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AGENDA**

EBS/82/230

CONFIDENTIAL

December 13, 1982

To: Members of the Executive Board

From: The Secretary

Subject: Turkey - Request for a Waiver and Modification of Performance  
Criteria Under Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a request from Turkey for a waiver and modification of performance criteria under the stand-by arrangement. A draft decision appears on page 6.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)



INTERNATIONAL MONETARY FUND

TURKEY

Request for a Waiver and Modification of Performance  
Criteria Under Stand-By Arrangement

Prepared by the European Department  
(In consultation with other Departments)

Approved by Patrick de Fontenay and Subimal Mookerjee

December 10, 1982

A three-year stand-by arrangement for Turkey in an amount equivalent to SDR 1,250 million (625 per cent of the then quota, 416.7 per cent of the present quota) was approved by the Executive Board and became effective on June 18, 1980 (EBS/80/126, 6/4/80, and Sup. 3, 6/19/80). Under the arrangement Turkey has thus far made nine purchases, totaling SDR 960 million, and as of October 31, 1982 the Fund's holdings of Turkish liras amounted to 543 per cent of Turkey's quota of SDR 300 million.

The tenth purchase under the stand-by arrangement (SDR 100 million) was to have become available at the end of October 1982. But, following the failure of Turkey to observe a performance criterion on the reserve requirement obligations of banks, it has not yet been made. In the attached communication to the Managing Director, the Minister of Finance of Turkey requests a waiver of the said performance test. Note is made in the communication of a number of policy actions that the Government plans to take, including an intention to hold the level of net domestic assets of the Central Bank (and central bank credit to the public sector) in the fourth quarter of 1982 below the levels stipulated as performance criteria in the existing program; in this connection, it is proposed that these performance criteria should be modified.

Discussions on this matter with Turkish officials took place in late October and mid-November 1982. 1/ Comprehensive discussions for the mid-year review of the program for the third year of the stand-by are under way at present, and it is envisaged that the staff's report will be issued around mid-January 1983 for consideration by the Executive Board around mid-February.

1. Recent performance under the monetary program

The credit limits established under the stand-by arrangement for the second half of 1982 2/ were intended to be consistent (i) with a reduction in the year-on-year growth in reserve money to about 33 per cent, from 51 per cent in the first half of the year; (ii) with a

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1/ The staff representatives were Messrs. Hole and Hansen (EUR).

2/ At EBM/82/115 (8/23/82), on the basis of EBS/82/130 (7/26/82).

corresponding reduction in the growth rate of  $M_2$  to 40 per cent from 65 per cent; and (iii) with a rate of rise in the GNP deflator for 1982 as a whole of about 32-33 per cent, following a rate of 42 per cent in 1981. The credit program was predicated, inter alia, on (i) an assumed absorption of bank liquidity through the stricter enforcement of, and increase in, banks' reserve requirements (which was seen as lowering the reserve money multiplier and thereby permitting a larger increase in Central Bank credit for a given target for  $M_2$  and inflation); and (ii) an assumed small increase in the net foreign liabilities of the Central Bank (i.e., an assumed absorption of part of the permissible credit expansion through the balance of payments). In this connection, a quarterly schedule for the absorption of bank liquidity through the tighter policy on reserve requirements was established as a performance criterion, and the Minister of Finance undertook to consult with the Fund if the development of the net foreign assets of the Central Bank resulted in a significantly faster growth in reserve money than was provided for in the program.

In the event, the absorption of bank liquidity in the period to end-September 1982, at some LT 13 billion, fell short of the amount programmed by about LT 10 billion. The shortfall came about in the wake of the bankruptcy in late June of a major nonbank financial institution (Kastelli) which led to a loss of confidence in several banks and severely impaired their ability to fulfill reserve requirement obligations. The shortfall has persisted, moreover, despite the imposition by the Central Bank of penal charges on reserve requirement deficiencies.

