REPUBLIC OF TURKEY
PRIME MINISTRY

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Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Dear Ms. Krueger,

1. **Following a year of successful macroeconomic management under our Fund-supported program, the economy is now at its strongest in a generation.** Last year, annual inflation fell to 18½ percent—below target for the second year running—with further declines in the first few months of this year. The economy grew by around 6 percent in 2003 exceeding the 5 percent growth projection, and is now in its third year of strong recovery, with key indicators showing continued strength. Financial markets remain positive, with benchmark bond yields halving last year to stand now at close to 20 percent.

2. **To build on the achievements of 2003, we are deepening and advancing the economic reform agenda.** Therefore, in addition to continuing with the macroeconomic policies that have yielded impressive results, we have formulated a comprehensive agenda for structural reform in 2004 (Annex A). These reforms are guided by our strong commitment to convergence towards European Union standards. The reforms that are detailed in this letter are aimed at putting the fiscal accounts on a more sustainable medium-term footing, moving the banking sector further in line with best international practice, and facilitating private sector development and investment.

3. **With regard to recent policy implementation, we have continued to make good progress under the program, although there have been some delays.**

- The program's **fiscal and monetary** targets were broadly met. We increased the public sector primary surplus to more than 6 percent of GNP in 2003—the highest ever recorded in Turkey and 2 percent of GNP higher than the 2002 outturn. All monetary performance criteria and indicative targets for end-December were met.

- On the **structural** side, we assessed the fiscal implications of planned social security reforms (meeting an end-December benchmark). While the end-2003 performance criterion on state enterprise redundant positions was missed, the *overall* reduction of positions—including positions not formally covered by the performance criterion definition—far exceeded the target.

- Due to a heavy legislative workload, legislation on the civil servant code of conduct and state enterprise governance has seen delays, as has the introduction of legislation and accompanying regulations covering pre-packaged bankruptcy provision (all December benchmarks). The code of conduct legislation has been submitted to Parliament and is expected to be passed shortly. Bankruptcy legislation was approved by Parliament in February, and the accompanying regulations are expected to be put in place shortly. We also refrained from introducing any new amnesty on public receivables, meeting a continuous performance criterion.

4. **We have also met several prior actions for this review to illustrate our commitment to take decisive steps to maintain the momentum of the program.** We have introduced remedial fiscal measures to secure this year's 6½ percent of GNP primary surplus target. We have also passed legislation for 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. On the banking side we have decided to resolve Pamuk bank by integrating it with Halk bank. We will also start the Imar bank inquiry shortly.

5. **Against this favorable backdrop, we request the completion of the Seventh Review under the Stand-By Arrangement.** Last year's central government surplus, of more than 5 percent of GNP, exceeded our target, although the state enterprise surplus monitored under the program fell somewhat short. The overall consolidated government sector balance was, however, better than the indicative target. Corrective fiscal measures have now been taken to ensure the achievement of the 2004 fiscal targets; accordingly, we request a waiver of applicability for the end-March 2004 performance criterion on the consolidated government primary balance. Based on our strong performance in reducing inflation and the resulting increase in currency demand, we request a waiver of nonobservance for end-March 2004 base money performance criterion. The base money targets for the remainder of the year are being revised upwards to reflect the increased money demand to date. We also request a waiver of nonobservance for the end-December 2003 performance criterion on the elimination of redundant SEE positions, in light of our strong record in reducing overall redundant positions in state enterprises.

6. **We also request a rephasing of remaining purchases.** In light of the period of time available before the arrangement expires, we request the number of remaining reviews be reduced from four to three. The outstanding access is to be spread evenly, with a final test date of end-December 2004 (Annex C). The arrangement would now expire on February 3, 2005. The associated fiscal and monetary program is set out in Annex B. To facilitate more timely monitoring within the new phasing, we have introduced an additional performance criterion on the primary fiscal balance excluding SEEs. 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**

7. **We remain confident that our macroeconomic objectives for 2004 will be achieved.** With lower real interest rates and increasing confidence, we expect private consumption and investment to be the main drivers of growth. Building on the recent impressive inflation performance, we believe that continued prudent macroeconomic policy will bring Turkey closer to achieving single digit inflation by meeting the program's 12 percent inflation target by end-year. On the external side, we expect the current account balance to be broadly unchanged as a percent of GNP (with strong exports and tourism receipts offsetting higher imports due to robust domestic demand) and increased net capital inflows (as market confidence continues). Our net international reserves position will be maintained.

