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February 28, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Turkey - Staff Report for the 1993 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1993 Article IV consultation with Turkey, which will be brought to the agenda for discussion on a date to be announced.

Mr. Reichmann (ext. 38610), Mr. Clifton (ext. 38796) or Ms. Lipworth (ext. 37184) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Commission of the European Communities (CEC), the GATT Secretariat, and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

TURKEY

Staff Report for the 1993 Article IV Consultation

Prepared by the Staff Representatives for the
1993 Consultation with Turkey

Approved by Michael C. Deppler and A. Basu

February 25, 1994

I. Introduction

The Article IV consultation discussions were conducted in Ankara and Istanbul during November 30-December 13, 1993. 1/ The mission met with the Undersecretaries for the Treasury and Foreign Trade, for the Ministry of Finance, and for the State Planning Organization, with the Governor of the Central Bank and with other senior officials, as well as representatives of the banking sector, the trade unions and the employers' federation. The last Article IV consultation with Turkey was concluded on March 17, 1993 (EBM/93/36).

Turkey's last stand-by arrangement expired in April 1985 and the final repurchase was completed in May 1990. In March 1990, Turkey accepted the obligations of Article VIII and its exchange system is free of restrictions on the making of payments and transfers for current international transactions. Turkey has been a major borrower from the World Bank Group, whose lending accounts for about 13 percent of medium- and long-term external debt, one third of which is in the form of policy-based loans. Disbursements from the last outstanding policy adjustment loan were completed in 1991.

II. Background

Turkey's economic performance since the mid-1980s, helped by the introduction of market-oriented structural reforms, registered impressive results in terms of economic growth. At the same time, however, macroeconomic imbalances became increasingly pronounced, reflecting primarily expansionary public sector policies. From 1986 to 1992 real GNP grew at an average annual rate in excess of 5 percent, sustained by the rapid growth of

1/ The staff team comprised T. Reichmann (Head), E. Clifton, B. Drees, G. Lipworth (all EU1), and S. Wajid (PDR), with K. Phillips (EU1) as administrative assistant.

investment and the flexible, export-oriented, response of the private sector to the sweeping liberalization of the economy. Over the same period, inflation almost doubled to some 70 percent, and the external position grew progressively weaker.

After a slowdown in 1991, economic activity rebounded strongly in 1992 and continued to be robust during 1993 when GNP is estimated to have grown by around 7 percent (Chart 1). Against the background of a continued large fiscal imbalance, rising real wages and increased access to consumer credit resulted in a marked expansion of private consumption . At the same time, private investment grew rapidly, partly in anticipation of Turkey's entry in 1995 in a customs union with the European Union. All in all, domestic demand was estimated to have increased by over 12 percent. The burgeoning demand was increasingly satisfied from abroad, resulting in the widening of the current account deficit and a mounting negative contribution to growth from the external sector.

Real wages have risen significantly in recent years, more than making up for the sharp decline they had experienced in the early 1980s. The rising trend of real wages continued unabated in 1993, and was especially marked in the public sector where job security appears to be the highest. Notwithstanding wage developments and the rising pressure of the fiscal imbalance, consumer price inflation has remained relatively constant since 1988, in the range of 60-70 percent a year (Chart 2). In the 12 months ending December 1993, inflation was 71 percent, up from 66 percent in 1992. The sluggish upward drift in inflation may be attributable to the inertia introduced by growing indexation, the opening of the economy, and the efforts of the Central Bank to follow a tight monetary policy with the attendant appreciation of the real exchange rate.

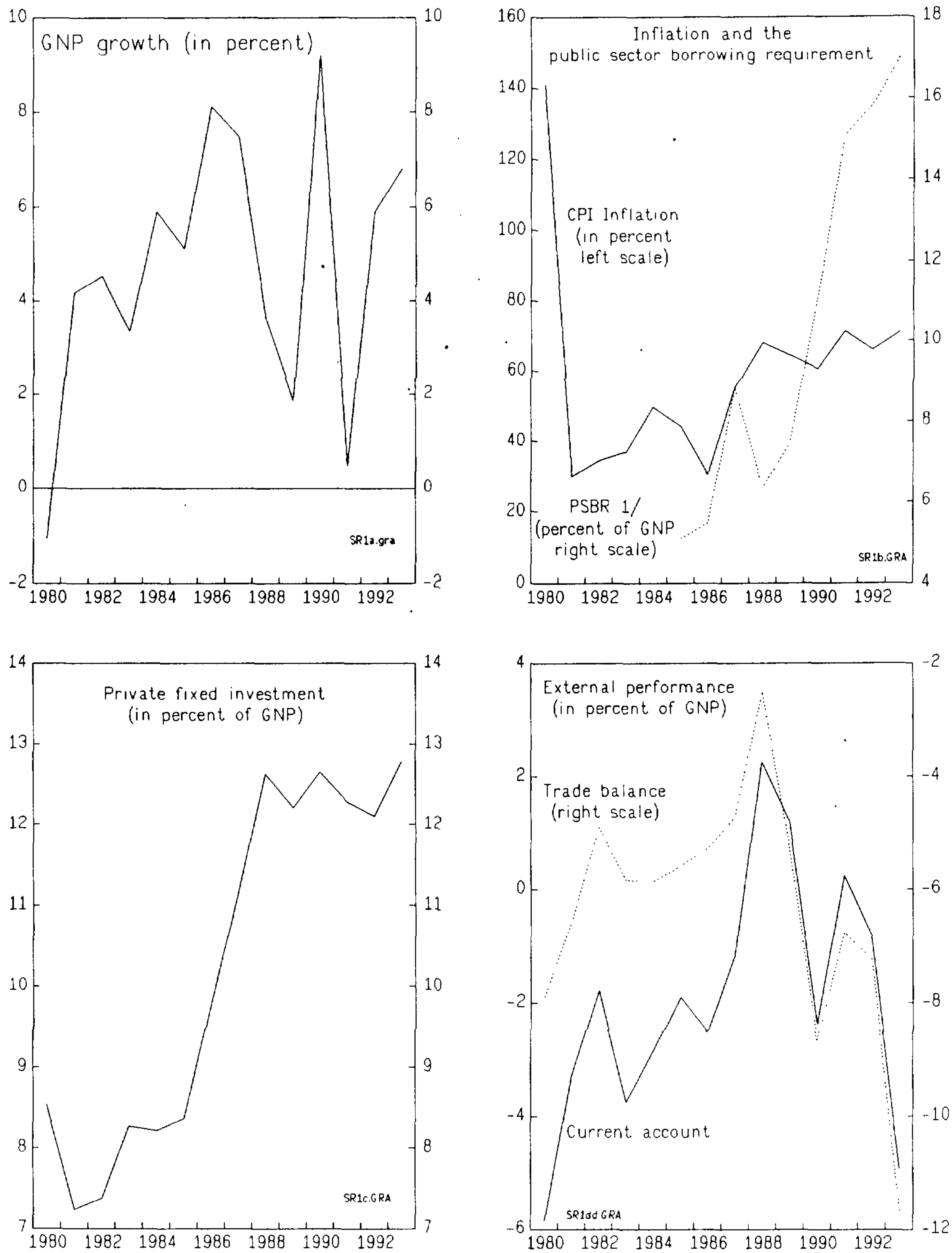
The growing deterioration of the public finances was not arrested in 1993 (Chart 3). From a deficit of 15.8 percent of GNP in 1992, the authorities had planned to reduce the PSBR (and the primary deficit) by some 6 percentage points in 1993. In the event, the reduction in the primary deficit was limited to some 2 percentage points (reducing it to 5 percent of GNP) while the PSBR moved up to 17 percent of GNP.

