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. **Our Fund-supported economic program continues to deliver on its central objectives.**

- Buoyed by the completion of the fifth review and our ongoing structural reforms, **market confidence** has markedly improved. Foreign reserves build-up has been higher than projected and net international reserves are now positive for the first time under the program. Treasury's borrowing terms have improved substantially, with benchmark government bond yields now at about 30 percent, reflecting increased demand for Turkish lira assets. On the international side, Turkish sovereign bond spreads have continued to decline relative to other emerging markets. Further reflecting improved investor confidence, our recent US$1.25 billion Eurobond issue was heavily oversubscribed.

- **Real sector performance** has also continued to strengthen. With cumulative inflation of less than 14 percent through end-September, our 20 percent end-year inflation target looks well within reach. With strong growth during the first half of the year, and several indicators, including industrial production, capacity utilization and exports, performing strongly, the program's 5 percent growth target may well be exceeded.

2. **Strong policy implementation is playing an important role in delivering these gains.**

- We met all monetary **performance criteria and indicative targets** for end-September. While the end-August performance criterion on the consolidated government sector primary balance was missed, the fiscal measures taken during the fifth review are now taking effect. To help ensure that the fiscal program is on track for the remainder of 2003, we have implemented an additional TL 0.8 quadrillion measures, mainly on the spending side. Draft legislation aimed at strengthening the effectiveness of BRSA has been submitted to Parliament but will not be passed by end-October. Therefore, the structural performance criterion regarding the Parliamentary passage of this legislation will be missed. But the legislation is expected to be passed shortly, certainly before Board consideration of the Sixth

Review. We have also refrained from introducing any new amnesty on public receivables, in line with the new continuous performance criterion.

- As **prior actions** for the sixth review we expect that: (i) the Cabinet will approve the second phase of direct tax reform, which progressively transforms free trade zones into export processing zones in line with international best practice, and targets regional incentives at employment generation in lower income regions, and (ii) the Parliament will pass the Public Financial Management and Control (PFMC) Law, setting out a clear framework for budget preparation, execution, and control.

- On the **structural reform** side, while some 33,060 redundant positions have been eliminated since the beginning of 2002, the end-September targeted reduction in redundant SEE positions (some 19,400 positions since end-January this year) was missed by some 7,000 positions. However, 3,600 positions were eliminated in the first two weeks of October, including delayed reduction of redundant positions in TEKEL in preparation for privatization. In addition, by mid-October, 3,500 positions were eliminated in some SEEs in excess of their original target. We believe our progress should be assessed taking into account this overperformance, particularly as we are canceling these positions. We are also taking steps to reinvigorate the process and expect to meet the end-year target. We are submitting legislation to Parliament on an augmented, but time-limited, SEE redundancy package. This is expected to be passed shortly. We have also requested the World Bank to change the terms of their severance payment-support program so that the available financing could be utilized in preparation for, rather than after, privatization of SEEs.

3. **To build on our success, we have formulated a strong macroeconomic framework and policy agenda for 2004.** Our updated structural reform program is outlined in Annex A, with the new fiscal and monetary program set out in Annex B. To preserve our recent foreign reserves accumulation, we request that the end-December net international reserve floor for end-December 2003 be increased by US$4.0 billion. We also request that NIR floors be adjusted up by half of any amounts of U.S. financing drawn down under the recent US$8.5 billion loan agreement (see below), and, in light of the increase in demand for Turkish lira deposits, we ask that the end-December base money target be adjusted. Finally, to capture more accurately the primary surplus of the public sector, we ask to widen the coverage of the primary surplus performance criterion to include 27 SEEs, instead of 12, starting in 2004 (Annex D).

4. **Against this backdrop, we request completion of the sixth review under the Stand-By Arrangement.** Based on the remedial measures we have taken, we request a waiver for the nonobservance of the end-September 2003 performance criterion on reductions in SEE positions; a waiver of applicability for the end-October primary balance of the consolidated government sector, for which data will not become available until mid-December; and a waiver of non-observance of the structural performance criterion on Parliamentary passage of the legislation aimed at strengthening BRSA effectiveness. 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 are aiming for continued strong macroeconomic performance in 2004.** Our determined implementation of the program and improved financial conditions should help deliver 5 percent real growth in 2004. We also believe that our monetary policy stance and supportive fiscal and incomes policies will further reduce inflation in line with next year's 12 percent target. The current account deficit is expected to stabilize in the period ahead as domestic demand and oil prices moderate and tourism recovers. Together with a strong capital account, helped by increased privatization-backed foreign investment and other private capital flows, this should maintain our net reserve position.

