting the structural benchmark with delay.

- The **Istanbul Approach for corporate debt restructuring** is progressing gradually. Since July 2002, 216 applications have been made, 96 restructuring agreements have been concluded, and US$3.6 billion of corporate debt has been restructured as of end-January 2003. The reform of the Execution and Bankruptcy Act will further improve the effectiveness and the pace of the debt restructuring process.

- To facilitate **resolution of banks' bad assets**, on September 18, 2002 the BRSA approved a regulation governing the establishment and operation of asset management companies. Moreover, by end-June 2003 we will introduce an exemption from value-added tax for second-hand loan and collateral sales by banks, nonbank financial institutions, and asset management companies to promote the rapid disposal of nonperforming loans and to facilitate the establishment of private asset management companies.

- Finally, **to sustain the profitability and the capital adequacy levels of the banks**, we will establish an inter-agency working committee comprising of the representatives of the Treasury, Ministry of Finance, Central Bank, State Planning Organization, and the BRSA. By end-May 2003, the Committee will develop an action plan to reduce the intermediation costs of the banking sector, including costs imposed by taxation, reserve requirements, and other duties imposed by various institutions (a **new structural benchmark**). This action plan will be implemented as monetary and fiscal conditions permit.

27. **The SDIF is continuing efforts to resolve the remaining intervened banks, although in some cases progress has been hampered by legal challenges.** Since no investor expressed an interest in its purchase, Toprakbank's license was revoked by the BRSA as of September 30, 2002 (meeting a structural benchmark). The bank's bad assets were transferred to the SDIF's Collection Department, and remaining good assets and liabilities were merged into Bayindirbank, which remains as a bridge bank. Tarişbank was sold to Denizbank on October 25, 2002. Türk Ticaret Bank was put into voluntary liquidation by the vote of its General Assembly on August 9, 2002. However, the Istanbul Commercial Court has issued a preliminary injunction halting the liquidation, and final resolution will depend on the outcome of this legal case.

28. **The resolution of the ownership issues surrounding Pamukbank and its sister bank, Yapi Kredi is underway.** While we had originally hoped to complete Pamukbank's sale in December of last year, this had to be suspended temporarily following the injunction of the General Assembly of the Administrative Lawsuit Chambers of the Council of State (Danıştay). Following agreement with Pamukbank's former owner on January 31, 2003, we now have implemented a comprehensive solution that will underpin the future of these two banks. Reflecting our commitment to transparency, the main details of the agreement have been published. As a result of the agreement:

- The SDIF has again taken control of Pamukbank and has reinstated its sales process, extending the period for offers for sale to be made to March 28, 2003. Since no offers were received by that date, the BRSA will again put the bank up for sale, with the bids to be submitted by June 13, 2003.

- The continuity of Yapi Kredi will be safeguarded, with the majority shareholders bearing the financial cost and assuming full responsibility for its successful resolution. The SDIF will exercise ownership rights through the stake it has acquired through taking over Pamukbank; it will also continue to exercise the ownership rights, excluding rights to dividends, of Yapi Kredi's majority shareholder (who is no longer regarded as fit and proper). Bank management will be appointed by an advisory firm of international repute, conditional on the final approval of the SDIF.

- If the majority shareholder is unable to sell its shares in Yapi Kredi within two years, they will be sold by an investment bank of international repute in the third year. Looking forward, the bank will be required to maintain its capital adequacy ratio above 10 percent.

29. **Compliance with the above agreement will be closely monitored.** To safeguard the public interest, we have developed a matrix defining responsibilities for implementing all parts of the agreement. To monitor the process and to assess the bank's financial condition and capital adequacy, a special committee has been established, which will

report quarterly to the SDIF and BRSA boards, and publish a summary of its findings, including the efforts to sell the bank. External auditors will be required to monitor the compliance of all parties to the agreement and to assess the bank's financial condition and capital adequacy annually. If either assessment reveals a shortfall of capital, SDIF will provide the capital needed to maintain a CAR of 10 percent in the event the majority shareholder fails to inject the capital needed. Yapi Kredi's violation of the single borrower lending limit will be resolved in the context of the sale of the bank.