The shortfall in the fiscal adjustment occurred mostly at the level of the consolidated budget (the deficit of the central government), which accounted for almost two thirds of the slippage. With revenues from both taxes and privatization largely in line with the original budget, the bulk of the deviation occurred on the expenditure side, where personnel expenditure and interest payments exceeded the budget by a substantial margin. The increase in interest payments reflected mainly the rising stock of domestic debt and a shift toward higher-cost debt instruments. The higher-than-budgeted deficit resulted in increased recourse to central bank advances and external borrowing beyond that required to meet principal repayments. As to public enterprises, their 1993 borrowing requirement was somewhat lower than in the previous year, mostly because of increased transfers from the budget, although they too failed to achieve the target set for 1993. Also, there was a notable deterioration in the financial position of the social security

CHART 1

TURKEY

MAIN DEVELOPMENTS, 1980-1993



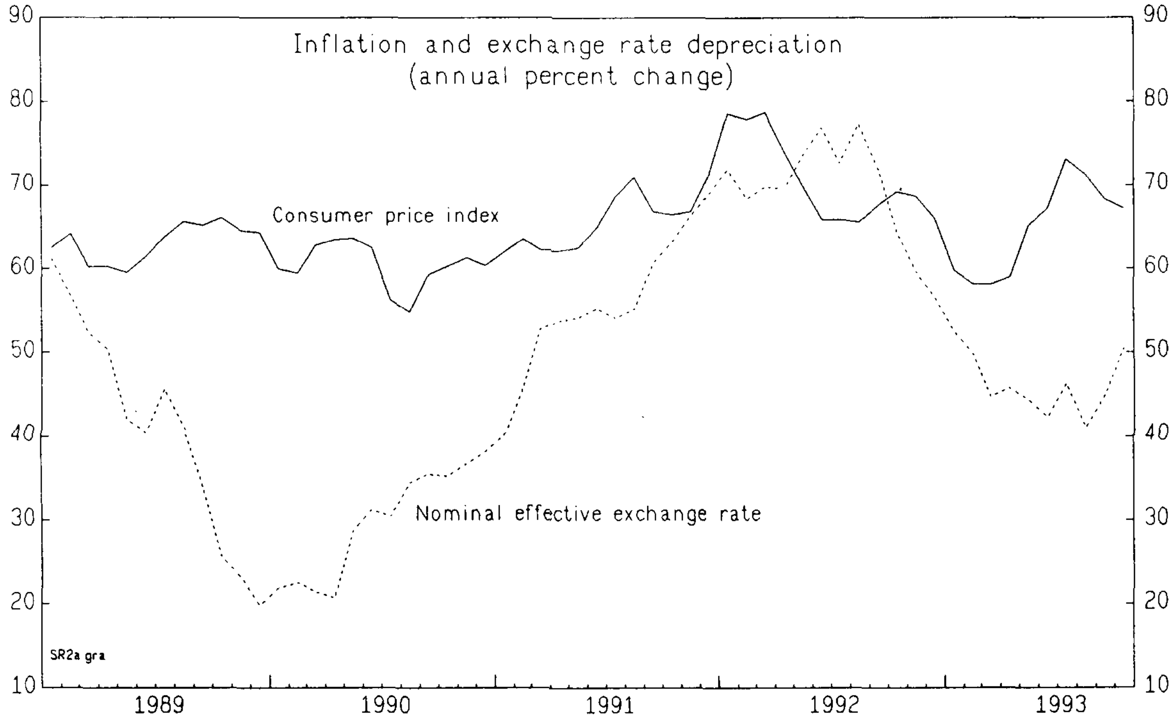
Sources: IMF, International Financial Statistics; and data provided by the Turkish authorities.

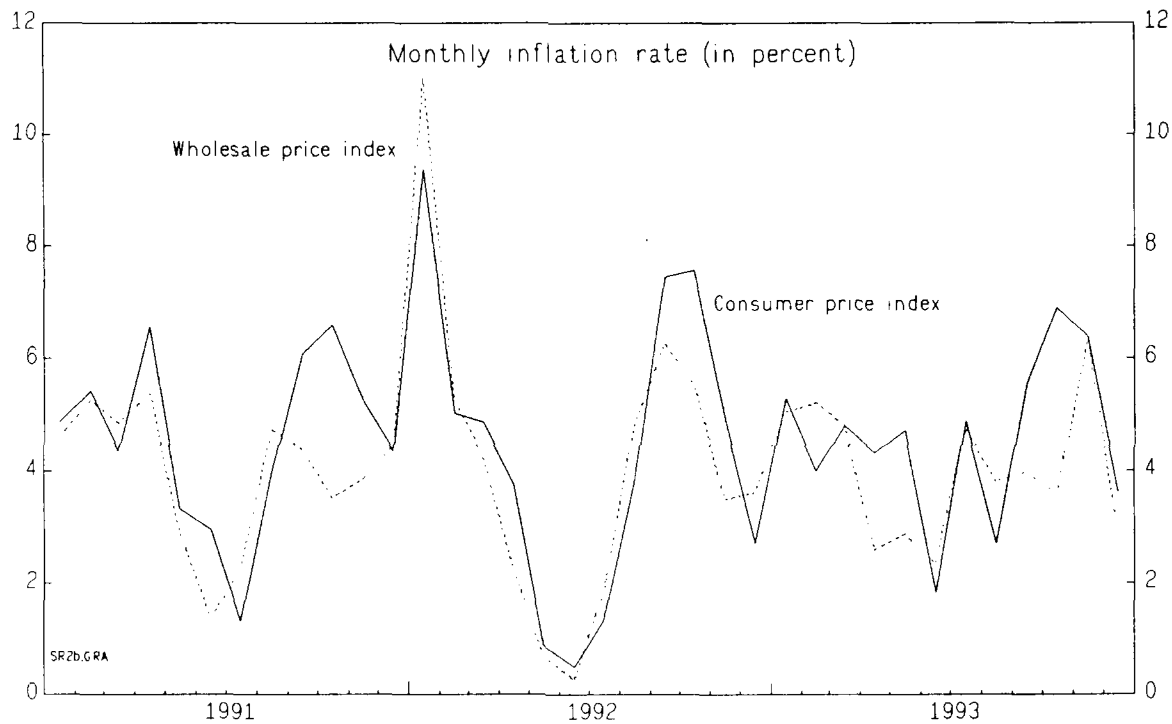
1/ Including Gulf war related (GCFCG) grants.

CHART 2

TURKEY

PRICE AND EXCHANGE RATE DEVELOPMENTS, 1989-1993





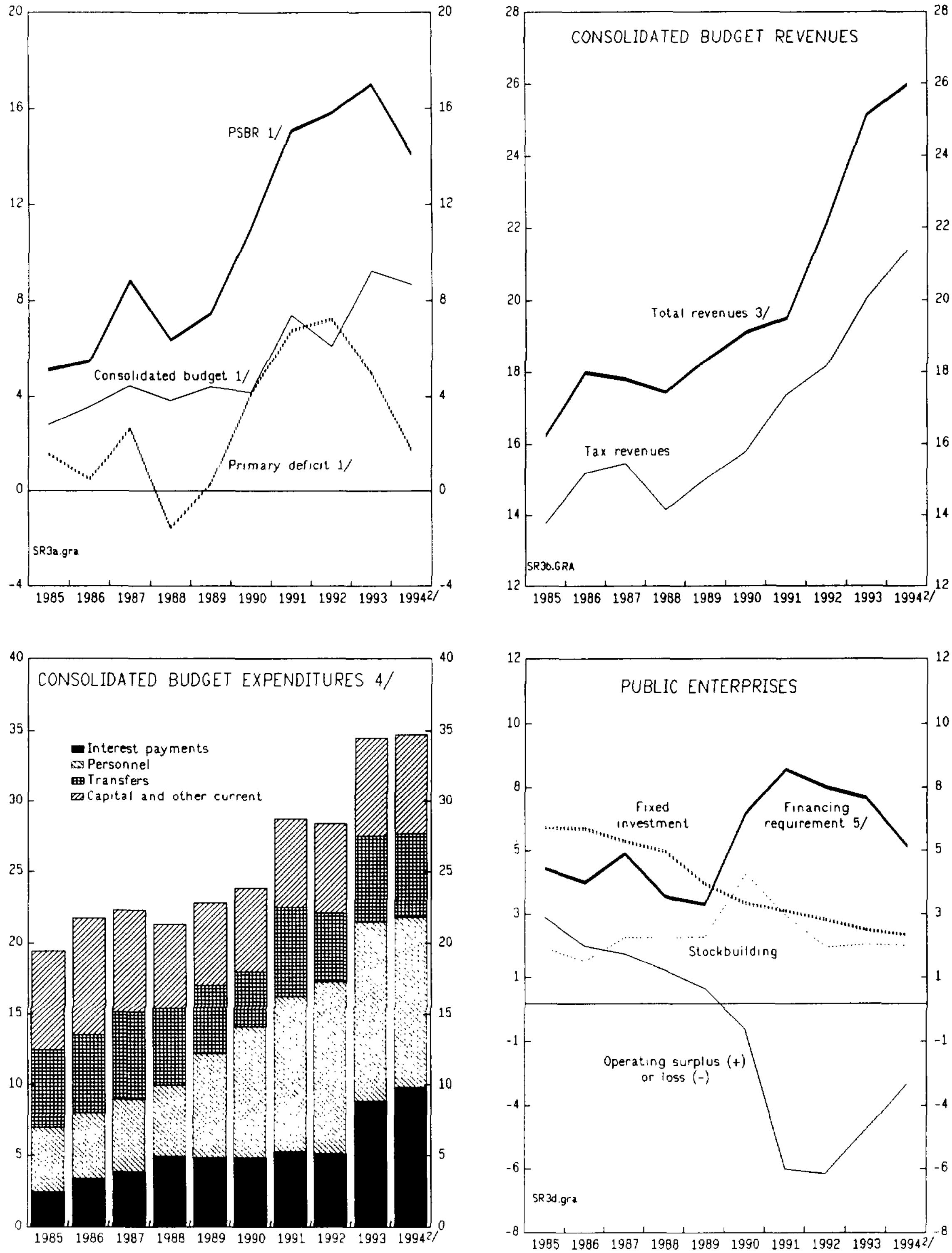
Sources: IMF, International Financial Statistics; data provided by the the Turkish authorities; and staff estimates.

