FOR AGENDA

SM/08/248

CONFIDENTIAL

July 21, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Turkey—Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access**

Attached for consideration by the Executive Directors is a paper on the ex post assessment of the Fund's longer-term program engagement with Turkey and an ex post evaluation of exceptional access by Turkey, which is tentatively scheduled for discussion on **Friday, August 1, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Turkey indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Dell'Ariccia, RES (ext. 38135).

Unless the Documents 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 European Central Bank forthwith; the WTO Secretariat on Tuesday, July 29, 2008; and to the European Commission, the Islamic Development Bank, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

TURKEY

Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access

Prepared by an Interdepartmental Staff Team[1]

Authorized for Distribution by the European and Policy Development and Review Departments

July 18, 2008

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EXECUTIVE SUMMARY

At the end of the 1990s, Turkey was plagued by chronic inflation, lack of fiscal discipline, and a weakly regulated and undercapitalized banking system. High real interest rates threatened public debt dynamics and stunted growth. By the conclusion of the last Stand-By Arrangement (SBA) in May 2008, vulnerabilities remained, but the economy had been transformed: inflation had dropped significantly, public debt ratios had declined sharply, the banking system had been restructured, and Turkey had enjoyed a prolonged expansion. However, the path from emergency to fledgling stability was not a smooth one. Over nine years of Fund engagement, Turkey went through a major financial crisis and the deepest recession since the 1940s before staging a remarkable economic revival.

Failures and successes

The 1999 Stand-By Arrangement (SBA) supported an ambitious exchange-rate-based stabilization program that ended in a major banking and currency crisis. While the risks to the program were well appreciated at the outset, its design left little room for error and could not withstand a combination of implementation slippages, adverse external developments, and the failure to adjust policy to emerging imbalances. After the crisis, much increased access to Fund resources and renewed political commitment to program implementation under a redesigned program (and later new SBAs in 2002 and 2005) led to a successful economic recovery. Key elements of the new strategy were an unprecedented fiscal consolidation, a newly independent central bank, and a far-reaching reform of the banking system and its regulatory framework; all under a much increased access to Fund resources. However, opportunities were missed to introduce reforms (especially in the fiscal areas) that would have entrenched Turkey's impressive macroeconomic gains. Success also brought new imbalances, as much improved economic conditions and disinflation attracted copious capital inflows, widening the current account deficit, and ultimately increasing external vulnerabilities.

The role of the Fund

The Fund shares some responsibility for the demise of the early stabilization program, but deserves credit for contributing to the post-crisis success. Slow progress with structural reforms, policy slippages, and bad luck doomed the 1999 stabilization program. However, its design, subject to multiple political and institutional constraints, demanded faultless implementation to succeed and was, in retrospect, too fragile given the political realities of the time. After the crisis, Fund resources were instrumental to easing rollover needs and buying time for an orderly return to market access. Fund staff's advice and the program's role as a commitment device were critical in supporting the authorities' disciplined macroeconomic policies and politically difficult structural reforms.

Looking ahead

The question for the Fund is how to best assist Turkey in entrenching stability and tackling its remaining serious vulnerabilities. Political commitment to sound policies and reform was and remains the key ingredient to ensure economic success, with or without a successor Fund-supported program. Past experience in Turkey indicates that a program will strengthen policy discipline in a politically difficult environment only in the presence of strong program ownership, especially with regard to structural reforms. Broad political support will also be critical for further strengthening Turkey's institutional architecture (especially in the fiscal area), a necessary element of any successful exit strategy for future Fund engagement.

I. INTRODUCTION

1. **Over the past ten years, Turkey went from economic emergency to fledgling stability, through a major crisis and a remarkable revival.** In 1999, Turkey was plagued by chronic inflation, lack of fiscal discipline, and a weakly regulated and undercapitalized banking system. High real interest rates threatened public debt dynamics and stunted growth. By the conclusion of the last Stand-By Arrangement (SBA) in May 2008, while considerable vulnerabilities remained, inflation had dropped significantly, public debt ratios had declined sharply, banks had become resilient, and the economy had enjoyed a prolonged expansion. In between, Turkey went through a major financial crisis, the deepest recession since the 1940s, a pervasive overhaul of its banking system and regulatory structure, and an unprecedented fiscal consolidation, all under Fund-supported programs.

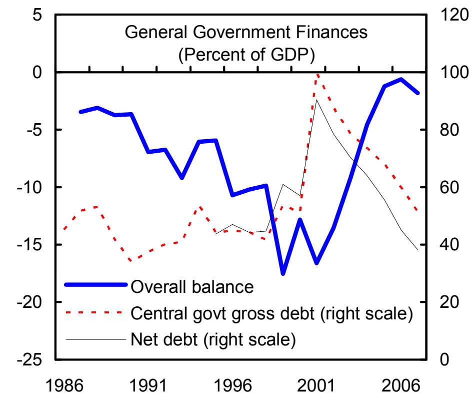
2. **This report selectively reviews the Fund's relationship with Turkey through failures and successes.** It focuses on the following main questions: What were the principal factors behind the demise of the 1999 stabilization program? In particular, were there features of the program design that contributed to its failure? What were the key elements that led to the success of the post-crisis strategy? In that context, what was the role of the Fund? And finally, did the programs help strengthen economic institutions? While the analysis inevitably benefits from hindsight, an attempt is made to reflect the constraints, political realities, and uncertainties prevailing at the time of the programs' design.

3. **The Ex Post Assessment (EPA) and Ex Post Evaluation (EPE) for Turkey have been combined in this report.** The report covers the past nine years of Fund assistance. The objective of the EPA is to provide an analysis of the main economic problems and of the progress under Fund-supported programs, with a view to identifying lessons for future Fund engagement. The EPE component of the report reviews the 2005 exceptional access arrangement, focusing on whether the macroeconomic strategy, design, and financing were appropriate and in line with Fund policy. Neither exercise is expected to review all aspects of the Fund's relationship with a country. In particular, neither report is supposed to delve into how decisions were reached through interaction between staff, departments, management, or the Executive Board. The report is based on numerous Fund documents, other written material, and extensive interviews with Fund staff, present and former authorities, and market participants.

4. **The report is organized as follows:** The next section provides an overview of events; Section III focuses on the 1999 exchange-rate based stabilization program; Section IV examines the main elements of the post-crisis recovery; Section V presents the Ex Post Assessment of exceptional access under the 2005 SBA; and Section VI takes stock and offers a perspective on the strategy for future Fund engagement with Turkey.

II. Overview

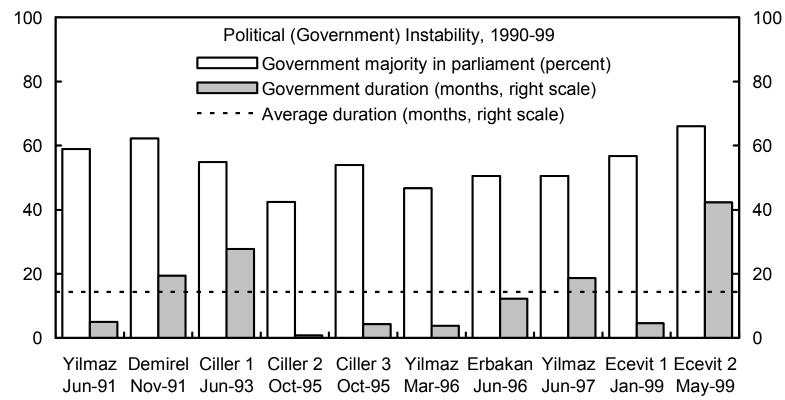
5. **At the end of the 1990s, Turkey found itself in troubled waters.** Lack of fiscal discipline—with sustained primary deficits since the 1970s—and heavy reliance on monetary financing had led to entrenched high inflation (Table 1 and Figure 1). This lack of macroeconomic policy discipline had led to high real interest rates and kept Turkey's growth performance significantly below other emerging economies[2]. (To facilitate comparison with earlier reports, all figures in this report, unless noted otherwise, do not take into account the national accounts revision announced in March 2008.)[3]



Sources: IMF, *World Economic Outlook*; and Turkish Treasury.

6. **Structural weaknesses were intertwined with macroeconomic instability.** A poorly regulated banking system had become an essential vehicle of government funding, funneling short-term borrowing from depositors and foreign investors into government debt. Several insolvent private banks were allowed to remain open under a public blanket guarantee, while public banks, a sizable component of the banking system, had accumulated large losses from subsidized lending. In this context, connected lending was widespread, but credit to the private sector was low. Not surprisingly, the private sector had been crowded out and state enterprises, generally operating at low levels of efficiency and representing a burden on the government budget, dominated several sectors (EBS/02/109, Box 6).

7. **Political instability had undermined several stabilization attempts.** Governments with slim parliamentary majorities, often relying on a coalition of several parties, had found it difficult to avoid populist measures (such as tax amnesties and repeated reductions in retirement age), as well as to muster the political support and build the credibility needed to sustain tough stabilization programs.



Source: IMF staff calculations.

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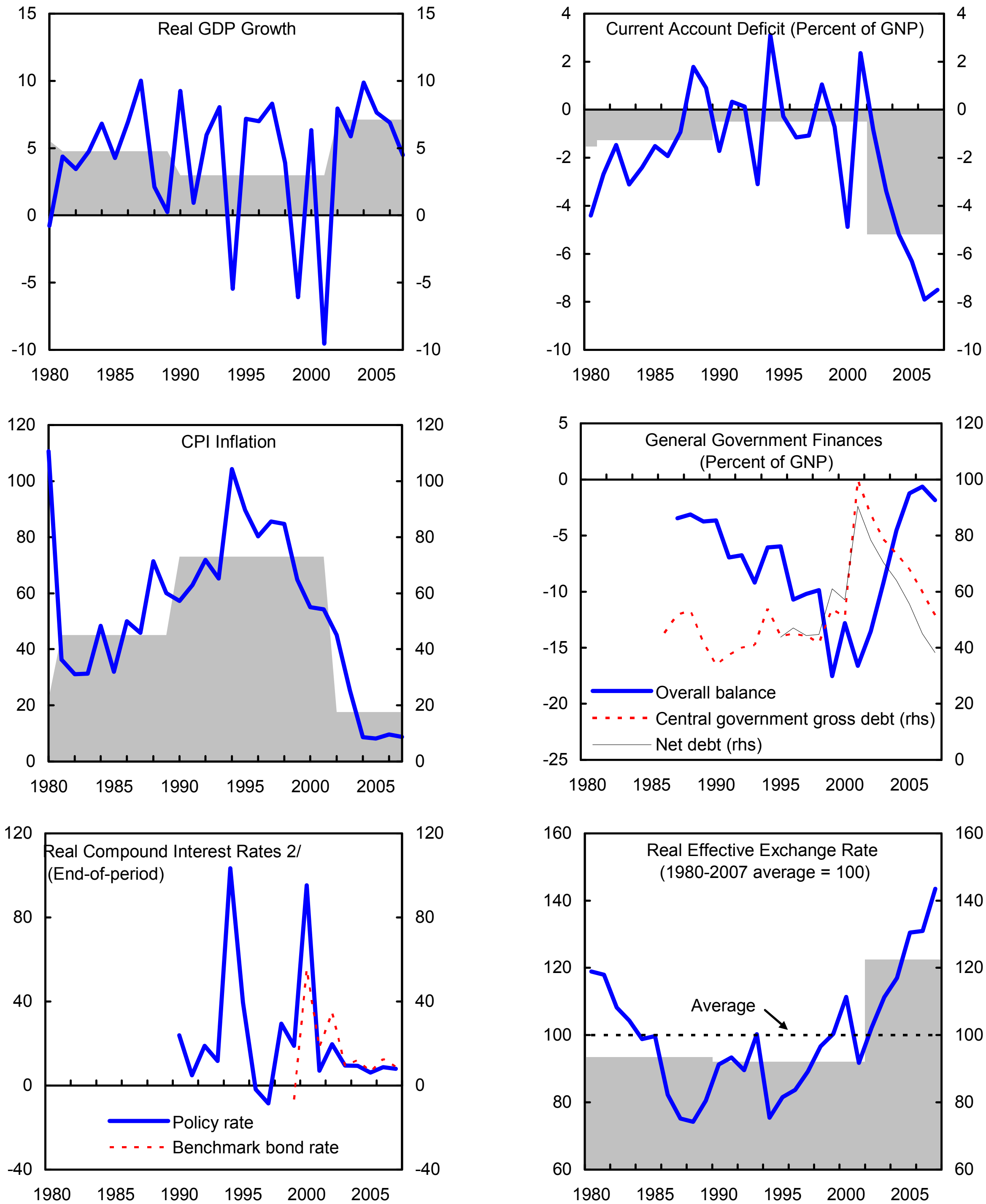
[2] SM/04/27, Chapter I.