30. **The SDIF has developed a detailed strategy for disposal of assets held by the SDIF Collection Department (meeting a structural benchmark).** The strategy announced on September 20 is in line with international best practice. However, the end-October structural benchmark for putting loan portfolios with face value of at least US$250 million up for sale, with bids to be submitted by end-2002, was missed. Initial market soundings also revealed that going ahead with the auction prior to the enactment of the bankruptcy and foreclosure law would negatively impact the results. To expedite the process, the SDIF will complete all technical preparations (including selection of the loan portfolio, and ensuring that all data and documentation issues are resolved) and announce the sale by end-June 2003 (a **new structural benchmark**), by which time the comprehensive bankruptcy reform will have been passed.

31. **With assistance from the World Bank, we have made good progress in the financial and operational restructuring of Ziraat and Halk and are proceeding with our plans to prepare them, together with Vakif, for privatization:**

- As of end-January 2003, 803 branches of Ziraat and Halk had been closed (compared with the planned 800), and the number of employees in these banks has been reduced to below the planned 32,000. The Government will continue to refrain from interfering in the commercial decisions of state-owned banks, and continue to adhere to the implementation of prudential and commercial banking principles as stipulated in Law No. 4603. Hence, any new lending by the two state owned banks will continue to be provided based on commercial criteria of creditworthiness and applicable interest rates. Ziraat and Halk will not carry out any subsidized lending practices without an appropriation in the government budget and prior payment as stipulated by law. The Sworn Bank Auditors of the BRSA will certify at the end of every quarter that (i) the financial statements of Ziraat and Halk reflect a true and fair picture, (ii) lending by Ziraat and Halk is being done on the basis of commercial creditworthiness, and (iii) any subsidized lending is based on an appropriation in the government budget and prior payment. Also, the external auditors of Ziraat and Halk will be requested to confirm in their annual statements that loans have only been extended based on commercial principles.

- On **Ziraat**, we are in the process of defining an appropriate corporate structure in advance of its privatization, which will take into account the sui generis role of the bank in providing public services and finance to the agricultural sector. Both activities shall continue to be carried out in line with standard commercial banking principles. However, the bank is in the process of solving the existing agricultural credit stock problems accumulated in previous years. Loans which were extended and fully utilized before January 31, 2002, and are classified as non-performing and which are fully provisioned, will be restructured on terms and conditions determined by the bank. They will be repaid in six semi-annual installments, the first installment due as of the restructuring date. This measure will help the bank to collect on its overdue loan portfolio, and to enable both debtors and guarantor agricultural producers to be eligible for financing by the banking system.

- For the privatization of **Halk** Bank, a strategic study will be carried out by independent outside consultants. This study will be commissioned by end-April 2003 and completed by end-September 2003. It will look into the future strategic directions of this bank, the prospects for different sectors of the economy, and the appetite of possible international and domestic investors, considering all options and formulations to make the privatization feasible. We anticipate that the privatization of Halk will take place in 2004, with Ziraat following soon afterward.

- On **Vakif**, after the first unsuccessful sale process, the bank has undertaken both operational and staff restructuring and has divested some of its nonfinancial assets. A strategy for the sale is being developed by the bank in consultation with the World Bank, with the aim of completing the sale by end-October 2003.

32. **We are also taking the necessary measures to further strengthen the regulatory and supervisory framework.** In this context:

- At present, the Treasury is responsible for **supervising nonbank credit institutions**, even though many of them are owned by banks. We will transfer the regulation and supervision of these companies from the Treasury to the BRSA effective September 1, 2003 following passage of the relevant legislation. In preparation for this transfer, the BRSA has conducted a reorganization study.