CHART 3

TURKEY

FISCAL INDICATORS, 1985-1994

(In percent of GNP)



Source: Data provided by the Turkish authorities.

1/ Including GCFCG grants.
2/ Authorities's program.
3/ Excluding revenues allocated to EBF expenditures.
4/ Excluding expenditures allocated to EBFs.
5/ Including transfers from government.

institutions, which saw a decline in contributions, a drop in the ratio of active participants to pensioners and a decline in the rate of return on their assets.

Turkey: Fiscal Indicators

(In percent of GNP)

	1992	1993 Program	1993 Prel.	1994 Program
PSBR	15.8	9.5	17.0	14.6
Consolidated budget	6.1	4.3	9.2	9.0
Extrabudgetary funds (EBFs)	2.0	1.7	0.9	0.5
Revolving funds and Social Security Institutions	0.3	0.1	1.2	1.3
Local governments	1.1	0.3	0.9	0.2
State Enterprises (SEEs)	6.3	3.0	4.7	3.6
Primary	7.2	1.3	5.0	1.8

In the absence of fiscal adjustment, monetary developments continued to be dominated by the need to finance the PSBR (Chart 4). Prior to 1993, monetary policy had been formulated within the framework of a monetary program articulated in terms of monetary aggregates. This policy resulted in generally high real interest rates and an appreciation of the real exchange rate, factors that, as mentioned, helped to prevent inflation from accelerating; however, these factors also had negative consequences for the interest cost of the public debt and for the competitiveness of exports. The pressure of these latter considerations resulted in a gradual easing of monetary conditions beginning during the first quarter of 1993, as indicated by the drop in the rate on 3-month Treasury bills from an average of 95 percent per annum in the year through March 1993 to an average of 85 percent per annum in the remainder of 1993. The comparable rates of consumer price inflation were 58 percent and 70 percent, respectively.

In view of the major uncertainties surrounding the fiscal program, the monetary authorities had decided against announcing a monetary program for 1993. Instead, the Central Bank was to focus on targeting the nominal exchange rate, with the rate of depreciation to be reviewed monthly on the basis of output and price developments. In actual practice, the rate of nominal depreciation increased steadily through the course of the year, albeit with a notable acceleration in the second half of 1993 (Chart 5) as concerns about competitiveness became apparent 1/ and in line with the lowering of short-term interest rates on government securities. This latter development, together with the Treasury's efforts to lengthen the maturity of the public debt, resulted in a shift of the yield curve to being positively sloped.

Turkey: Balance of Payments

(In millions of U.S. dollars)

	1991	1992	1992	1993	1993
			Jan.-Sept.		Proj.
Trade balance	-7,340	-8,191	-5,883	-10,770	-13,860
Exports, f.o.b.	13,667	14,891	10,685	10,900	14,900
Imports, f.o.b.	-21,007	-23,082	16,568	21,670	-28,760
Services, net	2,499	3,189	2,131	3,155	3,950
Travel	2,062	2,863	2,304	2,326	2,850
Interest	-2,495	-2,205	-1,589	-1,790	-2,500
Other	2,932	2,531	1,416	2,619	3,600
Private transfers	2,854	3,147	2,243	2,328	3,280
Official transfers	2,245	912	732	460	720
Current account	258	-943	-777	-4827	-5,910
Direct investment	783	779	613	428	875
Portfolio investment	648	2,411	1,723	2,125	3,900
Other long-term capital	-808	-938	-705	1,083	300
Short-term capital	-3,020	1,396	938	3,443	3,520
Errors and omissions	1,110	-1,221	-1,143	-1,543	-815
Overall balance	-1,029	1,484	649	709	1,870

Sources: Turkish authorities and staff estimates.

In 1993, there was also a sizable expansion in the banking system's credit to the private sector, 2/ particularly consumer loans, as banks took advantage of the possibility of repackaging such loans in the form of marketable asset-backed securities. With the decline in short-term interest

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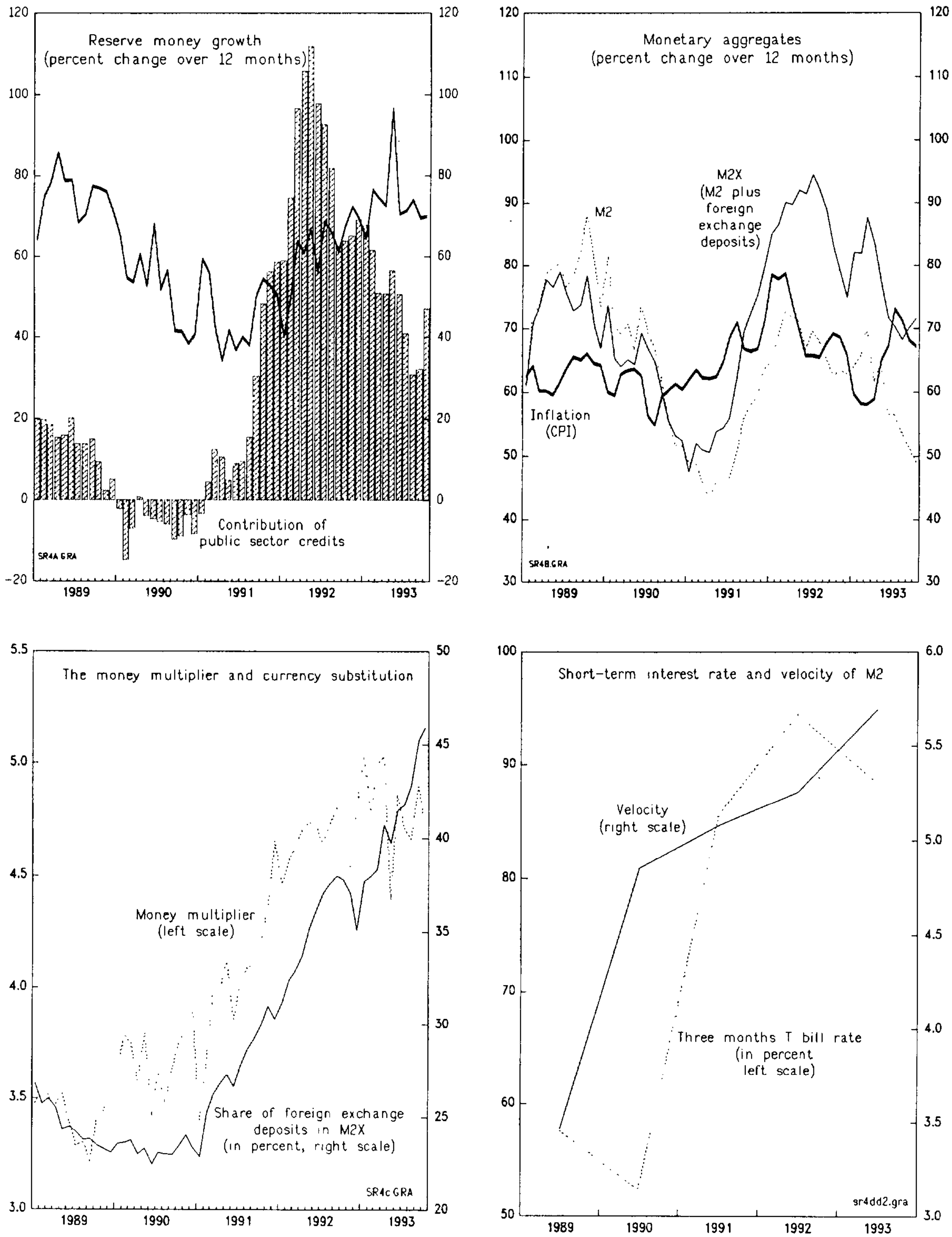
1/ The more rapid pace of nominal depreciation did not keep pace with the increase in consumer prices indicating a further appreciation in real terms. Measured in relation to consumer prices, the real effective exchange rate in 1993 was 42 percent higher than in 1987; however, other relative price indices showed a more limited appreciation. Furthermore, the satisfactory growth of exports and international reserves suggested that the loss of competitiveness has not been as great as indicated by real effective exchange rate calculations.

2/ By July 1993, the 12-month rate of growth of the banks' claims on the private sector had risen to 99 percent, from 84 percent at the end of 1992.