**Fiscal policy**

8. **The 6.5 percent of GNP public sector primary surplus target remains a cornerstone of our program.** The recent minimum wage and pension increases—motivated by our concerns for the most vulnerable segments of Turkish society—created challenges for meeting this year's target, as have weaker-than-anticipated revenues. We are therefore implementing a package of corrective fiscal measures that are expected to yield TL 7 quadrillion (1.7 percent of GNP) over the remainder of 2004 (a prior action for the Seventh Review). Many of these measures are permanent to help secure not only this year's target but also the medium-term fiscal position.

- While protecting key social spending programs, we recently passed legislation cutting **discretionary expenditures** by 13 percent and reduced investment incentives, saving some TL 3.9 quadrillion (1 percent of GNP). In addition, we will write over to the budget an additional TL 0.5 quadrillion (0.2 percent of GNP) of special **revenues** during 2004, not appropriating them for the associated special expenditures. To help underpin the spending cuts, we will monitor public sector arrears carefully during the course of the year and will take early action if any pickup is detected. No further increases for pensions (other than the already announced 10 percent increase in July) are planned this year.

- Petroleum, tobacco, alcohol and gas **excises** have all been increased to yield TL 2.4 quadrillion (0.5 percent of GNP). Looking ahead, we will also ensure that state enterprise prices and excises are adjusted promptly in line with budget assumptions during the year (see Annex A).

9. **We are also committed to a comprehensive structural reform program to support a sustained improvement in Turkey's fiscal performance.** Many of these reforms are designed to control expenditures, broaden the tax base, and shrink the unregistered economy over the medium term.

- We plan to upgrade revenue collection through **tax administration reform**. Planned legislation will transform the tax administration office into a semi-autonomous body within the Ministry of Finance with its Head reporting directly to the Minister. Importantly, the new body will be reorganized along functional lines and tax policy will be transferred to the Ministry of Finance. In addition, all local tax administration offices will be transferred to the new entity.

  We will submit draft tax administration legislation to Parliament by end-May and expect parliamentary passage by end-July (both new structural benchmarks). We have already set up a steering committee to oversee the implementation of these reforms and to prepare an action plan with clear delineation of responsibilities and targets by end-April 2004. The committee will then coordinate the implementation of the plan until the restructured tax office commences its operations in January 2005.

- Social security deficits will be addressed to put the system on a sustainable path. We are updating our assessment of the fiscal implications of planned **social security** reforms as well as analysis aimed at identifying additional savings. In the area of pensions, this would include institutional reform of the three existing systems and parametric reform, to move the system to long-run sustainability. By end-June, we will develop a range of ambitious reform options, run the associated simulations, and present the findings to the Council of Ministers. Moving forward, we will adopt a rules-based approach to increasing pensions based on the new social security framework.

  Regarding the planned introduction of universal health insurance, we will put together a coherent and affordable reform package that seeks to offset the costs from wider insurance coverage by end-July. Also, by end-June we will abolish the minimum social security contribution base. Submission to Parliament of draft social security reform legislation consistent with sustainability objectives, along with separate legislation for compensatory measures, will be set as a new performance criterion during the Eighth Review.

- We intend to improve the quality of our fiscal adjustment efforts to help place our medium-term fiscal targets on a stronger footing. To this end, we have sought technical assistance from the Bank and the Fund for a **Public Expenditure Review.** We expect to receive a preliminary study on short-term expenditure rationalization by the Eighth Review, followed by a more comprehensive assessment in the second half of the year. Preliminary recommendations, especially from the short-term study, will help guide the budget process, beginning with the 2005 budget. In the meantime, to help improve expenditure control, we have tightened existing regulations governing the use of the contingency account.

10. **Our agenda includes several other ongoing fiscal structural reforms.**

- We remain committed to containing the **state enterprise** employment. Building on last year's reduction of redundant positions, we will adhere to our policy of strictly limiting new hiring in state enterprises. At most 10 percent of those leaving through attrition will be replaced at each state enterprise, with limited exemptions for specialist positions (a new indicative target). An enterprise-by-enterprise workforce monitoring system was put in place in 2002. This will be used to help ensure strict compliance with the hiring policy.