At the same time that the programmed absorption of bank liquidity could not be achieved, the expansion of the economy's monetary base ran far ahead of the amount planned. While all credit limits continued to be observed (Table 1), the balance of payments strengthened unexpectedly sharply during the July-September quarter leading to a reduction of LT 68 billion in the Central Bank's net foreign liabilities, as against an assumed increase of LT 35 billion. Reserve money, correspondingly, increased considerably faster than envisaged (rising by 47 per cent year-on-year in the third quarter, compared with 35 per cent in the program), and in fact reached a level well in excess of that targeted for the end of the year (Table 2). The comparable rate of expansion of  $M_2$  (56 per cent) was likewise significantly larger than targeted (46 per cent).

The unanticipated strengthening of the balance of payments appears to have occurred on both current and capital accounts. Efforts by the authorities to compensate for the resulting injection of liquidity by cutting back on the growth of Central Bank credit were undermined by the shock to confidence precipitated by the Kastelli bankruptcy. Since that event the Central Bank has been called upon to provide emergency assistance to several banks, in an amount totaling nearly LT 35 billion thus far (some LT 25 billion of which was disbursed during the third calendar quarter). Alternative action to sterilize part at least of the external liquidity injection, meanwhile, was not forthcoming, partly because of a lack of readily usable policy instruments.

Table 1. Turkey: Credit Limits

(In billions of Turkish liras)

	Net Domestic Assets of Central Bank			Net Central Bank Credit to Public Sector		
	Limit	Actual	Proposed new limit	Limit	Actual	Proposed new limit
1982						
July-September <u>1/</u>	935	930	...	590	584	...
September <u>2/</u>	955	933	...	595	586	...
October-December <u>1/</u>	975	...	958	600	...	595
December <u>2/</u>	982	...	972	602	...	600

Source: IMF staff.

1/ Average of last reporting date in each month.

2/ Average of each weekly reporting date during this month.

Table 2. Turkey: Summary Reserve Money

(In billions of Turkish liras)

	June 1982	September 1982		December 1982
	Actual	Program	Actual <u>1/</u>	Program
Net domestic assets	<u>865</u>	<u>955</u>	<u>945</u>	<u>982</u>
Credit to public sector	566	595	592	602
Credit to private sector	426	480	436	500
Other items	-127	-120	-83	-120
Net foreign assets	<u>-110</u>	<u>-145</u>	<u>-42</u>	<u>-155</u>
Reserve money	755	810	903	827

Source: IMF staff.

1/ End-month.

Notwithstanding the foregoing developments, the recorded rate of inflation fell back in the third quarter of 1982 after an upward spurt in the first half of the year, and the development of prices has remained broadly in line with program targets. <sup>1/</sup> In part, this result has been facilitated by delays in adjusting the prices of some important public enterprise goods and services since midyear. These delays are now being rectified, with increases averaging 15-20 per cent in the prices of electricity, coal, petroleum, cement, textiles, sugar, and transportation fares having been announced in late November or scheduled for early December. In addition, some lag in the response of prices to the development of the monetary aggregates should normally be expected. Against this, the demand for money balances has strengthened more over the recent period, in response to positive real rates of interest, than had been assumed in formulating the current credit program. However, it seems unlikely that all of the recent overshooting of the monetary targets will have been matched by an increased demand for liquidity--especially given the size of the overshooting.

## 2. Policy response

Against this background, and recognizing that plans for a continued deceleration of inflation in 1983 could not but be jeopardized if present monetary trends were not checked, the Government is taking a number of measures to restrain the rate of monetary expansion. First, it intends to limit the increase in net domestic assets of the Central Bank, and in its credit to the public sector, in the fourth quarter of 1982 below the amounts provided for in the existing credit program. The proposed new credit limits are set out in the table annexed to this paper. In essence, they entail a reduction of LT 10 billion in the December limit on NDA and of LT 17 billion in the average monthly level of NDA in the October-December quarter, with corresponding reductions of LT 2 billion and LT 5 billion, respectively, in Central Bank credit to the public sector.

Second, the authorities will shortly call on those banks whose deposits have increased unusually rapidly as a result of developments since June to purchase special bonds in an amount totaling at least LT 10 billion. <sup>2/</sup> The proceeds of these sales will be blocked in an account in the Central Bank and the banks will not be able to apply holdings of such bonds to meeting their statutory liquidity requirements.