CHART 4

TURKEY
MONETARY DEVELOPMENTS, 1989-1993

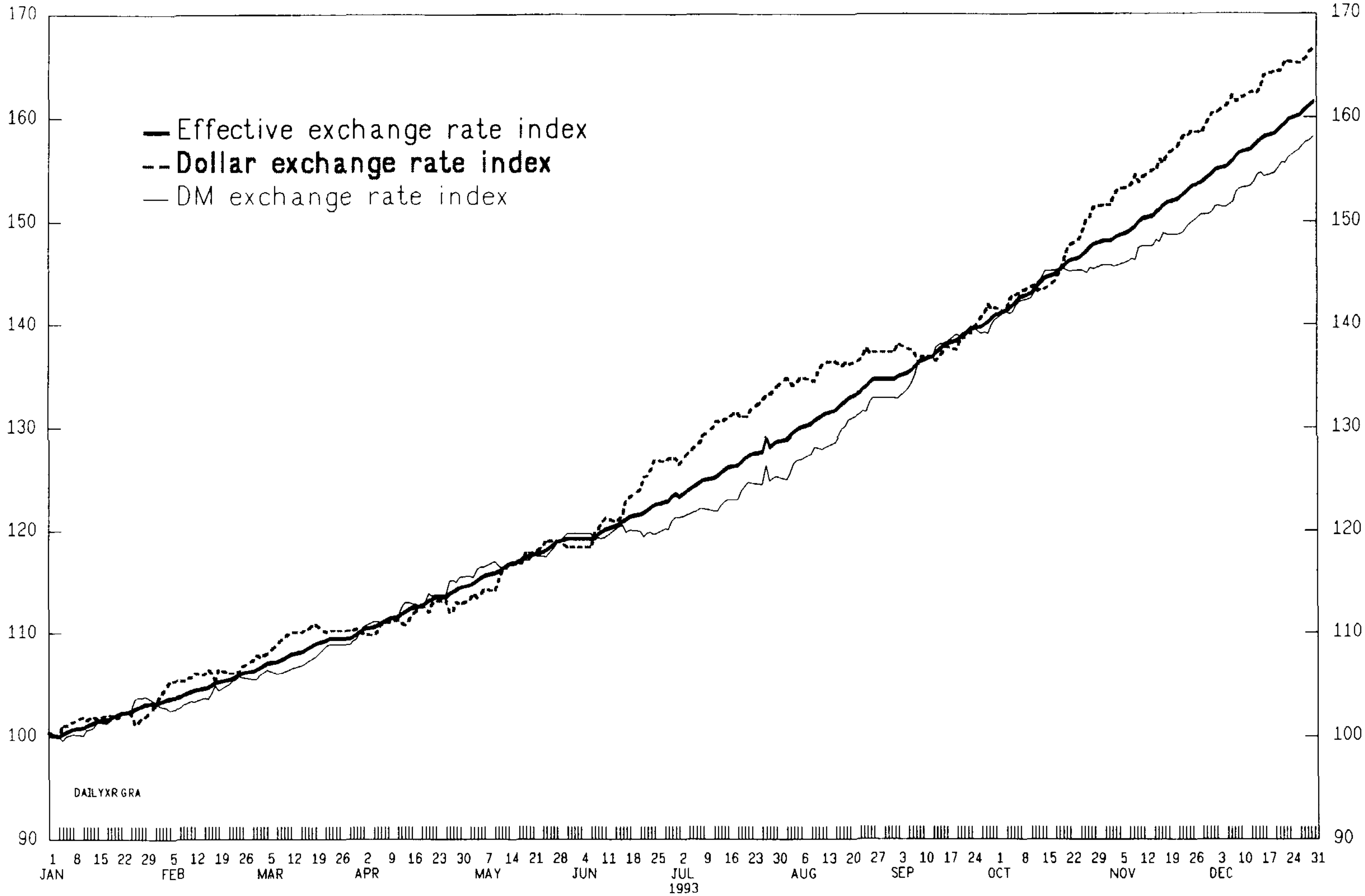


Sources: IMF, International Financial Statistics; data provided by the Turkish authorities; and staff estimates.

CHART 5

TURKEY

DAILY EXCHANGE RATE INDICES



Source: Central Bank of Turkey

1/ Updated to January 28, 1994.

rates, the increased depreciation of the nominal exchange rate, and rising inflation, there was a significant shift out of Turkish lira deposits into foreign exchange deposits, equity, and other financial instruments, including these asset-backed securities. By October 1993, deposits denominated in foreign exchange accounted for 46 percent of broad money, compared with 35 percent at the end of 1992. Counting these deposits, banks held a short position in foreign exchange of some US$5 billion, or about 6 percent of their total assets.

Reflecting the strong growth of import demand, Turkey's external current account has deteriorated sharply, moving from a surplus of 0.3 percent of GNP in 1991 to a deficit of 1.1 percent of GNP in 1992 and widening further to 5 percent of GNP in 1993 (Chart 6). Exports still maintained positive growth in volume terms in 1993, albeit at a much reduced rate, while imports grew by over 30 percent driven by excess demand and spurred by the appreciation of the real exchange rate and by reductions in nominal rates of protection for several commodities. The sharply enlarged current account deficit found ready financing in the markets, although there was a shift in the composition of this financing toward short-term credits and portfolio investments. The latter, in particular, contributed to the growth of Turkey's stock market, which in 1993 was among the fastest growing of the world's "emerging markets". At end-1993, Turkey's foreign exchange reserves amounted to US$6.4 billion, (US$6.1 billion in 1992), or the equivalent of 2½ months of imports of goods and services.

III. Near-Term Outlook

The authorities are expecting the growth of private consumption and investment to decelerate sharply in 1994 on the assumption of a moderation in wage growth, curbs on consumer credit, and an increase in taxation. In addition, a cut in the PSBR from 17 percent to 14.6 percent of GNP should contribute to a deceleration in the growth of domestic demand from 12.4 percent in real terms in 1993 to about 4 percent in 1994. The external sector is expected to make a positive contribution to growth due to a narrowing of the cyclical divergence between Turkey and its major trading partners and a significant rebound in tourism revenues which had been adversely affected by the recession in western Europe and terrorist incidents. Thus real GNP is projected by the authorities to grow by 4.5 percent, which appears to be in line with that of potential output. The authorities consider that there is still slackness in most labor markets, and that with output growing at its potential rate the upward pressure on prices should diminish and thus they expect inflation to moderate somewhat.

The staff's view of 1994 is less sanguine than that of the authorities largely because it is less optimistic about the prospects for fiscal consolidation. The staff foresees continued strong growth in aggregate demand, while output growth is likely to decline as bottlenecks caused by the high capacity utilization become more prominent. In this case a decline in inflation is doubtful, especially given indexation and the pressures stemming from the large PSBR. With the continuation of pronounced domestic imbalances, the staff does not see much prospect for a substantial narrowing of the external current account and a lessening of the vulnerability of the external position.

Since the time of the discussions, unsettled conditions in the exchange market have heightened the staff's concern. In January 1994, the lira came under pressure following the announcement by international credit rating agencies that they were downgrading Turkey's debt (to 1 point below investment grade in the case of one of the rating agencies). On the basis of their interpretation of market conditions, the authorities, as well as representatives from private banks, had been of the opinion that such a downgrading would not carry major negative consequences for the flow of financing to Turkey. Nonetheless, the developments in the exchange market led the Central Bank to let the lira depreciate by 12 percent on January 27 and to permit a sharp increase in short-term interest rates.

IV. Policy Discussions

The discussions were dominated by concerns about the sharp and sudden deterioration of the country's external position. This development compounded the problem of persistently high inflation that has plagued the economy for many years. At the conclusion of the last Article IV consultation with Turkey, Executive Directors had expressed their concern about the chronically high inflation and had emphasized the urgency of a comprehensive reorientation of economic policy, led by a durable fiscal retrenchment. Directors had also expressed concerns that the domestic imbalances would spill over into the external position.

The concerns just mentioned materialized in 1993 with the worsening of the net savings performance in both the public and private sectors. Even though the resulting large external current account deficit was financed with relative ease, it became clear that such a deficit was unsustainable and that the intensification of the external constraint carried the risk of pushing inflation to new heights. The vulnerability of the external position and the danger of a significant acceleration of inflation made it urgent to put in place measures to restore macroeconomic balance.

