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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/115

10:00 a.m., August 23, 1982

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Abdollahi	
J. Anson	C. Taylor
	E. Portas, Temporary
J. de Groote	H. G. Schneider
	A. Le Lorier
R. D. Erb	C. Dallara
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
	F. A. Tourreilles, Temporary
	D. I. S. Shaw, Temporary
A. Kafka	J. R. Gabriel-Peña
B. Kharmawan	
	F. Sangare
G. Laske	
G. Lovato	C. P. Caranicas
	A. B. Diao, Temporary
M. Narasimham	A. S. Jayawardena
Y. A. Nimatallah	S. El-Khouri, Temporary
	T. de Vries
A. R. G. Prowse	B. Legarda
	L. Vidvei
Zhang Z.	

L. Van Houtven, Secretary
K. S. Friedman, Assistant

1. Turkey - Review of Stand-By Arrangement and Program for Third Year, and Exchange System . . . . Page 3
2. Eighth General Review of Quotas - Draft Report to Interim Committee . . . . Page 28

Also Present
Asian Department: E. Gurgen. European Department: L. A. Whittome, Counsellor and Director; L. Alexander, L. Hansen, P. C. Hole. Exchange and Trade Relations Department: S. Kanesa-Thasan, N. Kirmani. External Relations Department: D. M. Cheney, I. S. McDonald. Fiscal Affairs Department: G. Blöndal, M. Z. Yucelik. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman. Middle Eastern Department: Z. Iqbal. Research Department: R. R. Rhomberg, Deputy Director; W. Easterly, R. Saracoglu. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; R. J. Familton, Deputy Treasurer; D. Williams, Deputy Treasurer; Q. M. Hafiz. Bureau of Statistics: B. Cozier, G. Talmain. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, A. B. Diao, L. Ionescu, M. A. Janjua, G. Jauregui, P. Kohnert, S.-W. Kwon, P. D. Péroz, F. Sarraf, Wang E., F. Yeo T. Y. Assistants to Executive Directors: H. Alaoui-Abdallaoui, T. A. Connors, R. J. J. Costa, I. Fridriksson, G. Gomel, W. Moerke, J. A. K. Munthali, J. R. Novaes de Almeida, J. G. Pedersen, G. W. K. Pickering, C. N. Pinfield, D. V. Pritchett, M. Z. M. Qureshi, J. Reddy, J. F. Williams, A. A. Yousef, Zhang X.

1. TURKEY - REVIEW OF STAND-BY ARRANGEMENT AND PROGRAM FOR THIRD YEAR, AND EXCHANGE SYSTEM

The Executive Directors considered a staff report on the review of the stand-by arrangement for Turkey and the program for the third year of the arrangement, together with a proposed decision on the exchange system of Turkey (EBS/82/130, 7/26/82).

Mr. de Groote commented that there were no differences of view between the staff and the authorities. The economy had made a remarkable recovery in the previous two years: the rate of inflation had been gradually reduced from more than 100 per cent to about 30 per cent; the central government deficit had fallen steadily, to the equivalent of 1.5 per cent of GNP in 1982; exports and workers' remittances had risen by 62 per cent and 20 per cent, respectively, in 1980-81; and current external receipts had risen from 9 per cent of GNP in 1980 to 13 per cent in June 1982. Government intervention in resource allocation had been reduced to the minimum necessary, and interest rates and the exchange rate had been fully liberalized. Those results had been achieved despite the generalized recession and mainly because the authorities had strictly adhered to the program and had reacted quickly to problems.

Strict application of the adjustment policies had caused in 1981 a 4.5 per cent increase in real terms in GNP, which had been falling in 1980, Mr. de Groote went on. The main elements of the policy stand were tight fiscal and monetary measures combined with flexible exchange rate and interest rate policies. To control aggregate demand, fiscal and monetary policy was supplemented by restraint on wage settlements in both the public and the private sectors. The Government was committed to keeping wages from causing upward pressure on prices.

In implementing their adjustment program, the authorities were paying special attention to problems that posed a threat to continued progress toward economic recovery, Mr. de Groote commented. The greatest threat was the resurgence of inflationary pressures. The downward trend of inflation had slowed, especially in the second quarter of 1982, as a result of developments in both the external and the internal sectors. The quick and strong recovery of the balance of payments had created excess liquidity in the economy, and the monetary aggregates had subsequently come under heavy pressure from unexpected developments in nonbanking financial circles, the failure of the banks to observe the reserve requirements, and central bank financing of the record harvest. The Government had already decided to tighten monetary policy in order to control the rate of expansion of the monetary aggregates and eliminate excess liquidity in the banking system. The measures outlined in the Finance Minister's letter of July 1982 would considerably limit the reserve money multiplier effect, and the authorities had reached an agreement with the staff on the limits to be placed on the net domestic assets of the Central Bank through the end of 1982.

As a result of their constant review of expenditure and of revenue performance, Mr. de Groote continued, the authorities were confident of their ability to meet the financing requirement in 1982, which, at about 1.5 per cent of GNP, represented a large reduction. Additional improvements in tax collection and administration were to be made, the projected increase in expenditures seemed to be within manageable limits, and the authorities' public investment strategy--including the scope and sectoral distribution of investment funds--had gained the support of the World Bank.

There was still a long way to go before the position of the state economic enterprises would be fully satisfactory, Mr. de Groote remarked. Further improvements had been made in the first six months of 1982, and the enterprises were no longer a burden on the budget, but the authorities continued to be unsatisfied. The first and essential step in rehabilitating the state economic enterprises, namely, subjecting their operations to market forces, had been taken. The authorities planned to give some momentum to the rehabilitation by making the operation and management of the enterprises more rational and autonomous.

Externally, Mr. de Groote said, the authorities had gone a long way in reducing and eliminating several preferential and selective practices that had been designed to protect domestic economic activities and had had a strong bias against exports. Further progress in eliminating the remaining distortions was an integral part of the present policy stance.

Unemployment was still a formidable problem, Mr. de Groote commented. The rate of unemployment had reached about 15 per cent and could probably not be reduced to any considerable extent in the short run. The staff had correctly noted that the more efficiently existing labor capacity was used, the less room there would be to lower the rate of unemployment. That constraint was particularly important in the medium term and underscored the need to encourage the best possible relationship among growth, employment, and the external current account position.

The authorities shared the staff's concern about possible developments in the coming four years, Mr. de Groote remarked. They had taken full advantage of the sizable foreign assistance and debt rescheduling available thus far, but they did not take for granted the desired steady improvement in the balance of payments in the coming years. They believed that the necessary adjustment effort left no room for concessions. Although several industrial countries had increased their reliance on protection, thereby placing in jeopardy Turkey's continued good relations with more than one country in the European Community (EC), the authorities were confident that Turkish exports would perform well enough to improve the current account position, mainly because of the flexible exchange rate policy, the promising opportunities for penetrating new markets, the effort to diversify exports, the measures for keeping domestic demand in check, and the prudent management of Turkey's external debt.

The limits within which the balance of payments would develop in the medium term were well illustrated in Appendix III, which the Turkish authorities felt provided useful guidance for determining the particular form and dimension of a number of policy options, Mr. de Groote commented. The figures in Appendix III should be seen as a kind of frame of reference rather than as projections. The authorities wished it to be clearly understood that they intended to maintain policies designed to improve the allocation of resources, something that was essential for achieving the desired rate of growth of the economy. After two years of overachievement in the balance of payments, the authorities were optimistic about securing the needed inflow of foreign exchange. They were firmly convinced that the country was on the path to achieving balanced and sustainable growth; they appreciated the understanding that had been shown toward, and the confidence that had been placed in, the country in the previous two years.

Mr. Laske said that Turkey had made considerable progress toward reducing the internal and external imbalances in the economy. The authorities were to be commended for the persistent and effective efforts that they had made to stabilize and restructure the economy. The main architect of the adjustment process in Turkey had recently left public service, and it was reassuring that the authorities had confirmed that the policy orientation of the previous two years was to be continued in the coming period. The bilateral and multilateral assistance that Turkey had received had enabled the authorities to maintain a vigorous and determined adjustment effort. Turkey had clearly made good use of the resources made available to it.