Fiscal policy

6. **We remain fully committed to our primary surplus target of 6.5 percent of GNP to support debt reduction and increase the resilience of the economy.**

- **We fully expect to meet this year's remaining fiscal targets.** In support of this aim, we have taken additional measures that will be reflected in the planned supplementary budget. These include revised expenditure ceilings reflecting currency-related gains on imported inputs, investment spending cuts, and some increase in excises that result in savings of TL 0.8 quadrillion.

- **For 2004, we have submitted to Parliament our budget consistent with a primary surplus target of 5.0 percent of GNP in central government and are planning to maintain the primary surplus for the rest of the public sector at 1.5 percent of GNP.** Our guiding principle in designing the 2004 budget has been to reduce the primary expenditure-to-GNP ratio in order to create room for elimination of some of the one-off measures that were put in place in 2003, introduce inflation-adjusted accounting, and reduce selected taxes on financial intermediation. In the draft 2004 central government budget, nominal expenditures are increased only in line with inflation, facilitating a decline of some ¾ percent of GNP in the expenditure ratio. Within this envelope, social spending relative to GNP has been protected.

- **To facilitate achievement of our fiscal target, we have taken a number of measures.** Special transaction and communication taxes and the PIT/CIT surcharge have been extended through next year; we are looking into ways of converting some of these taxes to more efficient and permanent sources of revenue. On the expenditure side, several measures have also been taken, including a continued hiring limit for civil servants, a hiring freeze for central government workers, and cuts in off-budget spending and the transfer of the associated special revenues to the budget.

7. **We will also press ahead with our fiscal structural reform program**. We observed key program conditions on direct tax reform and public financial control legislation, which will help lay the groundwork for improved medium-term fiscal performance (see above). In further support of this objective:

- We are taking steps to ensure that the next phase of **social security** reforms does not conflict with our broader fiscal goals. To this end, we will complete a detailed assessment of the fiscal implications of various options for social security reform by end-December 2003 (new structural benchmark). We will also introduce measures to offset any fiscal costs before the reforms are introduced.

- We will further improve the **transparency** of the public sector accounts. Building on the progress made when the "extrabudgetary funds" were brought on budget as special accounts, we will close these accounts, terminate special appropriations, and write over to the budget all special revenues. We will legislate these changes by the end of 2003 to take effect on January 1, 2005.

- Draft **state enterprise governance** legislation, for which Parliamentary passage is a structural benchmark for end-December 2003, is in the consultative process stage. A framework law, setting out the principles of public governance, and clarifying the division of labor between central agencies and local governments, consistent with the PFMC law is also being prepared.

- In order to broaden the tax base, we have requested technical assistance from the Fund to identify ways of bringing the informal economy into the tax net. Building on this work, we intend to upgrade our **revenue collection** through new tax administration reform legislation, which will be prepared by end-January and is expected to be passed by Parliament by end-March.

Monetary policy

8. **The CBT's monetary policy will remain focused on achieving the inflation target—20 percent by the end of this year and 12 percent by the end of 2004**. With all monetary program targets having been met through end-September, the appreciation of the Turkish lira and decline in inflation expectations have improved the prospects for meeting the inflation target. This has allowed us to steadily lower interest rates. In light of the recent increase in demand for Turkish lira deposits, we have adjusted our end-December base money targets. We have also extended our base money program through 2004, while the conditions for introducing formal inflation targeting are being put in place. As in previous years, program targets could be modified if there is strong evidence of a shift in base money demand.

9. **We remain committed to the floating exchange rate regime**. In light of the strength of the balance of payments and continuing reverse currency substitution, we have conducted foreign exchange purchase auctions, allowing us to exceed our end-September

program target for net international reserves by more than US$7 billion. To consolidate these gains, we are raising the end-December NIR program target by US$4.0 billion, and setting new NIR targets for 2004. While we have intervened on a few occasions to dampen excessive exchange rate volatility, such discretionary intervention will continue to be strictly limited. Foreign exchange purchase auctions will continue to be adjusted in light of prospective foreign exchange supply.

Financing

10. **We recently reached agreement with the U.S. authorities on a financial package totaling US$8.5 billion.** The package, which has a grant element of US$1 billion, would be made available in four equal tranches at approximately six-monthly intervals. Our borrowing strategy for 2004 does not depend on the availability of these funds. However, should we draw on this financing, we would use it for debt reduction. This would also enable us to raise our deposit buffer at the CBT, one for one above our current projection, and to build up our net international reserves. If we were to draw down the deposit buffer later, we would use it, at least for the first tranche, to repay debt denominated in foreign currency. This approach could then be revisited in future reviews.

Financial sector reform

11. **We are pressing ahead with our reforms to strengthen the banking system.** The independence of the Banking Regulation and Supervision Agency (BRSA) is being strengthened, progress is being made in resolving Pamuk bank and asset sales are proceeding as planned. We intend to phase out some financial transaction taxes to further promote intermediation. We have also started to implement a plan for compensating eligible depositors at Imar bank.