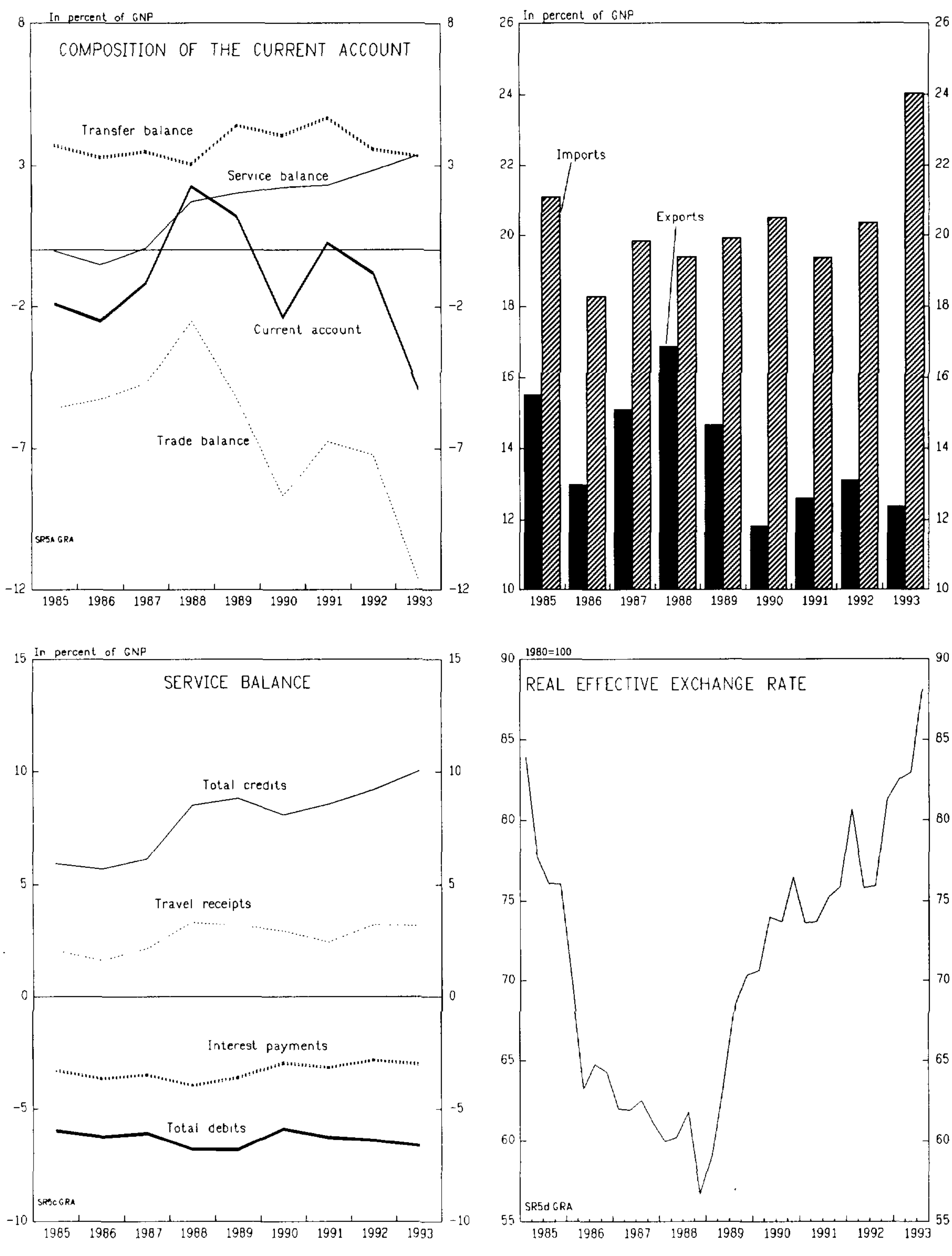
1. Fiscal policy in 1994

The authorities shared the staff's view that the fiscal deficit is the primary cause of the chronically high inflation rate as well as an important contributor to the worsening external position. However, in their view temporary factors--the overvaluation of the exchange rate, the recession in Western Europe, and credit-fueled consumer demand--had also played a large role in the deterioration of the current account in 1993 and thus they felt justified in continuing with a gradual approach to fiscal consolidation. The primary deficit had been reduced in 1993 and they were planning a further reduction in 1994. For the medium term, they expected that their program of tax reform and privatization would set the stage for a renewal of strong growth but with inflation at a sharply lower level.

CHART 6

TURKEY

EXTERNAL SECTOR, 1985-1993



Source: Data provided by the Turkish authorities.

The authorities saw the reduction in the primary deficit that took place in 1993 as a significant achievement, which they intend to follow in 1994 with a further decline of some 3 percentage points to a primary deficit of less than 2 percent of GNP. The mission acknowledged that such an adjustment could represent an important step in the process of fiscal consolidation, but considered that taken in isolation this effort was unlikely to be sufficient to affect the public's expectations. What was needed was to make this adjustment part of a medium-term strategy that would give the public a clear sense of the direction of fiscal policy and the authorities' commitment to macroeconomic discipline. The fragility inherent in the present situation did not allow much scope for gradualism and, in the view of the staff, such a commitment would likely entail the early move to a primary surplus that would be large enough (some 3 percentage points of GNP, after allowing for positive real interest rates to be paid on the domestic public debt) to prevent the further increase in the public debt ratio (the total debt averaged about 60 percent of GNP in 1993). Thanks to the large recourse to the inflation tax for the financing of fiscal deficits, Turkey had thus far avoided unmanageable increases in the domestic debt. Now, however, that inflation threatened to accelerate, there was no alternative but to seek a significant reduction in the deficits.

The authorities are projecting that consolidated budget tax revenues will increase by 2 percent of GNP in 1994. The main factor underlying these projections is the increase in VAT rates by 2-3 percentage points introduced in November 1993, as well as more efficient VAT collection. The projected increase in personal income tax receipts (0.5 percent of GNP) on the other hand is largely based on improved administration, and the staff cautioned the authorities about expecting too much in the short run on this account. The authorities also project nontax revenues to increase by 0.7 percent of GNP, largely reflecting privatization receipts from state economic enterprises (SEEs) such as the petroleum refinery and distribution system, Turkish airlines, shipbuilding and telecommunications. The staff observed that Turkey's recent experience with privatization raised questions about the likelihood of realizing the full extent of the projected increase in revenues. The authorities, however, pointed out that the legal and organizational problems that had slowed down the privatization program in the past had now largely been resolved.

Government expenditures are projected to increase only marginally in 1994 relative to GNP. The authorities indicated that to this end a number of measures have already been introduced, including limits on overtime pay and on the number of temporary and seasonal workers, the requirement for each spending agency to provide a detailed expenditure program, and restrictions on investment. Also, the privatization program is expected to reduce the need for transfers to SEEs. However, the mission failed to be convinced about the feasibility of realizing the expenditure projection, particularly in regard to personnel expenditures. These, which account for 35 percent of budgetary outlays, are projected to increase by 52 percent in 1994; however, the Government has already agreed that salaries are to be adjusted quarterly rather than biannually on the basis of past inflation and has granted increases for the first two quarters of 1994 that together amount to 29 percent, thus leaving room for an increase of only 18 percent in the second half of 1994. An early and sharp decline in inflation would be required for this projection to hold.

The projected increase in other current expenditure of 0.3 percent of GNP is in large part due to military expenditures in southeastern Turkey. Little progress had been made since the last consultation on quantifying military expenditure outside the budget as much of the cost of heavy equipment is off-budget, financed directly by external loans and grants, and through taxes collected by an EBF. The authorities estimated total military expenditure for 1993 to be roughly LT 20 trillion (or 1.5 percent of GNP), of which LT 3-4 trillion was provided in a supplementary budget for expenditure in the southeast. However, the estimated cost of the conflict in the southeast is likely to be considerably higher on account of losses in production and in tax revenues, among others.

The authorities have made progress in recent years in integrating a number of extrabudgetary funds (EBFs) into the budget. In 1994, the EBFs will be required to reduce their scale of operations as the central government will take a larger share of the petroleum consumption tax, which is one of their main sources of revenue, and since only a few large EBFs have access to borrowing. As regards the state enterprises (SEEs), it is expected that the increase in the pace of privatization would reduce the burden they entail on the public finances. 1/ The authorities have taken steps to limit new hiring by SEEs and to reduce expenditures for agricultural support. At the same time, they are ensuring that the prices of goods and services are not held down artificially as a method of restraining inflation temporarily.

With a primary deficit of 1.8 percent of GNP in 1994, the authorities project the total PSBR to amount to 14.6 percent of GNP to be financed entirely from domestic sources. In spite of the large domestic financing of the deficit, the interest bill on the domestic debt is budgeted to increase only by 0.8 percentage points GNP. Although the Government pays high real rates of interest on most new issues of government bonds and bills, a substantial amount of the outstanding government debt carries interest rates far below the rate of inflation, thus overall the average interest rate on the domestic debt of the central government is negative in real terms. 2/ The authorities further assume that interest rates on government securities will decline slightly in 1994, in line with the forecast of somewhat lower inflation, and that a lengthening of the average maturity of these securities will push cash interest payments beyond the 1994 fiscal year,

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1/ There are substantial deficiencies in the statistical information on SEEs, which hampers government oversight of them.