His authorities, Mr. Laske continued, attached great importance to a number of the positive results recorded in the previous two years. The reduction in the external account deficit had been substantially greater than expected, and, largely because of the progressive liberalization of imports, there had been a marked increase in the supply of foreign inputs essential to reviving the economy. In addition, the rate of inflation had been considerably reduced from the very high rate recorded in 1980, mainly because of the tight monetary policy that had been maintained in 1981. There had also been a marked improvement in the fiscal situation, as the public sector borrowing requirement--particularly the domestic element of it--had been reduced. However, the state economic enterprises continued to be a drain on the budget, and further improvements in those enterprises were clearly needed. Table 6 showed that the losses resulting from the maintenance of price controls were still relatively large; they had risen in 1981 in comparison with 1980 and were not projected to fall noticeably in 1982. More progress in pricing policy was urgently needed.

The 4.5 per cent real increase in GDP in 1981 was satisfactory, Mr. Laske considered. It was considerably better than originally expected, and it constituted a dramatic reversal of the poor performance in both 1979 and 1980. He hoped that the good growth performance in 1981 could be repeated in 1982.

The commendable progress in the first two years of the stand-by arrangement should be seen in the light of the medium-term outlook for the Turkish economy, Mr. Laske remarked. Turkey had received substantial financial assistance in the previous two years; the volume of the assistance would gradually taper off beginning in 1983. At the same time, Turkey's debt service obligations would begin to increase as many of the loans taken up by the country began to reach maturity.

Appendix III, which described the medium-term perspective for Turkey's balance of payments, was informative, Mr. Laske commented. It would be prudent for Turkey to avoid rolling over loans that were scheduled to fall due in the coming several years. Turkey would have to manage its affairs in such a way that it would be ready to pay off old loans and to pay its own way henceforth.

Commenting on the three scenarios presented in Appendix III, Mr. Laske said that it was unrealistic to assume no further improvement in the current account of the balance of payments. Nor was it realistic to assume a complete elimination of the current account deficit, which would entail a rather unsatisfactory growth performance and an unfavorable employment situation. The only sustainable alternative was the middle scenario's gradual, but by no means feeble, further reduction in the external current account deficit. Such a reduction would strengthen foreign creditors' confidence in the Turkish authorities' ability to deal with the admittedly difficult problems facing the economy; it would also increase the chances of there being a sufficiently large inflow of autonomous capital and of achieving and maintaining a viable balance of payments position. The middle scenario also provided for sufficient growth to prevent a worsening of unemployment.

The lessons to be drawn from the scenarios, Mr. Laske commented, was that demand management must steer a rather careful course to permit a continuous winding down of inflation. The authorities would have to press ahead vigorously with their efforts to restructure the economy in general, and to make more resources available for the external sector in particular, thereby generating a sufficient volume of exports. Moreover, exchange rate policy must be kept flexible to safeguard the economy's competitive position. Unfortunately, in the first half of 1982 there had been some important and worrying slippages, and he was pleased that the authorities were determined to take the necessary steps to deal with them. He was also pleased that the downward trend in inflation had recently been re-established, although the rate of inflation had not fallen to the rate recorded earlier in 1982. The rate of monetary expansion had accelerated dramatically--the increase in M-2 being 20 percentage points higher than expected--mainly because of the improved external position and the prolonged nonobservance of the minimum reserve requirements by banks. He wondered whether the nonobservance was characteristic of the entire banking community, or whether it was limited to a relatively small number of banks. The unexpectedly rapid increase in the growth of monetary aggregates was also due to the special assistance that had had to be given by the Central Bank to the banking system after the recent collapse of a large financing company in Turkey.

It was crucially important to bring the growth of the monetary aggregates back on track in the second half of 1982, Mr. Laske said, and he fully approved of the measures that the authorities planned to introduce in order to enforce the observance of the reserve requirements. One of the steps planned was to establish a schedule for eliminating the deficiencies in the observance of the reserve requirements; the schedule should certainly offset the previous underperformance, but care should be taken to avoid squeezing unduly the financial institutions that had been particularly affected by the recent financial crisis. The authorities also planned to increase the penalty rate for nonobservance of the reserve requirements and to increase the "effective" reserve requirement ratio for deposits that constituted the base for preferential credits. It would be useful to have an explanation of the meaning of "effective" in the reserve requirement ratio mentioned by the staff. The reserve requirement ratio on time deposits carrying an interest rate of more than 50 per cent was to be increased, and presumably the ratio for time deposits carrying a lower interest rate would remain unchanged. He wondered what the rationale was for maintaining different ratios.

It was important to stress the urgent need to restrain monetary expansion as a part of the effort to reduce the rate of inflation, Mr. Laske stated. In the first half of 1982, there had been a jump in wholesale prices and in the three cost of living indices covering the larger urban areas. The authorities believed that the rate of inflation would drop significantly in the second half of 1982, and he wondered whether they had a particular target in mind. The staff had mentioned that the Central Bank would have to continue providing financial assistance to banks that had been adversely affected by the collapse in June 1982 of an important financial institution. The financial program for 1982, including the performance criterion for the net domestic assets of the Central Bank, had been established before the crisis had hit the banking system. The authorities felt that the performance criterion could be observed despite the additional assistance that the Central Bank was expected to provide. Did the staff share that view? The authorities faced the delicate task of deciding on the amount of financial assistance that would be necessary to maintain the proper functioning of the banking system. In the banking system's present fragile state, a rapid reduction in overall liquidity might well push one or more banks to the brink; that danger should be avoided. If additional assistance was needed to avoid a kind of domino effect on individual banks, the Central Bank might have to step in. In doing so, the Central Bank should be careful not to be overgenerous and should avoid giving the banks the impression that the authorities would bail them out no matter how serious the managerial mistakes might have been. On the other hand, Turkey's foreign creditors had to be reassured that the authorities would not allow the financial system to become endangered. In dealing with the crisis, the hand of the Central Bank would have to be visible, but it should not be overextended. If the Central Bank provided further assistance to the banks, it should make certain that the resultant monetary expansion was reversed as quickly as circumstances would permit.

He was pleased, Mr. Laske said, that the management and overall effectiveness of the state economic enterprises had obviously improved in the previous two years. Ideally, the state economic enterprises should significantly reduce their recourse to the budget, thereby supporting the other efforts being made to increase public savings. One of the goals of the Government was a real decline in the rate of investment by state economic enterprises. Presumably that objective had to do mainly with a running down of existing stocks, and he wondered whether it would not include a decline in fixed investment. A fall in investment in plant and equipment might have a negative effect on the productivity and operations of state economic enterprises if it meant that obsolete equipment had to be kept in operation. There had been a large--perhaps excessive--increase in the inventory stocks of state economic enterprises, and he wondered whether the increase was due to overcautious stock management, or to an accumulation of unmarketable goods.

The authorities' flexible approach to exchange rate policy was welcome and should be continued in the coming period in order to enhance the competitiveness of the economy, Mr. Laske said. In that connection, reducing the rate of inflation by the desired extent was especially important. Pricing policy would have to be rational, and wage developments should not result in an increase in the operational deficits of state economic enterprises. Timely adjustments in the prices that they charged would help state economic enterprises to eliminate their operational deficits. Finally, he was pleased that the authorities had permitted increases in energy prices to be passed on fully to consumers, and that the authorities were determined to press ahead with their effort to reduce Turkey's dependence on imported energy products.

Mr. Erb stated that he broadly agreed with the staff appraisal. The appendix on the medium-term balance of payments perspective was particularly useful.

He was pleased, Mr. Erb went on, that Turkey had continued to make gains under the stand-by arrangement, despite the recent slippages in the monetary area. The determination of the new economic team to continue implementing the economic stabilization program was encouraging.

He agreed with the staff, Mr. Erb remarked, that the excessive growth of the monetary aggregates and the related increase in inflation were worrying. The authorities' intention of enforcing reserve requirements and of adopting other measures to reduce liquidity should help to control the monetary aggregates and increase confidence in the banking system. One of the difficulties in controlling the monetary aggregates was the unexpectedly strong improvement in the balance of payments. The authorities had successfully sterilized some, but not all, of the effects of the strengthening of the balance of payments on the money supply. What was the staff's view on the effectiveness of the instruments that the authorities had used in their attempts at sterilization? He, like the staff, attached importance to the authorities' commitment to consult the Fund if balance of payments developments should again lead to an unexpected increase in the rate of growth of reserve money.