- We are committed to further improve the **transparency** of public sector accounts. To this end, we will submit to Parliament by end-April 2004 legislation that will, effective January 1, 2005, result in the termination of "special" off-budget accounts and appropriations and expect passage by end-May 2004. Starting from April 2004, we are also providing details on a monthly basis on the primary surplus outcomes on Treasury's website, including the aggregate accounts of extra-budgetary funds, social security accounts and, on a quarterly basis, state enterprises.

- Further improving **public sector governance** is an important program goal. The civil service code of conduct legislation was sent to Parliament and is expected to be passed by end-June (a structural benchmark). After extensive consultation across government agencies, we have set up a committee, which will prepare a report by end-May 2004 on the key elements of our state enterprise governance strategy, including on audits and controls and state enterprise accountability (a new structural benchmark). The committee's findings will be used to decide on a legislative agenda to strengthen state enterprise governance.

- The **Public Administration Framework (PAF) Law**, setting out the principles of public governance, including decentralization, and clarifying the relevant responsibilities of central agencies and local governments, consistent with the Public Financial Management and Control (PFMC) law, is expected to be passed by Parliament shortly. We have set up a working group to look into fiscal intergovernmental relations to facilitate the decentralization process. We are also preparing framework legislation for regulatory agencies consistent with the PFMC and PAF laws.

**Monetary policy**

11. **The CBT's monetary policy remains focused on achieving this year's 12 percent inflation target**. Last year, we met all monetary targets and succeeded in reducing inflation to 18½ percent, well below our 20 percent target. In light of increased real currency demand due to the fall in inflation and the increase in banks' required reserves, we propose raising our base money targets for the remainder of the year (Annex B). The targets will continue to be kept under close review and further modification would be proposed if there is strong evidence of a shift in base money demand. The strength of the Turkish lira, the decline in inflation expectations, and the deceleration of inflation in recent months mean that prospects for meeting this year's 12 percent target are very good. To mark this success in disinflation

and strengthened confidence in the Turkish lira, in January Parliament passed a law introducing a new redenominated currency next year (dropping six zeros from the currency).

12. **We remain committed to the floating exchange rate regime**. In light of the strength of the balance of payments, in January we re-introduced daily foreign exchange purchase auctions and in March and April increased the purchase amounts. This will further bolster our international reserves. While we have intervened on a few occasions to dampen excessive exchange rate volatility, such discretionary intervention will continue to be strictly limited.

13. **The success of our policies has induced capital inflows and reverse currency substitution, creating a challenge for monetary policy.** We have used this opportunity to accumulate reserves. However, the sterilization associated with reserve accumulation has created losses for the central bank in 2003. During 2004, the Treasury and the CBT will continue to coordinate closely in their respective areas of debt management and monetary policy. Relevant laws, regulations and procedures will also be reviewed to remove any impediment to effective coordination.

**Financial sector reform**

14. **We are undertaking a comprehensive review of the Banking Act.** By end-April we will complete the review of the Banking Act and prepare draft amendments to strengthen the Act in line with EU standards. Areas that will receive particular attention include: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections; (iii) legal protection of BRSA and SDIF staffs for actions taken during the course of their duties; and (iv) delineation of responsibilities between BRSA and SDIF. We will submit a revised Banking Act to the Council of Ministers by mid-May 2004 and to Parliament by the summer recess (a new structural benchmark). Adoption of the Act will be set as a new performance criterion during the Eighth Review.

15. **Further progress is being made on the Imar bank case.** Upfront cash payments were made to depositors in January, and passbooks, which will be repaid according to the announced schedule over the next 36 months, have been issued for the remaining deposits. The Imar bank inquiry will start shortly with the appointment of its chairman and approval of its terms of reference (prior action for the Seventh Review), and we will make public its findings by end-August 2004 (a new performance criterion). The SDIF has taken over several companies and other assets of the former Imar bank owners to help offset the cost of compensating depositors.