[3] The new data featured an upward revision of nominal GDP for the years 1998–2006 of between 26 and 32 percent and altered somewhat the growth dynamics (EBS/08/48, Box 1).

Figure 1. Turkey: Long-term Macroeconomic Developments, 1980–2007 1/
(Percent, unless otherwise indicated)



Sources: IMF, *World Economic Outlook*; Central Bank of Turkey; and IMF staff estimates.
1/ Shaded areas indicate period averages for 1964 to 1980, 1981 to 1989, 1990 to 2001, and 2002 to 2007.
2/ Based on realized inflation.

8. **In the fall of 1999, however, conditions seemed ready for a more credible disinflation attempt.** A major recession, with real GNP falling over 6 percent in 1999, and renewed prospects for progress toward European Union (EU) accession helped the ruling three-party coalition reach agreement on a new stabilization program, though differences lingered within the government. With high real interest rates seriously threatening to generate explosive public debt dynamics, a new Fund-supported program—based on exchange rate-based stabilization, fiscal consolidation, and structural reforms—was adopted in December 1999 (Box 1 and Table 2).

Main Features of Turkey's SBAs, 1999-2008

Facility	Date of Approval	Date of Expiration	Amount Approved in Billions of SDRs (percent of quota)	Amount Drawn in Billions of SDRs (percent of quota)	Total Number of Structural Conditionality 1/	Phasing
SBA	12/22/1999	2/4/2002	15 (1560)	11.7 (1218)	73	13 equal-sized tranches envisaged 2/
Of which: Augmentation (SRF)	12/21/2000	...	5.8 (600)	...	...	...
Augmentation	5/15/2001	...	6.4 (660)	...	...	...
SBA	2/4/2002	2/3/2005	12.8 (1330)	11.9 (1236)	101	Front-loaded, first tranche available upon approval was 7.3 billion SDR
SBA	5/11/2005	5/10/2008	6.7 (691)	6.7 (691)	69	12 equal-sized tranches

Source: IMF Country Reports.

1/ Includes prior actions, structural performance criteria, and structural benchmarks.

2/ However, phasing changed following the Dec. 2000 and May 2001 augmentations. For example, of the 5.8 billion in SRF resources approved on December 21, 2000, 69 percent was disbursed within the first 5 months.

The 1999 stabilization program and its collapse (2000–01)

9. **The program encountered success initially, but soon ran into trouble.** Inflation began falling (although at a slower than anticipated pace) and interest rates dropped well beyond initial expectations. By the second half of 2000, however, signs of progress were mixed. Slower-than-anticipated disinflation contributed to a steady real-exchange-rate appreciation (16 percent by year end). Combined with the drop in interest rates, this fueled a boom in domestic demand and a widening of the current account deficit (which rose to nearly 5 percent of GNP for the year as a whole), exacerbated by rising oil prices and the appreciation of the dollar against the euro. Fiscal policy, the only lever available under the quasi-currency-board rules, did not play the countercyclical role anticipated under the program. At the same time, slow progress on privatizations and banking reforms fueled market unease about program implementation, while the rise in interest rates in September raised concerns about some banks' soundness.

Box 1. Key Elements of the 1999 SBA

Strategy. The program's primary objective was to ensure debt sustainability through a rapid and sustained reduction in inflation and interest rates. It relied on the exchange rate as nominal anchor to tame Turkey's chronic inflation. A major fiscal consolidation effort and pervasive structural reforms were to remove the need for monetary financing of the deficit and promote growth.

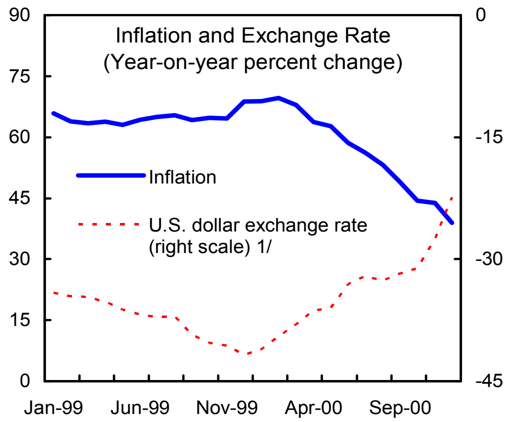
Exchange-rate anchor. A crawling peg was to provide a "visible" nominal anchor, while a preannounced exit strategy was to mitigate problems associated with the medium-term real appreciation typical of exchange-rate based stabilizations. In July 2001, midway through the program, the CBT was to introduce a symmetrical intervention band around the central parity that would gradually increase at a rate of 15 percentage points per year in the transition to a floating regime.

"Currency-board light." All base money was to be created through the balance of payments, as NDA were to remain within a narrow corridor. These quasi "currency-board rules" excluded the possibility of sterilized foreign exchange intervention, and *de facto* prevented the CBT from carrying out a lender of last resort function on a systemic basis. Fiscal and income policies were supposed to respond if the program went off-track.

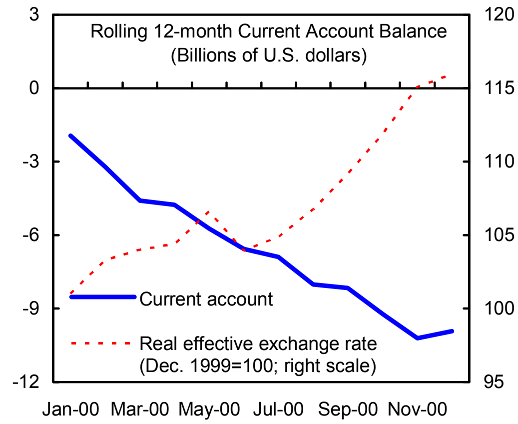
Fiscal consolidation. A large upfront adjustment in the primary fiscal deficit was to stabilize the public debt ratio. Even as the economy was emerging from the devastating 1999 earthquake, the 2000 fiscal package targeted an adjustment of 5 percent of GNP in the primary balance. The bulk of the adjustment was through revenue measures; a third of the measures were temporary. For the following two years, the public sector was to maintain the same primary surplus achieved in 2000 (excluding earthquake-related costs) and permanent measures would replace temporary ones.

Structural reforms. A comprehensive structural reform agenda covered: (i) reform of the pension system; (ii) agricultural subsidies; (iii) fiscal transparency, including closure of extra-budgetary funds, and consolidation of some state banks' quasi-fiscal activities into the budget; (iv) privatization of the telecommunications and energy sector, which would also have provided budget financing; and (v) a new independent bank supervisory authority, strengthened prudential rules, and more efficient bank resolution framework.

Access. Financing at 300 percent of quota over three years was expected to help build up reserves and provide confidence against the expected widening of the current account deficit.



Sources: Turkstat; and Central Bank of Turkey.
1/ Positive sign denotes appreciation.



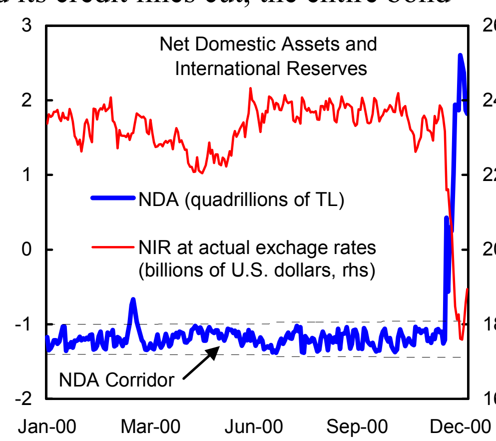
Source: Central Bank of Turkey.

Macroeconomic Performance, 1999–2000

	Original Program		Actual Outturn	
	1999	2000	1999	2000
GNP growth (percent)	-2.1	5.6	-6.1	6.3
CPI inflation (end-of-period, percent)	65.4	25.0	68.8	39.0
Current account deficit (percent of GNP)	-0.5	-1.8	-0.7	-4.9
Nonfinancial public sector primary balance (percent of GNP)	-2.7	2.2	-0.2	3.2
Nonfinancial public sector operational balance (percent of GNP)	-13.6	-9.8	-12.4	-6.9
Public sector net debt (percent of GNP)	58.0	57.9	61.0	57.1
Gross foreign reserves (billions of U.S. dollars)	24.3	29.7	24.2	23.2

Sources: EBS/99/225; IMF Country Report 04/227; and IMF Country Report 05/412.

10. **A localized liquidity crisis turned into a full-blown currency attack and laid bare the tensions within the program framework.** Shortly after a mid-sized bank that was a major primary dealer and investor in government securities had its credit lines cut, the entire bond market came under downward pressures in November 2000.[4] Facing sharp increases in interbank interest rates and strains in the payments system, the Central Bank of the Republic of Turkey (CBT) provided large amounts of liquidity. As a result, the program's net domestic asset (NDA) ceiling was exceeded by about 70 percent of base money. While temporary deviations from NDA targets were not inconsistent with the Letter of Intent (LOI), this liquidity fueled large outflows of international reserves (about US$6 billion between November 21 and December 4).



Source: Central Bank of Turkey.

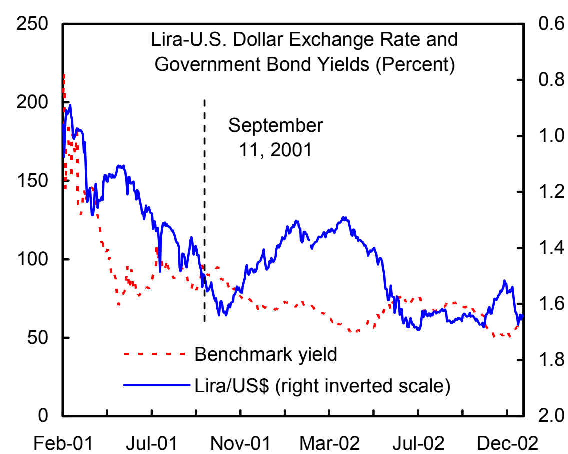
[4] The reasons behind the bank's difficulties are not completely clear. A liquidity squeeze by dominant banks and concerns about the bank's large sovereign debt exposure were both cited (Van Rijckeghem and Üçer, 2005).