He agreed with the staff, Mr. Erb commented, that the authorities would have to continue making progress in the area of the state economic enterprises. He attached the utmost importance to improving the efficiency of their operations and to ensuring that they did not drain scarce public sector resources or absorb credit that could otherwise be directed to the private sector.

As was clearly shown in Appendix III, Mr. Erb said, a further reduction in the external current account deficit was needed. The authorities had considerably improved the external position, and a key to continued success in the coming months was the further application of a flexible exchange rate policy. Which policy areas were expected to provide the basis for a further improvement in the external position in the medium term? The staff had concluded on page 18 that "in this connection, it remains crucial over the next two years for the authorities to replenish and enlarge the existing pipeline of project credits if the stream of capital inflows that can be counted on after mid-1984 is to be sufficient to limit the recourse to more general external payments financing to a feasible amount." In making judgments about major projects, did the authorities give a high priority to allocating resources to investments that would help to promote the needed adjustment of the economy?

As he had stressed on previous occasions, Mr. Erb recalled, medium-term analysis should be an integral and regular feature of all reports by the staff on member countries' programs. He recognized the uncertainties that were characteristic of any analysis of the medium-term outlook, but the approach that the staff had taken in Appendix III--namely, setting forth various different scenarios with related assumptions--was useful. While that approach might well serve as a model for other program presentations, the staff should be flexible, determining in each case how best to present its medium-term analysis. Finally, although additional adjustments would be needed, Turkey appeared to be on the road to achieving a sustainable balance of payments position, and he approved of the program for the third year of the extended arrangement.

Mr. de Vries remarked that, although he had expressed confidence in the Government's new policies when they had been introduced in 1980, he harbored some doubts about the likely course of the adjustment effort in the coming period. The results under the program in the first half of 1982 had been mixed. The fact that the main architect of the adjustment program had left public office had naturally led him to doubt whether the political commitment to the program that had been evident in the past would be maintained in the future. Reassuring statements had been made about the continuation of the present policies by the new economic team, but, over time, as the economic situation continued to improve, the program would have to be advanced by the adoption of new measures. He strongly hoped that the remarkable progress achieved in 1980 and 1981 would be continued in 1982 and 1983.

The economy had been placed on the right course, Mr. de Vries went on, and the authorities would have to make the necessary adjustments in coming months in order to keep on course. In that connection, particular attention would have to be paid to the rate of monetary expansion. The monetary situation was somewhat unclear to him. For instance, it was not fully clear why the reserve requirement had not been observed by the banks. The nonobservance was worrying because it undermined monetary control and because it could adversely affect the safety of the banking system in Turkey. He looked forward to hearing the answers to the questions about the nonobservance posed by Mr. Laske. Another worrying aspect of monetary policy was that the monetary program had been drawn up before the crisis in confidence resulting from the failure of the country's largest nonbank financial intermediary. A further comment on the monetary program and on the effects of the Central Bank's effort to support the banking system would be useful. The monetary authorities faced the difficult task of keeping the rate of increase in the money supply on track while providing the assistance needed to avoid additional bank failures. Given the difficulty of the present uncertain monetary situation in Turkey, the elaborate provisions for consultation with the Fund were certainly welcome.

There was a clear need to maintain budgetary discipline, and the authorities were determined to do so, Mr. de Vries remarked. However, there had been some deferments in tax payments from 1981 to 1982, and there had been an increase in accounts payable, apparently to circumvent the established monetary ceilings. As for the state economic enterprises, the situation had been difficult in the past, and some additional improvements in pricing policy still seemed needed. Moreover, better control of stockbuilding by the state economic enterprises seemed to be called for. The reduction in fixed investment by the state economic enterprises might well be a hopeful sign, as it would probably make some room for investment activities outside the enterprises.

In assessing the unemployment problem in Turkey, Mr. de Vries commented, the authorities had said that the more efficiently labor was used, the more difficult it became to create full employment. That conclusion was tantamount to saying that there was a given amount of work to be done and the more efficiently it was done the greater would be the number of persons without employment. If the situation were as simple as that, it would be easy to create full employment by decreasing labor efficiency until everyone was employed. His premise was of course wrong: there was never a given amount of work and unemployment. The opportunities for employment increased as workers became more efficient, a goal that seemed to be a major feature of Turkey's adjustment program. In the medium term, employment opportunities could increase significantly as labor efficiency improved.

He was pleased with the remarkable export performance of the previous two years, Mr. de Vries said; but he wondered how Turkey would manage after the completion of the stand-by arrangement and the expected tapering off of the special assistance that it had received in recent years. In that connection, the scenarios that the staff had described were illuminating.

As the implementation of the adjustment program continued in the coming months, Mr. de Vries remarked, it would become increasingly difficult to persuade the Turkish people to bear the hardships caused by a fundamental adjustment effort. Hence, it would be increasingly important to eliminate as soon as possible the remaining distortions in the economy in order to pave the way for even more rapid economic growth than had recently been achieved. He strongly hoped that the authorities would continue to work toward those ends.

Mr. El-Khouri said that, like previous speakers, he felt that Appendix III was particularly informative. Turkey had clearly made significant progress in the previous two years in reducing domestic and external financial imbalances. It was also clear that the country still had a considerable way to go before achieving balance of payments viability, especially as the debt service payments were expected to rise significantly in the coming few years, and as foreign aid flows were expected to be reduced from the present levels. The adjustment process facing Turkey would therefore take place in the medium term, and the authorities would have to make a sustained effort to reduce the existing imbalances in the economy. If they continued to show a firm determination to adjust the economy, further support of the authorities by the international community would be forthcoming. Saudi Arabia, for one, could be counted on to help support the adjustment effort.

He approved the proposed program for the third year of the stand-by arrangement, Mr. El-Khouri stated. It showed the willingness of the authorities to continue the process of adjustment as envisaged in the 1980 stand-by arrangement. The program was comprehensive, but its success, like that of the previous programs under the stand-by arrangement, would depend critically on firm action being taken by the authorities in several areas. For instance, revenue collections would have to be strengthened to reduce the fiscal imbalance, and the stockbuilding by the state economic enterprises would have to be checked. Those matters were generally within the control of the authorities, and it would be important for the authorities to deal effectively with them; otherwise, different measures might be necessary.

Commenting on the monetary program, Mr. El-Khouri said that he agreed with its objectives and supported the proposed credit limits for July-December 1982. Given the monetary developments in recent months, the staff had correctly concluded that there was little room for slippage in meeting the monetary targets for the coming period. The staff had noted that the unanticipated expansion in liquidity in the second year of the stand-by arrangement had been due mainly to the fact that the improvement in the balance of payments had been better than the authorities had expected. The authorities had indicated that if the development of the Central Bank's net foreign assets turned out to be more favorable than was expected under the program for the third year of the stand-by arrangement, they would reduce the targeted increase in net domestic assets by a broadly comparable amount. The same commitment had been given under the program for the second year of the stand-by arrangement, but apparently there had been some difficulties in observing it, and it was not fully clear to him how that commitment was to be fulfilled during the third year of the arrangement. Indeed, the supplementary paper showed that there had been an unexpectedly large increase in the Central Bank's net foreign assets in July 1982 together with a larger than programmed increase in net domestic assets, rather than the reverse.

It would be useful to learn, Mr. El-Khouri said, the staff's view on the effectiveness of the measures that had been taken to increase the penalty rate on reserve deficiencies of the banks in Turkey. The existence of a penalty rate in the past apparently had not deterred the banks from incurring the deficiencies, and he wondered whether increasing the rate would have much effect. The staff had mentioned that there would be stricter enforcement of the reserve requirement, but it was unclear to him how that enforcement was to be effectively implemented.

The success of Turkey's adjustment effort was of significance to the entire world community, Mr. El-Khouri remarked. His authorities attached importance to the successful implementation of the stand-by arrangement.

Mr. Lovato said that basically he agreed with the general thrust of the staff's assessment of the Turkish economy, the short-term outlook for Turkey, and the proposed decisions. Despite some impressive results on both the internal and the external fronts, the Turkish economic system still stood at a difficult juncture. Most of the targets under the programs for 1980 and 1981 had been met or overshot, and the authorities were to be commended for their firmness and their ability to maintain the difficult policy course. In general, the main improvement was that the economy had become more manageable than in the period before the implementation of the stand-by arrangement. Fiscal and external debt management in particular had improved. Nevertheless, while the exchange, external debt, and budgetary policies had had a stabilizing effect on the economy, monetary policy had been quite inflationary.