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<sup>1/</sup> During the first ten months of 1982, the year-on-year rate of rise in an average of three consumer price indices slowed to 32 per cent from 36 per cent in calendar 1981, while the corresponding rate of increase in wholesale prices slackened from 37 per cent to nearly 26 per cent. It should be noted that, in recent years, the rate of inflation as measured by these various indices has ordinarily been less than that measured by the GNP deflator.

<sup>2/</sup> In the light of the shock to confidence in a number of banks, fully 85 per cent of the increase in deposits of the banking system over the course of the third quarter was concentrated in the two largest banks, whose deposits grew by 31 per cent and 23 per cent, respectively, between end-June and end-September.

Thereby, an amount of liquidity will be mopped up from the banking system which corresponds roughly to the shortfall in such absorption under the performance criterion.

Third, the Government will shortly enact a banking law which will be designed to strengthen both regulation of the banking system and its financial structure. Details of the legislation are currently being finalized, but the authorities expect the measures to stem the need for further last-resort assistance from the Central Bank to the banking system. With the help of these measures, the authorities also expect to be able to meet the performance test on the absorption of liquidity from the banks through the stricter enforcement of reserve requirements in the period October-December 1982.

### 3. Staff appraisal and proposed decision

The bankruptcy in late June 1982 of a major nonbank financial institution in Turkey, through its effects on confidence, put severe pressure on a number of banks, and Turkey was not able in the period through September 1982 to meet a performance test on the absorption of liquidity from the banking system through the stricter enforcement of, and increase in, reserve requirements. Over the same period, while all credit limits continued to be observed, the pace of monetary expansion was appreciably faster than programmed as the result of a substantial and unexpected injection of liquidity through the balance of payments. In response to these developments, the authorities are taking steps to mop up liquidity through bond issues, to contain the growth of Central Bank credit below the amount previously envisaged, and to strengthen the structure of the banking system.

The staff believes that these measures are in keeping with the need to persevere with the stabilization effort and represent a reasonable policy response ahead of the midyear review with the Fund of the program for the third year of the stand-by arrangement. While the rate of monetary expansion in the second half of 1982 will inevitably exceed that originally foreseen by a considerable margin, the targeted deceleration of inflation in 1982 should still be attainable given the stronger increase in the demand for money than was envisaged earlier. With the measures now being taken, and with continued restraint over the growth of liquidity in the economy, a further deceleration of inflation in 1983 should also be feasible. In sum, the objectives of the program should not be materially affected. The staff therefore recommends that the Executive Board approve the authorities' request for a waiver and, in this connection, agree to a modification of the credit limits for the October-December 1982 period, in line with the proposal in the communication from the Minister of Finance.

Accordingly, the following draft decision is proposed for adoption by the Executive Board:

1. Turkey has consulted with the Fund in accordance with paragraph 3 of the stand-by arrangement for Turkey (EBS/80/126, Sup. 3, 6/19/80).

2. In the light of the letter from the Minister of Finance of Turkey dated November 29, 1982, the Fund waives for the purpose of purchases available through December 31, 1982, the understanding relating to the reserve requirements of banks, referred to in paragraph 4(c)(ii) of Decision No. 7189-(82/115), August 23, 1982.

3. In accordance with paragraph 3 of the above-mentioned letter, the limits on the net domestic assets of the Central Bank and on net Central Bank credit to the public sector for the final calendar quarter of 1982 shall be those specified in the table annexed to EBS/82/230 (12/13/82) in place of those referred to in paragraph 4(a) of Decision No. 7189-(82/115), August 23, 1982.



Turkey: Fund Position

(As of October 31, 1982)

Quota:	SDR 300 million
Fund holdings of Turkish liras:	SDR 1,629.9 million or 543.3 per cent of quota, of which:
	CFF: SDR 90.3 million, or 30.1 per cent of quota
	Oil facility: SDR 17.2 million, or 5.7 per cent of quota
	SFF: SDR 1,080 million, or 360.0 per cent of quota
SDR holdings:	SDR 4.6 million (4.1 per cent of net cumulative allocation of SDR 112.3 million)
Distribution of profits:	US\$24 million
Gold distribution:	129,230 fine ounces

November 29, 1982

Mr. J. de Larosière  
Managing Director  
International Monetary Fund  
Washington, D. C.

