REPUBLIC OF TURKEY
PRIME MINISTRY

Ref: B.02.1.HM.0.DEİ.02.00/500/45057 Ankara, July 15, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Dear Mr. de Rato,

1. **Adherence to our macroeconomic program has enabled Turkey to ride recent market turbulence with limited adverse effects.** Our floating exchange rate regime as well as our strong fiscal position have helped us adjust promptly to a combination of tighter international capital markets and pressures on the current account balance resulting from strong import demand and higher oil prices. We have continued to experience broad-based growth from the production side as well as the demand side, and we confidently expect to meet, or exceed, our program projection of 5 percent growth this year. Consumer price inflation has fallen to 9 percent, a new decades-long low.

2. **We are determined to end the "stop-go" economic policies of past years.** The recent pace of consumer demand growth as well as related imports, if continued, could have posed risks for the sustainability of our growth trajectory. However, a rise in market interest rates and slowing of credit growth should contain domestic demand while lira depreciation will impact the current account balance. The over performance of budget revenue should help to dampen demand pressures.

3. **In order to sustain rapid growth over the medium term we are also pressing forward with our ambitious economic policy agenda.**

- **We have met or exceeded most fiscal and monetary targets set under the program**. The primary surplus targets for March and April have been comfortably exceeded, as has the target for net international reserves. The base money target for April was missed by the narrowest of margins.

- In the area of **structural policies**, we have moved forward decisively in most areas although some unavoidable delays have arisen (Annex A). BRSA has assessed the strength of the banking system prior to replacing the blanket guarantee with a more limited deposit protection scheme. SDIF has revalued its assets and announced a new strategy for asset sales, excess capital in state banks has been removed and key elements of a strategy for restructuring and eventual privatization will be announced shortly. The wholesale revision of the Banking Act, however, is delayed to ensure adequate consultation with stake holders and will be passed on to parliament in

September. We have also driven forward our fiscal reforms: draft revenue administration restructuring legislation has now been completed and will be submitted to parliament shortly; the Commission on SEE governance has completed its work; and, the code of conduct for civil servants was approved by parliament on May 25. We have continued to refrain from introducing any new amnesty on public sector receivables, meeting a continuous performance criterion.

4. **In light of this strong performance, we request the completion of the Eighth Review under the Stand-By Arrangement.** Based on our exceptional record in reducing inflation and the resulting increase in currency demand, we request a waiver of nonobservance for end-April 2004 base money performance criterion. Performance criteria for the remainder of the program are set out in Annex B. We will continue to consult the Fund about the progress being made in implementing policies supported by the Stand-By Arrangement, and in advance of any changes to these policies.

Macroeconomic framework

5. **We remain on course to achieve our macroeconomic objectives for 2004.** Consumer price inflation has fallen to single digits, while growth in the first part of the year has been stronger than anticipated. Although higher world oil prices and the depreciation of the exchange rate in April and May could raise the level of consumer prices temporarily, we are well on track to meet our target of 12 percent inflation at end-year. These same factors, together with the recent increase in interest rates, should slow domestic demand growth in the coming months, bringing output growth more closely in line with the 5 percent program projection. On the external side, we expect a current account deficit of some 3½ -4 percent of GNP with strong exports and tourism receipts in large part offsetting higher imports. In light of strong net capital inflows early in the year our net international reserves position will be maintained.

6. **For 2005 and beyond, our emphasis will be on maintaining disinflation and debt reduction through sustaining our high primary surplus.** This environment should permit growth to continue at around 5 percent. We expect inflation to further slow to 8 percent by end-2005. In order to continue reducing real interest rates we will maintain our tight fiscal policy in 2005. Our 2005 budget call will be consistent with our medium term debt reduction strategy.

7. **We are finalizing our medium-term program aimed at accelerating economic convergence with the European Union**. Our economic policy priorities ahead are focused on tax reform – aimed at base broadening and rate reductions, affordable health and social security reform, and completing restructuring of the banking sector. We will continue our close policy dialogue with the Fund in 2005 and beyond.

Fiscal policy

8. **Fiscal policy remains on track to meet, or exceed, our 6.5 percent of GNP public sector primary surplus target in 2004.** Strong revenues as well as expenditure shortfalls

have contributed to this performance through end-May. We intend any revenue over performance to provide a cushion to help ensure that the 2004 budget can be fully implemented.

9. To ensure **full implementation of the approved budget and an appropriate fiscal stance** we have:

- Scaled back tax incentives for automobile purchase. From May, the automobile excise deduction available for new car purchase has been cut from TL4.5 billion to TL2.3 billion.

- Written over to the budget TL1.2 quadrillion of special revenues cutting the scope for extra budgetary spending appropriations as a prior action for this review. While this amount is slightly lower than previously envisaged, our intention remains to transfer TL2.5 quadrillion special revenues for the whole year.