The disappointing reacceleration of inflation in recent months, Mr. Lovato went on, was particularly worrying for the medium term. In its medium-term balance of payments projections for Turkey, the staff had clearly noted the great need in coming years for Turkey to reduce the current account deficit. To achieve that objective, the authorities would have to improve the country's international competitive position by reducing the rate of inflation.

It was important to remember, Mr. Lovato remarked, that in the coming several years the volume of official aid would decline and the volume of debt repayments would grow. As a result, the authorities would have to make external adjustments in order to meet what the staff had called "the difficult payment period that looms after mid-1984." To do so, the authorities would have to rely not only on a steadily depreciating exchange rate, but also, and even more important, on a competitive and less inflation-prone domestic economy. Accordingly, the authorities would have to maintain policies that improved the structure and productivity of the economy. He was glad that the authorities had recognized the high priority that should be given to combating inflation. They had appropriately reacted to the upsurge in prices in the first half of 1982 by committing themselves both to tightening monetary policy in order to observe the performance criteria on the ceilings on net domestic asset creation, and to enforcing the reserve requirement for banks. He wondered whether the monetary program was still feasible under present financial conditions.

The most desirable of the staff projections for the medium term, Mr. Lovato noted, included a halving of the current account deficit over five years, offsetting, albeit only partly, the decline in balance of payments assistance, and a rate of economic growth that would not cause any further increase in unemployment. The growth rate of exports implied by the scenario was more than 10 per cent per year in real terms. What were the chances of actually sustaining such a rate in the medium run? Finally, what kind of bilateral payments agreement had Turkey entered into with another member country, and how could the Fund be assured that the agreement was consistent with Turkey's obligations under Article VIII?

Mr. Taylor said that he was glad that the staff paper included an assessment of the outlook for Turkey's balance of payments, as it helped Executive Directors to place the program for the third year of the stand-by arrangement in a broad perspective and gave them some idea of the task that the authorities would still face at the end of the program period. A medium-term assessment should become a regular feature of program reviews.

The authorities were to be congratulated on the further progress that they had made under the stand-by arrangement, Mr. Taylor commented. The determined implementation of restrictive financial policies had resulted in a significant pickup in activity, particularly an improvement in the export performance and a generally downward trend in inflation. Those achievements were a vindication of the Fund's policy approach in Turkey and showed the authorities' commitment and ability to pursue the adjustment effort. The program for the third year of the stand-by arrangement, especially its emphasis on securing a further reduction in the rate of inflation, seemed appropriate and, if fully implemented, should further strengthen Turkey's economic position. Such an improvement seemed essential if the authorities were to be able to reduce the large external debt and the heavy dependence on official aid inflows and debt rescheduling, as was well illustrated in Appendix III. He hoped that the authorities would press ahead with the stabilization effort and would succeed in meeting the various macroeconomic targets and objectives.

He agreed with the staff, Mr. Taylor continued, that Turkey's policies in the external sector, and its exchange rate policy in particular, had played an important role in recent years. Hence, he welcomed the authorities' commitment to maintain the exchange rate at an appropriate level, and their undertaking to consult the Fund if Turkey's external competitiveness was not maintained. The flexible exchange rate policy, together with measures liberalizing imports and further steps to reduce reliance on the system of complex and ineffective export incentives, would be crucial in sustaining the still somewhat fragile pickup in exports. Given the substantial debt service burden, it would be important for the authorities to maintain a cautious debt management policy.

Commenting on the domestic economy, Mr. Taylor said that implementing the proposed tightening of monetary policy would be crucial to achieving further progress in reducing inflation and eliminating the excess liquidity in the economy. The reacceleration of inflation in the first half of 1982 was worrying, and a fuller explanation of its causes would be useful. The staff considered that the unexpectedly rapid monetary expansion had intensified upward pressures on prices; presumably, such an effect would be evident only with a time lag, and the main inflationary impulse in recent months was traceable to some other factor. He wondered to what extent the reacceleration of inflation was attributable to the special factors mentioned on page 7 or alternatively to the relatively rapid pickup in economic activity. There could have been an undetected boost in wage increases, or an increase in profit margins beyond what was fully appropriate in the circumstances. The rate of inflation had recently begun to moderate again, but the possibility that the surge of monetary growth might create upward pressures on prices later on in 1982 was a cause for concern. It would therefore be particularly important to control the rate of expansion of money and credit in the way described in the program for the third year of the stand-by arrangement. He hoped that the authorities would continue to monitor monetary developments closely.

In fiscal policy Mr. Taylor commented, both the staff and the authorrities recognized the continued need for substantial improvement in the administration of state economic enterprises. Those improvements represented the cornerstone of the budgetary adjustment effort, and he hoped that the planned reforms would result in a marked reduction in transfers from the budget and in Central Bank credit to the state economic enterprises. There was of course an underlying need to enhance the efficiency of the enterprises' operations, thereby enabling them to reduce their current costs rather than continuing to pass on the consequences of their efficiencies to consumers through substantial price increases.

The Central Government's financing requirement was projected to be somewhat smaller in 1982 than in 1981, primarily because of an increase in revenue, Mr. Taylor noted. Part of the projected increase in revenue was the result of the collection of tax payments deferred from 1981, and was presumably a once-for-all increase. The authorities proposed to strengthen tax administration, but he wondered whether further efforts to mobilize revenue, possibly through new revenue sources, might prove to be necessary in the period after the completion of the stand-by arrangement.

In the past, Mr. Taylor recalled, prices for flour and bread had been controlled. He wondered whether those controls still existed, and whether the state enterprises in the agricultural sector would be subject to the types of reform being implemented in other state enterprises. The authorities' policy of adjusting energy prices to changes in costs was welcome, and it would be useful to know whether energy prices in Turkey had reached international levels.

Recent increases in the salaries of government employees had been awarded net of taxes, thereby effectively insulating those employees from the effect of tax changes, Mr. Taylor observed. He wondered whether that kind of wage settlement might inhibit the effective operation of the incomes policy.

The policies that the authorities intended to implement in the coming year should result in a further significant step forward, Mr. Taylor considered, but their successful implementation would require some difficult decisions and considerable determination. The difficulty of the task facing the authorities in the coming period should not be underestimated.

Miss Le Lorier stated that she accepted the proposed decisions. Since the previous review of their performance under the stand-by arrangement, the authorities had maintained their impressive effort to rehabilitate the real economy, the balance of payments had continued to strengthen more quickly than had been expected, exports had increased at a record pace, and the rate of growth of GDP in 1982--4.2 per cent--was in excess of the original target. The reacceleration of inflation in the second quarter of 1982 had been a cause for concern, but the recognition of the effect of special increases in certain food prices and the slowdown in inflation in the period May-July were reassuring.

There seemed to be less cause for concern about public finances and state economic enterprises than during the previous review, Miss Le Lorier commented. The Central Government's financing requirement in 1982 was expected to be slightly larger--by the equivalent of about 0.5 per cent of GDP--than had been forecast in December 1981, but the estimated elasticity of tax receipts in relation to GNP had been revised upward, from 1.05 to 1.15 per cent, and the rate of growth of total expenditure had been much less than the initial forecast despite a substantial reduction in the outstanding level of the Central Government's accounts payable at the end of fiscal year 1981. The performance of tax collections, however, would continue to be crucially important, and she welcomed the authorities' intention to collect a sizable proportion of the tax payments deferred in 1981 and to limit strictly new deferments in 1982. If tax revenue fell short of the target, a reduction in appropriations might well be warranted. For the moment, the margin between outlays and appropriations was small, and the unused appropriations at the end of 1982 would not be restored for the following fiscal year.

The authorities had adopted a number of courageous decisions with respect to the state economic enterprises, Miss Le Lorier considered. Prices charged by the enterprises had been steadily increased, and transfers from the budget had been held comfortably below the limit agreed with the Fund. In addition, fixed investment by the enterprises was to be tailored to their operational income and was expected to fall in real terms. Furthermore, the level of the interest rate subsidy received by the enterprises on their commercial borrowing operations had been significantly reduced. As a result of those actions, the claims of the state economic enterprises on public resources were expected to decline by the equivalent of nearly 4 percentage points of GNP, an impressive achievement. Close monitoring of the state economic enterprise sector, including plans for three full-scale reviews during the third year of the extended arrangement, should certainly help to prevent slippages. It would be useful to know the expected effect of the present strategy on overall employment in the state economic enterprise sector.