11. **Strengthened policies, backed by greater access, brought only temporary respite.** In early December, a strengthened program was approved. This envisaged additional fiscal tightening and reinvigorated banking and privatization reform agendas and was backed by additional access under the Supplemental Reserve Facility of SDR 5.8 billion. The strengthened strategy led to a reversal of capital outflows and a decline in interest rates in the following weeks, but could not fully restore the credibility of the program. A public dispute between the Prime Minister and the President triggered the next attack. On February 22, 2001, after a brief interest rate defense and a limited loss of reserves, the authorities allowed the currency to float. The lira depreciated immediately by about 30 percent.

Crisis and the rise from the ashes (2001–02)

12. **New challenges confronted the authorities in the aftermath of the crisis.** First, the continued rollover of government debt, which had ballooned and whose maturities had shortened significantly, had to be ensured. Second, real interest rates had to be brought down to avoid explosive debt dynamics and a collapse in economic activity. Third, a new monetary anchor was needed to avoid an inflation-depreciation spiral and a breakdown of the payment system. And finally, a devastated banking system needed urgent restructuring. An ambitious strategy to tackle these challenges was devised with a new economic team and the support of a modified and augmented program (and a new SBA in 2002—Box 2).

13. **Notwithstanding improved implementation, Turkey slipped into its deepest recession since the 1940s.** Despite renewed commitment to the program, political uncertainties persisted due to continuing divisions within the government. Currency weakness as well as uncertainty about the government's ability to rollover its debt kept yields on government paper hovering above 80 percent for most of 2001. The lira continued to slide during most of the year, depreciating by about 60 percent against the U.S. dollar from February 22 through October. This fueled inflation pressures despite the sharp contraction in economic activity—end-year inflation reached 69 percent as real GNP contracted by 9½ percent from the previous year. Adding to the overall uncertainty, the shock associated with the September 11 attack caused new financial pressures and dimmed Turkey's economic prospects further.



Source: Central Bank of Turkey.

Box 2. Key Elements of the 2002 SBA

Strategy. The program maintained the main elements of the strategy adopted in May 2001 under the previous SBA: strong fiscal consolidation, money targets with a plan to adopt full-fledged Inflation Targeting, a floating exchange rate, and ambitious structural reforms.

Monetary and exchange rate policies. The 2002 SBA relied on base money ceilings as the nominal anchor (performance criteria) to lower inflation below 35 percent by end 2002, 20 percent by end 2003, and 12 percent by end 2004. Acknowledging the instability of money demand, the program allowed for subsequent revisions in money targets should significant deviations from program projections emerge. The commitment to a floating exchange rate regime was reiterated, with discretionary intervention to be replaced by preannounced auctions.

Fiscal policy. The 2002 SBA had the overarching objective of cementing debt sustainability. To that end, a public sector primary surplus target of 6½ percent of GNP (up from 5½ percent in 2001) was envisaged for 2002–03, along with some 2 percent of GNP of new measures (to be implemented mostly upfront).

Access. The 2002 SBA envisaged that some US$7 billion of Fund financing would be disbursed directly to the Treasury. Increased access to external resources would help smoothing the rollover of domestic debt.

Structural reforms

- ***Banking sector reform.*** The program aimed to complete the restructuring of the banking sector by strengthening private banks' capital base and improving their loan risk evaluation; resolve the intervened banks; continue with the operational restructuring of public banks (with the eventual goal of privatization); and further improve regulation and supervision.

- ***Public sector reform.*** The program set the goals of strengthening public expenditure efficiency, reforming the tax system, reforming the civil service, reducing inefficiencies in state enterprises, and improving fiscal reporting and transparency.

- ***Enhancing the role of the private sector.*** The program aimed at accelerating privatizations, facilitating corporate debt restructuring, improving the business climate, and encouraging foreign investment.

- ***Private sector involvement (PSI).*** During 2001, the authorities had (i) secured two voluntary agreements with foreign commercial banks to maintain their exposure to Turkey, and (ii) engaged in a voluntary public debt swap to lengthen maturities and widen the investor base in government securities through active and flexible debt management practices. Given the mixed results in the area of foreign banks' exposure (external rollover reached only 50 percent in 2001), the voluntary agreements were not renewed when they expired at end 2001. Nevertheless, the authorities continued to emphasize their strictly voluntary and market-friendly approaches as regards PSI on government debt.

14. **Economic conditions improved during 2002, but the recovery remained fragile.** Generally strong policy performance during 2002 allowed a small decline in interest rates and a recovery in the lira, as inflation slowed down and financing conditions eased. With geopolitical risks rising in the region, domestic uncertainty intensified when the fragile equilibrium within the coalition broke down in July and early elections were called. This heralded a new period of political uncertainty and weakening economic policies (especially on the fiscal front). However, around this time a recovery was taking hold: real GNP rebounded almost 8 percent in 2002 and inflation fell below 30 percent, the lowest rate in two decades.

The road to stability (2003–08)

15. **After a slow start, a new government reiterated its commitment to the program's reform strategy.** In November 2002, elections delivered a single-party majority government, which boded well for future stability. The election period, however, had also given way to considerable policy slippages.[5] Along with uncertainty about the direction of policies, this soured financial markets and complicated government bond auctions in early 2003. The prospect of bilateral financial assistance from the United States might have had a mitigating effect. Eventually, however, the new government affirmed its adherence to the program's objectives and introduced several measures to bring the program back on track, committing in particular to targeting a primary surplus of 6½ percent of GNP for 2003 (and beyond) and reenergizing the privatization agenda.

Macroeconomic Performance, 2003–07

	Original Programs					Actual Outturn				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
GNP growth (percent) 1/	5.0	5.0	5.0	5.0	5.0	5.9	9.9	7.6	6.9	4.5
CPI inflation (end-of-period, percent)	20.0	12.0	8.0	5.0	4.0	18.4	9.4	7.7	9.7	8.4
Current account deficit (percent of GNP) 2/	-1.2	-1.2	-4.4	-3.5	-2.8	-3.4	-5.2	-6.3	-7.9	-7.5
Net FDI (percent of GNP) 2/	0.6	0.7	1.1	1.1	1.0	0.5	0.7	2.4	4.7	4.0
Nonfinancial public sector primary balance (percent of GNP) 2/	6.5	6.5	6.5	6.5	6.5	6.1	7.2	6.7	6.1	4.6
Nonfinancial public sector overall balance (percent of GNP) 2/	...	...	-4.6	-2.3	-1.1	-9.2	-4.5	-1.2	-0.6	-1.8
Public sector net debt (percent of GNP) 2/	73.3	69.4	60.0	57.3	53.4	70.3	64.0	55.6	45.1	38.3
Gross foreign reserves (billions of U.S. dollars)	23.7	27.7	39.7	39.5	40.2	35.2	37.6	52.2	63.3	76.5

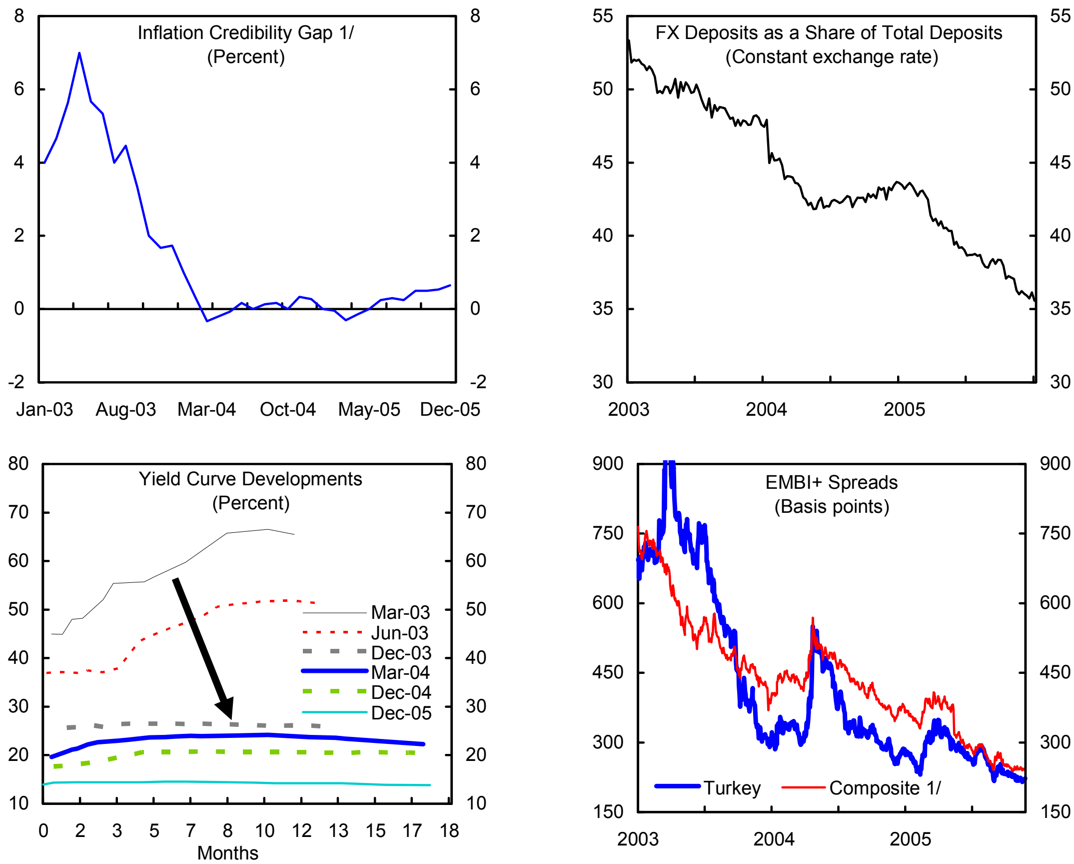
Source: IMF Country Report 02/136; IMF Country Report 05/412; and EBS/08/48.

1/ Actual outturns are prerevision data prior to 2006 and postrevision data for 2006–07.
2/ Actual outturns are based on prerevision GNP.

16. **Economic performance improved significantly once a virtuous cycle between policy implementation and political commitment to the program gained strength.** Continued adherence to the program's fiscal targets and progress with bank restructuring bolstered market confidence. The credibility of monetary policy rose in parallel with the fall in inflation and the

[5] Owing to pre-election slippages and measures adopted by the new government, the fiscal target for 2002 was missed by some 2½ percentage points of GNP. Moreover, court decisions challenged the effectiveness of the banking regulator while structural reforms remained off track in several areas.

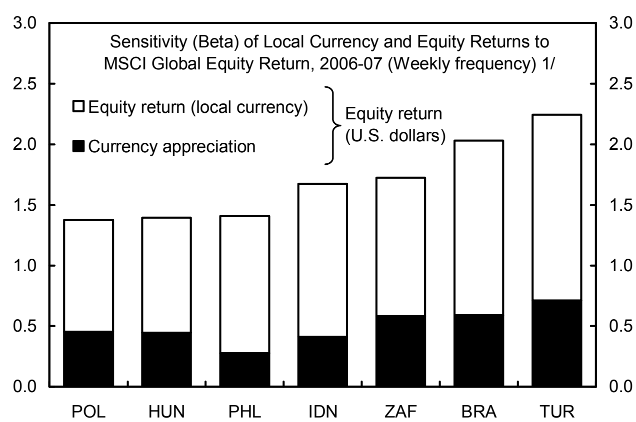
The Recovery of Market Confidence, 2003–05



Sources: Central Bank of Turkey; Turkish authorities; Bloomberg; and IMF staff estimates.
1/ Expected inflation one year ahead minus inflation target (interpolated from end-year values).