- Taking into account recommendations of a World Bank study on non-bank financial institutions, the Treasury has devised a plan for strengthening the **regulation and supervision of insurance companies**. Among other things, the Treasury will send to the Council of Ministers by end-April 2003 a new draft law to regulate insurance companies in line with applicable EU Insurance Directives. This legislation will move the regulatory framework closer to IAIS core principles.

- The BRSA is strengthening its banking supervision through **introduction of risk-based supervision**. BRSA has received training on risk-based supervision and has developed an action plan to introduce risk-based supervision. In preparation for implementation of Basel II, banks have been asked to participate in a comprehensive survey in terms of their product/service profiles, business lines, risk management processes and internal control systems. The outputs of the survey will enhance BRSA's capacity to make a more realistic risk assessment for individual banks as well as for making sector-wide assessments.

33. **We will strengthen the BRSA's financial and operational independence in light of its fundamental mission of strengthening Turkey's banking system.** The BRSA needs regulatory independence to bring international standards to the Turkish banking sector; supervisory independence to perform its operations and to grant and revoke licenses; institutional independence to manage its personnel and develop the careers of its personnel; and financial and operational independence in managing its resources. Accordingly, the Government will make every effort to preserve the BRSA's independence. As a first step, we will prepare legislation that will strengthen the effectiveness of the BRSA, including amendments to the Banking Act and related laws that will set out clear grounds for legal appeal of BRSA decisions, with firm deadlines and time limits for their consideration, by end-June 2003 (a **new structural benchmark**). These amendments include: (i) setting up a specialized chamber at the State Council that will only consider the administrative cases against the independent institutions; (ii) accelerating the consideration of administrative lawsuits against the BRSA by shortening the time limits and declaring such cases as priority cases, and (iii) informing the BRSA about temporary injunction appeals and calling both sides for a hearing before the decision regarding a temporary injunction is made. The Government is ready to pass these into law by end-October 2003 (a **new structural performance criterion**). The Government will also ensure the BRSA's financial independence by providing it the freedom to make spending decisions to carry out its operations.

34. **The BRSA has taken steps to improve the transparency and accountability of its operations.** The BRSA's accountability is already enshrined in Law. Each year, the BRSA must report on its activities to Parliament, and its expenditures are audited by representatives from the High Audit Board of the Prime Ministry, and Inspection Boards of the Prime Minister's office and the Ministry of Finance. The Minister responsible for the BRSA also reports on the BRSA's activities to the Council of Ministers. BRSA operations can also be examined by the State Supervisory Commission, which is under the control of the Presidency of the Republic. The BRSA has improved its accountability and transparency through issuance of regular reports on the strengthening of the private banking system, and through press releases clearly explaining its actions. Looking forward, we will improve this further, in the context of the new Public Financial Management and Financial Control Law.

Monetary and exchange rate policies

35. **The objective of monetary policy is to reach the inflation targets, with a view to bringing inflation down to single digits over the medium term.** In 2002, the CBT has met all monetary performance criteria and indicative targets. Adherence to the program, and the adoption of the new Central Bank Law in 2001, have helped to reduce inflation expectations. This has allowed the Central Bank to significantly lower overnight interest rates, from 80 percent (compounded) in January 2002 to their current level of

55 percent. Inflation ended 2002 at less than 30 percent—its lowest end-year level in two decades—and by February 2003 fell further, to 27 percent. This year the goal of monetary policy will be to reduce inflation further, to 20 percent. Sustained disinflation efforts should bring Turkish inflation rates to single digits over the medium term, which will be more closely in line with Turkey's trading partners and will also promote sustainable economic growth.

36. **While base money targets are still our main monetary policy anchor, we expect to supplant these with a formal inflation targeting regime soon:**

- **We have developed a quarterly base money program for 2003 consistent with our projection of 5 percent real growth and our end-year target of 20 percent inflation** (Annexes G–I) As in the 2002 program, the monetary targets are subject to modification if there is strong evidence of a shift in the demand for base money.

