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10:00 a.m., October 10, 1984

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
J. de Groote	
	X. Blandin
	C. A. Salinas, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
	T. Alhaimus
H. Fujino	T. Yamashita
	B. Goos
J. E. Ismael	
	L. Leonard
A. Kafka	C. Robalino
G. Lovato	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	A. Steinberg, Temporary
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
	J. E. Rodríguez, Temporary
	A. Lindø
N. Wicks	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; U. Dell'Anno, L. Hansen, M. Z. Khan, G. F. Kopits, T. H. Mayer, G. Tyler. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Mookerjee, Deputy Director; G. Belanger, G. Oliveros, R. Pownall, P. M. Thomsen. Fiscal Affairs Department: A. L. Antonaya, M. Z. Yucelik. IMF Institute: P. R. Rado. Legal Department: P. L. Francotte, W. E. Holder, Ph. Lachman. Research Department: B. E. Rourke. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. E. Bonangelino, A. Caetano Filho, M. Caiola, D. S. Hoelscher, J. Jaramillo-Vallejo, C.-J. Lindgren, L. L. Pérez, S. J. Stephens. Bureau of Statistics: M. J. Brimble. Advisors to Executive Directors: H. A. Arias, J. Delgadillo, D. Hammann, S. M. Hassan, P. Péterfalvy, G. W. K. Pickering, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, W.-R. Bengs, K. Celebican, L. E. J. M. Coene, G. Ercel, V. Govindarajan, G. D. Hodgson, A. K. Juusela, H. Kobayashi, S. Kolb, K. Murakami, D. J. Robinson, A. A. Scholten, L. Tornetta, Wang C. Y., A. Yasseri.

1. TURKEY - 1984 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1984 Article IV consultation with Turkey and review under the stand-by arrangement (EBS/84/192, 9/7/84; and Cor. 1, 10/9/84). They also had before them a report on recent economic developments in Turkey (SM/84/215, 9/19/84; and Cor. 1, 10/9/84).

Mr. de Groote made the following statement:

> I would like to express the thanks of my Turkish authorities to the staff for its balanced assessment of developments and prospects of the Turkish economy, with which they are broadly in agreement. As the staff papers indicate, the present stand-by arrangement is basically on track: during the period up to June 30, 1984 all performance criteria have been met and, with the exception of inflation, economic developments are well aligned with projections.
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> The performance of the Turkish economy was less satisfactory in 1983 than during the previous two years, when remarkable results were achieved under a comprehensive Fund-supported program launched in January 1980 for stabilizing and structurally reforming the economy. In 1983 a rapid expansion of central bank credit took place, together with a post-midyear reduction in nominal interest rates; as a result, monetary policy for that year became expansionary. Trends in exports, imports, and workers' remittances, and a further deterioration in the terms of trade brought the current account deficit to 4.3 percent of GNP, up from 2.3 percent the previous year. Bad weather lowered the contribution of the agriculture sector to value added, while declining workers' remittances and an increased import volume caused a negative contribution from the real foreign balance. These factors slowed real GNP growth for 1983 to 3.2 percent, down from 4.1 percent in 1981 and 4.6 percent in 1982. At the same time, the growth of domestic demand, led by private comsumption and increases in stocks, accelerated to 4.3 percent, up from 1.6 percent in 1981 and 2.8 percent in 1982. Inflation, which had declined steadily over the two previous years, began to climb again and by the end of 1983 had increased to about 40 percent over the last quarter of 1982.
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> In December 1983, a newly elected Government led by Mr. Ozal took office and immediately instituted policies designed to get the economy back on the adjustment path, continuing the reforms begun in 1980. The new Government's economic strategy aims at increasing the market orientation of the economy, further opening up the external sector. This strategy will put the economy on the road to an adequate and sustainable growth rate. It will continue to require appropriate policies in the area of demand

management to control inflation and restore external equilibrium, and in the area of structural changes. The Government is convinced that a more outward-looking orientation of the economy is essential to the achievement of a sustainable balance of payments situation in order to optimize relations between growth and the balance of payments and ensure better resource allocation. Further improvement in the external sector must therefore come mainly from removal of both restrictions on trade and payments and the present complex system of foreign exchange controls. The achievement of sustained export growth moreover requires the application of a flexible exchange rate policy to strengthen external competitiveness, and tight demand management. To achieve these goals, the new Government began in December 1983 to apply a wide range of radical policy measures, including depreciation of the lira, broad reform and liberalization of the exchange and trade systems, reorganization of the Government's own administrative machinery, higher interest rates, and the commencement of overdue adjustments in administered prices.

The determined efforts and timely actions of the Turkish authorities in the implementation of this latest program have already resulted in considerable progress, particularly in the external sector. The very encouraging improvement in the external accounts during the first six months of 1984 was led by a significant increase in export receipts, coupled with a moderate increase in imports, and with inflows of new medium- and long-term foreign borrowings which reflect the much improved standing of Turkey in the international capital markets. This improvement in the balance of payments was achieved despite the drop in workers' remittances due mainly to unemployment and low wage increases in the host countries, the dollar's strengthening against European currencies, and a shift from direct remittances to deposits at the Central Bank. The improved export performance should yield a reduction of the current account deficit from 4.3 percent of GNP in 1983 to 2.9 percent in 1984 and achieve an overall balance of payments surplus of about $600 million, permitting some buildup in the net reserves of the banking system. Until now, foreign direct investment has been slow to respond to the gains in political and economic stability, and to the measures taken to encourage it, which include simplification of regulations and elimination of a number of formalities. On the basis of ongoing negotiations with foreign firms, the Government expects a substantial improvement of foreign direct investment over the medium term.

The improvement in the balance of payments during the first half of 1984, which is expected to contribute 1.0 percentage point to real GNP, together with favorable outcomes in the agricultural and industrial sectors, leads to the expectation that the real growth rate will reach 5.7 percent in 1984. However, the inflation rate surged unexpectedly in the first half of 1984, mainly because of a liquidity overhang, which had been permitted to develop since mid-1983, and its lagged effect on prices. These supplementary pressures have been aggravated by the impact of corrective, policy-induced price adjustments such as substantial increases in the prices of state economic enterprises (SEE), a sharp increase in the prices of some agricultural products, and movements in import prices. However, there are encouraging signs that prices have begun to decelerate during the second half of 1984.

I would like to comment further on three aspects of Turkey's external position: its export performance, its increased creditworthiness, and its medium-term prospects. Given the outward-looking reorientation of policy which took place in 1980, the performance of exports has been not only heartening but remarkable: the increase was distributed across the board with respect both to product groups and geographic market areas, despite adverse circumstances. The total value of exports rose by 62 percent in 1981 and by 22 percent in 1982, and only began to stagnate during 1983. This stagnation conceals a rise in export volume of 13 percent in that year. Since the introduction of the new policies and the continued efforts to liberalize Turkey's foreign trading sector, export values have resumed their previous growth and are 32 percent above their level a year ago. Even more striking is the fact that this gain was achieved while the world economy was experiencing a generalized trend toward protectionism, and specifically in the face of recent new protectionist measures on the part of Turkey's main trading partners. This strength indicates that the improvement in export performance is not an isolated phenomenon which will soon run its course and disappear, but will continue over the longer run: the GNP share of exports, at 11 percent in 1983, is indeed still rather small.

Over the last four years, Turkey has achieved an extremely good record on debt servicing, which together with its continued adjustment efforts, sound economic policies, and remarkable export performance, has been an important factor in restoring its creditworthiness. In addition, the structure of the total external debt, which includes a relatively small share of international commercial bank debt and a large share of obligations to official bodies and other governments, and the improved maturity structure of outstanding debt, have also enhanced Turkey's creditworthiness. According to the September 1984 issue of Institutional Investor, for the last two years "Turkey has remained the world's stellar performer in terms of improved credit rating." The Turkish case provides a striking instance of the principle that the upgrading process for any country certainly does not work as promptly as the process of deterioration. Turkey's downward slide took only about 90 days in 1977, but despite the current "success story" and increased creditworthiness, Turkey is still waiting for certain countries to give the official authorizations which would restore her eligibility for medium-term borrowing.

As to Turkey's medium-term prospects, Appendix II of the staff report gives four different medium-term scenarios for Turkey's external debt and balance of payments, one of which is based on the 1985-89 Five-Year Plan. Even though these scenarios assume only a moderate annual growth of export volume on the order of 8-12 percent between 1985 and 1989, they project a debt service ratio of only 20 percent by the end of 1989, compared with 32 percent in 1983; in fact, the actual increases in exports since 1980 have been higher than those assumed. The different scenarios amply illustrate that while gradually lowering its debt service ratio, Turkey can obtain higher income growth and lower unemployment only by pursuing its export-led economic strategy, and thus explain the authorities' determination to pursue this strategy vigorously to improve the medium-term performance of the economy even beyond the scenarios' projections.

As regards monetary policy, the Turkish authorities have asked me to confirm their view that interest rate policy is an important tool of monetary policy, especially for enhancing the effectiveness of demand management and stimulating domestic savings: to this end, with effect from January 1, 1984, the interest rates on time deposits were substantially increased and the withholding tax on interest income was reduced. At the same moment, banks were freed to determine general lending rates, and the financial transaction tax on lending rates was lowered. In parallel with these measures, the interest rates applicable to central bank discount facilities were substantially increased. The Central Bank is authorized to review interest rates on deposits every three months. Targets for monetary aggregates were established, consistent with the projected inflation and growth rates.

During early 1984, the monetary aggregates came under additional pressure due to a dramatic improvement in the balance of payments and a rise in the reserve money multiplier. Based on data given in Table 9 of the staff report and Table 25 of the paper on recent economic developments, the changes in net domestic assets and reserve money diverged in 1984 as a result of a dramatic increase in net foreign assets: during the first half of 1984, net domestic assets increased by 13 percent, while the increase in reserve money was 42 percent; in 1983, these increases had been 35 percent and 36 percent, respectively. The efforts of the authorities to restrain public and private sector credit in 1984 were thus nullified by an expansion of net foreign assets, which had played an absorptive role in 1983. Indeed, net foreign assets increased from -43 billion TL at the end of

1983 to +106 billion TL by June 1984, which is substantially in excess of the -8 billion TL projected in EBS/84/42 (3/7/84). Moreover, restraint in credit to the public and private sectors, together with the interest rate measures, have adversely affected the ratio of currency in circulation to deposits and thus have increased the reserve money multiplier.

These pressures on domestic liquidity did not become apparent during the first three months of 1984, when price developments were in line with projected levels. Only in April, after the usual time lag, was the first unexpected rise in prices registered. At that moment, the Government rapidly took appropriate remedial steps: on May 14, 1984, the interest rates on deposits and the central bank discount rate were increased again. The penalties for nonobservance of cash reserve requirements by commercial banks were raised, and the seven largest banks were persuaded to agree to invest 10 percent of future increases in their deposits in government bonds. When the May indicators became available at the end of May, further steps were taken, beginning on June 1, 1984: a 5 percent increase in the liquidity requirement of the banking system, intensive sales of government bonds to commercial banks and to the public, an increase in interest rates on three- and six-month deposits. Steps were also taken to reduce the volume of new lending by the commercial banks. The Central Bank has acted to make the retrocession of foreign exchange by commercial banks unattractive. By these measures, the Turkish authorities believe that they reacted appropriately and in a timely manner to these developments on the basis of information available at the time.

These developments over the first half of 1984 illustrate the dynamic impact of a change in the money supply on price levels. The few existing studies of the Turkish economy indicate that the effect of an exogenous increase in the money supply tends to be spread over a period of up to a year. It is therefore not surprising that in spite of the restrictive monetary policies pursued since the beginning of 1984, the rapid expansion of central bank credits which took place in the second half of 1983 is still exerting its impact on prices in 1984.