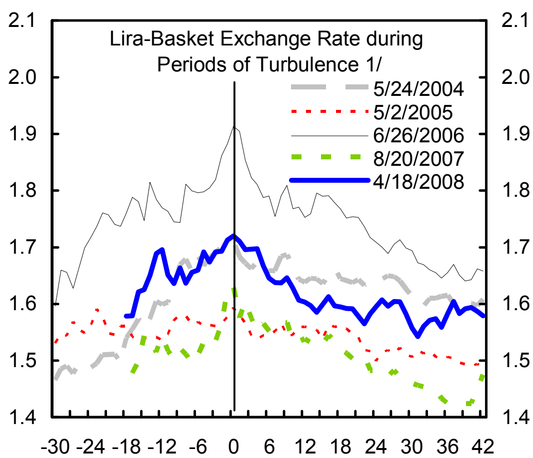
accumulation of international reserves, while the start of EU accession negotiations was a catalyst for reform. Favorable external factors, in particular a strong appetite for emerging market assets, eased financing pressures and lowered interest rates, while improved public debt sustainability helped attract even more foreign capital, feeding a positive loop between good policies and demand for Turkish assets.

17. **Economic performance under the last two programs was impressive.** Real GNP growth averaged 7 percent in 2004–07, while inflation fell into the single digits in early 2004. Public debt



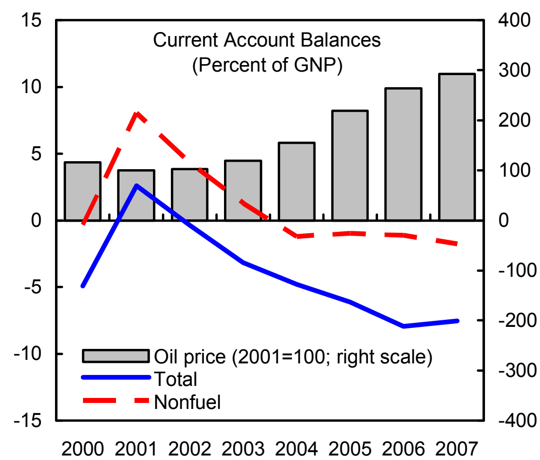
Sources: Bloomberg; and IMF staff calculations.
1/ Beta measures the local asset's volatility relative to global market movements. A beta of 1.5, for example, indicates that the local asset tends to increase by 1.5 percent in response to a 1 percent increase in the global index.

reduction and international reserve accumulation exceeded by wide margins the targets set in a new Fund-supported program approved in May 2005 (Section V)—policy implementation lagged during 2007, however, in part owing to a resurgence in political uncertainty and early elections in July. Foreign direct investment surged from virtually nothing at the beginning of the decade to close to US$20 billion in 2007. As a result, Turkey's resilience to financial shocks also increased (Table 3), as proven by the contained effects of the financial turbulence of the summer of 2006. That said, Turkey remains a "high-beta" country, prone to coming under pressure at times of market stress. Also, with success came new imbalances. The most evident were an overvalued lira—by an estimated 0–20 percent, at the time of the last review under the 2005 SBA—and a large and rising current account deficit (over 7 percent of GNP in 2007, or 5.7 percent of revised GDP).



Sources: Central Bank of Turkey; and IMF staff calculations.

1/ Lira price of a 50-50 dollar-euro basket. Reference day is peak day of turbulence.



Source: Turkstat.

III. What Went Wrong in 2000–01?

18. **The risks to the 1999 program were mostly viewed in terms of a slower than expected response of interest and inflation rates and potential problems in the banking sector.** To counter these risks, the program was thought to have enough buffers. First, the large initial output gap and the strong fiscal adjustment were to support the disinflation effort, while additional countercyclical fiscal measures could contain overheating pressures. Second, the fiscal targets were built on conservative interest rate assumptions. Third, disinflation was expected to bring in windfall profits for the banking sector from declines in the interest rates as the average maturity of the assets was longer than that of deposits. Finally, the preannounced exit strategy was to avoid the hard landing seen in other exchange rate-based stabilizations.

19. **With the benefit of hindsight, however, the program design was "too brittle"** (Deppler, 2001)**.** The program's failure was due to a combination of implementation slippages, adverse external developments, and the failure to adjust policy to changing conditions.

However, there were elements of the program design that made it inherently fragile and left little room for error, in a context where the heterogeneous nature of the coalition government posed a risk to implementation. First, the rigid exchange-rate regime left the entire burden of policy adjustment on fiscal tools. Second, a weak banking system exacerbated the tensions arising from the CBT's limited ability to serve as lender of last resort. Finally, the program was necessarily lopsided, with much of the macroeconomic adjustment to take place upfront and macrocritical structural reforms to be realized over time.

20. **In fairness, the strategy reflected multiple constraints.** First, potentially explosive debt dynamics demanded a visible anchor to lower interest rates rapidly, while providing little scope for a more phased macroeconomic stabilization. Second, in the absence of immediate balance of payment needs, Fund financial assistance could only be justified on the basis of boosting confidence against continued external vulnerabilities and a potential further widening of the current account deficit, as opposed to providing large-scale financing that could be used to ease the government's rollover needs and reduce vulnerabilities by breaking the vicious cycle between high interest rates and rising debt. In that context, access—sizeable in terms of quota (300 percent) but not of the Turkish economy—was to augment foreign exchange (FX) reserves. Finally, there was little political appetite for large programs after the financial crises of the late 1990s.

A. A Classic Exchange-Rate-Based Stabilization Tale?

21. **The history of previous exchange-rate-based stabilizations offered a sobering benchmark for Turkey's program.** By the onset of Turkey's program, it was well known that this approach presented clear risks (Calvo and Vegh, 2000, and Mussa and others, 2000). The rationale for exchange-rate-based stabilizations was that, by relying on a visible nominal anchor, they could buttress credibility and thus bring down inflation expectations at a faster pace than under a money-based stabilization. A typical problem had been, however, that an initial rapid reduction in nominal interest rates had not been matched by an equally fast decline in inflation, leading to a sharp fall in real interest rates and real exchange rate appreciation. This in turn had helped fuel credit booms, overheating, and rapid deteriorations in the external current account balances. Pegs had also led to balance-sheet mismatches driven by large interest rate differentials and the expectation of implicit government guarantees in case of a depreciation. Eventually, pegs had collapsed when the initial growth momentum had stalled and the external situation had become unsustainable.

Disinflation Attempts in the 1990s

Disinflation Program (Starting date)	Monetary Framework	Inflation Before the Beginning of the Program 1/	Inflation Target for the First Year of the Program 1/	Change in CPI Inflation after Six Months 2/	T-bill Rates Six Months after the Beginning of the Program	
					Nominal terms	Real terms 3/
Jan. 1990	Base money targeting	66.8	54.0	-5.5	50.4	-2.3
Jan. 1992	Base money targeting	70.9	42.0	-14.8	97.7	39.2
May 1994	Nonbinding crawling exchange rate floor	115.9	45.4 4/	-44.0	113.2	47.0
Jan. 1995	"Enhanced" crawling floor 5/	125.1	40.0	-24.7	103.2	44.5
Jan. 1998	Net domestic asset targeting	90.4	50.0	-43.6	92.2	28.0

Source: EBD/98/72 and EBS/99/225.

1/ GDP deflator (annual average) for 1990; CPI (Dec./Dec.) for 1992; CPI (June/June) for 1994; CPI (Dec./Dec.) for 1995; WPI (Dec./Dec.) for 1998.

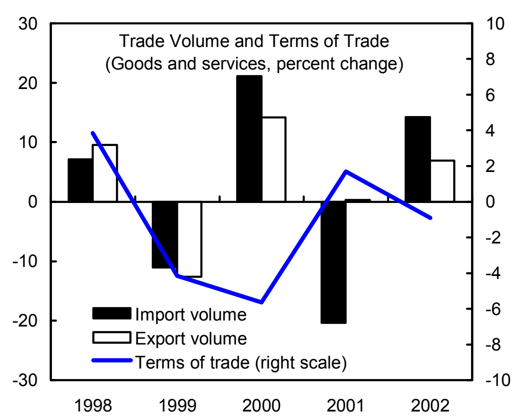
2/ CPI inflation in the first six months of the program, seasonally adjusted and annualized, minus CPI inflation in the six months before the program (also adjusted).

3/ Deflated with the inflation target.

4/ Inflation target for the period May 1994 to April 1995, derived from the annual targets for 1994 and 1995 under the Stand-by Arrangement program.

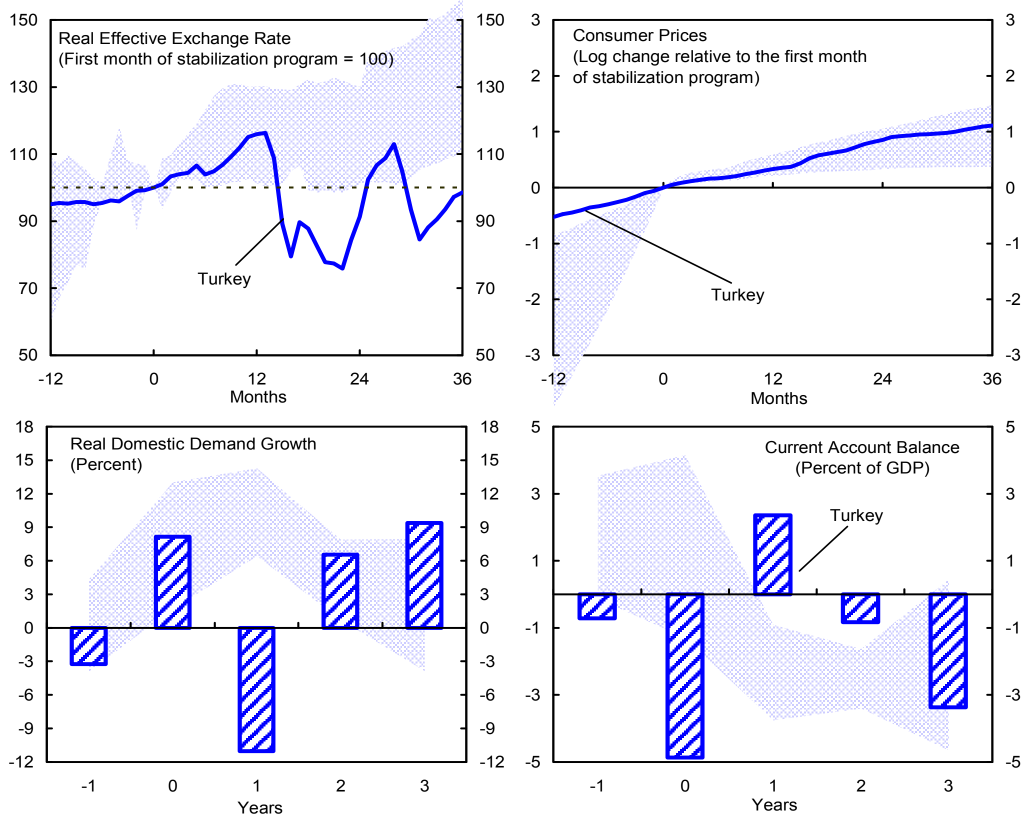
5/ In addition to the announcement of quarterly exchange rate floors, the authorities were committed, in case of slack under the floor, to avoid a rate of depreciation significantly different from the targeted inflation rate. This commitment, however, was expected to guide interest rate policy, with no specific commitment on intervention policy.