The proposed tightening of monetary policy was regarded by the staff as the cornerstone of the Government's economic strategy for 1982, Miss Le Lorier noted, but, like Mr. Taylor, she doubted whether the rapid rate of monetary expansion in recent months had been the main cause of the reacceleration of inflation in the second quarter of 1982. The staff seemed to have assumed that there was a very short lag between the expansion of the monetary aggregates and its effect on prices. To what extent was the recent upsurge in prices attributable to the special factors mentioned on page 7? Nevertheless, the continued overhang of liquidity in the economy certainly constituted a good argument for tightening monetary control in the coming months. One of the causes of the overhang--the unexpectedly strong improvement in the balance of payments--was certainly welcome; the unexpectedly large volume of crop credits, the unusually sharp decline in various deposit accounts in the Central Bank, and further special assistance to the commercial banks to meet the crisis of confidence had also played a role. How much longer were the decline in deposits and the special assistance likely to have a significant expansionary impact?

The Central Bank had already taken a number of important steps with respect to the reserve requirements for the banking system, Miss Le Lorier noted. The authorities felt that the proposed credit program was still feasible and that their effort to increase the observance of the reserve requirement could be continued. The staff, however, had concluded that the monetary program would not be easy to administer. Were the authorities now planning to mop up bank liquidity through open-market operations or marginal reserve requirements? Given the uncertainty about the likely development of net foreign liabilities and the ongoing structural changes in the financial system, she had no difficulty in accepting the limitation of the credit program to a period of six months. However, the limitation underscored the importance of the review to be held in December 1982 and of the authorities' intention to consult the Fund if reserve money grew faster than currently expected.

She agreed with the staff conclusions on exchange rate policy and the effort to reduce Turkey's dependence on imported energy, Miss Le Lorier said. However, the staff appraisal merely mentioned the incomes policy, the role of which seemed significant. Did the staff feel that the policy was fully appropriate?

Appendix III was useful, Miss Le Lorier commented, as it painted a clear picture of the tasks facing the authorities in the financial area and of the equally important roles of domestic policies and capital inflows in the overall adjustment process. Scenario II seemed to be the most desirable of the three scenarios described by the staff. It would be crucial for the authorities to maintain the present strategy of opening up the economy and of replenishing and enlarging the existing pipeline of project credits.

Mr. Abdollahi said that he fully agreed with the staff appraisal and accepted the proposed decisions. The strong effort to rehabilitate the economy in 1980 and 1981 had been continued in the first half of 1982, when all the performance criteria had been met. The authorities were to be commended for the determination that they had shown and for the success that they had achieved. Turkey's balance of payments had continued to strengthen, mainly because the authorities had maintained a competitive exchange rate, restrained domestic aggregate demand, and provided preferential credits and other incentives to exporters, thereby increasing the relative profitability of exports; the volume of imports had fallen by 8 per cent. The authorities had implemented a prudent external debt management policy, and their success in eliminating the payments arrears was welcome.

The prices of energy products and certain foods had been sharply increased, Mr. Abdollahi continued, and the prices charged by state economic enterprises had risen, thereby adding somewhat to inflationary pressures. There had been some slippage in the monetary and inflation targets, but in that connection an important role had clearly been played by the unexpected developments in the external sector, and particularly the LT 50 billion reduction in the Central Bank's foreign liabilities, instead of the expected LT 40 billion increase. In addition, broad money had increased by 65 per cent, considerably faster than expected. The authorities had quickly reduced the Central Bank's net domestic assets to compensate for about half of the recent unexpected increase in liquidity through the external accounts. The unexpectedly rapid increase in M-2 had played an important role in raising the rate of inflation to a higher level than had been expected.

Given the continued favorable developments, and despite some slippages, Mr. Abdollahi continued, the prospects for Turkey's economy, particularly in the external sector, seemed promising both for 1982 and 1983. The estimates of export growth and the authorities' firm commitment to maintaining a competitive exchange rate and prudent external debt management were encouraging. However, monetary and fiscal developments would continue to constitute a challenging task for the authorities, at least in the short run. Restraining the rapid rate of growth of broad money would be crucially important in the effort to contain inflation. Given the measures already introduced by the authorities, the target rate of increase for broad money of 50 per cent should be reasonable, provided that no other unexpected developments occurred.

On the fiscal front, Mr. Abdollahi commented, the authorities planned to reduce public expenditure, mainly by restraining budgetary transfers to state economic enterprises, and they hoped to reduce the public sector financing requirement by 20 per cent. Recent decisions designed to improve the management of state economic enterprises should prove fruitful. Did the authorities intend to reform the nonmanufacturing enterprises as well as those engaged in manufacturing? On the revenue side, there was a crucial need to increase tax collections. Were the problems in that area structural, and did the authorities have any additional structural reforms of the tax system in mind?

The high rate of unemployment and the continued slack in private sector investment were causes for concern, Mr. Abdollahi said. What were the causes of the slow growth in private investment, and what were the prospects for accelerating its growth? Finally, given the developments that he had described and the policies that had been adopted, he was optimistic that the authorities would be able to keep the economy on the path of adjustment.

Mr. Shaw remarked that he too had found Appendix III particularly useful. The authorities were to be commended on the significant progress that they had made in the adjustment effort, and he agreed with the staff appraisal and accepted the proposed decisions.

If the progress under the stand-by arrangement was to continue to be satisfactory, Mr. Shaw continued, the progress achieved thus far would have to be consolidated, and the authorities would have to avoid relaxing their adjustment policies. The inadequate control of the money supply evident in the first half of 1982 and the consequent higher than expected rate of inflation were worrying. The key objectives for 1982 were a reduction in the fiscal deficit, a continuation of the flexible exchange rate policy, and a decline in the rate of monetary expansion. Thus far, the authorities had succeeded in the first two areas, but not in the third. They had maintained commendable control over current expenditure, while the decline in revenue in the first half of 1982 had been offset by a reduction in expenditure.

The authorities hoped that the financing gap in 1982 would be limited to the equivalent of 1.5 per cent of GNP, a slightly--but not signficantly--larger margin than originally expected, Mr. Shaw observed. He wondered whether the authorities could not make a greater effort to tighten expenditure, especially in the form of transfers to the state economic enterprises, the volume of which in 1982 had been the equivalent of 2.7 per cent of GNP. That figure was lower than the figure for 1981, but the transfers in 1982 were projected to increase by almost TL 10 billion. It would be useful to know more about the level of employment in the state economic enterprises. Was the ban on reducing redundant labor in the enterprises still in existence? Had the managers of the enterprises been given the autonomy that the authorities had promised at the time of the previous review of their performance under the stand-by arrangement?

On the external side, Mr. Shaw commented, the authorities' intention to continue to manage the exchange rate in a flexible way--with the exception of the bilateral arrangement mentioned in the staff paper--was welcome. The flexible policy had clearly resulted in a reduction in the trade deficit and in the overall balance of payments deficit in the previous two years. Given the relatively large increase in the elasticity of imports and the expected decline in concessional capital inflows in the coming two years, Turkey would have to maintain a competitive exchange rate in order to achieve the export growth that would be needed further to reduce the current account deficit further. External competitiveness had been improved by the flexible exchange rate and other policies, but the authorities would have to continue to take appropriate steps to counter the previously entrenched anti-export policies and attitudes. The authorities should be encouraged to continue implementing their import liberalization policies.

He agreed with the staff that Turkey would have to reduce its dependence on official development assistance, Mr. Shaw remarked. He hoped that the authorities could consolidate the gains that they had made on the external side before the projected substantial increase in the debt service ratio.