- **Although our intention had been to introduce formal inflation targeting by the end of 2002, the exact timing of its adoption will be determined following the approval of the new budget, taking into account internal and external prospects.** The success of the inflation-targeting regime will hinge on achieving a favorable internal environment (including sustained fiscal discipline, reducing backward-looking indexation, and supportive incomes policy—all of which are policy priorities in this Letter of Intent) along with the existence of a favorable external environment. Once the inflation targeting regime is adopted formally, the CBT will announce the operational details of this framework via press releases and Monetary Policy Reports. Notwithstanding this slight delay, already in 2002 the CBT completed its institutional and technical preparations for inflation targeting. These preparations have included: (i) strengthening economic databases and reporting packages; (ii) development of inflation forecasting systems; and (iii) preparation of a core quarterly macroeconomic model. Building on its earlier efforts, including the publication of statistics and reports on its operations and policies, the CBT will further improve its dissemination of the rationale for monetary policy decisions, through issuance of additional press releases related to Monetary Policy Council meetings.

- **Although the CBT will maintain the existing framework for monetary policy during this transition period, once formal inflation targeting is in place, the monetary program's performance criteria will be revisited accordingly.**

37. **We remain committed to the floating exchange rate regime.** However, as before, the CBT could intervene in the foreign exchange market in a strictly limited manner to dampen excessive volatility. The CBT also stands ready to reintroduce foreign exchange purchase auctions, depending on developments in the balance of payments and currency substitution, given our longer-term objective of strengthening our international reserve position.

38. **In support of the floating exchange rate regime and the move to inflation targeting, we continue to make progress in strengthening foreign exchange and money markets:**

- The **measures already introduced** in 2002 (including lengthening the averaging period of reserve requirements and raising the proportion of reserve requirements where averaging is applied, removal of stamp duty on forward contracts and tax on interbank foreign exchange transactions, and introduction of one-month deposit auctions) have all helped stimulate money and foreign exchange market development. As a result, the daily average interbank foreign exchange transactions volume increased steadily from US$128 million in July 2002 to US$338 million in January 2003.

- The **CBT's gradual withdrawal as a blind broker** for banks in the foreign exchange and money markets has been concluded as of December 2002. The CBT ended its intermediation function in the forward market in March 2002, in the market for foreign currency banknotes in July 2002, and in the foreign exchange market in September. Moreover, as of December 2002, the CBT has completed its gradual withdrawal from the interbank money and foreign exchange deposits markets, which started on July 1, 2002.

- On August 1, 2002, the Turkish Banks' Association launched **the Turkish Lira Interbank Offer Rate (TRLIBOR)** which provides an interbank reference rate for transactions of a specified size (TL 1 trillion). 13 banks, each with assets exceeding US$1 billion, are participating.

- **State-owned banks have been allowed to re-enter the overnight money market**, but with their exposure restricted to no more than 2 percent of deposits. This will allow them to participate in the quotation of reference rates for TRLIBOR.

- **A key priority for 2003 will be to reduce tax distortions and increase efficiency of the money and foreign exchange markets.** For this purpose, through tax harmonization in the context of the direct tax reform (see above), we will take the following steps: (i) the BITT on interbank deposits and repo transactions will be eliminated, once fiscal conditions permit; and (ii) CBT bills will be subjected to the same tax regulations as government securities, so as to improve the efficiency of the monetary policy tools.