In the area of fiscal policy, the public sector borrowing requirement (PSBR), which decreased from 12 percent to 6.9 percent of GNP between 1980 and 1982, rose again to 9.1 percent of GNP in 1983, mainly because of the unsatisfactory performance of the consolidated budget and higher SEE financing requirements. For 1984, however, a substantial recovery is expected, with total PSBR declining to 5.8 percent of GNP and the consolidated budget's share of that to 3.3 percent of GNP. The Government has continued to strengthen its policies aimed at improving the efficiency of the SEEs, by urging them to reflect their increased costs in their prices, and to rely on sources other than budgetary transfers for their working capital.

> My Turkish authorities have shown their commitment and determination to carry through the stabilization program in order to attain the goals of a sustainable medium- and long-term balance of payments situation as well as a balanced and sustained development. The Government firmly intends to maintain its present policy direction and to intensify its efforts to reorient the economy by higher reliance on free market principles.

Mr. Ismael commended the Turkish authorities for the sweeping economic reforms that were taking place under the current stabilization program. The economic progress achieved in both the external and domestic sectors strongly indicated that the new approach taken toward a more liberalized, open economy was appropriate and timely.

An expansionary monetary policy in 1983 and the first half of 1984 had led to the acceleration of inflation and the buildup of excess liquidity, Mr. Ismael remarked. Despite various efforts to absorb liquidity, inflation had persisted; he considered that controlling liquidity was the most crucial factor for the success of the program. He therefore welcomed the inclusion of a nonquantitative criterion to review monetary policy for the second half of 1984 in consultation with the Fund, if that was deemed necessary to ensure a successful program. In addition, further reform was needed, particularly in respect of monitoring and control, to ensure timely and accurate reporting of commercial bank assets and liabilities and to strengthen the credit control mechanism by basing ceilings on the net domestic assets of the whole banking system rather that on those of the Central Bank alone.

The progress made in liberalizing the trade regime was noteworthy, Mr. Ismael continued. The liberalization of import controls and the pursuit of a freely flexible exchange rate regime had contributed to a significant extent to the improvement of export competitiveness and the balance of payments position. The authorities should persevere with those policies, emphasizing in particular the promotion of an export-oriented strategy to achieve external stability and satisfactory economic growth.

Considerable progress had also been made toward strengthening public finances, Mr. Ismael added. In view of the liberalization of trade, it was not surprising that some deterioration of government revenue had been recorded; nonetheless, more effort should be made to increase budgetary revenue; for instance, by strengthening the tax administration and examining other sources of revenue. Since it was not certain that inflation would be brought under control in the second half of the program, he agreed with the staff that the authorities should re-examine their earlier decision in favor of another reduction in income tax rates in 1984. The sharp rise in real disposable income in 1983, together with an accommodative monetary policy, had contributed significantly to the acceleration of inflation in 1983; the sharp increase in income projected for 1984 could again contribute to inflationary pressures and jeopardize the outcome of the program. Moreover, consideration should be given to an early introduction of the value-added tax.

He questioned whether the monetary measures proposed in the second half of the program would be adequate to contain inflation unless, at the same time, some form of incomes policy was introduced, Mr. Ismael went on; he would appreciate staff comment on that point. If inflation were not brought under control, credit restraints in addition to those presently envisaged would probably not be needed, since they would be likely to fall largely on industry and commerce, which could ill afford reduced access to credit and higher interest rates at the moment. In conclusion, he supported the proposed decision.

Mr. Suraisry remarked that following the resurgence of domestic inflationary pressures and the worsening of the external payments situation that had interrupted the momentum of economic progress in Turkey in 1983, it was encouraging to see that Turkey's present stand-by arrangement was being implemented as planned. He could therefore support the proposed decision. Nevertheless, further improvement was needed, particularly in the fight against inflation, which had been fueled mainly by the relaxation in financial policies in 1983 and the attendant excessive credit creation. Additional monetary and supportive fiscal measures were therefore required to absorb the liquidity overhang in order to subdue domestic inflation and keep it at a low level. To increase the effectiveness of credit policy, more emphasis should be placed on expanding the application of credit controls, which presently centered on the net assets of the Central Bank, to cover the net domestic assets of the commercial banks. While he recognized that that was not possible at present because of the lack of timely data for commercial banks, he welcomed the steps currently being taken by the authorities to speed up reporting by commercial banks to the Central Bank, and would support any needed technical assistance in that area from the Fund.

The fight against inflation would be enhanced by further strengthening public finances through a combination of expenditure-reducing and revenue-generating measures, Mr. Suraisry considered. It was essential to arrest the declining trend in government revenues and to maintain their value in real terms. In that connection, the authorities should consider the introduction of a value-added tax or other appropriate tax measures. With respect to expenditures, the reduction in budgetary transfers to the state economic enterprises and the efforts to improve their managerial and operational efficiency were welcome.

The projected improvements in the overall external position in 1984 seemed to be on target, thanks to the adoption of a flexible exchange rate policy and the liberalization of the trade and payments systems, Mr. Suraisry stated. Those policies had helped Turkey to expand its exports and increase invisible receipts substantially. The sharp reduction in import controls was commendable and had not led to an unmanageable surge in imports as had been generally feared. With increased export competitiveness, it would be very helpful to Turkey if its products had unimpeded access to markets now subject to restrictions.

He noted with satisfaction that the authorities intended to continue their outward-looking external policies, which should sustain a viable external payments position that would enable Turkey to cope successfully with debt repayment obligations in the years ahead, Mr. Suraisry went on. In the medium term, Turkey's foreign debt would remain manageable. Its creditworthiness had also improved, indicating that Turkey was definitely moving in the right direction. Moreover, the collaboration between the Fund and the World Bank was helping Turkey to adopt adjustment measures combined with appropriate structural policies, which would enable Turkey not only to realize its economic growth objectives, but also to sustain that growth.

Mr. Leonard remarked that the resurgence of inflation stemming, in part from fiscal forces and facilitated by monetary policy and the consequent deterioration in the current external account in 1983, had been especially regrettable. Nevertheless, at the same time, strong growth in exports and good performance by the industrial and services sectors had continued. Indeed, in the light of the sustained progress in 1981-82 and the authorities' commendable readiness to correct the defects in economic management which had produced the imbalances evidenced in 1983, prospects for continued progress were good. A positive outturn would, however, require that the authorities keep a tight grip on key areas of the economy and persevere in their policy of giving freer rein to market forces.

The projected strengthening of the external sector directly reflected the effectiveness of trade liberalization and a flexible exchange rate policy, Mr. Leonard noted. Over the coming years, it would be necessary for the authorities to give close attention to the current external account and to encourage growth in exports. Despite the major adjustment measures taken since 1979, Turkey's external debt as a proportion of GNP was above the average for non-oil developing countries and was continuing to grow; moreover, the debt service burden remained high and would increase in 1985. He agreed with the staff that with continued adjustment efforts, the debt burden should be sustainable over the medium term. Turkey was, however, in a highly vulnerable position and would have to ensure that the acquisition of new debt was associated with strong growth in production and exports. He noted with satisfaction the serious consideration that the Turkish authorities were giving to increased use of nondebt-creating financial flows, and in that connection invited the staff to assess the prospective effect on such flows of new investment laws currently being introduced.

On the domestic side, the main problem continued to be inflation, Mr. Leonard observed. By jeopardizing efforts to increase export competitiveness and improve the price structure, the recent high rate of price increases posed a serious threat to the success of the adjustment program. The increase in inflation in the first half of 1984 was a source of particular concern, and he welcomed the intention of the authorities to reduce inflationary pressures over the second half of the year as well as the measures that were being taken to tighten monetary and credit policies. Although there were signs that inflation was beginning to slow, the projected rate of price increase at the end of the year would still be above that in most OECD countries.

In containing inflation, nonaccommodating monetary and credit policies should play a central role in the program, Mr. Leonard considered. Further restraint in the growth of monetary aggregates than had recently been demonstrated was a necessary element of such policies. Another was the management of credit to ensure positive real interest rates, maintain commercial bank liquidity, and encourage an adequate flow of remittances from workers abroad. The inability of the authorities to contain monetary aggregates in the first half of 1984, despite adherence to the quantitative limits defined in the stand-by arrangement, supported the staff's concern about using central bank credit rather than the credit of the whole banking system as a control mechanism for monetary growth. The authorities should stand ready to review monetary targets and credit ceilings should the broad monetary aggregates deviate from expected trends. In that regard, he welcomed the steps being taken by the authorities to accelerate the speed of commercial bank reporting to permit the use of broader quantitative targets. Improvements in reporting would allow the authorities to take corrective action more quickly and would also permit the Fund to construct more meaningful credit ceilings for Turkish programs than was at present possible. Fund technical assistance might expedite such improvements.

The staff reports had failed to discuss measures to restrain the growth of incomes as part of the action to moderate inflation, Mr. Leonard observed. His reading of the papers indicated that some form of future pay explosion was possible; it would be useful to have the staff's views on that likelihood and whether any anticipatory action would be needed to avert it.

Recent methodological revisions would enable the fiscal stance to be more reliably assessed, Mr. Leonard remarked. Although the consolidated central government budget deficit would be reduced in 1984 and its size relative to GNP was modest, it would be unwise to assume that its future evolution would necessarily be favorable. The reduction in 1984, for example, partly depended on once-for-all receipts from land sales. Moreover, the deficit was also associated with rising medium- and long-term public sector debt (including that of the state enterprises) relative to GNP. In 1983 such debt amounted to almost 24 percent of GNP, compared with 23 percent in 1982 and only 10 percent in 1979. The growing debt burden had left the Government highly vulnerable to interest rate developments, and interest rate expenditures had risen from 3 percent of total government expenditure in 1980 to 11 percent in 1984.

Strict control of overall public expenditure would be needed, and adequate attention must also be accorded to government revenue, Mr. Leonard added. Although as a general principle it was important to avoid an excessive tax burden, government revenue in Turkey as a proportion of GNP was significantly below that of most OECD countries, and he questioned whether a further decline in its relative size would be beneficial. He supported the staff recommendations that the authorities reconsider further planned income tax cuts and proceed with the introduction of a value-added tax, although the inflationary effects of the latter would need to be carefully gauged. As to the state enterprises, the sizable adjustments in administrative prices and the increase in competition permitted from abroad should certainly help to improve their efficiency. The expected reduction in short-term borrowing in 1984 was also a positive development. Despite those improvements, however, the overall deficit of the state economic enterprises relative to GNP remained large. Continued efforts to increase efficiency would be needed over the coming years, and he hoped that the technical assistance being provided by the World Bank would be of value to that end.

It was regrettable that after five years of almost continuous Fund-supported programs, data classification problems in the budgetary area were only presently being corrected, Mr. Leonard remarked. The authorities should place high priority on improving the reliability and timeliness of economic statistics. Otherwise, one would always have the uneasy feeling that policy might, at least in part, be misdirected and that further disquieting budgetary reporting errors like those uncovered in 1983 might arise. Finally, he supported the proposed decision.

Mr. Steinberg stated that current economic developments in Turkey should be analyzed within the framework of the adjustment program which had begun in 1980 and had been heavily supported by Fund resources. The program, which had resulted in remarkable achievements during the first three years, had posted a marked retreat in 1983. The new Government had, however, already shown its determination to take measures to put the economy back on track and to provide for the next phase of adjustments needed to continue and consolidate past achievements.