Dear Mr. de Larosière:

1. As part of Turkey's monetary program for the period July-December 1982 under the stand-by arrangement, a time path was drawn up for the absorption of liquidity from the banking system through the stricter enforcement of, and increase in, banks' reserve requirements. It was agreed that if at either the end of September or at the end of December 1982 this was not observed, the Government of Turkey would consult with the Fund.
2. In the event, the absorption of bank liquidity in the period to end-September, at some LT 13 billion, fell short of the amount programmed by about LT 10 billion. This came about in the wake of the bankruptcy in late June of a major nonbank financial institution which led to a loss of confidence in several banks and severely impaired their ability to fulfill reserve requirement obligations.
3. In response to this development, and to an appreciably faster-than-programmed increase in the monetary aggregates since June as a result of a sizable and unexpected injection of liquidity through the balance of payments, the Government is taking a number of steps to restrain the growth of monetary expansion. First, it intends to ensure that the net domestic assets of the Central Bank at the end of December will be below the level agreed in the existing program. In line with this, the Government proposes that the limits on net domestic assets of the Central Bank should be lowered to LT 972 billion for December 1982 (from LT 982 billion in the present program) and to LT 958 billion on average for October-December 1982 (from LT 975 billion), and that Central Bank credit to the public sector should be limited to LT 600 billion (LT 602 billion) for December 1982 and to LT 595 billion (LT 600 billion) on average for October-December 1982. Second, the Government will require those commercial banks whose deposits have increased unusually rapidly as a result of developments since June to purchase special bonds in an amount totaling at least LT 10 billion before mid-December 1982. The proceeds of these sales will be blocked in an account in the Central Bank. Third, the Government will shortly enact a banking law which, inter alia, will strengthen regulation of the banking system and is expected to stem the need for the Central Bank to provide last-resort assistance to the banks. The Government is also determined to ensure that the programmed absorption of liquidity from the banks through the stricter enforcement of reserve requirements in the period October-December will be realized.
4. With these measures, the Government expects the rate of monetary expansion to slow in the period ahead. Taking into account also a stronger-than-assumed increase in the demand for money balances since midyear and the intention to reduce the rate of broad liquidity growth in

1983, the Government believes that the targeted reduction in the rate of inflation in 1982 will be achieved and that a further deceleration in inflation can be brought about in 1983.

5. I should like to reiterate that the continued deceleration of inflation remains a paramount objective of the Government and, in the light of the measures described above, to request a waiver of the performance test on reserve requirement obligations for the third quarter of this year.

Sincerely yours,

Adnan Baser Kafaoglu  
Minister of Finance

Turkey: Limits on the Net Domestic Assets of the Central Bank  
and on Net Central Bank Credit to the Public Sector 1/

(In billions of Turkish liras)

	<u>Limits on</u>	
	<u>Net domestic assets</u> <u>of the Central Bank</u>	<u>Net Central Bank credit</u> <u>to the public sector</u> <u>2/</u>
October-December 1982 <u>3/</u>	958	595
December 1982 <u>4/</u>	972	600

1/ The concepts used in calculating these limits and adjustments to be made are set forth in a separate technical memorandum. The limits will be reduced by the amount of any net cumulative disbursement of balance of payments support loans after May 25, 1979 which are not included in the foreign liabilities of the Central Bank or for which a corresponding deposit in a blocked account of the Central Bank has not been made or maintained in full.

2/ Net Central Bank credit to the public sector is defined as the net of all Central Bank assets and liabilities to all public sector entities comprising, inter alia, the Central Government, the annexed budget, the Monopolies Administration, revolving funds, local authorities, and all State Economic Enterprises. Amounts of repayments of principal and interest, in respect of the Central Government's and other public sector entities' external debt, which have not by the due date been deposited with the Central Bank, are also included in the Central Bank credit to the public sector.

3/ Average of last reporting date in each month.

4/ Average of each weekly reporting date during this month.