Enhancing the role of the private sector

39. **The Government regards independent regulatory boards operating in line with international best practice as essential for a well-functioning market economy.** These boards include the Capital Markets Board, the Competition Authority, the Banking Regulation and Supervisory Agency, the Telecommunications Regulatory Authority, the

Energy Markets Regulatory Authority, the Tobacco Board, and the Public Procurement Agency. The independent boards have helped de-politicize economic management in Turkey by creating a level playing field and transparent rules of the game for investors and protection for consumers in strategic sectors of the economy. They have also contributed to improved public expenditure management and more effective government. The Government is committed to protect the financial and operational independence and specific regulatory authorities of the boards as set out in their respective establishment laws. At the same time, the Government is committed to ensure full accountability of the regulatory boards. This accountability will be enhanced by the Public Financial Management and Financial Control (PFMFC) law to be adopted by end-June 2003. The PFMFC law will also provide for audit of the boards on behalf of Parliament by the Turkish Court of Accounts (TCA) following an appropriate transition period during which the TCA will implement its own internal reforms. In parallel with establishment of this framework for enhanced accountability, the Government will remove unnecessary ex-ante controls on expenditures by the boards—including visa approvals by the Ministry of Finance—and will ease restrictions on salaries of their staff.

40. **In 2002, the privatization targets were not fully met, in part because of the elections.** Total sales reached US$540 million, of which cash proceeds accounted for US$260 million, against an indicative target for cash proceeds of US$700 million. Among the privatization activities since the previous program review in August, in November 2002 PA shares in DİTAŞ (crude oil transportation) were transferred to the other major existing shareholder, TÜPRAŞ, for US$16.5 million. In addition, in the third quarter of 2002, we tendered out the sale of four TDİ ports, TAKSAN (machinery), GERKONSAN (iron and steel), İGSAŞ (fertilizer), TZDK (agricultural equipment) and four facilities of SEKA (paper and pulp). Negotiations regarding the four TDİ ports and two facilities of SEKA, initiated in 2002, have been finalized, and will be submitted for approval by the Privatization High Council by end-April 2003. The rest of these tenders were renewed in February 2003, as no sufficient bids could be collected during September 2002 tenders.

41. **In 2003, privatization is a top agenda item in the Government's program.** The Government has conveyed its strong intentions by announcing the 2003 privatization program on January 13. Annex L lists the companies to be sold under this program in detail. Moreover, the Privatization Administration (PA) is examining the related legislation to include the Istanbul Stock Exchange, the Istanbul Gold Bourse, the National Lottery Agency, and Halk Bank in its portfolio. The new program aims at attracting a wider range of investor interest and is expected to yield US$4 billion in 2003. The Government will concentrate on privatization of large public companies, but will also sell some medium and small-sized public assets. To highlight the main efforts:

- The PA, working with international consultants, has formulated a privatization plan for **TEKEL**, including strategies for dealing with the key issues of over-employment, debt settlement, and excess inventory. Owing to the elections, this plan could not be adopted in 2002. However, on March 31, 2003 the Privatization High Council approved the plan, meeting a prior action for this review.

- Since the present market conditions do not support a global offering, the PA is proceeding with the preparations for the privatization of **TÜPRAŞ** through a block sale to a strategic investor in the second quarter of 2003. Other methods (such as a convertible bond issue) that would result in a majority privately owned company could also be considered depending on market conditions.

- With regard to **Türk Telekom**, the Council of Ministers was unable to adopt a privatization plan by end-November 2002 (a structural benchmark) since the necessary amendments to the Telecom Law could not be passed owing to the elections. The plan is now expected to be approved by the Council of Ministers by end-April 2003. This strategy will aim to divest at least 51 percent of the company through: (i) a single block sale, or (ii) a combination of block sale and public offering, or (iii) a public offering. The plan may also include provisions for convertible bond offerings.

- Concerning **TŞFAŞ** (**ŞEKER, the sugar company**), the road map for its privatization is expected to be approved by the Privatization High Council by end-June 2003.

42. In the **electricity sector,** we will move decisively with the preparation for sale and privatization of key assets. As a first step, distribution will be reorganized into 33 entities. The number of distribution entities may be further consolidated. Similarly, power plants will be grouped into multiple-plant entities by end-April 2003. These distribution and generation entities (excluding those subject to legal process regarding TOORs) will be transferred under the scope of privatization by mid-May 2003. Following preparatory work—by the PA to ready the companies for sale and by the Energy Market Regulatory Authority to ensure a well-functioning energy market—the distribution entities will be transferred to the PA portfolio by end-September 2003. The tenders for the distribution entities will start in December 2003. To complement this process, the government will determine the best way to resolve the outstanding transfer of operating rights (TOOR) contracts expeditiously, based on a review and estimate of the contingent liabilities attached to such contracts to be completed by end-April 2003.