During the Board's discussion of the stand-by arrangement (EBM/84/52, 4/4/84), some Directors had considered the staff's 1984 forecasts to be optimistic, Mr. Steinberg recalled. At present, it appeared that some of the forecasts had been understated rather than overstated. In particular, export growth in 1984, which had previously been projected to be about 17 percent, was presently estimated at more than 22 percent. Also, in April the growth of GNP for 1984 had been forecast at 3.7 percent by the OECD and at 4.5 percent by the staff; the staff projection had currently been updated to 5.75 percent.

The improvement in the balance of payments in 1984 was more the result of exogenous factors than a consequence of policy measures taken earlier in the year, Mr. Steinberg considered. Nevertheless, the courageous measures to liberalize the trade and payments system and to adjust administered prices and interest rates were commendable. Although the real devaluation of the Turkish lira in the first quarter of 1984 had not greatly affected exports thus far, neither had the real appreciation of the Turkish lira in the second quarter. Nevertheless, the sharp fluctuations in exchange rates raised the question whether the current rate was still compatible with maintaining external competitiveness and providing for export-led growth.

The exchange rate policy also touched on Turkey's most crucial economic development--inflation, which in April had been forecast to reach 29 percent for 1984 and was currently estimated at close to 50 percent, Mr. Steinberg continued. The staff attributed the resurgence of inflationary pressures in 1983 mainly to expansionary monetary policy, while the even higher inflation in early 1984 was attributed to the adjustment of administered prices, to trade liberalization, and to the devaluation of the Turkish lira. The unavoidable adjustment measures taken in the exchange and trade systems required stern financial policies to counteract inflationary pressures.

Although monetary expansion had played a decisive role in fueling inflation, fiscal demand pressures had also played a part, as both expenditures and the deficit had risen in relation to GNP in 1983, Mr. Steinberg observed. Also, while total expenditures had risen, real investment had decreased, thus hampering future growth. Once again, interest payments on both external and internal debts were contributing to budget rigidity; that phenomenon was to be observed in developing and developed countries alike and deserved the Fund's close attention.

The World Bank was playing an important role in financing the balance of payments deficit through its structural adjustment loan program and in promoting growth through project lending, Mr. Steinberg added. He noted with satisfaction the coordination between the Fund and Bank staffs and called on the Turkish authorities to follow Bank recommendations on the privatization of public sector enterprises. In that connection he wondered whether the staff could bring the Board up to date concerning the outcome of a newly passed law providing for the sale of income-sharing bonds derived from various public sector assets (EBS/84/42, Sup. 3, 4/3/84).

Turkey's external debt position, a source of grave concern in the late 1970s, had shown some improvement, particularly in its maturity structure following the recent rescheduling, Mr. Steinberg remarked. The debt service ratio had nevertheless risen from 26 percent of GNP in 1980 to 32 percent in 1983 and was expected to reach 33 percent in 1985 before starting to decline. It was noteworthy that although the level of medium- and long-term debt had hardly changed from 1982 to 1983, there had been a shift in sources of financing; the Fund and the World Bank had provided about $0.5 billion, while indebtedness to OECD countries had declined by a similar amount. Moreover, the staff considered the outstanding external debt to be underestimated. He hoped that correct statistical reporting would eventually be attained with the technical assistance provided by the World Bank and the Fund. Considering the significance of external debt statistics and the fact that discrepancies existed in many other countries, perhaps the staff should consider improving debt records on a more general basis.

Mr. Wicks stated that he endorsed the staff appraisal and the proposed decisions. He noted with satisfaction that the Turkish authorities had met all the performance criteria so far under the arrangement, and that targets in some, if not all, areas had been met. The substantial growth in export volume projected for 1984 and the upward revision of real GNP growth to nearly 6 percent were particularly welcome.

Although the authorities had adhered to the monetary targets, inflation and broad money growth had been much higher than expected, Mr. Wicks added. Moreover, the medium-term prospects appeared difficult, and targets in the Five-Year Plan could perhaps prove to be too ambitious, especially if the external debt figures were actually higher than presently indicated, as suggested by the staff in Appendix II to the staff report; he would appreciate staff comment on whether the possible revision was expected to be large or small. He agreed with Mr. Leonard that it was regrettable that the statistical data base was still unreliable after five years of Fund-supported programs and several World Bank structural adjustment loans which had furthered the improvement of the collection of external debt statistics.

It appeared that the World Bank had utilized a foreign exchange risk insurance scheme for the disbursement of some loans that might have caused a multiple currency practice, Mr. Wicks remarked. More information would be helpful, as a matter of Fund-Bank collaboration.

Substantial progress had been made in the fiscal area, with the public sector borrowing requirement in 1984 projected to be less than half that in 1980, reflecting both firm expenditure restraint and a considerable improvement in the financial position of the state economic enterprises, Mr. Wicks commented. The upward revisions of the deficit implied, however, that further emphasis would have to be placed on fiscal restraint. At 6 percent of GDP, the financing needs of the state economic enterprises remained high; very little of their capital expenditure had been financed from internally generated funds. While the measures that the authorities had taken both in restricting budgetary transfers and in implementing necessary price increases were welcome, considerable scope for improvement remained. Some of the state economic enterprises were concentrated in the manufacturing sector, and he would welcome further information on the possibility of transferring any of them to the private sector. Moreover, as a number of Directors had noted during the April discussion of the stand-by arrangement, the fall in the ratio of revenue to GDP in the past few years remained a concern, and the decline was projected to continue for direct and indirect taxes alike in 1984, underlining the need to continue to improve tax administration. He agreed with the staff that the authorities would be well advised to introduce a value-added tax before proceeding with further income tax reductions.

The most important immediate problem was monetary policy, Mr. Wicks considered. Given the sharp increase in broad money and the accompanying surge in inflation in the first half of 1984, the measures the authorities had taken to tighten monetary policy and sterilize excess liquidity were welcome. The ceiling on the net domestic assets of the Central Bank, however, was clearly not a satisfactory instrument of control; like the staff, he urged the authorities to move quickly to improve the speed with which data on the net domestic assets of the banking system as a whole became available. Technical assistance from the Fund could be helpful. In the meantime, the authorities would need to stand ready to take quick action if the growth of broad money appeared to be excessive, to avoid any repetition of the inflationary pressures in the first half of 1984.

With relatively high levels of debt service and amortization over the next few years, the medium-term balance of payments position, although certainly manageable, would not be easy, Mr. Wicks remarked. The authorities should continue to reduce the current account deficit both to maintain renewed creditor confidence and to avoid undue reliance on capital flows. In that regard, some aspects of the Five-Year Plan gave rise to concern. An average real GDP growth rate of 6 percent over the remainder of the decade would require substantial recourse to both long- and medium-term as well as short-term borrowing. The authorities seemed to have recognized that potential problem in view of the importance they had placed on the encouragement of nondebt-creating flows. Nevertheless, he questioned whether medium-term inflows averaging well over US$2 billion a year would be readily available, especially since some two thirds were projected to come from official sources, and Turkey was not eligible for further World Bank structural adjustment loans. Moreover, much of the increase in medium- and long-term debts since 1980 had been attributable to increased use of Fund credit and disbursements from the World Bank; that could not be expected to continue. Indeed, Table 29 in the report on recent economic developments (SM/84/215) showed that the almost $2.1 billion increase in total debt since 1980 could be accounted for in net terms by borrowings from multilateral and private agencies abroad; medium-term bank and private lending had, in fact, declined since 1980, suggesting somewhat uncertain prospects for the future. As for short-term financing, the Plan assumed annual net inflows averaging around $1.1 billion a year; including Dresdner Bank deposits, short-term debt would amount to $10 billion at the end of 1989 or over 35 percent of total inflows. While he welcomed the expansion of the ceiling on short-term debt to include all such debt except deposits under the Dresdner scheme, the shift away from workers' remittances toward Dresdner deposits--which were potential short-term liabilities denominated in foreign currency--had had the incidental effect of increasing the current account deficit. He urged the Turkish authorities to place more emphasis on reducing the current account deficit in the medium term along the lines of the staff's "adjustment" scenario. In the short term, that might mean lower growth--although the adjustment scenerio did anticipate real growth averaging over 4.5 percent in the period 1985-89, and some 2 or 3 percent in real per capita terms--but in the long term, growth prospects might be enhanced because lower debt service payments would make the external position considerably more secure.

Ms. Bush noted that when the Board had discussed the stand-by arrangement with Turkey in April 1984, it was already aware that significant slippage had occurred in the adjustment effort during 1983. The full extent of the setback was even more apparent at present than it had been then. However, some corrective measures had been taken to reduce excess liquidity, and recent balance of payments data were encouraging as was the comprehensive liberalization of internal and external controls on the economy. Turkey's rather good performance with regard to real economic growth since the adjustment effort had begun to take hold was also noteworthy.

The economy was, however, still suffering from the rapid credit expansion and cuts in nominal interest rates that had occurred in 1983, with the resulting accumulation of excess liquidity, acceleration of inflation, and worsening of the balance of payments position, Ms. Bush continued. Unfortunately, the series of corrective monetary measures taken in early 1984 had proven to be insufficient; nevertheless, the authorities had not hesitated to take reinforcing measures in July and August, which she hoped would have the effect of completely absorbing excess liquidity in the third quarter, as was anticipated in the staff report. It appeared that money supply might still have exceeded the target, and she wondered whether the staff could provide an updated assessment of the effects of those recent measures. She noted with satisfaction that the authorities had promised to consult with the Fund on the growth of monetary aggregates and on the level of interest rates, if developments in those two areas should endanger the success of the program, and she supported the staff recommendation that the authorities move rapidly to improve the availability of financial data on the commercial banking system, so that future monetary targets could be related to the entire banking system rather than to the Central Bank alone.

Data for the first six months of 1984 showed a reversal of the negative balance of payments developments of the past year, with the current account deficit falling to about $1.2 billion, compared with $2.2 billion in 1983, Ms. Bush noted. Emigrant remittances had, however, fallen in 1983, partly because of declining employment abroad and partly because of the drop in the exchange rate of the currencies of some host countries against the U.S. dollar. Although increased deposits by emigrants under the Dresdner scheme compensated to some extent for lower outright remittances, she wondered whether there was a secular trend working against the growth of total exchange receipts from that source. Also, since export growth was important over the medium term, she would appreciate staff comment on the probable impact of the real effective appreciation of the lira which had apparently occurred since March; would improved inflationary performance in the second half of 1984 be sufficient to preserve international competitiveness, or was faster movement in the nominal exchange rate called for?

The wide-ranging reform of exchange and trade restrictions would have a very salutary effect on the long-term efficiency of the economy, on Turkey's international competitive position, and on the preservation of free and fair trading among nations, Ms. Bush considered. If the Turkish authorities continued their efforts to encourage direct foreign investment, a response would certainly be forthcoming as confidence in Turkey's economic and financial well-being grew. She could accept the waiver under the stand-by arrangement and temporary approval under Article VIII of the multiple currency practice created by the new foreign exchange risk insurance system. However, like Mr. Wicks, she was concerned about the restriction, and requested clarification of the statement in the staff report that the authorities did not intend to use that system further "in its present form."

While there had been concern about Turkey's ability to meet the rising debt repayments that would come due in the mid-1980s, the medium-term debt scenarios in the staff paper were reassuring in that they indicated that the debt burden should remain manageable during the next few years, Ms. Bush remarked. Admittedly, the economic growth and export targets were rather ambitious, but not unreasonable with good policies. However, there had been a large accumulation of debt to the Fund and the World Bank group, amounting to $1.6 billion and $2.5 billion, respectively, at the end of 1983; debt to the Fund and to the Bank accounted for 23 percent and 32 percent, respectively, of gross total foreign debt between end-1979 and end-1983. That was worrisome in view of the questions that had been raised about the actual size of the external debt.