Monetary developments in 1982 had not been encouraging, Mr. Shaw commented. The authorities continued to display an inability to control domestic credit. The money supply had grown at an annual rate of 65 per cent in the first half of 1982, partly because of the support effort following the failure of a major nonbank financial institution. However, monetary control would have to be improved if inflation was to be reduced further. To that end, tighter regulation of commercial bank reserve requirements would be an important step forward, and he looked forward to hearing the answers to the questions asked by previous speakers about the application of the requirements. In addition, the 40 per cent growth target for M-2 in the second half of 1982 should be seen as a strict maximum, especially as the rate of inflation for the year was estimated to be in excess of the initial target of 25 per cent. Finally, he agreed with Mr. Taylor that the prices for energy products in Turkey should be increased to international levels. The price increases for energy products that had been introduced in the recent past were commendable; they had clearly helped to reduce the total import bill significantly.

Mr. Finaish said that he accepted the proposed decision. The authorities were to be commended for their determined effort, which was reflected in a range of reform measures that they had introduced to deal with the imbalances in the economy. The implementation of the stand-by arrangement in the previous two years had been along the lines originally envisaged. Substantial progress had been made in reversing the trends in the balance of payments, inflation, the fiscal deficit, and the rate of economic growth. The economy had withstood the demands of a painful adjustment process. Moderation in domestic demand and a flexible exchange rate policy had helped to establish the basis for the impressive export performance, and the authorities had managed to direct resources to the export sector. As a result, manufactured exports constituted about half of total merchandise exports. The supplementary paper showed that exports had continued to grow at a vigorous pace in recent months despite the stagnation in the growth of the volume of world trade and despite the difficulties caused by the rise in protectionism. Another important feature of the export performance in recent years was the sharp increase in Turkey's exports to countries in the Middle East and North Africa. The medium-term export projections should take into account the slowdown in the pace of economic activity in the countries where substantial import growth had occurred in recent years.

The expansion of exports together with the slowdown in imports had contributed significantly to the improvement in the current account position, Mr. Finaish noted. The estimated current account deficit for 1982 of $1.4 billion was substantially lower than the initial estimate of $1.8 billion, a figure that some Executive Directors had thought to be ambitious at the time of the previous Board discussion on Turkey. Another welcome feature of recent developments in the external sector was the virtual elimination of payments arrears. The staff had noted that a current account deficit of the order of $1.4 billion should not be difficult to finance. Equally important gains had been made in the area of prices. The deceleration in the rate of inflation had been made possible by the authorities' prudent financial policies and in spite of the frequent and sizable depreciation of the Turkish lira and the significant decline in the current account deficit.

The rate of economic growth had been satisfactory, Mr. Finaish commented. Further progress in reducing the imbalances in the economy and in maintaining the growth momentum would be made if there was a substantial increase in investment and if the productive base was expanded. The increase in investment was also needed to reduce the high rate of unemployment. A rate of economic growth in excess of 5 per cent a year would be needed to reduce unemployment in 1982-86. Those figures clearly indicated the large size of the task facing the authorities in the coming years.

The program for 1982/83 correctly gave priority to reducing further the rate of inflation, and the data in the supplementary paper indicated the progress made in demand management, Mr. Finaish remarked. Despite the demand for resources to deal with the recent financial crisis, both monetary policy and the Government's financial position had continued to move in the desired direction. The monetary program for the coming six months was stringent and, given the need to increase the Central Bank's net assets as a result of the financial crisis, the monetary program might well have to be implemented in a flexible manner. It would be useful to know to what extent the activities of nonbank financial intermediaries were subject to control by the Central Bank and/or the Treasury.

Commenting on fiscal policy, Mr. Finaish said that the somewhat less than projected rate of growth of revenue had been due largely to the diversion of resources to mitigate the consequences of the financial crisis. The sharp deceleration in the rate of growth of expenditure was impressive, and it would be useful to know whether there was any element of seasonality in the trend. Both the recent progress of, and the prospects for, the state economic enterprises were satisfactory. There had been a substantial reduction in the financing requirements of the state economic enterprises; the level of investment of the enterprises, transfers to them from the budget, and their access to central bank credit had been reduced. More important, the authorities' determination to introduce reform measures should result in a sustained improvement in the enterprises' performance in the coming years.

Good progress had recently been made in expanding exports and in opening up the economy, Mr. Finaish commented, and expansion of the productive base would strengthen the forward momentum. Heavy reliance on exchange rate adjustment for the expansion of exports and production could create difficulties. It would be useful to have the staff elaborate on the mechanics of determining the country's external competitiveness and on the prospects for expanding investment and the domestic base.

Turkey had made a significant effort to implement the needed reforms, Mr. Finaish considered, but there was still some question whether the expected size and speed of the inflow of external resources would be realized. The staff had correctly underscored the need for a substantial inflow of resources, particularly in the mid-1980s.

The staff representative from the European Department commented that the nonobservance of the reserve requirements had been limited to Turkey's largest bank and to several medium-size banks. However, the nonobservance was a cause for concern because of its effect on monetary control, and the new economic team was actively exploring possible ways of strengthening banking regulation.

Commenting on the changes in the reserve requirements system mentioned on page 9, the staff representative said that, in the past, a specific percentage--for example, a 5 per cent reserve against deposits used for investment credits to underdeveloped regions--had been required. Under the present system, the reserve requirement would be tied to the credit and, for investment credits, would be the reserve requirement ratio less 25 per cent. As demand deposits carried a higher reserve requirement--35 per cent--than time deposits, the new requirement was expected to absorb a significant amount of bank liquidity. Also, the reserve requirement ratio had been increased for bank deposits with interest rates above 50 per cent. However, there would be no change in the reserve requirement ratio for banks that offered interest rates below 50 per cent. The reason for introducing a penalty rate for banks offering interest rates above 50 per cent was essentially prudential; the authorities felt that the banks had been overaggressive in competing for deposits, and that official action was needed to rein them in. In their effort to strengthen the observance of the reserve requirement, the authorities had agreed on a schedule with the banks that were in default in observing the requirement. Under the schedule, the banks made monthly payments in order to bring themselves into compliance with the reserve requirement by a specified date. The penalty rate on nonobservance of the reserve requirement had been significantly increased from 35 per cent to 54 per cent, with the rate becoming increasingly severe the longer the nonobservance continued.

The so-called crisis of confidence had arisen because the active competition of a nonbank finance institution for deposits had worsened the maturity profile of its liabilities and badly squeezed its profits, thereby causing a cashflow crisis, the staff representative explained. The institution was known to be closely linked with a number of banks; it had marketed the banks' certificates of deposit. The crisis had caused a run on some of the banks by depositors, and the authorities had quickly responded by assuring depositors that both their regular deposits and certificates of deposit held by the nonbank finance institution would be honored. The assistance had been fairly limited; most of it had been provided in the first week after the outbreak of the crisis. Since then, there had been small amounts of additional assistance to banks that were still being squeezed, but the total amount of direct assistance to the banks in the wake of the crisis had been limited to TL 15 billion. The activities in which nonbank finance institutions were permitted to engage had been formally limited by the authorities, but the limits had been breached in a number of areas. The institutions had branched out, and, because their operations had become closely linked with those of the banks, the overall system of operations of nonbank finance institutions had developed a life of its own.

The question had been raised, the staff representative recalled, whether the credit program for the coming period could be implemented despite the need for exceptional assistance by the banks. In that context, the authorities wished to steer a difficult middle course of resisting excessive requests for assistance from the banks while being careful not to lean into the wind in an excessively rigid way. The authorities presumed that the extent of the crisis and the need for assistance would be limited, and, thus far, the presumption had proved accurate. The staff felt that implementation of the monetary program was still feasible, if suitable action was taken. There were obvious limits--especially the bumper harvest and the needs of the banking system--on the extent to which the authorities could reduce the net domestic assets of the Central Bank; therefore, heavy emphasis would have to be placed on the sterilization, through one device or another, of new injections of liquidity. The staff had not yet had an opportunity to discuss with the authorities the feasibility and appropriateness of one course of action as opposed to the other.

The limited number of devices for sterilization in Turkey had posed a problem in the past, although the authorities had been able to honor the spirit of the understanding with the Fund under which credit was to be kept from expanding to the same extent as the injection of liquidity through the balance of payments, the staff representative explained. The authorities had occasionally been unable to offset fully the amount of the liquidity injection, and late in 1981 they had drawn up a scheme that was to operate like a special reserve scheme or a marginal reserve requirement, involving the placement of 25 per cent of the increase in the banks' deposits into Treasury bonds. The scheme had proved to be inadequate and inefficient; the authorities had failed to enforce the scheme, and the banks had complained of the difficulties that they had faced in trying to implement it.