- Increased petroleum excises. In light of the exceptional increase in world oil prices in recent months, excises were lowered temporarily to limit the pass through to domestic prices. As oil price increases now appear not to be temporary, we have increased petroleum excises effective June 29, only narrowly falling short of budget assumptions (structural benchmark for the review). Adjusting excises in line with budget assumptions remains a structural benchmark. The petroleum product market will be liberalized on January 1, 2005 with prices determined by market forces.

- Maintained our incomes policy consistent with our inflation objective. Public sector wages and salaries have been increased in line with the inflation target. The Minimum Wage Commission announced the minimum wage for the remainder of 2004, with an increase in line with those of public workers and civil servants and with no budget compensation for employers.

- Submitted the draft decree to the Council of Ministers to eliminate the RUSF levy on commercial credits later this month as a further step to reduce financial intermediation costs.

- Finally, significant future changes in tax policy will be aligned with the budget cycle.

10. **We are moving forward in implementing our structural reform program to support a sustained improvement in Turkey's fiscal performance**.

- Draft **revenue administration restructuring legislation**, including provisions to make GDR a semi-autonomous agency within the Ministry of Finance, reorganization along functional lines, and to move tax policy functions into the Ministry of Finance has been finalized. The draft legislation will be submitted to Parliament before end-July (structural benchmark). However, parliamentary passage (July structural benchmark) has been delayed due to a heavy legislative agenda. Passage is now expected by end-October 2004 (new structural performance criterion).

- Our strategy for enhancing **state enterprise governance** (May benchmark) is complete. The strategy entails introducing performance targets, strengthening the accountability and efficiency of management, and allowing performance and financial auditing by external auditors. We will complete the legislative changes in line with the strategy by end-2004.

- We have improved our **public sector personnel system**, through passage of legislation to establish a code of conduct for civil servants and public administrators (June benchmark).

- **The Ministry of Labor has developed a framework for analyzing social security reforms**. Over the Summer we will work on a range of reform options. We will decide our preferred pension system reform strategy by end-September 2004 (new structural benchmark). This strategy will include unification of the existing three pension institutions and an objective to place the pension deficit on a firm downward path by 2007 and to reduce it to 1 percent of GNP over the long term. In the area of health insurance, we plan to have a phased introduction of universal health coverage with any additional expenditures covered by compensatory measures. We will submit this reform package to parliament in mid-December 2004 (performance criterion) with a view to passage by January 2005 and a phased implementation during 2005-07.

- In the context of preparing **legislation for the decentralization of some central government functions to municipalities and special provincial administrations** we will ensure that budgetary discipline is maintained. The legislation will limit municipalities and special provinces debt stock to no more than annual revenue. Metropolitan municipalities debt stock will be limited to 1.5 times annual revenue. Debt limits will be reviewed and tightened, if necessary, in the context of forthcoming legislation concerning intergovernmental relations. New domestic borrowing of all local governments in excess of 10 percent of annual revenues will require central government authorization. The legislation will also require local governments to disseminate timely and accurate fiscal data to enable monitoring and will be complemented by separate legislation that clarifies intergovernmental fiscal relations. A committee is preparing a comprehensive report on the current level of local government debt, including enterprises under local government control.

- **Arrears of local governments**, including penalties and interest, will be dealt with on a case by case basis by a newly created Commission empowered by law to restructure claims, subject to Council of Ministers' approval. Formal settlements will be guided by the ability to pay, contain adequate safeguards for repayment including claw back of central government transfers, and will be made public.

Monetary policy

11. **Monetary policy remains focused on achieving this year's 12 percent inflation target, and reducing inflation over the medium term**. With inflation falling faster than anticipated, demand for base money has again exceeded our projections, causing the end-April performance criterion on base money to be missed by a fractional amount. In light of this increase in money demand we have raised our base money targets for the remainder of the year (Annex B). While our policy of implicit inflation targeting has been successful, we are making progress toward the eventual adoption of formal inflation targeting.

12. **The floating exchange rate regime remains central to our ability to adjust promptly to changing global circumstances**. At end-April we terminated foreign exchange purchase auctions in response to a decline in foreign exchange supply occasioned by banks closing their positions and a reversal of hitherto strong portfolio inflows. Since then we have intervened once in a small amount to dampen excessive exchange rate volatility, and such discretionary intervention will continue to be strictly limited. The recent exchange rate depreciation represents a correction largely in response to tightening global capital markets and a weakening of the current account balance. Its impact on the price level should be contained, and monetary policy will aim to limit second-round effects on inflation.

13. **Coordination between the Treasury and the CBT in their respective policy areas of debt management and monetary policy has been strengthened.** Coordination at the operational level, on a daily basis, is working well. To further enhance the effectiveness of policy coordination we will prepare a joint CBT-Treasury action plan, by end-September 2004, to address remaining legal, regulatory or procedural obstacles (a new structural benchmark).

Financial sector reform

14. **Our efforts to strengthen the financial system continue to move ahead** across several fronts. In particular, through strengthening the legal framework for banking activities, disposing of assets of liquidated and intervened banks, and restructuring state banks for privatization.