Those figures and the number of programs Turkey had had with the Fund raised the equally important question of the future of IMF lending in Turkey, Ms. Bush observed. Turkey had already scaled down its reliance on special aid from the OECD and other bilateral donors as well as debt relief from official and private creditors. Its international creditworthiness had improved considerably, and should facilitate future access to both official and private capital sources on a more normal and voluntary basis. Good progress in economic adjustment had been achieved under Fund programs in recent years, but the serious setback to adjustment in 1983 might prolong the need for outside financial support. When the present stand-by arrangement expired in 1985, however, the Turkish authorities should consider carefully the advisability of incurring more debt to the Fund. At the same time, consideration would have to be given to whether or not further lending to Turkey would be consistent with the revolving character of Fund resources.

Mr. Lovato stated that Turkey's performance under the economic stabilization program to date had been mixed. On the one hand, the improvement in the external account appeared to be on track even as Turkey took effective measures to liberalize its exchange and trade arrangements. On the other hand, concerns remained about the medium-term sustainability of the current trend of economic growth, price developments, and the conduct of monetary policy--all factors that were likely to have an extended influence and that raised the question whether the gains achieved could be consolidated after the program had ended.

A buoyant expansion of exports in 1984 and beyond was crucial, particularly in view of the serious setbacks in 1983, future debt service obligations and the projected expansion of domestic demand, Mr. Lovato considered. Exports were at present expanding more briskly than had been expected six months previously, confirming both the vitality of the Turkish economy and the fruitfulness of the authorities' flexible exchange rate policies. Merchandise imports had also expanded, though at a moderate pace; early indications of the impact of the trade liberalization efforts underway were encouraging. The modest recovery envisaged for workers' remittances, although partly compensated by new flows of Dresdner deposits, had been disappointing, particularly as the liberalization of exchange practices and capital flows, as well as the increase in domestic real interest rates, had been expected to increase the inflow of remittances. In April 1984 the staff had projected that remittances would increase by more than 22 percent in 1984; they were at present expected to increase by only 4.2 percent. Given the importance of workers' remittances for the Turkish balance of payments, a staff study providing an in-depth quantitative analysis of the main determinants of workers' remittances, their substitutability with different forms of savings, and the degree of accuracy with which they could be projected would be useful.

Some Executive Directors had expressed concern over the pace of the expansion of domestic demand during the April 1984 discussion of Turkey's stand-by arrangement, Mr. Lovato recalled. The revised projections of domestic demand for 1984 given in Table 2 of EBS/84/192 and the medium-term outlook embodied in the Five-Year Plan reinforced those concerns. The Five-Year Plan assumed that all components of domestic demand would grow at high and rising rates through the end of the decade; over the same period the current account was projected to remain substantially in deficit, despite growth rates of exports that averaged about 11 percent annually for 1985-89. He wondered whether the authorities intended to consolidate the gains and adjustments achieved during the program over the coming years or whether they wished to create the conditions for the "growth" scenario given in Table 16. The latter scenario left little room for maneuver to face unforeseen--but quite possible--unfavorable events in the second half of the 1980s, such as, for example, a significant slowdown in the demand for Turkish manufactured exports. Moreover, the successful control of the inflationary pressures that had developed would require a tighter control of domestic demand than the Turkish authorities seemed willing to implement.

The inability of the Central Bank to sterilize the short-run impact of excess liquidity on the balance of payments should be attributed largely to the lack of short-term financial instruments in the domestic money market, Mr. Lovato considered. The need to develop that market was all the more compelling as the process of liberalizing foreign payments and capital movements would make it progressively more difficult to predict the foreign component of the monetary base, and consequently would increase the need for more flexible and effective stabilization instruments. The recent sale by the Central Bank of six-month bonds to absorb bank liquidity was a step in the right direction, and larger use of instruments of that kind, possibly with shorter maturities and, in any case, with competitive real interest rates, should be pursued. The authorities should resist the temptation to increase their reliance on administrative instruments such as their gentleman's agreement with commercial banks to purchase government bonds to absorb excess liquidity and credit ceilings for purposes of credit control. The experience of several European countries with bank credit ceilings in particular had not been favorable; ceilings tended to generate inefficiencies in the allocation of resources, to stimulate the diffusion of alternative and often less reliable financial instruments, and to reduce the effectiveness of more traditional instruments of monetary policy. Moreover, the introduction of relatively effective tools for the regulation of bank liquidity would not entail more technical problems than would administering a credit ceiling. If the staff believed that in the particular case of Turkey, there might be special advantage in the temporary use of such instruments, more detailed information in support of that viewpoint would have been helpful. Finally, he supported the proposed decisions.

Mr. Fujino noted that favorable economic developments in Turkey since 1980 had been interrupted in 1983 by the rising rate of inflation, increasing public sector borrowing, and widening external deficits. As the result of a number of corrective measures introduced since the end of 1983--namely, the raising of the interest rate, the depreciation of the lira, and the adjustment of administered prices--the economy was coming back on the right track. The slippages from the path of economic stabilization had resulted from the relaxation of monetary policies, partly to assist commercial banks facing a difficult financial situation. Credit extension and enlarged discount facilities from the Central Bank amounting to LT 210 billion had led to an expansion of base money, resulting in a significant excess of liquidity. The consequent increase of domestic credit expansion and cuts in nominal interest rates had also contributed to the upsurge in the rate of inflation. To absorb excess liquidity, the Government had recently sold six-month bonds to commercial banks and the nonbank public amounting to LT 80 billion. At the same time, central bank borrowing had become a less important source of financing, and the budget deficits had been increasingly financed through the issuance of Treasury bonds. He welcomed that development as the only means of securing public sector borrowing without inflation. The relationship between short-term bond sales to absorb liquidity and the issuance of government bonds for budget financing was unclear, and he would appreciate staff elaboration on that point. Moreover, the smooth operation of government bond issues required the existence of a fairly broad-based capital market; he would appreciate a more detailed explanation of the functioning of the capital market in Turkey and whether there was any plan for its further development.

Export performance had been extremely good in the past several years, Mr. Fujino observed. Even in 1983 when exports had stagnated in value, they increased by 13.4 percent in volume. Moreover, the gains registered were for many manufactured rather than traditional exports. As for future prospects, in view of market constraints, further effort should be made to strengthen export competitiveness by improving and expanding the economy's productive capacity.

Receipts from tourism had been almost stagnant for the past several years, Mr. Fujino noted. Considering the natural and historical endowments of the country and its proximity to Europe, tourism could be a more promising source of invisible income. The return on investment in that sector would be immediate, especially in terms of foreign exchange earnings. He would appreciate more information on the views of the authorities concerning the development of tourism. Finally, he considered that the latest developments and policy orientation went in the right direction, and he supported the draft decisions.

Mr. Goos stated that after the rather disappointing performance of the Turkish economy in 1983, there were presently clear signs of improvement. Although a few areas of serious concern remained, the new Government was to be commended for its overall policy stance and, in particular, for the decisions that it had taken so far in an effort to restore external equilibrium and reduce controls within the trade and payments system.

He broadly agreed with the staff's overall assessment and policy recommendations and with the proposed decisions--with some qualifications--relating to the approval and waiver with respect to potential multiple currency practices that might arise under the foreign exchange risk insurance scheme in connection with several World Bank loans, Mr. Goos continued. First, as his chair had stated during the April discussion of the stand-by arrangement, the Fund, in his opinion, had no jurisdiction over capital transactions; the World Bank loans in question clearly belonged to that category of transactions. Second, the stand-by program with Turkey contained a performance criterion relating to multiple currency practices, and there was a risk of that criterion being breached. Because the amount of money involved was limited and the authorities intended to abolish the scheme in the near future, he could support the proposed waiver. However, he wished to express his authorities' view that such waivers should be restricted to exceptional cases to prevent undermining Fund conditionality. He would appreciate staff comment on how the multiple currency practice arose despite the active collaboration between the Bank and the Fund.

The continuing depreciation of the Turkish lira had no doubt greatly helped Turkey's trade account, Mr. Goos considered. While the exchange rate policy had improved the country's external competitiveness, however, it might also have contributed to the recent upsurge of inflation. The overdue adjustment of administrative prices to improve the fiscal position had also affected price performance, fueling inflation. He agreed with the staff, however, that expansionary monetary policies were the main cause of the renewed acceleration of inflation and, in particular, the inability of the monetary authorities to sterilize the liquidity overhang resulting from large foreign exchange sales to the Central Bank. The proposed monetary program to absorb the liquidity overhang before the end of 1984 was therefore welcome. Although the placement of bonds to banks and nonbanks might be particularly helpful in that effort, he questioned whether the very high yield on those bonds--more that 50 percent--might not promote inflationary expectations. It would appear worthwhile to consider whether an increase in minimum reserve requirements, together with the envisaged control on credit expansion by commercial banks, might not be more appropriate. An improvement of monetary statistics to obtain more timely data on developments in the banking system could also contribute greatly to the more efficient conduct of monetary policy. Considering the misleading reports on budget performance in 1983, he strongly urged that accounting practices be adjusted to international standards as soon as possible. Given the continuing high inflation rate, further devaluation of the lira would be unavoidable if the country's competitive position was to be preserved. To remedy the potential negative repercussions on workers' remittances and foreign capital inflows, the authorities might consider ways of increasing the scope for the private sector to hold foreign exchange accounts, and improving the underlying arrangements.

He agreed with the staff that fiscal policy should shoulder a larger burden of the adjustment effort than hitherto, Mr. Goos continued. In particular, the proposed introduction of a value-added tax appeared most appropriate.

Like other Executive Directors, he was concerned about the continuous use of Fund resources by Turkey, Mr. Goos concluded. In view of the high debt service burden Turkey was facing in the years ahead, he wondered how the protracted use of Fund resources was to be avoided. He strongly urged the Turkish Government to persevere in its export promotion policies to reduce the country's foreign exchange requirements over the medium term as well as its indebtedness vis-à-vis the Fund.

Mr. Alhaimus stated that since early 1984 the major task of economic policy in Turkey had been to steer the economy back onto the path of strong adjustment after the setback experienced in 1983. The rise in domestic demand and the expansionary monetary policy pursued in 1983 had contributed significantly to the resurgence of inflation and the deterioration of the current account. Faced with those difficulties, the authorities had adopted a new approach based on an open, market-oriented economy, supported by a new stand-by arrangement with the Fund. Since the adoption of the present program in April 1984, positive developments were already evident, although problems persisted--in particular the need to control inflation.

The authorities had acted promptly to reverse the trend toward real negative interest rates, arrest the excessive rate of monetary expansion, and strengthen credit controls, Mr. Alhaimus continued. The average after-tax yield on time deposits and certificates of deposit had turned positive in real terms as a result of sharp increases in interest rates and the reduction of the withholding tax rate on interest early in 1984. The effective cost of borrowing seemed to have risen by much less than deposit rates--an interesting development given the usually high lending rates charged by banks in Turkey. Monetary growth, however, had clearly exceeded the program target by midyear, despite measures to improve interest rates and to limit the Central Bank's net domestic assets. The continued efforts planned for the second half of the program, which aimed at full absorption of excess liquidity at the end of the third quarter, were therefore welcome. Nevertheless, other measures to contain demand, particularly in the fiscal field, were clearly needed to contain the serious inflationary pressures which were expected to continue for the year as a whole.