It was true, as Mr. Taylor had suggested, that monetary policy in Turkey operated with a time lag, the staff representative said, but evidence suggested that the lag was fairly short. Special factors had certainly played a role in the reacceleration of inflation in the first quarter of 1982, but it was impossible to estimate quantitatively the weight of each factor in the trend. The staff continued to feel that the monetary expansion had been the underlying factor in the pickup in inflation. In that connection, it was important to bear in mind that there had also been a rapid rate of increase in monetary growth in the final months of 1981, and that the effects of that increase would probably have been felt in the first half of 1982. The authorities had not established a target for the rate of inflation for end-1982.

There had been a reduction in real terms in investment--including investment in plant, equipment, and stocks--by the state economic enterprises, the staff representative explained. The reduction reflected the recognition by the authorities and the World Bank and Fund staff of the need to rationalize investment by the enterprises; in recent years, their investment had become increasingly inefficient. The increase in 1981 in the stocks of the state economic enterprises had resulted from both production and trading factors. The accumulation of oil and wheat stocks had been primarily a matter of timing; the oil shipments had arrived at one particular time, and there had been a need to import wheat. Excess production and sales difficulties had resulted in increases in stocks of iron, steel, and, especially, sugar.

The ban on laying off workers was still in force in both the public and the private sectors, the staff representative commented. In the public sector, however, there was also a requirement that a proportion of total positions should be eliminated. Employment in the state economic enterprises had fallen by 1-2 per cent in 1981 and was expected to increase by about 1 per cent in 1982. Labor costs were estimated to rise in 1982 by less than the rate of inflation because of a shift to lower-paid and lower-skilled workers.

The Soil Products Office purchased wheat and flour for the municipalities, which were the main distributors of bread, the staff representative said. The price for bread was subsidized, and the subsidy was to be reduced. Most of the energy prices had been raised close to international levels. The World Bank energy sector mission was completing its assessment of the situation in Turkey; its findings on energy prices had been reasonably positive. Gasoline prices, for instance, covered costs and were equivalent to about $2 per gallon.

There was no evidence, the staff representative explained, that the plans for reforming the agricultural state economic enterprises were as far advanced or on the same scale as the plans for restructuring the manufacturing state economic enterprises.

As to the accounts payable in the consolidated budget, the staff representative said, there had been some exceptional circumstances at the end of the previous fiscal year. In the first quarter of the present fiscal year, accounts payable had been substantially reduced. The net stock of accounts payable at the end of FY 1981 had been nearly TL 135 billion, and the figure had been reduced by more than TL 90 billion in the first six months of FY 1982.

There was a clear need for new measures to increase tax revenue, the staff representative considered. Budgetary expectations were based on improved tax collection. The new Minister of Finance was a fiscal expert and had set generating new sources of tax revenue as one of the major tasks of the Ministry of Finance. There was obviously some room for maneuver to reduce expenditure if revenue fell short of expectations, but the amount of room should not be exaggerated, and the objective of augmenting revenue was certainly important.

The question had been raised, the staff representative recalled, whether there was some scope for cutting more deeply into the transfers to state economic enterprises. The authorities strongly hoped that the achievements in that area in the previous two years could be continued in the coming period. The efforts made by the authorities in the previous two years should not be underestimated. Transfers from the budget to the state economic enterprises had been cut from the equivalent of 4.8 per cent of GNP in FY 1980 to 2.7 per cent in FY 1982, despite the difficult economic situation.

Incomes policy continued to play an important role in Turkey, the staff representative explained. The staff had not mentioned the policy in detail in its appraisal because the present policy was mandatory and represented a continuation of the policy that had been maintained in recent years.

The recent increase in government employees' pay net of taxes was felt to be a once-for-all change in response to the widespread perception that government employees had been badly squeezed in the recent period of austerity, the staff representative remarked. Obviously, the change could intensify pressures exerted by other wage groups in the coming period.

The slow growth in private investment, the staff representative remarked, was traceable primarily to the containment of domestic demand, the low rate of capacity utilization, and the high cost of credit for production that was not export oriented or did not benefit from a particular preference. There were some hopeful signs of a pickup in private investment, and the authorities were particularly encouraged that the signs had appeared in precisely the areas of the economy in which adjustment in the future was desired.

The exchange rate, the staff representative explained, was based on a basket of currencies. As for the medium-term policy course, he agreed with Executive Directors who felt that the course that had been steered in the past should be maintained so that advances--particularly the improvement in the economy's fundamental efficiency and competitiveness--could be consolidated. To that end, further reducing the rate of inflation through a tight monetary policy would be important. At the same time, given the relaxation of external constraints, the time was right to improve the efficiency of the economy by opening it up to foreign competition to a greater extent, and the authorities planned to take steps in that direction.

To an increasing extent, the staff representative from the European Department said, the authorities had emphasized development projects that would help to facilitate adjustment. With the assistance of the World Bank, the authorities were paying particular attention to energy, agriculture, and infrastructure development. The effort to improve infrastructure directly complemented the effort to increase exports. The projection of a 10 per cent increase in export volume in each of the coming five years should be thought of as a kind of framework and assumption. However, the export sector was still relatively small, opportunities to increase exports existed, and substantial percentage increases in the volume of exports were still feasible. A substantial increase in export volume might well be recorded in 1983.

The staff representative from the Exchange and Trade Relations Department, commenting on the bilateral payments arrangement maintained by Turkey with a Fund member, said that Turkey had previously maintained a trade agreement with the same member. The authorities had stated that the restrictive features of the present bilateral arrangement with the Fund member were unintended and would be removed in the event that the arrangement was renewed. Accordingly, the proposed decision on Turkey's exchange system approved the related restrictions only for the life of the present bilateral arrangement.

Mr. de Groote said that the new Minister of Finance was highly regarded and well trained for the position. The results of the program had been so positive that there was no wish in the leading circles of Turkey to change course. The performance of the economy under the stand-by arrangement had been much better than anyone had expected, and the authorities fully wished to continue along the same lines.

The effort being made to reallocate resources, Mr. de Groote continued, should induce an increase in employment. The present unemployment projections seemed to be on the pessimistic side. It seemed best not to make too much of those projections, especially as there was relatively little information on unemployment.

The low rate of private investment was unsurprising, Mr. de Groote commented, because the period of structural readjustment had not been completed, and the level of unused capacity was still high. In the circumstances, substantial investment was unlikely to occur except in tourism and such new fields as the provision of technical expertise to neighboring countries, the production of some light equipment, and the processing of agricultural products. The rate of unemployment should fall as the new phase of investment progressed. The World Bank had provided support through a structural adjustment loan.

A number of factors in addition to the expansion of the monetary aggregates had contributed to the recent resurgence of inflation, Mr. de Groote remarked. Food prices had risen, and there had been one-time-only corrective increases in prices charged by state economic enterprises. In addition, the pace of economic activity had picked up. The latest information suggested that the rate of inflation had begun to moderate.

The authorities had no intention of abandoning the present policy stance in favor of another strategy, Mr. de Groote remarked. They had no predetermined idea of the best exact combination of monetary, fiscal, and incomes policies in the coming period, but they recognized that priority should be given to carrying out monetary policy and to improving the state economic enterprise sector. The authorities had taken steps to restore the normal growth path of the monetary aggregates, and major decisions were being taken in the field of the state economic enterprises. Although the enterprises were autonomous of the budget, they were in the process of opening themselves to market forces and competition, a process that took time.

The authorities recognized the need to increase the competitiveness of the economy by keeping it on the present adjustment path, Mr. de Groote commented. The goal of near-autonomy in balance of payments financing by 1985-86 was realistic, provided that present policies were maintained and, if necessary, reinforced. External financing in the coming period would amount to about $500 million a year compared with the present level of $2 billion. In that context, it was interesting to note that the ratio between balance of payments financing and the import bill plus the debt service had fallen from about 35 per cent in 1980 to about 15 per cent at present; if the existing policy objectives were achieved, the ratio would fall to about 4-5 per cent--equivalent to about $500 million a year--a fairly small percentage for a country in Turkey's stage of development. Another constraint on policymaking was the high rate of unemployment. A rate of increase in real income significantly less than 4.5-5 per cent would not prevent unemployment from rising further. The Government's main objectives should be attainable, if exports rose by 10 per cent a year in the coming three years, if income from services, remittances, and sales of technical expertise in neighboring countries also increased by 10 per cent, and if all forms of credit rose by the same rate. Those assumptions should prove to be realistic, if Turkey maintained access to markets in neighboring countries. If the exchange rate continued to be flexible, a restrictive monetary policy stance was maintained, and further structural improvements were made, especially in the state economic enterprise sector, the authorities' goals should be attainable, and the program should be a great success for the Fund, as Turkey would move from heavy dependence on balance of payments assistance to near-autonomy by about 1985-86.