16. **We are currently working on a strategy and detailed action plan on how to prepare Halk bank and Ziraat bank for privatization.** The strategy would aim to increase the operational efficiency of these banks while ensuring a level playing field for competition in the banking sector. We will make public key elements and a timetable for the action plan by mid-June 2004 (a new structural benchmark). We have already announced that Pamuk bank will be integrated with Halk bank (prior action). The integration will be completed by

end-September 2004. If needed, Treasury will provide securities to facilitate the integration. For Vakif bank, the due diligence has been delayed as it will be based on audited end-2003 financial accounts. The due diligence will be completed by end-June 2004, and will be used to determine how to increase private participation in the bank.

17. **We are pressing ahead with reforms to facilitate asset collections:**

- The separation of the Boards of the **SDIF** and **BRSA**—designed to facilitate asset recovery and allow greater focus by the BRSA on its supervisory responsibilities—has now been completed. The new SDIF board took office in late January.

- SDIF did not complete the first auction of assets of intervened banks last December since the highest bid fell short of the Board's reference price. The new SDIF board is reconsidering the strategy for selling **SDIF assets** and will, by end-April 2004, announce revised strategies for the resolution of assets of intervened banks, including claims against former bank owners, and shares and companies taken over including those seized from the former owners of Imar bank (a new structural benchmark). The first asset disposal auction will be completed by end-July 2004.

- We will reassess 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, by end-June 2004, 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.

- Treasury has already issued debt to cover all **liabilities of the SDIF**. As of end-December 2003 SDIF liabilities amounted to US$36.2 billion, including US$13.6 billion of accrued interest. After the revaluation of assets and expected future recoveries, the SDIF and Treasury will, by end-December 2004, agree on the resolution of Treasury receivables from the SDIF.

18. **We are also making progress in other important areas of banking reform:**

- As previously announced, we intend to replace the **blanket guarantee** with a limited deposit protection scheme, in line with EU practices, on July 5, 2004. In preparation for this step, the BRSA will, by end-April 2004 present to the government a thorough assessment of the banking system (a new structural benchmark) and publish at the same time a summary of the presentation. In parallel, the CBT will also assess the effect of the abolition of the blanket guarantee on the Turkish payments system.

- We will submit, by the summer recess, legislation to Parliament enabling the transfer of the regulation and supervision of **nonbank financial institutions** from the Treasury to the BRSA, effective by January 1, 2005.

- Following the recent amendments to the **Execution and Bankruptcy Law**, implementing regulations are expected to be introduced shortly (a December 2003 structural benchmark).

**Private sector development**

19. **Privatization is accelerating.** A good start to the year has been made with the recent successful TÜPRAŞ auction (petroleum refineries), facilitated by Parliamentary approval, in December, of a new Petroleum Market Law. The winning bid for the 66 percent stake, of US$1.3 billion, was approved by the Privatization High Council in February and we expect the sale to be completed by mid-April. The sale of the alcohol unit of TEKEL, worth some US$300 million, was completed in February.

20. **We are determined to build further momentum in this area and have announced a comprehensive privatization strategy for the remainder of the year.** Having secured cabinet approval of a privatization plan for Türk Telekom last November, we expect to move ahead with the block sale of 51 percent of the shares by end-May 2004. We plan to announce a new strategy for the sale of TEKEL's tobacco unit by end-April 2004, and we will shortly hold fresh talks with potential investors in PETKIM (petrochemicals). This year we also plan to proceed with the privatization of ŞEKER (sugar refineries), up to a 15 percent stake in Turkish Airlines, and the National Lottery. We have adopted an electricity reform and privatization strategy, which envisages the launch of privatization tenders in energy distribution by March 2005. To expedite the privatization process, we will amend the public procurement and public contract legislation to allow for success fees and underwriting, and more flexibility in the hiring of consultants. We expect cash proceeds from privatizations to reach US$3 billion in 2004 (see Annex J).

21. **To encourage foreign direct investment, an inaugural Investment Advisory Council (IAC) meeting was held on March 15.** This high-level meeting included the participation of CEOs of a number of leading multinational companies, and developed many proposals that will help attract FDI in Turkey. We are carefully considering these proposals, and will draw up an action plan with the aim of presenting concrete results to the next meeting of the IAC.

Very truly yours,

Ali Babacan
Minister of State for Economic Affairs

Süreyya Serdengeçti
Governor of the Central Bank of Turkey