Fiscal performance had improved somewhat over the past few years, reflecting expenditure restraint rather than measures increasing revenue; that trend was expected to continue in 1984. The projected large decline in tax revenues of about 18 percent in real terms in 1984 would have to be balanced by reductions in expenditures, especially investment expenditure, in order to achieve a reduction of the fiscal deficit to about 1.6 percent of GDP. Improvement was anticipated in the financial position of the state economic enterprises; their financing requirement was expected to fall markedly in 1984, and efforts were planned to improve their efficiency and competitiveness. Like other Directors, he noted that the reclassification of certain budget items had resulted in a significantly different picture of fiscal performance, especially for 1983, when the budget deficit had turned out to be 2.9 percent of GDP higher than expected in earlier staff reports. Doubts about the previous classification had been expressed in the OECD economic report on Turkey and referred to in the Board meeting in April (EBM/84/52, 4/4/84). He wondered whether the staff had previously noted the fundamental difference between the former presentation and the standard Fund presentation, and whether that difference had been discussed with the authorities.

Developments in the external sector during the first half of 1984 were encouraging and prospects for the current account were improving, Mr. Alhaimus commented. The staff expected that the trade forecast for 1984 would be exceeded. The authorities had also taken wide-ranging steps to improve external performance through a more liberal trade and exchange policy. Unfortunately, the opening of the economy had been met by new measures on the part of some major trading partners that limited the access of Turkish goods to their markets. Since Turkey's medium-term prospects depended so crucially on maintaining a high export performance, that was particularly worrisome. It would be useful if the staff could attempt to quantify the impact of those protectionist measures on Turkey's export prospects.

The overall prospects of the Turkish economy had clearly improved, reflecting the strong adjustments undertaken so far and the better external environment. Output growth was forecast to reach 5.7 percent in 1984, and foreign debt servicing was expected to remain manageable over the medium term. Inflation, however, remained a major problem despite some recent signs of deceleration. Structural rigidities and social strains reflecting the high unemployment rate and falling incomes continued to complicate the task of reorienting the economy. The authorities had dealt with those complex circumstances with determination, and he wished them further success in their difficult task.

Mr. Lindø observed that after some years of relatively favorable performance, the Turkish economy had begun to show signs of adverse developments in 1983, with respect to inflation. Nevertheless, the setback in the current account appeared to have been of a temporary nature; recent export performance had improved and was forecast to continue to do so in the near future on the assumption that the exchange rate was allowed to adjust appropriately.

The policies of the present Government appeared to be largely on the right track, Mr. Lindø continued. Reducing the deeply imbedded inflationary expectations should be one of the primary targets. Therefore a tight monetary policy stance would, he hoped, be pursued with determination. Foreign debt and debt service payments would remain at a high level in the medium term; in addition to adhering to ceilings on long- and medium-term nonconcessional foreign borrowing, short-term credit developments should be kept under close scrutiny. The authorities should reconsider their tax policies to allow more room for investment expenditure, which would otherwise have to be cut further to improve the fiscal balance. The balance of payments currently seemed to be improving; competitiveness had been restored by pursuing a flexible exchange rate policy, which he understood the authorities intended to continue. He commended the authorities for the recent trade liberalization measures.

The present policies and stabilization program appeared to be broadly appropriate for achieving a more balanced rate of growth, Mr. Lindø concluded, and he therefore supported the proposed decisions.

Mr. Salehkhou stated that the performance of the Turkish economy during the first six months of 1984 had been mixed; owing to the tentative nature of the current data, however, any final assessment should await the availability of actual figures for 1983 and 1984. Nevertheless, certain slippages from the program objectives relating to money and credit were conspicuous, despite the observance of the relevant performance criteria. The initial projections with respect to the reserve money multiplier and expected inflation in 1983 had not reflected actual developments, and the sterilization of an excess accumulation of net foreign assets had not taken place as expected. As a result, monetary expansion had become excessive.

The authorities had taken a number of measures to correct monetary imbalances during the second half of 1984, Mr. Salehkhou went on. To fully absorb excess liquidity by the third quarter of 1984, the Government had embarked on the sale of six-month bonds to both commercial banks and the nonbank public, and liquidity requirement ratios had been increased accordingly. Nevertheless, to avoid future unanticipated developments and slippages, data pertaining to the net domestic assets of the whole banking system rather than those of the Central Bank alone should be used as a basis for future program formulation. He noted with satisfaction that the authorities were taking steps to improve the statistical reporting of commercial banks.

While the rate of real GNP growth had slowed down, reflecting the slower growth of fixed investment expenditure as a result of budgetary restraint, Mr. Salehkhou noted, unanticipated monetary expansion had been chiefly responsible for intensifying inflationary pressures.

In the external sector, the terms of trade had deteriorated substantially, declining from -0.6 percent in 1982--a figure which had been revised upward on an ex post basis--to -6.1 percent in 1983, Mr. Salehkhou observed. In that light, the projected improvements for 1984 and beyond might prove optimistic. The external performance had not been encouraging in 1983, with the current account deficit rising to 4.3 percent of GNP, compared with 2.3 percent in 1982. Agricultural export prices had declined, and exports to markets in the Middle East, which in terms of the direction of trade had registered the highest rate of growth in 1981 and 1982 (Table 38, SM/84/215), had lost their momentum and become negative in 1983. That was a major factor responsible for the stagnation of export values in 1983. Nevertheless, exports to that region had accounted for 34 percent of total exports in 1983. Considering the volatility and the present pattern of exports, export growth might not materialize as expected, and protectionist policies of industrial countries might also hamper further export diversification. Trade performance in the first half of 1984 had, however, been encouraging, with exports rising much faster than imports. Overall, a flexible exchange rate policy and import liberalization had restored export competitiveness, improved the structural basis of foreign trade, and helped to improve resource allocation. It was encouraging to note that the reduction in import controls had not led to an unexpected surge in imports.

The revised fiscal data for 1983 showed unexpected slippages Mr. Salehkhou continued. In 1984 expenditure restraint should continue to compensate for possible revenue shortfalls. In the medium term, there appeared to be a trade-off between pursuing a high growth, low unemployment course of action, with the resulting sizable deficit in the current account, and a more adjustment-oriented policy based on greater caution, less ambitious growth objectives, and therefore a more manageable debt and debt service profile. The assumptions underlying the various medium-term scenarios, especially those relating to the terms of trade and international interest rates, might yet prove sanguine. It was therefore necessary to exercise prudence, considering the relatively high external debt and the sizable annual debt service burden, bordering on 33 percent in 1985 because of the bunching of maturities from past debt rescheduling arrangements. A high growth scenario would further increase total external debt and if the crucial assumptions did not materialize, the external position would deteriorate drastically.

He agreed with the staff that the thrust of government policies was toward continuous adjustment, which should permit room for maneuver in the future if necessary, Mr. Salehkhou concluded. The performance criteria for the second half of the year correctly emphasized the need for tighter monetary policy. In particular, the commitment to avoid new deficiencies in the reserve requirement obligations of commercial banks should ensure more significant monitoring of monetary developments. In conclusion, he supported the proposed decisions.

Mr. Malhotra stated that he supported the proposed decisions. In 1983 there had been a setback in price performance and a deterioration in the current account of the balance of payments as the result of excessive monetary expansion. The new Government that had come into power in December 1983 had initiated several measures to control money supply and credit, but inflation continued to pose the real challenge.

Although fiscal policies had concentrated on cutting expenditures, he agreed with the staff that the recent deterioration in revenue receipts, which had declined to 14.9 percent of GNP in 1984 from 17.9 percent in 1982, deserved more attention, Mr. Malhotra added. The decisions to reduce both the marginal rates for personal and corporate income taxes needed to be re-examined and the value-added tax, proposed in the budget, should be expeditiously introduced. In the long term, fiscal balance should be achieved not only by exercising restraint on expenditures but also by raising revenues.

The efficiency of the state enterprises also required improvement, Mr. Malhotra considered. Those enterprises, which had shown a small profit on current operations in 1983, would show some loss in 1984 despite the large price increases that had been introduced in the closing months of 1983 and the first half of 1984.

Although export receipts had suffered a setback in 1983, they were rising in 1984, largely as a result of the liberalization of the trade and payments regime and a flexible exchange rate policy, Mr. Malhotra noted. The credit rating of Turkey had also improved. Nevertheless, there was a large bulge in short-term credits and in errors and omissions. The bulge would imply a further sharp addition to debt service, which as a percentage of foreign exchange earnings--after debt relief--stood at 31.75 percent in 1983 and was likely to be about 30 percent in 1984.

The staff's medium-term scenario regarding foreign debt showed that debt servicing could be managed, and the assumptions underlying that scenario seemed reasonable, Mr. Malhotra added. However, despite the improvement in Turkey's credit rating, it would be important for the international financial institutions to continue to offer their support. Certain aspects of the economy could cause concern and the continued association of the Fund and the World Bank with Turkey would be useful. Finally, he agreed that the monetary and commercial bank data were weak and needed to be improved in order to underpin policy formulation and response to developments.

Mr. Morrell stated that he supported the proposed decisions, although, like other speakers, he would be interested in the answers to the questions raised about the foreign exchange risk insurance scheme and the involvement of the World Bank in that arrangement. The Turkish authorities were to be commended for their adjustment efforts over the past few years, particularly in the external sector. It was regrettable that they had to face barriers to trade in their markets.

Like other Directors, he was concerned about basing credit control on the net domestic assets of the Central Bank rather than those of the whole banking system, Mr. Morrell added. That was particularly disconcerting considering the Fund's close involvement with Turkey for a number of years and the problems Turkey had had with its banking system. He wondered how many other programs featured monetary control exercised through the accounts of the Central Bank rather than through the banking system as a whole.

He shared the views of the staff and other Directors concerning the proposed reductions in the marginal rates of income tax, Mr. Morrell added. It was wholly inappropriate that a government taking a relatively low share of GDP should be considering reductions in investment expenditures and reductions in income taxes at a time when presumably more investment and a broadening of the tax base was needed. Finally, he commended the authorities for what they had accomplished and supported the proposed decisions.

Mr. Ramtoolah stated that he supported the proposed decisions and wished the Turkish authorities well in their endeavors.

The staff representative from the European Department stated that the Turkish authorities agreed that controlling national domestic assets through the Central Bank had been unsatisfactory; they were therefore devising a system whereby commercial banks would report on a more timely basis to permit the net domestic assets of the entire banking system to be utilized in the formulation of performance criteria. That, however, would require time: the Turkish banking system was comprised of a large number of banks spread over a large geographical area with poor mass communications. Consequently, while the banking system was well developed in a geographical sense, its operating efficiency was similar to that of systems in many other developing countries.

Because the performance criteria had been applied to the more limited ceilings of the Central Bank, in the past the authorities had felt that monetary policy was operating correctly as long as those ceilings were not exceeded, the staff representative explained. The present Government was aware that a better indicator was required, and for that reason it had agreed with the Fund to set targets using broad money, M-2; if trends in that aggregate proved unsatisfactory, targets could be adjusted after consultations with the Fund. That represented an improvement and a step toward an ultimate solution. The latest information regarding developments in overall monetary aggregates at the end of August indicated that M-2 was on track with respect to the program targets. Moreover, during the past few months the authorities had demonstrated their willingness to use a broad range of instruments to control net domestic assets: they had changed interest rates, they had sold bonds to the bank and nonbank public, and they had increased reserve requirements both in May and in August.

The new Government was committed to making the capital market more efficient, the staff representative remarked. It had decreased the transactions tax between banks to almost zero; consequently, the interbank market had become an important factor in the capital market. In addition, the Government was introducing new laws to reinforce those introduced by the previous Government that had increased the capitalization of banks, encouraged more efficient operations, and decreased the excessive number of bank branches. Although the current bond sales were relatively short-term instruments, the authorities believed that those short-term securities could be rolled over in the market and that the demand for net sales of Treasury bills in 1985 would be less than in 1984.