The Executive Board then turned to the proposed decisions, which it approved.

The decisions were:

Review of Stand-by Arrangement and Program for Third Year

1. Turkey has consulted with the Fund in accordance with paragraph 3(e) of the stand-by arrangement for Turkey (EBS/82/126, Supplement 3, 6/19/82) as modified by paragraph 3(b) of Decision No. 6836-(81/67), April 24, 1981, paragraph 3(b) of Decision

No. 6945-(81/121), September 9, 1981, and paragraph 2 of Decision No. 7062-(82/25), February 26, 1982, in order to establish performance criteria subject to which purchases may be made by Turkey during the third year of the stand-by arrangement.

2. The letter from the Minister of Finance of Turkey dated July 20, 1982, setting forth the objectives and policies which the authorities of Turkey will pursue for the third year of the stand-by arrangement, shall be annexed to the stand-by arrangement for Turkey, and the letter of June 2, 1980, annexed to the stand-by arrangement, supplemented by the letters of April 15, 1981, July 22, 1981, and January 27, 1982, shall be read as supplemented by the letter of July 20, 1982.

3. Pursuant to paragraph 2(c) of the stand-by arrangement, purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 960 million until October 29, 1982, the equivalent of SDR 1,060 million until February 18, 1983, and the equivalent of SDR 1,160 million until April 29, 1983.

4. Turkey will not make any purchase under the stand-by arrangement that would increase the Fund's holdings of its currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of its currency resulting from purchases of supplementary financing or borrowed resources beyond 12 1/2 per cent of quota during the third year of the arrangment:

(a) during any period up to December 31, 1982, in which the limits on net domestic assets of the Central Bank of Turkey or its credit to the public sector specified in the table appended to the memorandum attached to the annexed letter of July 20, 1982, are not observed;

(b) during any period after December 31, 1982, in which understandings have not been reached or are not being observed on

(i) the net domestic assets of the Central Bank of Turkey, and

(ii) net Central Bank credit to the public sector;

(c) during any period in which the limit on new foreign borrowing specified in paragraph 10 of the memorandum attached to the annexed letter is not being observed, or in which understandings relating to:

(i) the exchange rate of the Turkish lira, referred to in paragraph 5 of the annexed letter;

(ii) reserve requirements of banks, referred to in the penultimate sentence of paragraph 3 of the annexed letter and in the penultimate sentence of paragraph 3 of the memorandum attached to the annexed letter; and

(iii) net transfers from the budget to the state economic enterprises referred to in paragraph 5 of the January 27, 1982 letter from the Minister of Finance of Turkey

have not been reached or, having been reached, are not being observed.

Decision No. 7189-(82/115), adopted
August 23, 1982

Exchange System

Turkey has recently entered into a bilateral payments agreement with a Fund member which is subject to approval under Article VIII. The Fund notes Turkey's intention not to renew this agreement in a form which retains features which constitute exchange restrictions subject to approval under Article VIII. In the circumstances, the Fund grants approval of this bilateral payments agreement until June 30, 1983.

Decision No. 7190-(82/115), adopted
August 23, 1982

2. EIGHTH GENERAL REVIEW OF QUOTAS - REPORT TO INTERIM COMMITTEE

The Executive Directors considered a revised draft, based on the discussion at EBM/82/111 and EBM/82/112 (8/19/82), of the report to the Interim Committee on the Eighth General Review of Quotas, beginning with paragraph 7 on page 4 (SM/82/170, Revision 1, 8/20/82).

Mr. Nimatallah, commenting on the second sentence, said that he wondered how many Executive Directors felt that further discussion of the role of the Fund was needed before the Executive Directors could agree on the size of the overall increase in total quotas. Mr. Erb, for one, had clearly taken that position.

Mr. Laske remarked that he agreed with Mr. Erb.

After a further brief discussion, Mr. Anson commented that it would not be appropriate to attempt to quantify precisely the number of the Executive Directors who favored the various particular positions mentioned in the report. In any event, the issue raised in the sentence cited by Mr. Nimatallah was not controversial; there was widespread agreement that any discussion on the size of the Fund would necessarily involve the role and financial structure of the institution, and it was in that sense that he had accepted the text in question.

Mr. Erb noted that the text in question was the same language that had been used in the communiqué of the Interim Committee's meeting in Helsinki. It reflected the fact that not every Executive Director--himself included--was able to express even a tentative view on the size of total quotas.

Mr. Prowse considered that the use of the words "not to express even a tentative view" could be seen as pejorative. It might be better to say that "not every Executive Director felt that it is necessary to express a view on the appropriate size of the Fund."

Mr. Erb said that Mr. Prowse's language was acceptable. He had been careful during the Executive Board discussions not to use the word "small" in describing the appropriate increase in the size of the Fund or to give a specific minimum or maximum figure, as others might be tempted to read too much into his words. It was correct to say that he had not been able to express even a tentative view, but that fact could be expressed in a less pejorative way.

Mr. Narasimham considered that the sentence in question could be changed to read: "Some Executive Directors thought that they were not ready to express a view on the appropriate size of the quota increase as they felt that the discussion of the role of the Fund was necessary before it would be possible to agree on the size of the overall increase of the quotas of the Fund." The present text did not clearly distinguish between Executive Directors who did not wish to express a view on the size of the Fund and others who wished to hold further discussion on the size and role of the Fund before expressing a view on the size.

After a further brief debate, Mr. de Vries stated that the sentence in question was particularly informative. It clearly gave the impression that the United States was not ready to express any view whatsoever at the present stage.

Mr. Kafka suggested that the sentence in question could be split into two sentences so that a clear distinction would be made between the reference to "not every" Executive Director and "some" Directors. The first sentence could end after the word "increase." The next sentence could begin by saying "some Executive Directors were of the view...."

After a further brief discussion, Mr. Laske suggested that the final sentence in paragraph 7 should appear as a separate paragraph. The sentence in question was now misplaced, as it gave the impression that the Executive Directors mentioned in the previous sentence would not necessarily agree to an increase of 100-125 per cent in the size of the Fund under the Eighth General Review of Quotas.

Mr. Zhang said that he preferred to keep the words "even a tentative view" in the second sentence of paragraph 7, as they helped to give a more precise understanding of Executive Directors' positions.

Mr. Erb commented that he, too, felt that the words "even a tentative view" helped to make it fully clear that he had not expressed even an initial view on the appropriate range for the size of the Fund.

Mr. Anson said that the first sentence could be changed to read: "Some Directors, however, believed that increases of 25 per cent or 50 per cent of present quotas of SDR 61.1 billion should also be considered."

Mr. Laske said that he preferred to keep the present text. Mr. Anson's proposal did not cover Executive Directors who might favor an increase of between 25 per cent and 50 per cent.

Mr. Prowse commented that he, too, preferred the present text, as it clearly stated that a few Executive Directors felt that a range of 25-50 per cent should be considered.

Mr. Caranicas considered that the present text was clear and informative and should be changed as little as possible.

After a further brief discussion, the Executive Directors agreed that the text in question should read:

> Some Directors, however, believe that smaller figures should be considered and suggest increases ranging between 25 per cent and 50 per cent of present quotas of SDR 61.1 billion. Not every Director feels ready to express even a tentative view on the appropriate size of the quota increase. Some Directors are of the view that further discussion of the role and the financial structure of the Fund is necessary before it would be possible to agree on the size of the overall increase of quotas of the Fund, since there has not been a full discussion of these matters in the Executive Board since the Helsinki meeting.
>
> Other Directors feel that if total quotas would be confined to the range of SDR 100-125 billion, or less, the interval between the end of this Review and the next (Ninth) General Review of Quotas would need to be shortened to less than the normal period of five years.

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

APPROVED: February 17, 1983

LEO VAN HOUTVEN
Secretary