22. **Yet, many of these symptoms were faster to appear in Turkey than elsewhere.** Domestic demand grew rapidly in 2000, contributing to a current account deterioration in excess of what had been seen in previous episodes (the current account deficit reached 5 percent of GNP during the *first* year of the program). This was partly due to adverse external developments (the terms of trade worsened 6 percent in 2000 on a rapid rise of oil prices), while the real exchange rate appreciation (16 percent in 2000) and the rise in real domestic demand were not exceedingly large in light of other episodes. However, the collapse came particularly fast, taking place in the early stages of the post-stabilization expansion and despite the buffers that were built into the program.



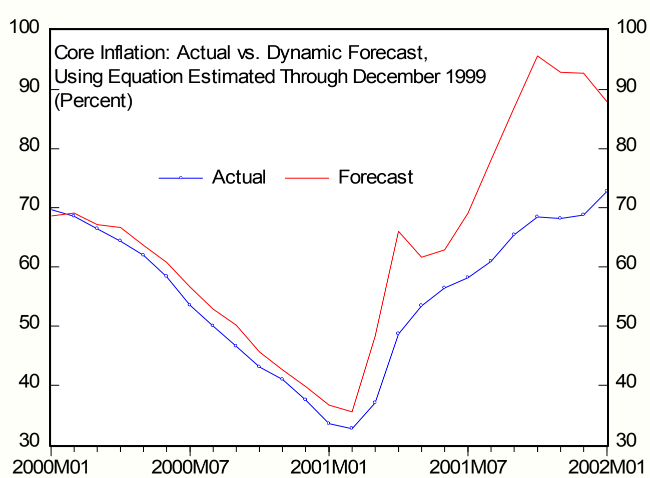
Source: IMF, *World Economic Outlook.*

Turkey's Exchange Rate Based Stabilization in a Comparative Perspective 1/



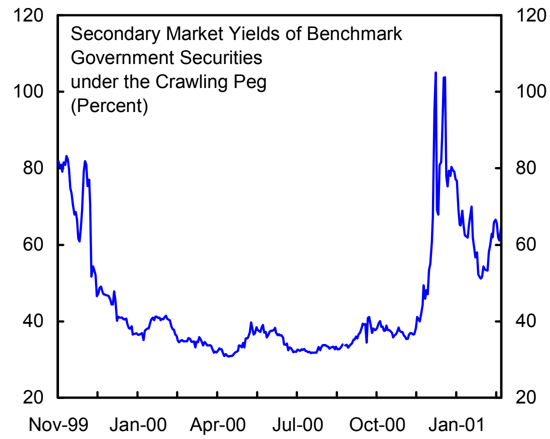
Sources: IMF, *International Financial Statistics;* IMF, *World Economic Outlook;* Central Bank of Turkey; and IMF staff estimates.
1/ The chart compares Turkey's exchange rate based stabilization programs with other exchange rate based stabilizations: Argentina (1991), Brazil (1994), Mexico (1987), Israel (1985), and Uruguay (1990). Month 0 is the first month of the stabilization program; year 0 is the year of the stabilization program if the latter started in the first six months of the year, and the following year otherwise. The shaded areas in the chart represent the range of experiences across the other stabilization cases.

23. **The program helped tame inflation temporarily but failed to generate the desired structural break in the price-setting process**. Inflation fell at a pace more gradual than projected (year end inflation was 39 percent instead of the programmed 25 percent). While this was in part the result of too timid fiscal and income policies, staff argued that this stickiness was also a symptom of the program's failure to generate a break in the inflation process. Indeed, a dynamic forecast based on pre-1999 data was able to track actual inflation very closely up to the crisis (EBS/02/61), suggesting that the expectation formation mechanism remained the same as before the adoption of the peg.



Source: EBS/02/61.

24. **Elements of the exchange rate regime may have undermined its credibility.** Initially, the crawling peg had an unambiguous effect on interest rates. However, after bottoming out in mid 2000, these came under upward pressure from September onward, as the decline in inflation continued to fall short of the program target and the external imbalance became more evident. Rumors about the banking system's FX exposure also likely contributed to the pressures. Against this background, the lack of firmer institutional constraints—present in "true" currency board environments and preferred by staff—may have weakened the credibility of the peg. Also, with pressures emerging, the preannounced exit strategy may have undermined the credibility of the peg by providing investors with an explicit time horizon for its abandonment.



Source: Turkish authorities.

25. **The lack of fiscal discipline and weak banking system heightened the risk of conflicting policy objectives, further undermining the stabilization program.** While the currency board rules (CBR) may have not lent credibility to the peg, they did prevent sterilized intervention.[6] This left the entire burden of cyclical management on fiscal policy, in a country with a history of poor fiscal discipline. The weak state of the banking system was also a threat to the peg. First, banks had an incentive to take large foreign exchange positions, fueling the credit boom and the external imbalances (Özatay and Sak, 2003). Second, it heightened the risk that the CBT would find itself in the position of having to choose between defending the peg and supporting the banking system as lender of last resort, further undermining credibility.

B. Was the Fiscal Response to Emerging Pressures Adequate?

26. **The program did include the authorities' commitment to implement contingent fiscal measures if overheating were to become apparent.** With monetary policy constrained by the CBR, fiscal policy was the only lever for macroeconomic management. Recognizing this critical role, the authorities committed at the outset to tighten fiscal policy if external imbalances grew too large. At the time of the Second Review, this commitment was strengthened, as the authorities identified contingent fiscal measures to implement if needed to limit the current account deficit to 3 percent of GNP.

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[6] Sterilized intervention is not always effective (Ishii and others, 2006, and Disyatat and Galati, 2007), but it could have been in Turkey in 2000 given the imperfect substitutability of domestic and foreign currencies.

27. **However, despite staff's recommendations, the response to the emerging pressures was too slow.** From July 2000, staff had argued that the external position was becoming unsustainable and that a policy correction was needed. The authorities, instead, were concerned about growth prospects and held a more sanguine view on the current account. As a result, cyclically adjusted fiscal policy became less restrictive than programmed, as the government chose to shield the private sector from the effect of higher energy prices. Only in November 2000—a few days before the eruption of the crisis—did the authorities agree to a major fiscal tightening as part of the 2001 budget.

28. **It is far from obvious that tighter fiscal policy could have stabilized the economy.** It should be recognized at the outset that a major fiscal adjustment was a critical part of the program, with the primary surplus improving nearly 4½ percentage points of GNP relative to 1999. That said, would an even tighter fiscal position—in the order of 1½ percent of GNP, as advocated by staff—have been able to reduce the current account deficit enough to fundamentally alter the real dynamics? Literature on the topic suggests that the short-term impact on growth and the current account would likely have been limited,[7] especially since overheating pressures were fueled by sharply lower-than-expected real interest rates. However, tighter fiscal policy could have helped break inflation inertia by boosting the credibility of the program, given Turkey's history of fiscal dominance.

C. Were the Risks from Banking Sector Fragility Underestimated?

29. **At the outset of the 1999 program, the banking system was weak and poorly regulated, but the true scale of vulnerabilities was unclear** (Box 3). State banks—which collected 40 percent of deposits—were politicized, inefficient, technically insolvent (largely due to losses associated with subsidized lending, "duty losses") and highly exposed to interest rate risk. Many private banks were undercapitalized and laden by balance-sheet mismatches and underprovisioned loan portfolios. Furthermore, the quality of private banks' capital and the exact size of their risk exposures were distorted by weak accounting and prudential rules, as well as supervisory forbearance.[8] An overhaul of the regulatory and supervisory frameworks was thus long overdue.[9] Some reforms had been implemented under the 1998 Staff Monitored Program—in particular, a new Banks Act was passed in 1999—but overall progress had been insufficient.

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[7] Fiscal multipliers are generally small, around ½ for taxes and one for spending (Hemming and others, 2002). Moreover, the impact of the fiscal balance on the current account for a sample of OECD countries is less than one tenth of a change in the fiscal balance (Bussière and others, 2005).

[8] Staff was given access only to summary information, while during the Asian crisis reform strategies were based on bank-by-bank supervisory data (Lindgren and others, 2000).

[9] A Basel Core Principles (BCPs) assessment noted that the deficiencies in supervision and resolution arose from split responsibility between the Treasury and CBT and lack of independence (Coats and others, 1999).

Box 3. Banking Reform Strategy and Conditionality in the 1999 SBA

The banking strategy underpinning the 1999 SBA program conditionality (Table 4) had three main elements:

- ***Immediate amendment of the Banks Act to further strengthen supervision and bank resolution*** (prior action). The program required amendments to strengthen supervisory independence (in particular by vesting the BRSA Board with powers to license and revoke licenses and approve regulations, and enhancing the ability to attract active professionals to the Board), to limit exposures to significant owners (those with more than 10 percent of equity) to 25 percent of capital by 2006, and to require the intervention and sale or liquidation of all insolvent banks by the deposit insurance and resolution agency (SDIF). However, the appointment of the BRSA Board was not a prior action, while the performance criteria on the operational start of the BRSA was set for end-August.

- ***Timely adoption of stricter prudential rules to increase capitalization and strengthen risk management.*** Issuing more stringent provisioning regulations and changing the capital adequacy ratio and FX exposures limit rules to apply on a consolidated basis were also prior actions. To further strengthen the system, amending or issuing new regulations in line with international standards and practices in the areas of accounting rules, capital adequacy requirements (in particular to include market risks) and risk management (to deal with other risks, such as interest and liquidity risks) were structural benchmarks and performance criteria between April and end-June of 2000. The government also intended to amend tax regulations to allow loan provisions to be tax deductible as an incentive for banks to be adequately provisioned.

- ***Timely actions to clean up weak and problem banks.*** The stricter rules imposed in January 2000 would allow supervisor to better detect weak banks and require timely recapitalization plans. However, initially this was focused on the 16 banks under enhanced supervision. As such, performance criteria for mid-April required the Treasury (given BRSA was not yet operating) to prepare quarterly compliance and remedial actions reports on the 16 banks under enhanced supervision; finalize a memorandum of understanding to guide the recapitalization (to be completed by end-June 2000) of any undercapitalized, but solvent bank; determining the solvency of—and, if insolvent, intervening in—three critically undercapitalized banks; completing the financial restructuring at the least cost to the SDIF of the eight banks already intervened at the start of the program; and providing the SDIF with appropriate financial means to undertake the full recapitalization of the banking system.