With respect to fiscal policy, the revenue base needed to be increased, the staff representative commented. He agreed with Executive Directors that the intended reductions in marginal income tax rates in 1985 should be reviewed and that new forms of revenue were desirable. He noted in that regard that the authorities were seriously considering a value-added tax.

The problem of obtaining reliable fiscal data was complicated by a Turkish legal requirement that the budget be operated on the basis of expenditures and receipts, the staff representative observed. The law did not distinguish between loan receipts and revenue receipts nor between repayments of loans and payments of a current nature, including interest payments. Under an informal arrangement with the Fund staff, the authorities had transformed their budget presentation into one appropriate for staff papers. Unfortunately, especially in 1983, the data had not been properly reorganized; the process was technically complicated, and genuine mistakes had been made. Those mistakes had been recognized by the OECD and also by the Fund staff. During the last two staff visits to Turkey, a major effort had been made to improve the accuracy of the data presentation, and there would be a technical staff visit to Turkey in November to confirm the data presented in the staff reports before the Executive Board.

The Turkish Government was committed to the privatization of part of the public sector in order to improve the efficiency of the state economic enterprises, the staff representative remarked. Implementing laws were now being passed, but no precise arrangements for the sale of assets or revenue sharing in any particular enterprise was in existence. Concrete steps toward privatization, were, however, expected in 1985.

The Government was also initiating legislation to encourage direct foreign investment in Turkey, the staff representative went on. Although the number of approved proposals for direct investment had increased greatly, corresponding balance of payments transactions were not expected for some time. In the medium term, the authorities could be expected to obtain more capital inflows from direct investment that would not have to be repaid until they had started to make a positive contribution to the balance of payments.

Projecting the current account had been particularly difficult, the staff representative noted, because of the way receipts from workers' remittances were recorded. Workers' remittances totaled more than $2 billion a year and could be immediately converted--in which case they were recorded as a worker's remittance in the current account--or transferred to a foreign exchange account at the Central Bank via the Dresdner scheme or to a foreign exchange account in a Turkish commercial bank--in which case they were recorded as short-term capital inflows. There had been a growing trend in favor of transfers to a foreign exchange account. In projecting the current account, therefore, an assumption had had to be made about that trend. For 1984 the extent of immediate conversions might have been overestimated and the extent of movement into foreign exchange accounts underestimated; the trade account might be better than indicated in the current projections. Nevertheless, because of the uncertainties, the staff had not changed the LT 1.2 billion current account deficit projection.

The secular trend in total receipts from workers abroad was not expected to decline, the staff representative added. The demand for workers in Western Europe was decreasing, and despite a probable increase in the wage rate, a gradual decrease in receipts from that area was probable. The number of Turkish emigrant workers in other parts of the world had, however, increased sharply, particularly in the construction industry. That demand was not expected to decline and it might even increase somewhat.

A strong and sustained growth in exports was an integral part of the Turkish program, the staff representative noted, particularly as it affected the medium-term foreign debt position. The Turkish authorities had therefore adopted a flexible exchange rate policy and had endeavored to implement it pragmatically, faced as they were with the immediate problem of the acceleration in the rate of inflation; their record had been good. In all probability the absolute size of the foreign debt was greater than Turkish statistics indicated. The World Bank had been conducting an intensive study of the debt problem, and the Fund had been providing technical assistance for more than a year in order to improve the debt reporting system. Although the exact size of the statistical shortfall on outstanding debt at end-1983 was not precisely known, it probably exceeded $1 billion. While that figure was by no means insignificant, it represented only a small part of current total reported debt.

The current account deficit in the foreign debt scenarios was based on current Turkish projections and excluded transportation receipts totaling about $300 million a year, the staff representative continued. To that extent, short-term debt was greater than it seemed. The Dresdner and other foreign exchange deposits of Turkish workers, however, contributed significantly to the increase in short-term debt. While the potential liability of those deposits should not be underestimated, if the balance of payments were kept manageable, they would be somewhat different in character than short-term bank deposits of nonresidents. In addition, the Five-Year Plan, which was the basis of one of the scenarios, was an indicative plan; if the results of the previous year did not meet expectations, the authorities stood ready to adjust the plan for future years.

There had been a major liberalization of resident foreign exchange accounts since the beginning of the year, the staff representative remarked. Residents and emigrant workers could hold foreign exchange deposits more freely than in the past. Invisible receipts could be completely retained and up to 20 percent of receipts from exports could be retained without question.

In the past few years capital inflows from the World Bank and from the Fund had accounted for a large proportion of total capital inflows, the staff representative noted. That situation was changing significantly; in 1984 Turkey would not be receiving net inflows from the Fund but would be making net repayments to the Fund. Also, the present stand-by arrangement relative to quota was much more modest in size than those of 1980 and 1983. Although the World Bank had provided substantial assistance to Turkey through its structural adjustment loan program, Turkey was not eligible for further use of that program and future World Bank activity in Turkey would probably consist of project loans.

The multiple currency practice had arisen from domestic arrangements to ensure the utilization of World Bank loans by a Turkish development bank in order to provide foreign exchange for on-lending to domestic enterprises for capital investment, the staff representative explained. The domestic enterprises, however, had been unwilling, in the light of experience with borrowing in foreign exchange in the late 1970s, to run the risk of having to repay loans in appreciated foreign exchange. The loans, therefore, had laid completely idle. The authorities then devised a scheme whereby the borrowers, borrowing in lira, would pay a premium to enable the investment bank to meet its foreign exchange risk; the difficulty arose when the Government set up a foreign exchange risk insurance fund with resources from several sources to provide the additional amount of lira needed to repurchase foreign exchange in any combination with repayment from the domestic borrower. Because the purchase of foreign exchange included two elements--a payment by the final domestic borrower and an unspecified payment that depended upon the difference between the exchange rate at the time at which the World Bank loan was utilized and the exchange rate at the time when a specific interest or capital repayment was made to the World Bank, the legal effect was to create a multiple currency practice. Although the authorities had not agreed with the staff's interpretation of the scheme, the staff believed that it was undesirable, not only because it involved a multiple currency practice, but also because it required an unspecified subsidy to the foreign exchange transaction. The authorities agreed that they would limit the scheme to the proceeds of the World Bank loan. Meanwhile, the World Bank had already started to release the funds inside Turkey, not knowing that a multiple currency practice existed. The magnitude of the transactions involving a multiple currency practice was quite small, and in the circumstances, the staff considered it reasonable to recommend a waiver under the stand-by arrangement and the temporary approval of the practice under Article VIII. The World Bank and Fund staffs had worked together to limit to the maximum extent the impact of that practice.

The authorities had had a relatively strict incomes policy since 1980, under which incomes were decided by a high level arbitration commission, and for much of the period, real incomes had been declining significantly, the staff representative from the European Department stated. The new Government, however, believed that direct government intervention should be minimized in line with its open market orientation, to allow incomes to be determined in negotiations between workers, their unions, and employers. The full implication of the wage increases that had been reported recently in the press would be one of the topics for discussion with the Turkish authorities within the next few weeks. While excessive wage increases could seriously jeopardize the program, the authorities believed that by reducing inflation and providing a proper economic environment, market forces would operate to contain increases at a level that would not damage the program targets.

The staff representative from the Exchange and Trade Relations Department stated that in 31 of the 104 stand-by arrangements with the Fund between 1979 and 1983, the net domestic assets of the central bank had been used to establish ceilings. In 22 of the 50 programs supporting an extended arrangement during that same period, the ceiling was also based on the net domestic assets of the central bank. The choice of the ceiling had, to some extent, depended on the manner in which credit control had traditionally been exercised in the country: where the central bank controlled commercial bank credit through the allocation of quotas, the more comprehensive ceiling had been used. Nearly all programs in the Western Hemisphere had utilized a ceiling on the net domestic assets of the central bank; between 1979 and 1983, 17 out of 23 stand-by programs contained ceilings on aggregate credit, all of which were based on the net domestic assets of the central bank.

Mr. de Groote remarked that with regard to monetary policy, the Turkish Government had correctly respected the performance criteria and had taken appropriate measures as soon as they realized that inflation was getting out of hand. Although the surplus on the current account had been much larger than could have been expected and ought to have been sterilized in due time, the slippage had been reinforced by the increase in interest rates, which had resulted in a shift toward time deposits. Consequently, the reserve base multiplier had increased much more rapidly than had been foreseen in the targets. In the past, the attitude of the Turkish authorities had been that as long as they respected the monetary ceilings, they were on safe ground. Ceilings, however, did not necessarily indicate with certainty that the economy was on the right track. The difficulty arose perhaps in the distinction between targets and ceilings; the Turkish authorities had been expected to react quickly on slippages vis-à-vis the targets, even when the ceilings indicated that there was no slippage. He wondered whether it would not have been better to establish a more integrated program that would have taken into account the possibility of deviations from some magnitude that could influence the monetary aggregates and that would have envisaged alternative strategies for slippages beyond the control of the authorities. Slippages could then have been corrected within the alternative strategy without appearing to contribute to nonperformance.

He would be hesitant to admit a secular downward trend in workers' remittances, Mr. de Groote continued. Although many Turkish workers presently in Europe had settled there with their families and their reason for expatriating funds to Turkey was diminished, there was also a great flux of Turkish workers to other areas, especially the Middle East. It was noteworthy that the total amount remitted during the first seven months of 1984 was at the same level as for the first seven months of 1983--about $850 million--and remittances had increased over the past months. Also, there was a rational relationship between remittances and expectations of exchange rate movements. It would therefore be some time before a clear answer could be given to the question whether or not workers' remittances were on a secular downward trend.

As for other concerns expressed by Executive Directors, Mr. de Groote remarked that there was no reason whatsoever to expect that the Turkish authorities would abandon their attitude concerning the flexibility of the exchange rate; the adaptation of the exchange rate was part of the program and would continue to be so. As for tourism, the medium-term prospects for an increase were minimal. While he agreed with Mr. Salehkhou that a change in the Middle East situation would certainly have an impact on Turkish exports to that region, he noted that staff projections had been very conservative. With respect to inflation, the latest figures had been extremely satisfactory, and the Turkish authorities expected that good performance to continue through the end of the year.

The "growth" scenario for the medium term was based on very conservative assumptions, Mr. de Groote noted. Table 16 on page 45 of EBS/84/192 indicated a debt service ratio of about 22 1/2 percent for 1989, compared with 30 percent for 1984, even with an assumed high rate of expansion of real GNP; the growth in import volume, at 9.2 percent in 1989, was not very high, and export volume growth for 1989 had been forecast at 8 percent, while--in spite of all the economic difficulties--export volume growth had been 22 percent and was expected to continue at that level in the coming years. His Turkish authorities were firmly convinced that they had to readjust their economic planning according to export performance. The "adjustment" scenario might indeed be the one that would lead in the medium term to a higher income increase than the growth scenario because, paradoxically, it would reduce the weight of indebtedness and would allow the country to use more resources for investment rather than the repayment of debt. The Five-Year Plan was, however, indicative, and the growth scenario was a possibility if export performance were much better than now envisaged.

The multiple currency practice had been introduced at the suggestion of the World Bank, although aspects of the practice were purely Turkish, Mr. de Groote observed. The World Bank had been concerned that companies would not have an incentive to borrow from the Turkiye Sinaiye Kalkinma Bankasi because of the exchange risks involved: the loan would be available, but unused. That had been clearly explained on pages 51 and 53 of the World Bank report entitled "Turkey, Special Economic Report: Policies for the Financial Sector," published in September 1983. Similar multiple currency practices could be found in the export insurance and credit schemes used by many industrial countries to attract foreign investments. The need to request a waiver for that practice appeared to be a matter of interpretation; he would therefore prefer to consider it as a "contingent" waiver.