- We have completed a comprehensive **review of the Banking Act and prepared a new draft Law on Credit Institutions** to bring the legal framework more closely in line with EU standards. The law will place particular emphasis on strengthening the legal framework in the following areas: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections; (iii) lending to related parties; (iv) legal protection for BRSA and SDIF board members and staff for actions taken in good faith during the course of their duties; and (v) delineating the responsibilities of BRSA and SDIF respectively and providing for their effective coordination. By end-September, 2004, we will conduct seminars for the banking community and other stakeholders to help contribute to the understanding of the new law's principal objectives and features. We will submit the draft law to Parliament by end-September 2004. We expect

Parliament to pass the Law on Credit Institutions with the features above by end-November 2004 (new structural performance criterion). We are committed to maintain the operational and financial independence of the BRSA and the SDIF in the new banking act and other relevant legislation.

- **Regulation and supervision of non-bank financial institutions will be transferred from the Treasury to the BRSA** by January 1, 2005.

- **The Imar bank inquiry** is underway. The commission was appointed in late April and is expected to present its findings to the government in a final report, to be made public by end-August 2004 (performance criterion).

- We have reassessed the **value of SDIF asset holdings** to foster a better understanding of the recovery rates that might be expected from asset sales. To this end, for each intervened bank the SDIF will, in mid-July, announce the value of assets taken over at the time of intervention, accrued interest based on market rates as of end-June 2004, estimated market values (or recovery rates), and the costs borne by SDIF for restructuring or liquidating banks.

- Our **new strategy for SDIF asset resolution** has been announced (structural benchmark for April 2004). The main features are: (i) at end-May 2004, an offer was made to all borrowers except bank owners and individual borrowers to repay all outstanding debt by July 15 with a discount of 50 percent applied to principal and discounted interest, or to pay a 20 percent down payment with a discount of 30 percent on the remaining balances paid in installments over a 24-month period; (ii) in mid-July will re-launch the auction that was cancelled in December with bids to be submitted by August 16 and the winning bid to be selected by end-August (new structural benchmark); (iii) thereafter, new portfolios will be put up for sale by auction periodically until all assets have been disposed; (iv) for assets sold individually SDIF will always obtain a third party opinion about the price; and (v) all asset sales will be conducted transparently ensuring a fair and equal process.

- Our plan for **the resolution of Treasury receivables from the SDIF arising from financing the restructuring of the banking system** by end-2004 is on track.

- The **blanket guarantee** was lifted on July 5, 2004 and replaced with a limited deposit protection scheme protecting savings deposits up to TL 50 billion. Before the replacement, the BRSA undertook a thorough assessment of banking system soundness (April structural benchmark). A brief summary of the assessment has been published. In parallel, the CBT also assessed the effect of the abolition of the blanket guarantee on the Turkish payments system.

- The key elements of our **new strategy for state banks** will be announced shortly (a June structural benchmark**.** Legislation for the integration of Pamukbank into Halkbank is expected to be approved by Parliament shortly. All legal, managerial and financial issues regarding the integration, will be completed by end-August 2004 (a new structural benchmark). The integration is expected to be completed by end-October 2004. Treasury will recapitalize Pamukbank and eliminate the negative net worth before integrating Pamukbank and Halkbank. Over time, Treasury will also replace Halkbank's holding of non-marketable securities with securities issued on market terms. The strategy for Ziraat bank has been developed and will be announced by end-July. Our objective remains to privatize these banks as soon as the restructuring is complete and when market conditions permit.

- The **due diligence for Vakifbank** has been delayed. The terms of reference have been finalized, the bank is in the process of hiring a consultant, and the due diligence will be completed by end-September 2004 (new structural benchmark).

Private sector development

15. As a follow up to the **Investment Advisory Council** (IAC) meeting in March, we have prepared draft legislation to streamline permission and approval procedures for investors. Moreover, we revised the draft law on establishing an Investment Promotion Agency and reflected the views of the various stakeholders. Our work also extends to the effective protection of intellectual property rights enforced by new legislation. We will submit a progress report to the Prime Minister and IAC members by October 2004.

16. **Our privatization program is delivering good results and we have made progress on some legal and procedural issues**. In the first quarter, cash receipts from privatization reached U.S.$311 million, exceeding the indicative benchmark. We have amended public procurement legislation to simplify the hiring of advisors, and are preparing legislative amendments to facilitate sales of minority holdings.

17. Due to a **legal ruling halting the sale of TÜPRAŞ** we may fall short of our annual privatization receipts target of U.S.$3 billion, though we are determined to maintain forward momentum. To this end, a law enabling the sale of more than 45 percent share of Türk Telekom to foreigners is approved and we expect to launch the tender process before the end of the year. We are also planning public offerings for 10-15 percent shares of PETKIM (petrochemicals) and Turkish Airlines. Privatization of the National Lottery is pending parliamentary approval of the legal framework, and then we will proceed to a request for proposals.

Very truly yours,

Ali Babacan
Minister of State for Economic Affairs

Süreyya Serdengeçti
Governor of the Central Bank of Turkey