FOR
AGENDA

EBS/78/154

CONFIDENTIAL

March 27, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Turkey - Request for Stand-By Arrangement

Attached for the information of the Executive Directors is the text of a letter dated March 23, 1978, from the Government of Turkey requesting a stand-by arrangement. The staff paper describing and analyzing the financial program of the Turkish authorities will be circulated later.

This subject has been tentatively scheduled for discussion on Monday, April 24, 1978.

Att: (1)

COPY

T. C.
MALİYE BAKANLIĞI
ANKARA

23 March 1978

Dear Mr. Witteveen:

1. The Government of Turkey hereby requests of the International Monetary Fund a stand-by arrangement under which for a period of two years the Government of Turkey will have the right to purchase from the Fund currencies of other members in exchange for Turkish liras up to an amount equivalent to SDR 300 million. Before making purchases under the stand-by arrangement, the Government will consult with the Managing Director on the particular currencies to be purchased from the Fund. There is an understanding that after further consultation with the Fund this amount may be supplemented by funds available to the Fund under the supplementary financing facility.

2. The purpose of the stand-by arrangement is to support the policies that have been and are to be adopted by the Government of Turkey to strengthen the balance of payments position and create the conditions in which it will be possible to resume a strong and sustainable rate of growth of gross national product in order to provide gainful employment to a rapidly rising population.

3. While the rate of growth was largely unaffected by the international recession of 1974 and 1975 because of strongly increasing investment expenditures, financed in large part by Central Bank credits, Turkey's external accounts worsened sharply. The large balance of payments deficits which emerged were financed by running down Turkey's international reserves and by a substantial increase in short-term debt which, in 1977, began to include sizable arrears on current payments. From March 1977 onward, official foreign exchange transfers for imports have been largely confined to essential commodities such as petroleum, fertilizers, other raw materials, and pharmaceuticals.

4. In response to the emergence of the severe financial difficulties, the Turkish Government has designed a coherent stabilization program, the objectives of which are to restore balance of payments equilibrium and to achieve a significant reduction in the rate of inflation. It also aims to achieve a satisfactory growth rate and a reduction in unemployment. Attainment of the balance of payments objective requires a reduction of the current account deficit from an estimated 7 per cent of GNP in 1977 to 4 per cent of GNP in 1978 with a further strengthening in 1979. The program has taken into account the effects on the price level of the adjustment of controlled prices to more realistic levels taking into account the increase in minimum wages effected in late 1977 and other cost measures, but the intention of the Government is to lower the rate of inflation from an annual rate of over 36 per cent at the end of 1977 to one of about 20 per cent by early 1979.

5. The key element of the adjustment program is to reduce the borrowing requirement of the public sector. In fiscal year 1977 total gross borrowing by the public sector (including foreign borrowing) amounted to LT 93 billion. Of this amount, borrowing from the Central Bank amounted to LT 58 billion, equivalent to 60 per cent of the stock of reserve money at the beginning of the fiscal year. The intention is to reduce the total borrowing requirement of the public sector in 1978 to LT 75 billion, of which not more than LT 38 billion will be borrowed from the Central Bank.

6. It is the intention of the Government to establish support prices for agricultural export commodities at levels consistent with world prices and accordingly, in February 1978, the support price of tobacco was raised from LT 50/k to LT 57/k, which represents an increase of 14 per cent.

7. The Government has traditionally provided subsidies through the consolidated budget. The Government realizes that a sustainable policy for the future requires SEEs to adjust prices and fees in response to increasing costs and to aim at a surplus of current income over operational costs large enough to ensure that planned public sector investment can be carried out without undue recourse being made to the Central Bank. The Government is convinced that this policy will prove conducive to the restoration of stability and to strengthening the financial structures of the State Economic Enterprises.

8. With these objectives in mind, Parliament has approved a budget for fiscal year 1978. The Government has established the policies to be pursued by the SEEs and the price support agencies. Policies designed to bring the economy into better balance will be pursued also in 1979.