- ***Measures for the comprehensive reform of state banks, while part of the overall strategy, was to be covered by World Bank Financial Sector Adjustment Loan (FSAL).*** The LOI, however, contained an extensive discussion of the authorities' intention to strengthen oversight and pursue commercialization with an eventual privatization goal, through the development of strategic plans and financial and operational restructuring with phased-in timetables to be initiated in 2000. In the interim, to improve financial discipline and cash management, the 2000 budget would include cash transfers to cover losses on subsidized lending, and 15 percent of the stock of unpaid duty losses at end-1999 would be converted into CPI-indexed securities serviced in cash, with the yield on the stock of remaining unpaid losses indexed to Treasury bill rates plus a spread to remunerate banks for services provided to the government. Management would be expected to maintain profitability under this budget constraint. A World Bank FSAL was to assist the reform of state banks.

30. **The ambitious structural reform agenda to address these problems suffered from not securing supervisory independence early on.** [10] The program emphasized several measures to strengthen the banking system (Box 3): (i) passing Banks Act amendments to strengthen the Banking Regulation and Supervision Agency's (BRSA) independence, reduce related lending limits, and improve bank exit provisions; (ii) tightening key prudential regulations and applying them on a consolidated basis; (iii) requiring undercapitalized private banks to reach the minimum capital adequacy ratio (CAR) within set timebounds; (iv) quickly intervening and resolving insolvent private banks (under least cost principles); and (v) fiscalizing duty losses at state banks. However, while addressing the issue of BRSA independence, the program delayed the time at which the BRSA would start operations to August 2000. In the interim, regulatory authority remained with the Minister for Economic Affairs and supervision remained split between the Treasury and CBT, an arrangement not consistent with international standards.[11]

31. **Structural conditionality focused on dealing with problem private banks and tightening key prudential rules, with less emphasis on state banks and supervision.** Key legal amendments and reforms to regulations—in particular, on stricter loan provisioning and application of capital adequacy ratios and FX exposure limits on a consolidated basis—were prior actions. However, the appointment of the BRSA Board was not. Most conditionality for the year 2000 focused on dealing with the sixteen weak private banks already under enhanced supervision (including the financial restructuring of eight insolvent banks to facilitate their sale or liquidation), as well as introducing and implementing new or amended regulations (in particular on market risk capital requirement and risk management). However, there were no conditions covering the implementation of the tightened rules in the system, for example by reporting on special inspections or audits. Finally, the reform of state banks, while discussed in the first LOI, was left to a World Bank Financial Sector Adjustment Loan (FSAL).

32. **Strict adherence to the reform agenda was crucial to contain losses and risk exposures, but there were implementation slippages.** The authorities did complete the prior actions under the SBA, as well as other recommended actions. However, before the BRSA became operational, regulatory and supervisory decisions were prone to political interference and hindered by imperfect coordination, contributing to delayed implementation. The conditions on restructuring insolvent private banks by mid-April 2000 remained unmet until after the November crisis. Also, there were delays in amending or issuing key regulations—in particular the regulations on risk management and market risk capital requirements. State bank reform

[10] The measures were largely based on the strategy developed jointly between MAE and the World Bank in November 1999 (contained in Lindgren et al, 2000a).

[11] BCP 1 calls for, inter alia, a supervisory agency to possess operational independence (from government and industry) and power to set prudential rules.

stalled, owing to delays in passing a privatization law and consequent late approval of the FSAL (in December rather than March). Finally, a commitment to a clear communication strategy was not followed in practice.

33. **Failure to rapidly strengthen the banks' financial position and the regulatory and supervisory framework exacerbated the risks to the program, with important fiscal implications.** Banks with weak balance sheets had strong incentives to gamble for resurrection by taking large open short FX positions. Indeed, on-balance-sheet open positions increased from US$12.8 billion in January 2000 to US$18.1 billion in September. While hedges reduced these positions to well below the regulatory limit, many were of doubtful quality.[12] This rise in open FX positions contributed to fueling a credit boom and, ultimately, to increasing vulnerability to interest rate and exchange rate shocks. In light of this, the delay in setting up the BRSA meant little progress on consolidated supervision as well as on the resolution of SDIF banks and, more generally, less forceful enforcement of regulation. Furthermore, failure to financially restructure state banks led to large accumulated losses and short term borrowing, further increasing risk exposures and pressure on market interest rates.

34. **This increased the tension between macroeconomic goals and systemic lending of last resort.** This tension exploded at the time of the February crisis, when a state bank's liquidity problems led to its default on the interbank market and a breakdown of the payment system. The banking systems' large risk exposures eventually required the transfer of some of these to the government's balance sheet. This, together with the resolution of already insolvent private banks, increased public debt by about 30 percent of GNP (see Section IV).

35. **In retrospect, the exchange-rate-based stabilization was inherently risky, but a timelier implementation of reforms might have improved its chances of success.** The Fund could have pushed for the BRSA to be made fully operational much earlier in the program. Supervision of stricter loan provisioning and FX limit regulations and timely implementation of additional capital and risk management requirements might have contained the risks from external borrowing and the credit boom. Additional buffers could have been created by forcing weak banks to capitalize the windfall gains from the decline in interest rates by suspending the distribution of dividends as was done in 2001. While reforms may have taken time, the Fund had some scope to insist on actions to contain the eventual public costs from state and SDIF bank restructuring. First, it could have insisted on strict adherence to the plans for insolvent SDIF banks (making missed performance criteria prior actions for the following review, as was done in late 2000). It could also have included the restructuring of state banks into program conditionality and placed them under BRSA supervision (as was done in late 2000 and 2001).

[12] Insufficient supervisory powers as well as poor accounting and reporting standards limited the effectiveness of regulation on FX exposure.

IV. From Failure to Success: Ingredients of the Post-Crisis Recovery

36. **The crisis presented new formidable challenges.** The floating of the lira had ended the exchange-rate-based inflation stabilization initiated in 1999, creating the risk of an inflation-depreciation spiral. The steep fall of the lira had sharply increased public debt ratios, which, along with much increased interest rates and rollover needs, magnified doubts on government solvency. The crisis had also devastated the already weak financial sector, leaving several banks insolvent and threatening a breakdown of the payment system.

37. **The urgency of these problems led to strengthened international support and renewed political commitment to reform.** The result was a successful stabilization. A strengthened Fund-supported program (and new SBAs in 2002 and 2005) hinged on three main elements: unprecedented fiscal consolidation; drastic structural reforms in the banking system; and central bank independence, with monetary policy anchored in the short run by money targets and the eventual goal of full-fledged inflation targeting. All these were under the umbrella of much increased access to Fund resources justified by Turkey's very large balance of payments needs. These additional external resources were also critical for easing the government's rollover needs, especially in the early years. The program succeeded through consistent implementation—key in restoring market confidence—initially by the government's new economic team and later, with stronger political support, by a new single party majority (Box 4). Through this process, economic institutions improved markedly, in particular in the areas of monetary policy and bank supervision.

38. **Yet, opportunities for reforms that would have further entrenched stability were missed and new imbalances emerged.** In particular, once the crisis emergencies subsided, more progress could have been made in strengthening fiscal institutions to improve budget quality and ensure long-term fiscal discipline. In addition, with success came new imbalances. In particular, a relatively large current account deficit emerged with the sustained strong economic recovery, the real appreciation of the lira, and rising oil prices. Moreover, its financing, while improved, has remained largely reliant on non-FDI flows.

A. It Was Mostly Fiscal

39. **The crisis swelled public debt and rollover risks.** The currency depreciation and the fiscal cost of the banking crisis pushed gross public debt above 100 percent of GNP. This, along with a high degree of economic and political uncertainty, increased rollover risk substantially. Indeed, debt rollover and the risk of failed auctions became critical concerns for the authorities and staff following the crisis. Monetization, a route taken in the past under similar circumstances, was not a practical option given the high level and short maturity of the debt and the desire to avoid a return to high inflation. At the same time, the authorities were committed to avoiding public debt restructuring, or outright default, and recognized the magnitude of adjustment and resources necessary to avoid it.

Box 4. The Evolution of Program Ownership

During the 1999 program, the heterogeneous nature of the coalition government rendered disciplined and cohesive implementation difficult. The coalition government was formed by three parties with differing political and economic views. Developing common policy positions often required lengthy internal discussions, after which coalition partners would often publicly criticize the government. While the economic team had ownership in the program, the same could not be said for the cabinet as a whole.

In the aftermath of the crisis, a newly appointed government's economic team helped propel reform momentum, but political divisions continued to undermine the credibility of the program. Program implementation was fairly strong, with a high proportion of prior actions and performance criteria met with at most modest delays. However, this success was often accompanied by public differences or even crises inside the coalition government. Weaknesses in communication policy compounded this problem. This contributed to keep risk premia at extraordinarily high levels, weakening debt dynamics. In this context, a political letter of support for the 2002 SBA, signed by the leaders of the three coalition parties, helped improve public confidence in the program.

The formation of a single-party government following the November 2002 elections was a turning point in program ownership. The new government faced a plethora of pressing political issues in its early months, both internationally (EU accession, Cyprus, Iraq) and domestically. There was also the prospect of financing from the United States in connection with the planned operations in Iraq. In March, however, the United States reduced the scale of the financing offered. At the same time, the government committed itself with renewed vigor to program implementation.

Ownership grew with the program's success, creating a virtuous cycle. A strong track record of implementation both improved debt sustainability and built market confidence. In particular, the strong recovery provided widespread benefits, broadening the support for the program within the government and increasing the weight of the economic team. Continued progress with Turkey's EU candidacy also contributed to market confidence.

In recent years, program implementation slipped somewhat, reflecting a slackening support for reforms. Reduced dependence on market confidence (especially for debt rollover) and abundant global liquidity relieved immediate pressure for program performance. With reduced urgency pressures for relaxation rose.

40. **From the onset of the new program, Fund financial assistance played a critical role for reducing financing pressures.** The large rollover burden could not be rapidly reduced by a strengthening of the primary surplus alone (Figure 2)—though the indirect benefits of boosting confidence and lowering interest rates should not be underestimated. With private banks being the main source of market financing, there was also a risk that the government's rising financing needs could exceed the banks' ability to absorb increasing amounts of government paper, and in turn crowd out private sector lending and drive up interest rates even further. A high level of Fund assistance therefore proved crucial for easing financing pressures. Indeed, simulations show that, in the absence of Fund support, market debt would have likely exceeded 100 percent of deposits by end-2003, even assuming that interest rates would not have been higher in its absence. Debt management operations also helped relieve pressure, including a debt swap in mid-2001 to lengthen maturities and structural measures to boost the debt market.[13]

41. **Against this background, Turkey's fiscal adjustment was remarkable.** The adjustment started in the 1999 program and, by 2001, the primary surplus had reached 6 percent of GNP,[14] an impressive adjustment given the sharp 2001 recession. Starting with 2002, the 6½ percent primary surplus target became a cornerstone of the program and, save for the election years of 2002 and 2007, fiscal policy came close to or exceeded the target (Table 5). This was notable in view of the poor track record of fiscal adjustments under earlier Fund-supported programs (SM/04/247, Chapter VII).