As to the prolonged use of Fund resources, Mr. de Groote noted that Turkish repayments to the Fund would be extremely high in the next three or four years. In other words, there was certainly a revolving use of Fund resources. Moreover, the possibility remained that Turkey would continue to need Fund assistance for some time: a Fund program would provide useful indicators to the banking community, establish a good framework of reference for the Turkish authorities to evaluate their own performance, and be useful in mobilizing public and intragovernmental agency support for the adjustment effort.

The Acting Chairman made the following summing up:

> Executive Directors were pleased with the recent marked improvement in Turkey's external payments position and, in particular, with Turkey's trade performance, following the temporary slippages from policy targets and the disappointing outcome for 1983. Directors found this turnaround particularly encouraging, at a time when the authorities implemented a significant relaxation of exchange controls and removed most quantitative import restrictions. For the most part, the successful external result was attributed to the combination of liberalization measures with a flexible exchange rate policy and a tighter monetary policy.
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> However, on the domestic front, Directors expressed concern about the re-emergence of inflationary pressures. While stressing the need to allow for adequate adjustments of key administered prices, they urged the authorities to refrain from accommodating--through monetary expansion--secondary inflationary repercussions of cost-push price increases. In this regard, most Directors felt that domestic credit growth should have been more restrictive so as to sterilize the balance of payments impact on the monetary base. While welcoming the recent increase in the legal liquidity requirement and government bond sales to commercial banks and the nonbank public, Directors supported the staff views with regard to the need for the monetary authorities to improve monetary policy instruments and techniques--including less

reliance on direct central bank credit allocation--and stressed that adequate control over liquidity was crucial to the attainment of the Government's objectives on inflation. While the maintenance of positive real interest rates and restrictive domestic credit creation were viewed as mutually supporting monetary instruments for bringing about a deceleration in the rate of inflation, Directors also stressed the role that fiscal policy could play in easing inflationary pressures, and some Directors suggested that more attention needs to be paid to restraining possible future wage increases.

Directors regretted the deterioration of the fiscal deficit in 1983, as against the improvement estimated earlier, and emphasized that it would require resolute and prompt action to attain a reduction in the deficit targeted for the current year. Noting the continued large overall public sector financing requirements and the relatively low level of government revenue to GNP, a number of Directors believed that a reduction in income taxes would be inappropriate, and that the authorities should consider the early introduction of a value-added tax. In addition, they urged early progress in improving tax administration to broaden the tax base. Directors also underscored the importance of effective implementation of the expenditure cuts envisaged in the 1984 program. Directors praised the policies aimed at increasing the efficiency of the operations of State Economic Enterprises, as well as plans to privatize some enterprises; they added that the overall financing requirements of the State Economic Enterprises remained excessive and should be reduced.

A number of Directors observed that the concentration of external debt maturities in 1985, as well as the gradual phase-out of concessional financing from official sources, imply that Turkey will have to resort to new borrowing from international capital markets over the next few years. They emphasized that the evolution of short-term obligations should be carefully monitored. They commended the authorities on the improvement in Turkey's creditworthiness, but they stressed that, in their view, Turkey's external debt position, while appearing to be manageable over the medium term, was presently still vulnerable, and noted with concern that available debt data may understate the true external debt position. Thus, great priority should be attached to further improving the external current account position and exercising caution in contracting further external debt. In this connection, concern was expressed that the Government's Five-Year Plan may be too ambitious in light of the external circumstances. Directors expressed full support for stepped-up efforts to encourage direct foreign investment and to sustain high export growth. It was noted that besides adherence to a flexible exchange rate and tight demand management, the ongoing structural reforms in the areas of trade, finance, and public enterprises, which were warmly welcomed by Directors, should help to promote greater efficiency in resource allocation. Such reforms should assist in reducing unemployment while maintaining a viable external payments position over the medium term.

Directors commended the Turkish authorities for the significant reduction in import licensing at the beginning of the 1984 and for their plans to implement further trade liberalization. Directors noted with regret the recently introduced foreign exchange risk insurance scheme and welcomed the decision to limit its scope and modify the practice in the future. Directors also regretted that a number of trade restrictions had been imposed on Turkish goods by other industrial countries.

Directors more generally noted the remaining weaknesses in the statistical data base in various areas that are crucial for financial policy formulation. They urged the authorities, with technical assistance from the Fund and the World Bank, to move promptly to improve the reliability of the statistical data base.

The next Article IV consultation with Turkey is expected to be completed within the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1984 Article IV Consultation

1. The Fund takes this decision relating to Turkey's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Turkey, in the light of the 1984 Article IV consultation with Turkey conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund welcomes the major liberalization of the exchange and trade system as described in EBS/84/192 and grants approval for any multiple currency practice that may arise under the operation of the Foreign Exchange Risk Insurance Scheme until December 31, 1985, or the next Article IV consultation with Turkey, whichever is the earlier. The Fund urges Turkey to terminate the remaining bilateral payments arrangement with a Fund member as soon as possible.

Decision No. 7821-(84/148), adopted
October 10, 1984

Stand-By Arrangement

1. Turkey has consulted with the Fund in accordance with paragraph 4(g) of the stand-by arrangement for Turkey (EBS/84/42, Supplement 4, April 5, 1984), and the letters of the Minister of State and Deputy Prime Minister, annexed to the stand-by arrangement, dated March 12, 1984 and March 28, 1984, in order to reach understandings with the Fund regarding policies and measures which Turkey will pursue through April 3, 1985 and to establish performance criteria subject to which purchases may be made by Turkey during the remainder of the stand-by arrangement.

2. The letter of the Minister of State and Deputy Prime Minister, dated September 4, 1984, shall be attached to the stand-by arrangement for Turkey and the letters of March 12 and March 28, 1984 shall be read as modified by the letter of September 4, 1984.

3. Turkey will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Turkey's currency in the credit tranches beyond 25 percent of quota:

a. During any period in which the data at the end of the preceding period indicate that:

(i) the limit on net domestic assets of the Central Bank referred to in paragraph 9 of the communication of September 4, 1984 and specified in the table attached to that communication is not observed; or

(ii) the limit on net Central Bank credit to the public sector referred to in paragraph 9 of the communication of September 4, 1984 and specified in the table annexed to that letter is not observed; or

(iii) the limit on the increase in outstanding foreign debt of the nonfinancial public sector and the banking system of up to and including one year described in paragraph 2 of the communication of September 4, 1984, which includes all normal trade-related credits and reserve liabilities of the banking system with the exception of savings schemes for workers abroad, and foreign exchange deposits is not observed.

b. If the understandings in paragraph 3 of the communication of September 4, 1984 are not observed.

4. The Fund finds that Turkey may make purchases under the stand-by arrangement notwithstanding any multiple currency practice that may arise from the operation of the Foreign Exchange Risk Insurance Scheme.

5. Paragraph 4(i) of the stand-by arrangement for Turkey (EBS/84/42, Supplement 4) shall be amended to read as follows:

(i) during the entire period of this stand-by arrangement, while Turkey has any overdue financial obligation to the Fund, or if Turkey...."

Decision No. 7822-(84/148), adopted
October 10, 1984

2. COLOMBIA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Colombia (SM/84/216, 9/18/84; and Cor. 1, 10/5/84). They also had before them a report on recent economic developments in Colombia (SM/84/220, 9/27/84; and Cor. 1, 10/5/84).

Mr. Kafka made the following statement:

My Colombian authorities fully agree with the general thrust of the staff analysis and recommendations.

Accordingly, they have accelerated the execution of the adjustment program, which the staff considered to be correctly addressed to Colombia's problems. The only delays presently envisaged in carrying out the program are those due to the need to secure legislative approval for some of the measures contained in the program; these delays are not expected to prevent the program from being fully in place by the end of the current year. Those measures not requiring legislative approval are for the most part already being applied.

The staff and the Colombian authorities agree that the most urgent problem is to stop the decline in reserves, although they still represent more than 5 months' imports and although the seasonal pattern of Colombian payments suggests that the reserve loss will be sharply reduced till the end of the year. In the view of the Colombian authorities, the principal means to reduce the reserve loss both in the immediate future and in the context of medium-term adjustment will be reductions in the fiscal deficit and in the rate of growth of bank credit. This would be without prejudice to the temporary use of restrictions. The reserve loss does not, however, stem exclusively from excess demand; there is also an ongoing net reduction in foreign loans outstanding. My Colombian authorities propose to arrest this latter source of reserve loss through negotiations with official and private creditors. In fact, the current account deficit is now reduced to the same level as in 1981 when reserves were still growing. Were it not for the increase in interest rates, of course, the current account deficit would be well below that recorded in 1981. Official capital inflows also are almost the same as in that year. Only private sector capital net inflows and, to a much smaller extent, transactions of the financial system are substantially below their 1981 levels. Thus considerable adjustment has been achieved, but in view of the changed situation in the capital markets, it is not sufficient. It is noteworthy that the adjustment was achieved while substantially reducing the rate of inflation. Colombia was helped in its anti-inflationary policy by the fact that wage pressures have been relatively moderate.

The fiscal deficit is being attacked on several fronts. Current expenditures rose by 1.5 percent of GDP from 1979 to 1983, and it is estimated that they will have increased by 2.5 percent between 1979 and 1984. Capital expenditures are expected to rise by a slightly lower percentage between 1979 and 1984. Thus public sector expenditures are expected to increase by nearly 5 percent of GDP between 1979 and 1984, of which about 2 percent correspond to increases in wages and salaries. Slightly more than half of the increase in expenditures, but only a third of the rise in wages and salaries, pertain directly to the Central Administration. In addition, a high proportion of the current transfers of the Central Administration cover salary expenses of the decentralized agencies. The steps which the Government has taken to reduce current and capital expenditures are fully described in the consultation report and there is therefore no point in my adding to it. Since the report was written, however, the authorities have brought forward the submission of additional bills which were contemplated at the time of the Fund's mission but had not yet at that time been sent to Congress. It is particularly noteworthy that the plan of the Colombian authorities envisages a reduction in real terms and in relation to GDP not only in capital, but also of current expenditures, the latter largely through limitations on increases in the public sector wage bill. Total public sector revenue is expected to fall by 2 percent of GDP between 1979 and 1984; it had fallen more to end-1983, but has already started rising, owing to revenue measures adopted since 1983; a series of further measures await adoption by the Congress. They include both increases in the scope, and acceleration of the collection, of income taxes; reductions in deductions; increases in the stamp tax; and measures to control tax evasions. Increases in the customs tariff, which have already been enacted, and increases in the gasoline tax are also expected shortly. The authorities propose to continue to adjust public sector prices in real terms.

In addition to reducing the deficit, the authorities propose to reduce its financing through bank credit by the issuance of government bonds accompanied by interest rate policies that will ensure their ability to place these bonds with the public rather than with the banking system, and particularly with the Central

Bank. Particularly noteworthy in this connection is the restructuring of electricity rates, which is designed substantially to raise the sector's revenue without excessively raising the cost of electricity to the lower income groups; consumers are being classified into six categories according to their capacity to pay, and rates will burden consumers of greater wealth in a more progressive fashion than at present.

As indicated by the projections in the staff paper, the rate of expansion of credit by the financial system is expected to be reduced in 1984, mainly at the expense of the private sector. The reduction in the deficit, however, will make it possible to reduce the overall expansion of the net domestic assets of the financial system while alleviating the burden on the private sector.

The Colombian authorities do not interfere in private wage negotiations except by setting the minimum wage. They have decided that the increase in minimum wages should be reduced significantly in the coming year, although precise increases can only be decided toward the end of the year.

Coffee policy can become a problem leading to demand expansion both when coffee prices rise and when they fall. Under present conditions the neutrality of the coffee sector as an element in demand expansion will be assured by the Government's refusal to subsidize that sector and, specifically, to face up to its costs of stockholding.