2/ Most of the debt which carries below market rates of interest is held by the Central Bank. On these credits the Treasury pays an annual interest of 4 percent or less, thus in practice representing the virtual monetization of the deficit. See Appendix I of the accompanying Recent Economic Developments paper for more details on the public sector interest bill.

thus restraining the growth of the interest bill. The mission noted that the authorities' projection of the public sector interest bill appeared to be based on optimistic assumptions about the course of inflation and interest rates and that, while it was true that with cash accounting a lengthening of the maturity structure of government paper would reduce the 1994 interest bill, this would not represent a fiscal savings when viewed from a longer-term perspective.

2. Fiscal policy in the medium term and structural issues

The authorities recognize the importance of conducting economic policy in a medium-term framework and indicated that they were working on a three-year plan--expected to be completed by March 1994--integrating fiscal, monetary, and other policies. 1/ As noted above, and on the basis of illustrative scenarios (presented in Appendix I), the mission recommended the early shift to a primary surplus in the public sector as a means to garner the credibility required to begin the process of disinflation.

The fiscal consolidation will require a critical examination of virtually every aspect of public sector activities. As regards revenues, the mission attached importance to the tax reform package that was passed by Parliament at the end of 1993 and would result in increased revenues beginning in 1995. This package includes three main items: (i) lowering the corporate income tax rate from 46 percent to 35 percent and sharply reducing exemptions so as to ensure a minimum corporate tax of 20 percent; (ii) changes in tax administration; and (iii) measures to increase the progressivity of the personal income tax. The authorities also expect to introduce a consumption tax on luxury goods during 1994. Further in the tax area, the mission urged the authorities to streamline and reduce the scope of the extensive system of fiscal incentives, exemptions, and other tax expenditures that is not only costly in terms of foregone revenues but introduces allocative inefficiencies. The efforts on the revenue side should be complemented by initiatives to restrain expenditure growth, particularly seeking a more flexible system of wage determination in the public sector, and additional controls on outlays by extrabudgetary funds.

Notwithstanding the disappointing experience thus far, the authorities are confident that the privatization program is now poised to take off and fulfill the expectations in terms of decreasing the burden of the state enterprises on the public finances, promoting an efficient allocation of resources, and deepening the existing capital market. As a start, over the next five years, the Government intends to privatize at least 30 percent of state shares and aims to generate an income of approximately US$10 billion. The mission welcomed the authorities' intentions to accelerate the privatization process. The mission emphasized that the main benefits of privatization should be seen in terms of an improved structure of the

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1/ In addition, government planning utilizes a one-year financial management plan and a seven-year plan geared toward long-term sectoral priorities.

economy and cautioned the authorities against considering non-recurrent privatization revenues as a lasting solution to the fiscal problem. The mission also encouraged the authorities to adopt measures to improve enterprise governance in the time until enterprises can be sold.

The authorities intend to improve the social safety net for workers who are laid off as part of the privatization program. The draft privatization law requires purchasers of SEEs to assume all accrued liabilities to the employees of the enterprise, which would be paid upon dismissal in one installment. The authorities are preparing an unemployment insurance law that should take effect in 1994 or 1995. As it would take two years before regular payments from this scheme could start, 15 percent of privatization revenues would be used to finance severance payments to workers in the meantime. The authorities are also discussing a loan from the World Bank for the retraining and relocation of laid-off workers. The mission indicated the need carefully to target safety net expenditures so as to avoid duplications between payments by private owners and the state and, more generally, the need to secure the financial balance of the proposed unemployment insurance scheme.

A further area of critical importance in strengthening the public finances relates to agricultural support prices. The present system has frequently given rise to large purchases by state regulatory agencies and to indirect subsidies that have been hard to quantify and monitor. The authorities intend to cut back such subsidies over the medium term. Already in 1993 the Government ceased to purchase cotton and chose instead to provide a direct and explicit subsidy to producers when required to cover differentials between production costs and the world market price. This pilot program is intended to be extended to most other agricultural crops. The authorities are also taking measures to limit output of certain loss-making crops, such as tobacco and tea.

The social security system is currently experiencing financial difficulties and the authorities are concerned that these negative trends may intensify over the medium term, given demographic factors and labor market pressures that are likely to exceed the capability of the unemployment compensation scheme that is being put in place. The present difficulties reflect also a recent reduction in retirement age and lax tax collection practices. The authorities have begun to address the latter problem and are also taking measures to improve the financial management of the social security funds. Assistance from the World Bank is being sought to study ways of overhauling the system.

3. Monetary and exchange rate policies

In reviewing the developments in recent years, the authorities noted that the large fiscal deficits have severely constrained the ability of the monetary authorities to undertake an independent monetary policy. They indicated that, given the expectation of a further large deficit, the Central Bank was again not planning to set targets for the monetary aggregates during 1994 but would instead focus on securing a stable financial environment. On a day-to-day basis, the Central Bank intends to follow, without formally announcing it, what would amount to a crawling peg-type nominal exchange rate rule ensuring that on present projections--notably regarding the inflation rate--there would be a 6 percent real depreciation of the exchange rate.

The authorities indicated that such a depreciation was justified by signs that the large profit margins that had existed in the export sector in the mid-1980s had by now been largely eroded. They added, however, that the evidence about the extent of the loss of competitiveness of exports remained unclear, and that the slowdown in their growth in 1993 was largely attributable to temporary adverse external factors. While acknowledging that there was no unequivocal evidence as regards the extent of the loss of competitiveness of exports, the mission indicated that the progressive decline in their rate of growth was a matter that needed to be addressed. In this regard the mission emphasized that the only way to open room for such a strengthening of the external position, was to restrain the expansion of domestic demand, in particular by reducing the claim on resources exerted by the public sector.

The mission argued that, in the face of strong domestic demand, a worsening balance of payments, and an unaddressed fiscal imbalance, monetary policy had no choice but to be tight. The mission stressed, however, that the responsibility for fighting inflation could not rest on monetary policy alone and urged the authorities to put in place policies requiring a significant strengthening of the public sector's financial performance combined with a strict observance of limits on the growth of monetary aggregates consistent with the inflation target. Over time, if credible fiscal consolidation were implemented, it would become possible to proceed to some easing of these monetary conditions.

As regards the immediate conduct of monetary policy, the mission expressed its concern about the lack of an effective limit on access by the public sector to central bank financing. The staff agreed with the authorities that under these circumstances, and in the absence of fiscal adjustment, the targeting of monetary aggregates would not be seen as credible and that the authorities were left to fight an uphill battle in attempting to restrain the growth of reserve money as best as possible with the available instruments. The staff, moreover, noted that the present policy of informal nominal exchange rate targeting did not provide an effective guide to the public's expectations and that there was a risk that this policy would end up being focused on the real exchange rate, with the consequent loss of any nominal anchor and the acceleration of inflation. In the staff's view, there is no option but to keep interest rates tight to offset the expansionary effects of the budget, and the public sector's access to monetary financing needs to be restrained.

Financial innovation, currency substitution, and disintermediation have contributed to complicate the task of monetary management. Banks have been moving away from deposit liabilities toward nondeposit liabilities, such as repurchase agreements and asset-backed securities, thus lowering effective reserve requirements. During 1993, in particular, asset-backed securities were used to transform consumer loans into marketable instruments and the authorities were concerned that this had excessively fueled the growth in private consumption. The continued advance of foreign currency substitution further reduced the base on which the inflation tax is levied, while, on the other hand, businesses with access to foreign financing generally tried to avoid borrowing from the domestic banking system because of the high intermediation costs, partly due to the taxation of financial instruments. 1/

There was a need to curtail the expansion of credit to the private sector and the authorities indicated that they will eliminate the use of asset-backed securities in consumer lending in 1994. They also intend to tighten and simplify the system of reserve requirements and liquidity ratios with a view to gaining better control over the expansion of banking system credit. Over the medium term, they hoped to reduce the burden on the financial system stemming from reserve requirements, liquidity ratios, and withholding taxes in order to stop financial disintermediation.

4. Incomes policies

The mission observed that the very strong increase in real wages of recent years was not sustainable. On the basis of partial information, it appeared that by 1990 real wage levels had already surpassed the levels existing in 1983, prior to their subsequent compression, and increases since then seemed to have exceeded reasonable estimates of growth in productivity and were likely to have had negative consequences for external competitiveness. The authorities largely agreed with this assessment and indicated that the Government would stand firm in wage negotiations in the public sector in 1994 and thus, they were not expecting further large increases in real wages to occur. Moreover, the authorities stressed that significant wage flexibility existed in the private sector where 65-70 percent of wage earners are not unionized, and where the worker turnover rates are high. In addition, the authorities expected that, with privatization, wage demands on the part of state enterprise workers would be moderated.