9. Consolidated budgetary appropriations amounted in fiscal year 1977 to LT 312 billion. As a result of restrictive expenditure authorizations by the Ministry of Finance, actual cash expenditures were limited to LT 238 billion. Budgetary revenue benefited from increases in monopoly prices effective September 1, 1977, estimated to yield LT 10 billion at an annual rate. Total budgetary revenue, including borrowing, other than from the Central Bank, amounted to LT 210 billion, leaving a deficit to be financed by drawings on the Central Bank amounting to LT 28 billion.

10. For fiscal year 1978 Parliament has approved budgetary appropriations amounting to LT 266 billion. Budgetary appropriations for investment expenditures amount to LT 63 billion, which implies an increase of about 21 per cent in nominal terms compared to estimated actual expenditures in fiscal year 1977. Appropriations for transfer expenditures amount to LT 82 billion compared with LT 67 billion. Appropriations for current expenditures amount to LT 121 billion, only 12 per cent more than estimated actual expenditures in 1977. The intention of the Government is to pursue a restrictive policy with regard to hiring of new personnel and to the purchase of other goods and services. The Government has already completed a comprehensive tax reform package. The main purposes behind this tax effort, which will cover income tax, corporate tax, taxation procedure law, and six other types of taxation legislation, are to eliminate the distortions resulting from past high inflation and effect a significant net increase in the revenue of the public sector especially in the course of 1979 and later years. The purpose of the reform is also to provide greater fiscal equity by shifting the tax burden from the low-income groups to higher-income groups and to try to reduce tax evasion by introducing efficient and flexible tax administration. These measures are expected to yield additional revenues of over LT 20 billion for 1978. The Government intends to avoid additional budgetary appropriations, during the course of the present fiscal year, which are not covered by increases in revenue from these sources. Furthermore, a bill has

been proposed to Parliament that requests the granting of wide-ranging powers to the Government in all areas pertaining to the efficient use of all resources. The proposed bill will enable the Government to issue various decrees with the same legal effect as legislation in all areas in which the Government's stabilization policy aims to have an impact. The overriding governmental objective is to try to affect consumption and investment patterns and promote efficiency in resource use, both in the public and private sectors. Apart from occasional seasonal assistance, the Treasury will seek to avoid borrowing from the Central Bank in fiscal year 1978. Policies will be designed with this objective in mind also in the following fiscal year.

11. In recent years, investment expenditures of the SEEs greatly exceeded the operational surpluses of these enterprises after taking account of subsidies provided through the government budget. Measures were taken in October 1977 to increase the controlled prices of the products of a number of SEEs, such as petroleum products, cement, iron and steel, and paper products, which were raised from 50 to 150 per cent. The price of gasoline was raised by 100 per cent. These increases raised the net revenue of the SEEs by LT 26 billion on an annual basis, the equivalent of about 3 per cent of GNP. Even so, total borrowing of the SEEs from domestic sources and from abroad was substantial and recourse had to be taken to Central Bank finance, amounting to LT 23 billion.

12. For 1978, fixed investment expenditures of the SEEs are to be limited to LT 60 billion, which implies an increase of 50 per cent in nominal terms, compared to 1977. Priority is to be given to projects in the field of energy and export promotion and to those investments which are close to completion. Since operating expenditures are expected to rise markedly in 1978 the Government has further raised the prices of iron and steel on average by 35 per cent and intends to make other necessary price adjustments in the course of this year in order to yield a total of LT 20 billion (net) in 1978.