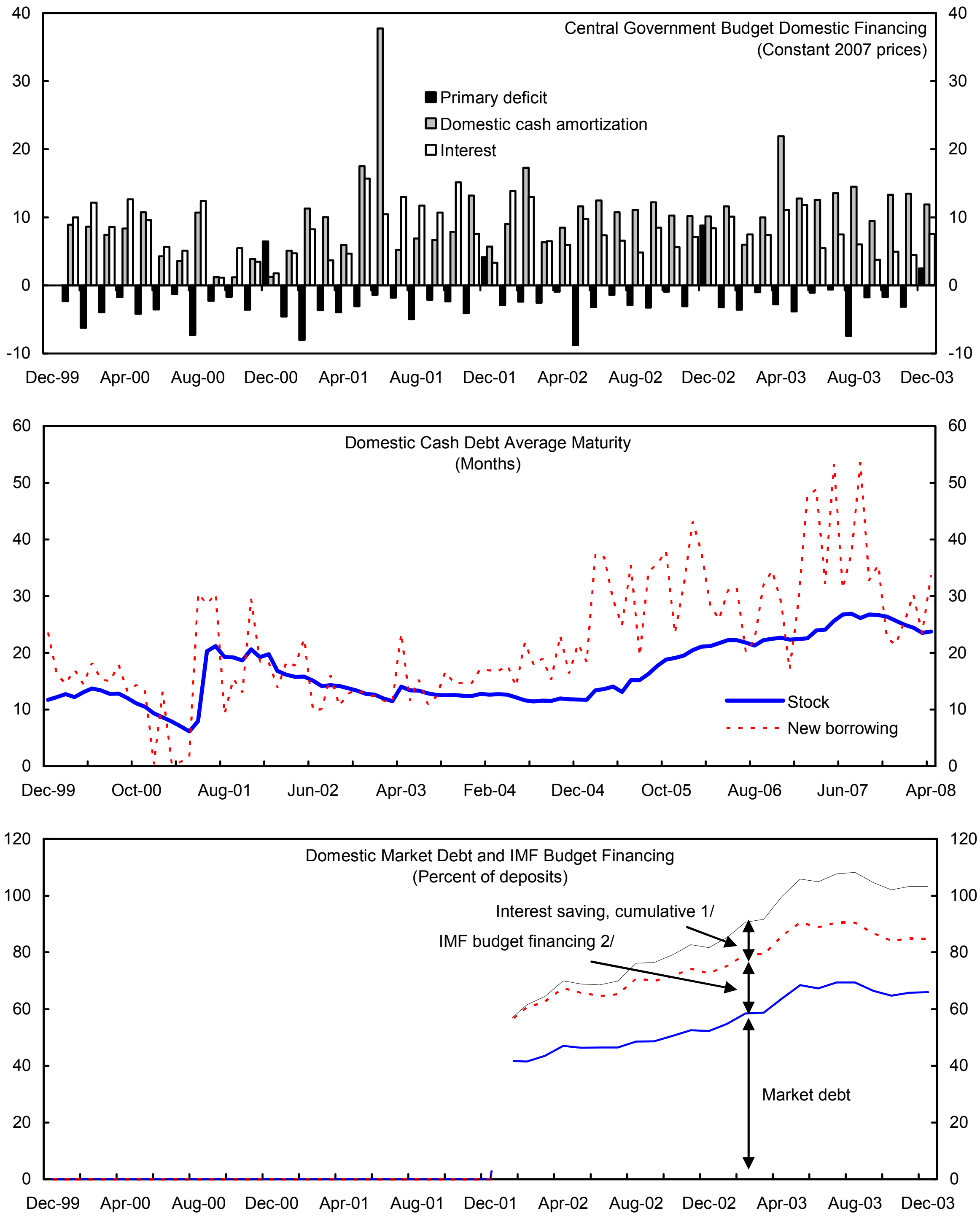
42. **Sustained fiscal consolidation cemented the credibility of the program and was critical for the economic turnaround.** The 6½ percent of GNP primary surplus target filled a gap in Turkey's fiscal institutions and effectively functioned as a fiscal rule, promoting accountability. The Fund-supported program added credibility by certifying budget projections ex ante (including the scoring of policies enacted to achieve the target) and verifying performance ex post. Fund staff also played a less visible function, playing an informal advisory role on initiatives of relevance for the fiscal targets, for example by advising against sectoral tax breaks and tax incentives.

43. **The primary surplus target became a simple and highly visible yardstick to assess fiscal commitment**—and, as the target was met, it became key to restoring confidence, bringing

[13] These included adjusting withholding rates to encourage long-term deposits, increasing the tax exemption on government paper (with unclear effects on the overall fiscal position), and ensuring that state banks holdings were rolled over.

[14] Unless otherwise noted, the primary surplus refers to the Consolidated Government Sector (CGS)—essentially the nonfinancial public sector—measured per program definitions. Data revisions, including to make the coverage uniform across time, cause some ratios to change relative to earlier program documents.

Figure 2. Turkey: Domestic Financing, 1999–2008



Sources: Turkish authorities; CEIC; and IMF staff estimates.

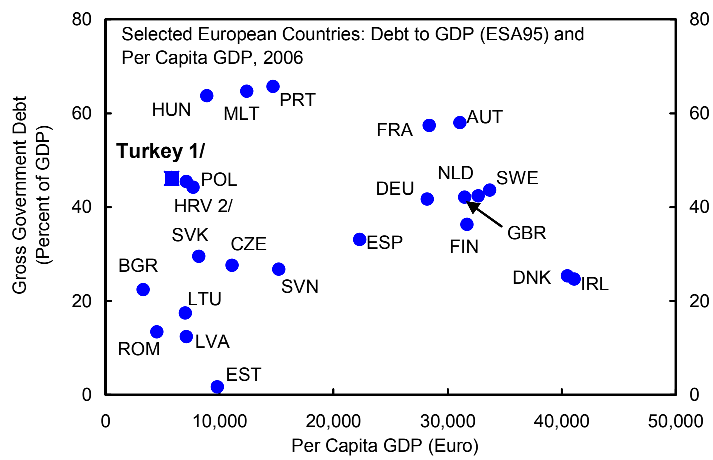
1/ Caclulated by subtracting actual interest payments to the IMF from the estimated cost of financing an equivalent amount of debt in the market. Market cost is based on the average of the benchmark bond and treasury bill (simple) interest rate, compounded monthly.

2/ Includes SDR linked domestic borrowing from the CBT and direct Treasury financing.

down interest rates and broadening market access.[15] The target was never envisaged to remain in perpetuity but, as its symbolic status rose, it became more difficult to abandon without signaling a weakening of fiscal resolve. Having largely served its purpose, the target was eventually abandoned during the preparation of the 2008 budget when large slippages—related both to the slowdown in growth and the electoral cycle—made it hard to go back. The national accounts revision also reduced its symbolic value.

44. **Achieving the primary surplus target was, however, a constant struggle.** The post-crisis emergencies encouraged a focus on the short term. Virtually every review included new, often temporary, fiscal measures needed to meet the target, which put a premium on expediency. As such, the quality of fiscal adjustment remained weak, with heavy reliance on indirect taxes—such as petroleum and alcohol excises—and reductions in investment and other easier-to-cut spending. Over the medium run, this came at the cost of making the central government budget increasingly rigid—predetermined spending rose from 60 percent of primary expenditure in 2000 to 68 percent in the 2008 budget.

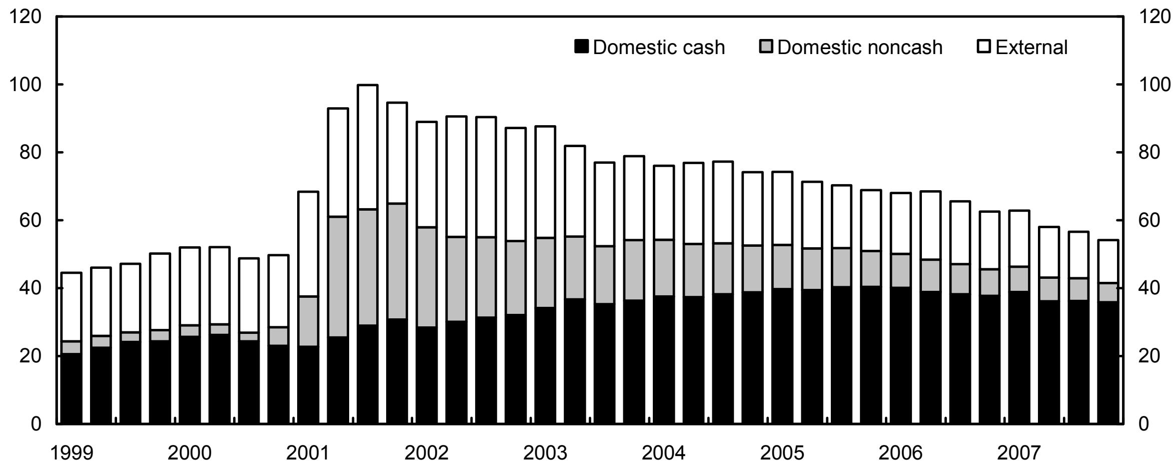
45. **Tight fiscal policy drove debt reduction and put debt sustainability on firm grounds** (Figure 3**).** Cumulative primary surpluses of some 35 percent of GNP led the reduction in net public sector debt—the most widely followed measure—from a peak of 90 percent of GNP in 2001 to 38 percent of GNP by end 2007, beating program expectations by a wide-margin. The debt structure also improved, as maturities lengthened and the shares of external, domestic foreign currency denominated, or foreign currency linked debt fell. In terms of gross general government debt, Turkey is now comparable to other European countries, but is still on the high-side relative to countries with a similar income level (Figure 3).

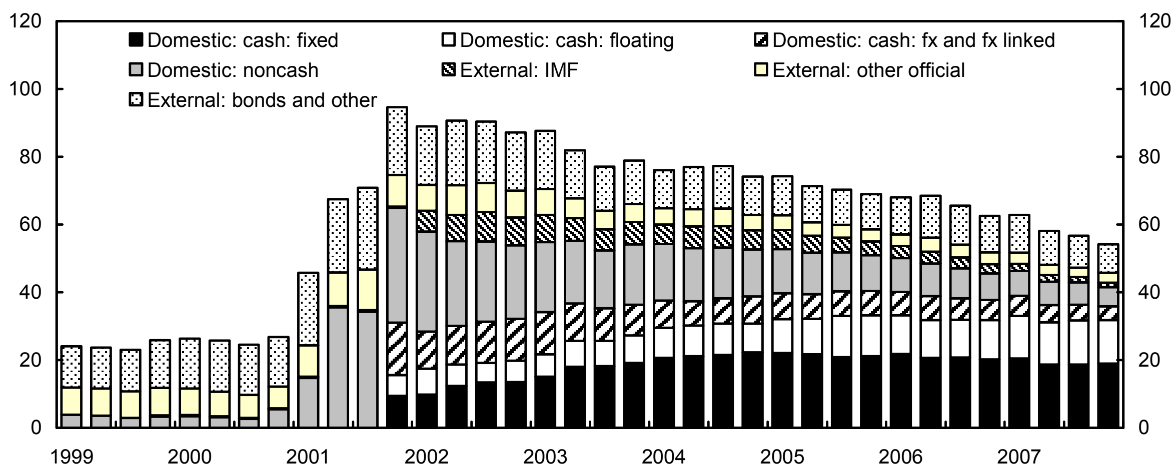


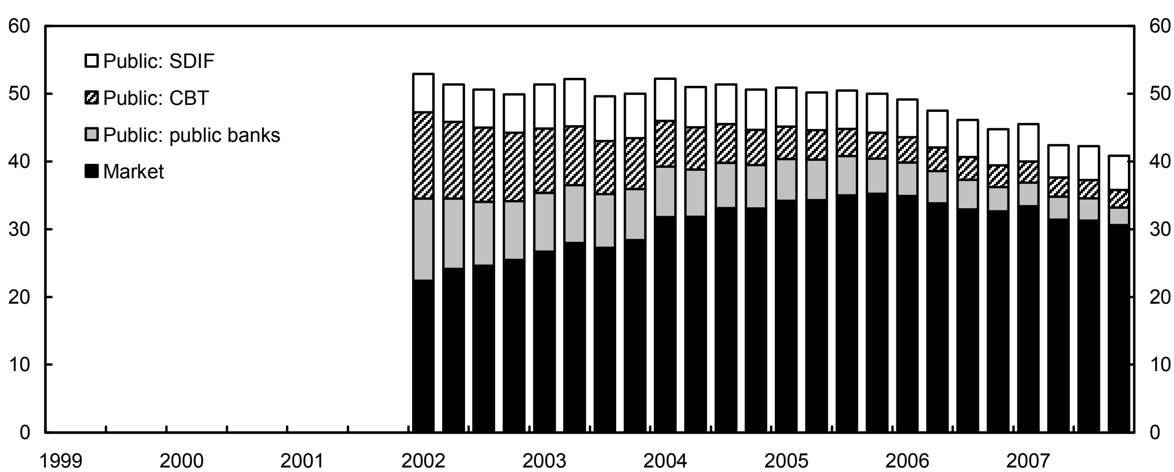
Sources: Eurostat; Turkish authorities; and IMF staff estimates.
1/ Based on postrevision GDP.
2/ Data for Croatia as of 2005.