43. **We expect all the efforts described above to provide a major boost to privatization.** We have already announced that our privatization program for 2003 is expected to yield sales of US$4 billion. Consistent with this, and taking into account the pipeline from last year, we have set quarterly indicative targets for cash proceeds, with a full-year target of US$2.1 billion (Annex M).

44. **We are continuing our efforts to improve the private business environment.** While there has been a pause since political uncertainty caused the postponement of the inaugural Investor Advisory Council (IAC) meeting scheduled for July 2002, the Coordination Council for the Improvement of the Investment Climate and the nine technical committees established last year resumed their meetings in mid-December 2002. A decision of the Council of Ministers has been issued on the organizational

structure and the operational procedures of the Coordination Council for the Improvement of the Investment Climate. In 2003, the Council of Ministers will take further steps to improve the investment climate, as emphasized by the Action Plan of the Government, guided by the recommendations made in the Coordination Council's reports. Taking the calendar of events into account, we will try to determine the most appropriate timing for the inaugural meeting of the IAC. Moreover, we are preparing (i) a new draft law on Prohibition and Prosecution of Smugglers, (ii) legislative amendments to simplify and streamline the company registration process, and (iii) new legislation establishing an Investment Promotion Agency, so that all three are ready to be submitted to parliament in April 2003. Also the new draft law on Foreign Direct Investment has been resubmitted to Parliament, and we expect it to be enacted by end-April 2003 (a **new structural benchmark).** Moreover, to improve corporate governance and support banking reform, the draft regulation regarding the operations of the Turkish Accounting Standards Board was prepared and submitted to the Prime Ministry and related Ministries for review. In addition, a communiqué, regarding the implementation of 30 international accounting standards (in line with IIAS) previously put in force, was prepared and submitted to the related institutions for review. Similarly, we expect parliament to pass legislation to establish the Turkish Auditing Standards Board by October 2003.

45. **Our steps to improve public sector governance will also enhance the private business climate.** A national strategy to enhance transparency and good governance in the public sector was adopted in January 2002. The basic structure and actions of this strategy has been reflected in the Urgent Action Plan (UAP) of the Government. The Government is undertaking efforts to improve public awareness about good governance and is counting on the active contribution of national NGOs. The Government is committed to implementation of the UAP which is in line with the framework set out in the national strategy. A ministerial committee for enhancing transparency and improving good governance was established in March 2003. The committee will steer relevant actions of both the UAP and national strategy in this reform area The responsibility for implementation of each action is clearly specified in the UAP. The ministerial committee will prepare regular implementation reports for the national strategy within the context of the UAP. Among a comprehensive set of actions is the Law on "Freedom of Information for Citizens", which has already been drafted and sent to agencies for comments and is expected to be passed by end-September 2003. Legislation establishing a code of conduct for civil servants and public administrations is expected to be passed by end-July 2003, meeting a structural benchmark with delay.

Follow-up on safeguards assessment

46. **We continued to strengthen the transparency and effectiveness of the CBT's control, accounting, reporting, and auditing systems, including in the context of the IMF safeguards assessment, which is required for all new Fund-supported programs**. In particular, the CBT has taken further steps to reorganize its internal audit function, including the adoption of a new charter and the appointment of the head of the newly created internal audit department. By the end of 2002, the CBT formulated an

implementation plan identifying staffing levels, reporting lines, scope of audits, risk assessment methodologies, and developing an internal audit manual and training programs. With these actions, an end-2002 structural performance criterion under the program was met.

Very truly yours,

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