13. Consistent with the Government's overall stabilization policy, a monetary program has been drawn up. In order to prevent the re-emergence of excessive domestic demand pressures, the Government has established limits on net domestic assets of the Central Bank. These limits are set forth in the annexed Table 1. Limits on the net credit of the Central Bank to the public sector have been established consistent with the fiscal policy outlined in the preceding paragraphs. These limits are set forth in the annexed Table 2. Furthermore, in September 1977 the Government increased by 5 percentage points the effective rates of reserve requirements in respect to deposits with banks. In February 1978 liquidity ratios for banks were raised from an average rate of 10 to 15 per cent. However, the regulations were modified to enable the banks to fulfill their marginal reserve requirements by investing 10 per cent of the increase in bank deposits in government bonds. The Government intends in the first year of the stand-by period not to lower the effective reserve and liquidity requirements. The system of interest rebates has been modified and the scope of the rebates narrowed, resulting in a reduction in the budgetary allocation.

14. With a view to encouraging real domestic savings through the banking system, and to ensuring that undue reliance is not placed on the use of domestic credits, interest rates on loans and deposits have been raised substantially and are set forth in the annexed Table 3. At the same time, the exchange rate guarantee in respect of additions to the present stock of convertible lira deposits, acceptance credits, and other private foreign credits has been eliminated, thereby raising the effective interest rate on new borrowing abroad. This elimination applies also to borrowing abroad under arrangements made in the preceding two years. Furthermore, in connection with the most recent depreciation of the currency, importers have also been requested to increase deposits pertaining to outstanding import applications. The Government intends also to raise the discount and penalty rates of the Central Bank, in line with the new interest rate policies already adopted, and intends to ensure that the increase in liquidity resulting from the remaining exchange rate guarantee applying to convertible lira deposits is blocked.

15. The Government is very much concerned about the overall inflationary climate affecting the world economies and the differentials that have occurred between the inflation rates of Turkey and its various trading partners. It is the understanding of the Government that the maintenance of Turkey's competitive position and confidence in the external value of its currency are of foremost importance. Taking into account that these inflationary differentials have led to the slow performance of exports of goods and services in the past, the Turkish Government depreciated the lira in September 1977 by 9.1 per cent (from LT 17.50 = US$1 to LT 19.25 = US$1) and again on March 1, 1978 by 23 per cent (from LT 19.25 = US$1 to LT 25 = US$1). This further depreciation of the lira has more than compensated for the differential rate of inflation between Turkey and countries abroad and has permitted the reduction of export tax rebates on Turkish manufactured goods by 20 percentage points. The export tax rebates on the main nonmanufactured products have been abolished. It is the intention of the Government to pursue policies that will keep the economy in better balance and preserve conditions needed to promote a more rapid growth of exports of goods and services. To eliminate the cross-rate differentials associated with the fluctuations in the international money markets, the Government will shortly link the Turkish currency to a basket of currencies and will then adjust rates for the Turkish lira against other currencies accordingly.

16. The Government considers it essential for the re-establishment of confidence to repay in an orderly way arrears in respect of payments and transfers for all external transactions. New arrears in respect of payments and transfers for current transactions will not be allowed to arise. At the present time the Government is entering into discussions and negotiations with foreign governments, export credit guarantee institutions, and other organizations as well as with foreign banks. The Government expects to negotiate a large-scale funding operation which would permit the repayment of arrears and other short-term debt obligations. The Government will present a schedule for the elimination of arrears acceptable to the Fund not later than November 1, 1978. The Government, moreover, is aware of the rapidly rising debt service burden resulting from previous short-term foreign borrowing and continuing large current account deficits. It will, therefore, limit

as far as possible the contracting of short-term debt. In any event it intends to limit, in the first year of the stand-by arrangement, the contracting of new public sector or government-guaranteed debt denominated in foreign currency, other than by the Central Bank, to an amount not exceeding $750 million for such debt with a maturity of less than five years and to an amount not exceeding $1,500 million for such debt with a maturity of less than ten years. It will inform the Fund at quarterly intervals of the amounts of such newly contracted debt with original maturities of ten years or less.