The Government is taking several measures which should reduce further the current account deficit of the balance of payments as well as that of the capital account. The exchange rate has been and will continue to be devalued at a rate substantially in excess not only of the differential between Colombian and world inflation (the most usual technique), but considerably in excess of domestic inflation. In this way the international competitiveness of the Colombian economy will be assured and purchasing power parity will have been re-established at the mid-1970s' level--the period when the exchange rate was most depreciated in real terms--within approximately 12 months. The authorities are at all times alert to exchange rate problems that movements in the major currencies may produce. The cost imposed on a country opting for a gradual rate of real depreciation (apart from some delay in the full re-establishment of competitiveness), is an increase in the domestic real interest rate which it requires to prevent capital outflows. In Colombia's present circumstances, in which it is obliged to reduce demand pressures, such increased real interest rates, although inconvenient, are felt by authorities to be tolerable. The real rates necessary to prevent capital outflow would in any case be far lower than in many other Latin American countries. The authorities have also taken steps to reduce net capital outflows (and in fact to arrange for some modest increase in borrowing). They have established incentives for private debtors in Colombia to renegotiate their debts without putting at risk the Central Bank's operational performance. Their incentive system is somewhat similar to that being applied by Mexico. In addition, the authorities intend to obtain new financing from commercial banks and from official creditors. Furthermore, a series of measures are being adopted to stimulate foreign private direct investment in Colombia, including measures designed to reduce bureaucratic obstacles to such investments as well as liberalizing the rules for remittance of profits. For these purposes, important modifications are being introduced into Resolution 24 of the Cartagena Agreement.

My authorities also agree with the two scenarios on which the staff bases its medium-term projections. Even in the less favorable Scenario II, Colombia will still realize a decline in the debt service ratio compared with 1984, as well as in the final year of the period encompassed by the scenario. Moreover, throughout the period the ratio will be only slightly higher than in the favorable Scenario I. My authorities believe, however, that the effect of the most recent oil discoveries on the medium-term current account deficit may make it possible to approach the growth rate in Scenario II with a lower level of indebtedness than that presented in the scenario.

Altogether, therefore, my Colombian authorities feel that their program and its acceleration are well designed to bring the reserve loss to a halt in the near future, and thereby preserve their ability--almost alone among Latin American debtor countries--to continue to discharge their interest obligations as well as their amortization payments.

Mr. Templeman stated that during the past few years Colombia had largely been able to escape the grave international debt problems that had confronted a number of other Latin American countries. Its history of responsible economic management and its relatively low foreign debt had helped to protect Colombia from the backlash of the debt crisis. However, gradual slippages in a number of policy areas, notably with regard to the exchange rate, the public sector deficit, monetary expansion, and wage rate increases, were presently jeopardizing Colombia's financial position and its image in financial markets. Although some external factors were to blame and a few corrective measures had been taken, it was not clear that enough was being done.

The deliberately stimulative fiscal and monetary polices of 1983, although prompted by the desirable objective of preserving real economic growth, had not produced the desired results, but had in fact contributed to the steady loss of foreign reserves, Mr. Templeman added. Fortunately, the authorities had recognized the need to reorient financial policies. First priority had to be given to measures aimed at immediately limiting the decline in international reserves and preserving Colombia's competitiveness and creditworthiness over the medium and long term; domestic demand must be contained through the reduction of the public sector deficit and a lower rate of monetary expansion; and nominal and real wage rate increases needed to be moderated. Furthermore, if the resulting slackening in domestic demand was to be offset by export growth--ending a prolonged period of export stagnation--more attention must be given to the adequacy of exchange rate policies. The rapid growth of restrictive devices must also be reversed to improve economic efficiency and international competitiveness. The Fund could play a helpful role in strengthening the adjustment effort.

The rundown of reserves, adverse developments in the capital account, and the reversal of Colombia's current account was striking, Mr. Templeman observed. The current account had shifted from a surplus of 2 percent of GDP in 1979 to a deficit equal to 7 percent of GDP in both 1982 and 1983. Total exports in dollar terms had actually declined for three successive years, while imports had grown rapidly until 1983. Nontraditional exports, which had peaked at $2.2 billion in 1980, had hovered around $1.8-1.9 billion thereafter. The composition of GDP showed a relative decline in the importance of manufacturing and commerce since 1979, while the relative size of the public administration had increased. Such a shift in the structure of the productive system did not seem conducive to economic development, modernization, and diversification.

Careful management of both exchange rate policy and domestic demand was required, Mr. Templeman considered. While the real effective exchange rate had been depreciating since the end of 1982, Colombia was still some distance from restoring its competitive position of the mid-1970s. He had no problem with the crawling peg mechanism; it was the rate of movement that mattered. The path of the real effective exchange rate did not in itself provide convincing evidence of competitiveness, but Colombia's poor export performance in recent years, increasing resort to trade and payments restrictions, and the use of direct export incentives strongly suggested that something might be amiss. The need to increase exports was related both to Colombia's overall economic growth prospects and foreign debt situation. The ratio of debt to GDP had risen from about 20 percent in 1980 to over 30 percent in 1984. While that figure was much lower than in many Latin American countries, the pace of increase had been rather fast and the expected debt service ratio of more than 40 percent for 1984 was nearly double that of the average non-oil developing country.

The two key policy issues for demand management were the continued large public sector deficit and the corresponding pressure on monetary policy and the high rate of real wage increases in recent years, Mr. Templeman observed. Despite the legal limitations on the ability of the Government to impose wage restraints, wage moderation in government salaries and in the minimum wage could have an important effect. The budget deficit problem was closely related to the wage problem, since the rapid rise in nominal and real wages in the public sector constituted a large and growing burden on the budget. For example, the ratio of wage and salary payments to GDP had increased from 5.4 percent in 1979 to 7.1 percent in 1983. Capital expenditures had also been growing relative to GDP, while total revenues had declined from more than 22 percent in 1979 to about 19 percent in 1983. The decline in nontax revenues had been particularly large, amounting to 2.1 percent of GDP between 1979 and 1983, due in considerable part to lost income from declining foreign exchange reserves--further evidence of the gravity of the balance of payments problem.

He was encouraged that the authorities contemplated limiting public sector wage rate increases in 1985 to 10 percent, considerably below the expected rate of inflation and that total current outlays of the Central Administration in the 1985 budget would be limited to a 10 percent increase, compared with 30 percent in 1984, Mr. Templeman remarked. However, the fate of those various proposals still seemed unclear. Could the staff or Mr. Kafka provide more detail on the prospects for implementing those measures, the possible effects on the forecast public sector deficit of 8.2 percent of GDP in 1984, and the corresponding deficit/GDP ratio in 1985?

On monetary policy, he would reiterate the staff's advice that limiting central bank financing of the public sector was essential to fighting inflation and improving the balance of payments, Mr. Templeman added. The authorities recognized that although real interest rates were quite high, they contributed to protecting the capital account and might therefore be unavoidable. Colombia, like a number of countries, was having some difficulty managing monetary policy, in part because of the financial difficulties of the local banking system. That phenomenon seemed to be sufficiently widespread in member countries to be an interesting subject for further study.

Finally, Mr. Templeman remarked, the steady growth of new trade and payments restrictions was greatly disappointing. His current concern was not just a formal one in connection with Colombia's obligations under the Articles of Agreement but reflected the firm belief that those measures would seriously jeopardize Colombia's future prospects for economic growth with financial stability as part of an open world trade and payments system.

Mr. Polak recalled that during the Board discussion of the 1983 Article IV consultation with Colombia (EBM/83/97, 7/1/83), there had been considerable concern about the rate of decline in reserves. The official view in Colombia, as conveyed by Mr. Kafka, had seemed to be that the loss in reserves had been stopped and that the problem had ceased to exist. That had not been the case; the reserve loss had got out of hand, and the lag in recognizing the problem as well as the lag in implementing a corrective policy action had led to the adoption of measures that were both too little and too late. It was true that, thanks to prudent policies over the preceding years, Colombia's reserve position was still not a cause of major concern; indeed, at the onset of the recession, it had been far more favorable than that of the other major Latin American countries. Non-gold reserves, which had totaled SDR 4.1 billion at the end of 1981, were currently SDR 900 million. However, if the present rate of reserve loss continued for the balance of 1984, reserves would be exhausted. Prompt action was required, and he noted with satisfaction that the authorities planned to act already in 1984 to stem the reserve loss, as well as in 1985.

Improvement of the overall balance of payments could be achieved by capital inflows or by better performance on the current account, Mr. Polak observed. Although the staff report indicated that the authorities intended to resort to larger foreign financing, that would require improved demand management; in his view, it would be better for all efforts to be devoted to improving the current account. Over the years 1981-84, Colombia had run up a staggering $9 billion cumulative current account deficit compared with a total figure of $600 million for the preceding 12 years. While the authorities had taken the view that the current rate of depreciation of 28 percent a year in comparison with the lower rate of inflation would, by end-1985, restore the competitive position of Colombia to that in the mid-1970s, he questioned whether that assumption was true and whether the results would be achieved early enough. Both the authorities and the staff had placed excessive confidence in the theory of purchasing power parity, which had limitations and raised questions concerning the fundamental structure of Colombia's balance of payments at present compared with what it had been ten years previously, as well as questions of measurement. The staff comparison had been based on cost of living indices, when the problem in Colombia had been increased in the real wage rate; would a wage-based index have given different results? The staff had indicated that a close review of the problem was needed, and it would have been helpful if it had taken the opportunity provided by the 1984 Article IV consultation to undertake such a review.

The authorities had decided to center their demand management effort on a reduction of the fiscal deficit in 1985, and he welcomed the intended policy of holding wage increases below inflation, which would partially correct the substantial increase in real wages that had taken place in 1983-84, Mr. Polak remarked. Some budget measures should be brought forward to enable early decisive action on reserves. Public sector wages had risen even faster in the rest of the public sector than in the Central Government, and as Mr. Kafka had indicated in his opening statement, the Central Government reimbursed other public authorities for a considerable part of their wage bill, including increases that had been granted by those authorities, apparently without Central Administration control. Such a situation could not be allowed to continue, and he hoped that the announced proposals for new laws would help to tackle that problem. Moreover, the central authorities should ensure that they received the necessary information on public sector transactions that took place outside the Central Administration.

Over the past 24 months real wages as a whole had increased 15 percent, Mr. Polak noted, suggesting that not only fiscal but also monetary policy had been too expansionary. In that connection, more information on the impact of interest rates and exchange rate policy would have been useful. The staff appraisal had mentioned that although interest rates were highly positive, they were not high enough given interest rates abroad and the current exchange rate. Was the staff referring to the actual exchange rate, exchange rate policy, or exchange rate expectations? He would appreciate further clarification.

The exchange rate, Mr. Polak considered, appeared to be overvalued, since the country had found it necessary to shift heavily in the direction of import restrictions, especially in February and April. While more appropriate demand measures could have prevented the need for such action to some extent, he wondered whether the authorities might not also need to reconsider their exchange rate policy.

The scenarios for the medium-term outlook indicated the need for immediate and difficult adjustment, Mr. Polak observed. In previous years, Colombia had been able largely to avoid difficult adjustment because of the favorable position it enjoyed as a result of earlier sensible policies. He hoped that measures would be quickly taken lest that advantage be wasted and Colombia find itself in as difficult a position as other countries in Latin America.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/147 (10/9/84) and EBM/84/148 (10/10/84).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 84/68 are approved. (EBD/84/258, 10/3/84)

Adopted October 10, 1984

APPROVED: July 15, 1985

LEO VAN HOUTVEN
Secretary