Indexation has become extensive in the formal sectors of the economy. In the central government, wages will be adjusted on a quarterly basis during 1994 and in the private sector biannual adjustments have become widespread. The mission strongly encouraged the authorities to move away from the present backward-looking indexation practices, as they ingrain inflationary inertia and increase the costs of adjustment by reducing the flexibility of labor markets. There appeared to be an appreciation among the authorities and the social partners of the need for an understanding on wage and price objectives to break the inflationary momentum of wages; however, it was felt such a proposal would in all likelihood require the prior demonstration of a credible fiscal adjustment effort.

1/ See Appendix II of the accompanying Recent Economic Developments paper for a discussion of currency substitution in Turkey and Appendix III for a discussion of interest rates in Turkey.

5. External outlook and trade policy

The authorities explained that the special factors that adversely affected the trade balance in 1993 were not expected to influence performance in 1994 when other positive factors, such as a more realistic exchange rate, extension of export credits and domestic demand restraint, would be in place. The current account deficit was projected to narrow to US$4.5 billion (or 3½ percent of GNP). The staff regards the authorities' projections as optimistic, especially in view of the continued rapid growth of domestic demand that can be expected. The staff also stressed its concern about the shift in the composition of external financing toward short-term credits and portfolio investments. Turkey's external debt had started growing again, and by mid-1993 it amounted to 50 percent of GNP (with the public sector accounting for some 80 percent of this total). The fact that the large current account deficit registered in 1993 had been financed with relative ease provided no assurances against a shift in market sentiment that could greatly reduce the availability and increase the cost of external financing.

A significant reduction of import duties took place in 1993, continuing the process of simplification and liberalization of the trade regime implemented in recent years. Any remaining discrepancies from Turkey's obligations relating to GATT-bound tariffs were to be removed during 1994. The authorities intend to complete a customs union with the EU by 1995 and in this context, they noted that the existing rates of protection, averaging 23 percent for third countries and 19 percent for EU/EFTA members, would be reduced to about 19-21 percent and 13-15 percent, respectively. 1/ The staff observed that considerable changes, including legislative ones, still needed to be effected within a short span to meet the January 1995 date for the completion of the customs union; the authorities indicated that they were not deviating from the January 1995 timetable, although it was possible that delays may arise on certain issues.

Turkey had been forced to accept quantitative restrictions on some 18-19 categories of exports to the EU, including textile and clothing products, under a voluntary restraint agreement. While the United States had also imposed similar restrictions, these were not binding. Turkish exporters were responding to these by diversifying their range of products and markets, and the Government was assisting with organizing trade missions and with the opening of investment and trade offices abroad. Turkey's trade relations with countries in the former Soviet Union had grown. A long-term natural gas agreement for the import of natural gas from Russia was in effect. Trade relations with FSU states besides Russia were also growing; in 1993, exports to these states had risen by about 40 percent and were helped by the extension of credits from Turkey. Activities of Turkish contractors and construction companies in FSU states were also expanding and were estimated at some US$2.5 billion in 1993.

1/ This reduction was implemented in January 1994.

The payments restrictions against Iraq and against the Federal Republic of Yugoslavia (Serbia/Montenegro) imposed pursuant to relevant U.N. Resolutions and notified to the Fund in accordance with Decision No. 144, are still in effect.

V. Staff Appraisal

Notwithstanding buoyant economic activity and a robust growth of GNP, Turkey's economic performance in 1993 took a turn for the worse as the problem of persistently high inflation was compounded by a sharp widening of the external current account deficit. The heightened vulnerability of the external position has greatly added to the urgency of taking action to tackle the macroeconomic imbalances in the economy and, in particular, it highlights the need to correct the deterioration of the public finances, which is at the root of the imbalances.

The large current account deficit that emerged in 1993 and the shift toward shorter-term capital for its financing clearly indicate that the economic situation has now become much more dangerous. If present trends were to continue, it is only a matter of time until the economy begins to push against external financial constraints with foreign capital flows either drying up or becoming very expensive. Such a development would force increases in interest rates and a depreciation of the currency, choking off domestic activity and causing inflation to accelerate. The pressures to which the lira was subjected in the period since the discussions give a further warning that time is running out and that it is urgent to put in place a major and comprehensive adjustment strategy to restore macroeconomic balance and a basis for sustained noninflationary growth.

The adjustment strategy that is required should be formulated in a medium-term framework and led by a sizable, upfront, and durable fiscal adjustment, with emphasis on measures in the area of public enterprises, subsidies, and social security. An effective incomes policy could contribute to the disinflation process while reducing the effects of the adjustment on economic activity. In the short run, monetary policy will need to continue to be relied upon to keep inflation in check and to secure financing for the balance of payments; however, over time, the credible implementation of a suitable fiscal consolidation plan should permit an easing of monetary conditions.

In the light of the required adjustment, the measures in the fiscal area proposed by the authorities for 1994 are important, but they are insufficient. The borrowing requirement that would result is unlikely to prevent inflation from rising or help close the external gap. There are questions, moreover, about the feasibility of the authorities' fiscal targets without additional measures. In particular there is a concern that a substantial part of the projected increase in revenues is accounted for by either improved tax administration or the proceeds from the expected sale of state property; both these sources of revenue have often disappointed expectations in the past.

On the expenditure side, interest payments are likely to be considerably higher than projected in the budget as the increased recourse to domestic financing and the planned lengthening of the maturity structure of the public debt is likely to push up interest rates. Personnel expenditures are also likely to have been understated in the budget given the wage increases already determined for the first half of 1993 and the commitment that wage adjustments in the latter part of the year will be indexed to past inflation. The staff urges the authorities to seek a reformulation of the public sector's wage policy that eschews backward-looking indexation practices and, more generally, to prepare alternative measures, not only to offset likely deviations from the proposed budget, but to help deepen fiscal consolidation. The deficiencies in regard to the transparency and the coverage of the fiscal accounts are a matter of concern.

For the medium term, the reform of the corporate income tax and related changes to the tax system proposed by the authorities are welcomed and can be considered as an important step in the comprehensive program of fiscal consolidation that needs to be formulated for the medium term. This program should also contemplate measures to restore the financial health of the social security system and should include a critical examination of the continued need for the fiscal incentives, tax expenditures, and other subsidies that, beyond adding to the deficit, introduce distortions and inefficiencies in the working of the economy. In particular, measures to eliminate or at least reduce the scope of the agricultural price support system should be introduced. The staff urges the authorities to push ahead expeditiously with the privatization program.

Evidence of strong and credible action in the fiscal area may provide the setting for understandings with the social partners on incomes and employment policies that could help break the momentum of inflation and alleviate the costs of adjustment. In this context, the social safety net will need to be targeted more tightly, in particular to provide support for and retraining of those most adversely affected by enterprise restructuring. The staff supports the proposal of devoting part of the proceeds from privatization to this end as well as the introduction of an effective and financially balanced unemployment compensation scheme.

As regards monetary policy, it is clear that restrained monetary conditions will need to be maintained until progress in fiscal consolidation becomes evident. The authorities will need to continue restraining the growth of reserve money as best as possible with the available instruments, seeking to limit the public sector's access to monetary financing. In such a setting, interest rates will need to be kept tight to offset the expansionary effects of the budget, which would also contribute to reversing the recent trend toward financial disintermediation. In this connection, and also with a view to reducing distortions in the allocation of domestic savings, it will be important to eliminate or reduce the factors that contribute to widen the wedge between deposit and loan rates.

Notwithstanding the resilient performance of exports under the difficult market conditions of 1993, it has become evident that the existing profitability margins in the export sector are being exhausted and that there is a need to strengthen the competitiveness of the real exchange rate. The only way this can be achieved in a lasting fashion is by maintaining appropriate financial policies to prevent an acceleration of inflation in response to a depreciation of the nominal exchange rate. Sufficient fiscal adjustment, and a strengthened competitiveness of exports would help underpin a move of the Turkish economy to a higher growth path with higher levels of domestic savings and investment.

The major liberalization of the trade and exchange system carried out in the past few years was an important factor contributing to the modernization and rapid growth of the economy. The staff welcomes the authorities' commitment to the further liberalization of the trade system as witnessed by the new cuts in tariffs that were announced recently, and encourages them to work toward creating the conditions that will permit a further generalized reduction in tariffs and levies in line with Turkey's obligations under the GATT.

It is recommended that the next Article IV consultation with Turkey be held on the standard 12-month cycle.