17. The Government has abolished the entitlement of holders of convertible lira deposits with maturities of more than 3 years to use a portion of up to 50 per cent of their convertible lira deposits for their import needs. On the other hand, the Government has for monetary policy purposes recently doubled the guarantee deposits for all imports of the private sector which now range from zero to 40 per cent. The stamp duty on imports which amounted to 9 to 10 per cent of the import value was raised to 22.5 to 25.0 per cent. This measure was introduced as part of a package to reduce the public sector deficit and is of a temporary nature; it will be replaced by other revenue measures in due course. A number of less important goods have been shifted from liberalized list I to liberalized list II, where they are subject to stricter licensing procedures. With a view to encouraging exports, exporters of some manufactures and industrial and mining products are entitled to preferential foreign exchange allocations equivalent to up to 25 per cent of the value of their exports for their own import needs. Moreover, in order to discourage tourism by Turkish residents abroad, with effect from March 1, 1978 a tax of 50 per cent has been imposed on the sale of foreign exchange for tourism. The Government recognizes the need for a liberalization of the system of payments and transfers for current international transactions and will begin to liberalize following an improvement in the balance of payments position. During the period of the stand-by arrangement, the Government does not intend to introduce any new multiple currency practices or practices having the same effect, introduce new or intensify existing restrictions on payments and transfers for current international transactions, enter into any new bilateral payments agreements with Fund members, or introduce new or intensify existing restrictions on imports for balance of payments reasons.

18. The Government believes that the policies set out in this letter are adequate to achieve the objectives of its program, but will take any further measures that may become appropriate for this purpose. The Turkish Government will consult the Fund, in accordance with the policies of the Fund on such consultations, on the adoption of any measures that may be appropriate. Given the many uncertainties of the international and domestic economic situation, it is the intention of the Government to review the evolution of the program in the first half of January 1979 and on that occasion to reach such understandings with the Fund as may be necessary. The Turkish authorities will reach understandings with the Fund before May 15, 1979 on their policy intentions and the performance criteria for the remaining period of the stand-by arrangement.

/s/ Ziya Müezzinoḡlu
Minister of Finance

Table 1. Turkey: Limits on Net Domestic Assets of the Central Bank[1/]

(In billions of Turkish liras)

Time periods	Limits
May-July 1978	224
August-October 1978	238
November 1978-January 1979	252
February-April 1979	267

1/ The limits are defined as arithmetic averages of net domestic assets on the last reporting dates of each of the three months during a quarter of the calendar year.

Table 2. Turkey: Limits on Net Credit of the Central Bank to the Public Sector[1/]

(In billions of Turkish liras)

Time periods	Limits
May-July 1978	171
August-October 1978	181
November 1978-January 1979	190
February-April 1979	197

1/ The limits are defined as arithmetic averages of net credit to the public sector on the last reporting dates of each of the three months during a quarter of the calendar year.

Table 3. Turkey: Interest Rates on Commercial Banks' Loans and Deposits

(In per cent)

	Prior to 2/25/78	As of 2/25/78
Banks' lending rates		
Credits to agriculture and artisans	10.5	10.5
Short-term credits to priority sectors	11.5	14.0
Medium- and long-term credits	14.0	16.0
Long-term credits of over five years' maturity	... 1/	... 1/
Banks' deposit rates		
Three to six months	3.0	3.0
Six months to one year	6.0	9.0
One to two years	9.0	12.0 2/
Two to three years	9.0-10.0 3/	16.0 2/
Three to four years	10.0-11.0 3/	20.0 2/
Over four years	12.0 3/	... 3/

1/ To be determined by the borrower and the bank.
2/ In the case of deposits made by Turkish workers abroad, deposit rates for terms of one year or more are 4 percentage points higher than shown in this table.
3/ To be determined by the depositor and the bank; prior to February 25, 1978, interest rates on deposits of over two years were determined by the depositor and the bank, but these rates were normally in the ranges shown.