12. **The BRSA's independence is being strengthened.** We have submitted to parliament legal amendments expediting court cases involving the BRSA (performance criterion) and expect that the proposed legislation will be passed shortly. These amendments include: (i) setting up a chamber at the State Council that will specialize in cases against independent regulatory institutions, including the BRSA; (ii) accelerating the consideration of administrative lawsuits against the BRSA by introducing strict deadlines; and (iii) informing the BRSA about temporary injunction appeals and holding preliminary hearings before final decisions are taken. To help preserve the BRSA's independence, we have also provided for the direct submission of the BRSA budget to parliament under the new PFMC Law covering independent agencies. In the same vein, we are working on a new Framework Law for independent agencies (including the BRSA) consistent with the PFMC Law.

13. **The oversight committee for Yapi Kredi has published its first report**. This report confirms that the bank has continued to restore its balance sheet by selling off fixed assets and equity participations.

14. **The Pamukbank sales process will be brought to a close before end-December 2003.** The preferred option is to sell the bank while any remaining assets and liabilities will be transferred to the bridge bank, Bayindirbank. If the sales process cannot be completed, Pamukbank will be resolved by merger or liquidation. The Treasury will issue the necessary government securities to facilitate the resolution strategy.

15. We have started to implement a plan for compensating eligible depositors at Imar bank.

- **Under the plan eligible depositors will be protected**. Deposits with a value of about US$6 billion backed by matching securities will be transferred to Ziraat. Eligible depositors will be compensated with upfront cash payments in amounts up to TL 10 billion and given passbooks for remaining deposit amounts. These passbook deposits will be repaid according to a preannounced time schedule.

- **We are also committed to a detailed follow-up inquiry on Imar.** We will conduct an investigation into Imar's losses and are committed to make available whatever resources are needed to maximize recoveries to help lower the burden to the public sector. At the request of the BRSA, an independent inquiry is being launched into lessons to be learned from the Imar case and how to strengthen the supervisory framework, external bank audits and other relevant agencies involved in supervising financial markets. The findings will be used to help strengthen supervisory functions, and the report will be published by end-May 2004.

16. **Preparations for the sale of Vakif are progressing.** We will initiate two due diligence tests of Vakif to determine its financial condition and market value, to be completed by end-February 2004. Based on the outcome of this exercise, a decision will be made within one month of the completion of the due diligence test on the method of sale of the shares held by the General Directorate of Foundations.

17. **The privatization of Ziraat and Halk is being delayed** until a decision has been made on the resolution of Pamuk and Vakif. The Sworn Bank Auditors have confirmed that lending procedures in the state banks during the first six months of this year were based on commercial principles.

18. **Financial transaction taxes will be further lowered to support bank intermediation.** Selected stamp duties will be abolished from January 1, 2004. We also intend to reduce other intermediation taxes, including the Resource Utilization Support Fund levy and the Banking and Insurance Transaction tax, but in a phased and gradual manner.

19. **We are also taking other necessary measures to reform the banking system and to strengthen the supervisory framework:** (i) we will submit legislation to Parliament enabling the transfer of the regulation and supervision of **nonbank credit institutions** from the Treasury to the BRSA, effective January 1, 2004; and (ii) a portfolio of **SDIF assets** with

a face value of US$330 million has been put up for sale, with final bids to be submitted by December 8, 2003.

Enhancing the role of the private sector

20. **To further increase the role of the private sector in the economy, we expect to complete soon the privatization of key SEEs.** Despite some technical setbacks in the privatization program, we plan to finalize the privatization of TUPRAŞ and TEKEL by end-2003 and of PETKIM in early 2004. Despite cash privatization proceeds of only US$144 million so far this year—meaning that the end-September indicative target on privatization proceeds was not observed—we believe that the end-year privatization receipts target of US$2.1 billion remains within reach. We have prepared the privatization strategy for Türk Telekom, which the Council of Ministers is expected to adopt shortly (structural benchmark). Next year we are committed to proceeding with the privatization of Türk ŞEKER, Turkish Airlines, the National Lottery and other state-owned enterprises. We expect cash revenues from privatization to reach US$3 billion in 2004.

21. **We are also continuing to improve the business climate in Turkey.** To promote Turkey as a foreign direct investment destination, legislation establishing the Investment Promotion Agency has been prepared and is expected to be considered by Parliament in early 2004. The inaugural Investor Advisory Council meeting is planned to be held in Spring 2004. In further support of the business climate, we have prepared draft legislation establishing a code of conduct for civil servants and public administrators, and intend to submit it to parliament shortly for passage by end-2003 (structural benchmark).

Very truly yours,

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