Turkey: Selected Economic Indicators

	1987	1988	1989	1990	1991	1992	1993 Preliminary	1994 Authorities' Projections
Real economy (change in percent)								
Real GNP	7.5	3.6	1.9	9.2	0.5	5.9	7.0	4.5
Domestic demand	6.0	0.4	2.5	16.0	-2.2	7.9	12.4	4.0
CPI (Dec. to Dec.)	55.1	67.8	64.3	60.4	71.1	66.0	71.1	...
GNP deflator	38.4	65.7	66.3	54.4	56.8	62.6	58.8	54.6
Unemployment (percent)	8.1	8.0	8.6	7.4	8.2	7.8	7.2	...
				(Percent of GNP)				
Public finance								
General government budget deficit 1/	4.4	3.8	5.0	5.2	9.9	9.5	12.3	11.0
Public sector borrowing requirement 1/	8.8	6.4	7.5	11.0	15.1	15.8	17.0	14.6
Primary deficit	2.7	-1.5	0.3	4.1	6.8	7.2	5.0	1.8
GCFCG grants	...	...	...	0.6	1.7	0.2	--	--
				(Percentage change)				
Money and credit (end of year)								
Reserve money	37.6	85.0	71.2	40.6	50.6	69.5	70.0 (Oct.)	
M2	45.0	54.1	73.3	51.8	63.6	62.9	49.0 (Oct.)	
M2X 2/	57.5	59.6	66.9	52.4	80.9	74.9	71.6 (Oct.)	
Interest rate (percent per annum) 3/	50.6	66.2	57.5	52.3	85.6	95.1	86.4	
				(In billions of U.S. dollars)				
Balance of payments								
Trade	-3.2	-1.8	-4.2	-9.6	-7.3	-8.2	-14.0	-13.2
Current account	-0.8	1.6	1.0	-2.6	0.3	-0.9	-5.9	-4.5
Foreign exchange reserves								
Official	1.7	2.3	4.8	6.0	4.9	6.1	6.4	8.6
External debt								
Total	40.2	40.7	41.8	49.0	50.5	55.6	59.4 (June)	
Medium- and long-term	32.6	34.3	36.0	39.5	41.4	42.9	44.9 (June)	
Short-term	7.6	6.4	5.7	9.5	9.1	12.7	14.5 (June)	
Debt service ratio 4/	34.0	36.9	33.6	29.9	30.2	31.0	27.9 (June)	
Nominal effective exchange rate (percent depreciation)	40.8	64.6	37.3	25.7	53.6	56.7	50.4 (Oct.)	
Real effective exchange rate (1980=100)	63.0	56.2	71.0	76.4	80.6	82.1	89.1 (Oct.)	

1/ Including GCFCG grants.
2/ M2 plus resident foreign exchange deposits.
3/ Three-month Treasury bill rate, annual average.
4/ Debt service as percent of current receipts excluding interest and official transfers.

Illustrative Medium-Term Scenarios, 1994-1998

To provide a basis for discussions between the staff and the authorities on a disinflation strategy founded on fiscal consolidation, the staff prepared the attached two scenarios for illustrative purposes. The first scenario is based on the assumption that the primary deficit of the total public sector (primary PSBR) declines only slowly over the next several years. The implications for the current account of the balance of payments are then derived. In the second scenario, it is assumed that the authorities set a goal of reducing the current account deficit to 1 percent of GNP by 1996, which would appear to be consistent with the available financing. The adjustment in the primary PSBR that would be required to attain the balance of payments target is then derived.

The scenario of a gradual fiscal adjustment takes as its starting point the authorities' fiscal projections for 1994 but assumes some slippages relative to the official projections. With the primary PSBR declining only slowly, 1/ inflation would continue to increase and real interest rates would gradually rise to attract external savings and to generate the private savings needed to finance the total PSBR. With rising interest rates and increased uncertainty, private investment would start to decline, which eventually leads to falling real GNP growth. Assuming that external financing on the order of 5-7 percent of GNP per year were to be available, the current account deficit would persist at high levels and the debt ratio would grow further. This scenario underscores that without a substantial fiscal adjustment, Turkey's dependence on foreign capital inflows would reach an unsustainable level.

The scenario of sharp fiscal adjustment, assumes that a sharp fiscal contraction is implemented starting in 1994. This would result in a fall in real growth below potential in 1995-96 and a temporary drop in private investment. Subsequently, as more balanced macroeconomic conditions are restored, growth would rise back to its potential level of 4.5 percent. With the tightened fiscal policy, inflation and real interest rates gradually decline. The projected decline of pricate saving relative to GNP reflects not a weakening of underlying saving but a gradual decline of the amortization component of interest receipts on holdings of public sector debt as inflation and nominal interest rates come down. Inflation-adjusted national accounts would not include these amortization payments as new saving out of current income. Nonetheless, this scenario suggests that while a sharp fiscal contraction will likely lead to a fall in growth in the short term, over the longer run the economy should be able to grow at closer to potential and under more sustainable external conditions.

1/ Starting in 1994, interest payments on the public debt are projected on the basis of accrual accounting rather than cash accounting. This is estimated to add between 3-4 percentage points of GNP to the PSBR. Thus on a cash basis the PSBR for 1994 would be roughly comparable to that of 1993.

Turkey: Illustrative Medium-Term Scenarios

(In percent of GNP)

	1992	1993 Est.	1994 Projection	1995	1996	1997	1998
Gradual fiscal adjustment scenario							
PSBR (+ = deficit)	15.8	17.0	19.5	22.9	22.7	23.7	24.7
Interest	8.6	12.0	16.5	19.9	21.7	22.7	23.7
Primary	7.2	5.0	3.0	3.0	1.0	1.0	1.0
Private investment	13.2	14.2	14.0	11.7	10.5	10.5	10.5
Private savings	28.2	26.2	27.0	27.5	28.0	28.0	28.5
Current account balance	-0.8	-5.0	-6.5	-7.1	-5.2	-6.2	-6.7
GNP growth (in percent)	5.4	6.8	5.0	4.0	3.0	3.0	3.0
GNP deflator (in percent)	62.6	58.8	65.0	70.0	75.0	80.0	85.0
Interest rate on public debt	...	...	55.0	70.0	77.0	82.0	87.0
Total public sector debt		64.8	64.0	65.3	67.0	68.1	69.3
Domestic		34.8	34.1	34.9	35.6	35.7	35.8
External		30.0	29.8	30.5	31.4	32.5	33.5
Sharp fiscal adjustment scenario							
PSBR (+ = deficit)	15.8	17.0	15.6	12.6	8.4	5.8	5.8
Interest	8.6	12.0	16.5	14.5	11.5	8.6	7.1
Primary	7.2	5.0	-0.9	-1.9	-3.1	-2.9	-1.3
Private investment	13.2	14.2	13.4	13.4	14.6	15.8	15.8
Private savings	28.2	26.2	25.5	24.0	22.0	20.5	20.5
Current account balance	-0.8	-5.0	-3.5	-2.0	-1.0	-1.0	-1.0
GNP growth (in percent)	5.4	6.8	4.5	3.5	3.5	4.5	4.5
GNP deflator (in percent)	62.6	58.8	55.0	50.0	40.0	30.0	25.0
Interest rate on public debt	...	...	55.0	50.0	40.0	30.0	25.0
Total public sector debt		64.8	63.9	62.4	60.4	57.6	55.5
Domestic		34.8	33.9	31.6	28.8	25.5	22.8
External		30.0	30.0	30.8	31.6	32.1	32.7

Sources: Turkish authorities and Fund staff estimates.

Turkey: Fund Relations
(As of December 31, 1993)

I. Membership Status: Turkey became a member of the Fund on March 11, 1947. Article VIII as of March 22, 1990.

II. General Resources Account:	SDR Million	% Quota
Quota	642.00	100.0
Fund holdings of currency	609.73	95.0
Reserve position in Fund	32.27	5.0

III. SDR Department	SDR Million	% Allocation
Net cumulative allocation	112.31	100.0
Holdings	.13	.1

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by arrangement	4/04/84	4/03/85	225.00	168.75
Stand-by arrangement	6/24/83	4/03/84	225.00	56.25
Stand-by arrangement	6/18/80	6/17/83	1,250.00	1,250.00

VI. Projected Obligations to Fund: (SDR Million; Based on Existing Use of Resources Only):

	Overdue	Forthcoming				
	12/31/93	1994	1995	1996	1997	1998
Charges/interest		4.6	4.5	4.5	4.5	4.5
Total		4.6	4.5	4.5	4.5	4.5

VII. Exchange Rate Arrangement:

Flexibly managed floating exchange rate.

VIII. Article IV Consultations:

The 1992 Article IV staff report was issued on January 28, 1993 (SM/93/25). The last Board discussion took place on March 17, 1993 (EBM/93/36).

IX. Technical Assistance:

Year	Dept	Purpose	Dates
1990	STA	Public enterprise data reporting	Feb.
1990	STA	Compilation of monetary statistics and construction of a monetary survey	Dec.
1991	STA	Follow-up visit to December mission	June

X. Resident Representative: None