[15] Confidence, of course, also depended on international developments. Markets perceived that the degree of access to international financial support depended on both Turkey's relationship with the United States following the September 11 terrorist attacks and the status of Turkey's candidacy for the EU.

Figure 3. Turkey: Central Government Debt, 1999–2007
(Percent of prerevision GNP)

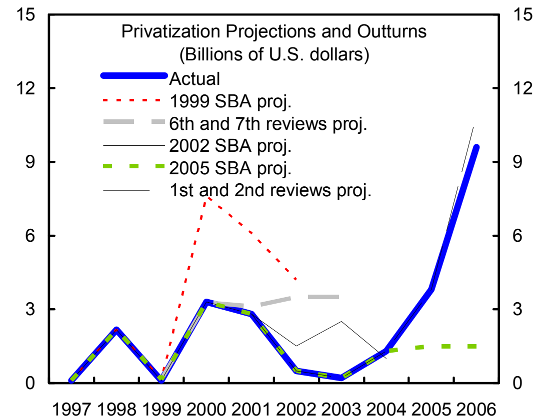






Sources: Turkish authorities; CEIC; and IMF staff estimates.

46. **Privatization receipts became an important source of financing—while boosting the private sector's role in the economy.** Starting from the 1999 SBA, the privatization agenda had been ambitious, but progress tended to fall behind program projections, reflecting various legal issues and changes in market conditions, in addition to political resistance. The pace of privatizations picked up from end-2004, except for energy distribution companies—the largest transaction was the sale of a majority stake in Turk Telekom (US$6.6 billion).



Sources: Ministry of Finance; and IMF staff estimates and projections.

47. **These remarkable achievements were not matched by equally decisive progress on strengthening fiscal institutions.** The constant struggle to achieve short-term targets took a toll on longer-term objectives. As the immediate threat of a crisis abated, the program's attention did turn to structural fiscal reforms, but, until late in the 2005 program, there was little discussion of an exit strategy from the "6½ percent rule". That said, the reform agenda was large, and it often exposed a tension between the goals of boosting sustainable growth and bolstering fiscal credibility. For example, lower tax rates would have helped fight informality and improve the business climate, but, absent compensatory measures, would have reduced the fiscal surplus. While progress was made in some critical areas, such as fiscal transparency and social security, several weaknesses remained (Box 5).

48. **In particular, more progress could have been made in improving budget quality and tax policy and administration, ensuring long-term fiscal discipline.** Desired improvements in budget quality did not materialize. On the revenue side, excises remained high, at about one quarter of central government tax revenue. Tax rates remained generally high and tax administration inefficient, with generous tax incentives. On the spending side, public investment remained relatively low (about 4 percent of GNP including local government spending). Finally, Turkey did not establish a fiscal framework that could satisfactorily preserve fiscal discipline in the long term. While medium-term fiscal forecasts began being regularly published, targets were frequently changed and did not serve as an effective tool to constrain policymakers or anchor expectations about fiscal policy. Similarly, the medium-term fiscal framework (announced at the end of the 2005 SBA) calling for debt, under the EU definition, to fall to 30 percent of revised GDP by 2012, was not supported by a formal institution.

Box 5. Structural Fiscal Reforms

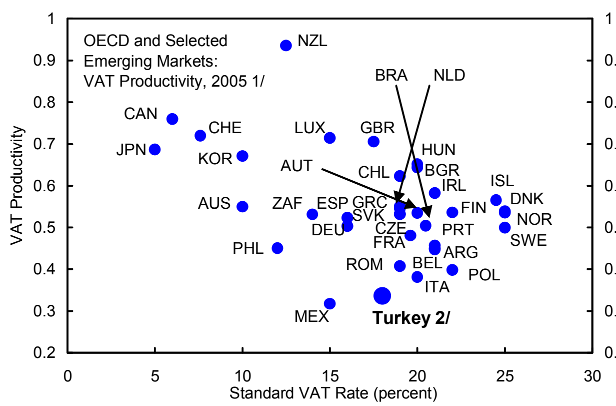
Fiscal consolidation was accompanied by an ambitious agenda of structural fiscal reform aimed to both improve the fiscal balance and promote sustainable growth. These broad-ranging agenda included measures to improve fiscal transparency, social security reform, and the reform of tax policy and revenue administration. While progress was made in critical areas, much remains to be done.

Fiscal transparency. Given the importance of quasi-fiscal and off-budget activities in the run-up to the program, the 1999 SBA emphasized closing nonbudgetary and extra-budgetary institutions (down from over 70 to less than a handful). Substantial progress was made in improving budget coverage and data publication and strengthening the institutional and legal framework with the passage of the Public Procurement Law (2002), Public Finance and Debt Management Law (2002), and Public Management and Financial Control Law (2003). Nonetheless, further progress is needed—a sentiment echoed by the Fiscal ROSC update in 2006.

Social security. The Social Security system runs large fiscal deficits (4 percent of GNP in 2007) covered by central government transfers. Parametric reforms to gradually reduce the deficit, including by increasing the retirement age and lowering replacement rates, were passed in 1999 and again in 2006. The latter, however, was withdrawn after the Constitutional Court ruled some parts were unconstitutional. In 2008, a revised Social Security Law was passed projected to yield, in present value, savings of around 75 percent of (revised) 2007 GDP. However, the system remains generous relative to other OECD countries. Progress was also made in strengthening administration of the system, including through the unification of the three institutions.

Energy sector. The 1999 program focused on privatization, where progress has been slow (indeed, the final review of the 2005 SBA, in May 2008, still included a related prior action). Energy sector reform became macrocritical in 2007 as fiscal pressures emerged from the failure to increase end-user tariffs over a five year period. The first step was taken by raising end-user tariffs in late 2007, with the commitment to introduce automatic price adjustments in mid-2008. More measures are needed, however, to avert future energy shortages, including strengthening collection and increasing private sector involvement.

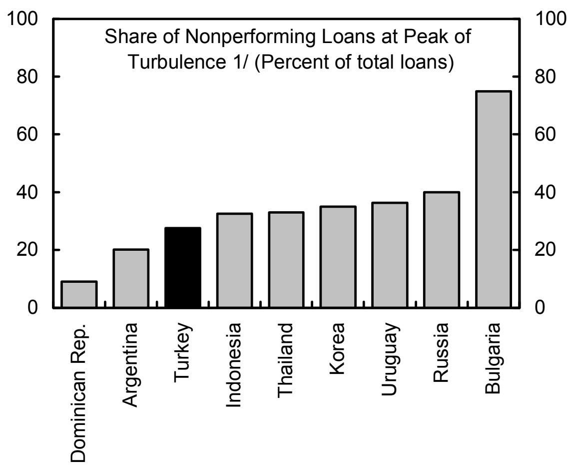
Tax policy and revenue administration. Reflecting its importance, FAD provided substantial TA in tax administration. However, despite some progress with the creation of a Revenue Administration (RA) within the MOF, the establishment of a large taxpayer office, and the consolidation of the three social contribution institutions into a Social Security Institution, tax administration remains too fragmented and weak enforcement undermines compliance. In particular the tax audit function is fragmented and underresourced. Within SSI, weak enforcement has resulted in a series of amnesties which undermined compliance. Turkey's low VAT productivity exemplifies the shortcomings in tax policy and administration, with the so-called "c-efficiency" productivity indicator the second lowest ratio among OECD and selected emerging market countries.

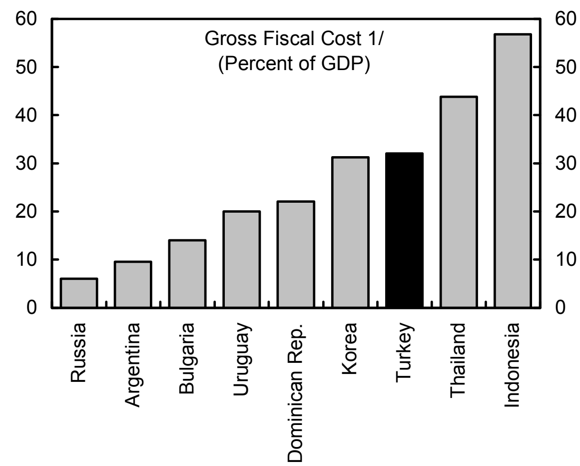


Sources: Turkish authorities; and IMF staff estimates.
1/ VAT productivity is defined as the ratio of VAT revenue to consumption divided by the standard VAT rate. Data for Portugal as of 2003. Data for Australia, Belgium, Greece, Ireland, Romania, and South Africa as of 2004. Data for Philippines as of 2006.
2/ Data based on postrevision GDP.

B. It Was Also Banking Reforms

49. **The crisis hit the banking system hard.** The run on the currency in late 2000 and early 2001 and the associated extreme interest rate volatility (overnight rates reached over 4,000 percent) and subsequent lira devaluation cost the banks dearly, due to their large currency and maturity mismatches. While a few banks benefited from the crisis, most banks' profitability and balance sheets weakened significantly. Especially vulnerable to interest rate shocks were intervened SDIF banks and state banks—which lost an estimated US$2.5 billion (about 2 percent of GNP) during the week preceding the float of the lira. The crisis also exposed the widespread lack of adequate capital buffers, banks' poor risk management and the extensive evasion of loan provisioning and connected lending rules.





Sources: Hoelscher and Quintyn (2003); Honohan and Laeven (2003); and IMF staff estimates.
1/ The starting date of the systemic banking crisis is 1996 for Bulgaria, 1997 for Korea, Thailand, and Indonesia, 1998 for Russia, 2000 for Turkey, 2001 for Argentina, 2002 for Uruguay, and 2003 for Dominican Rep.

50. **The realization of the extreme fragility of the system brought a new impetus and commitment to the bank reform effort.** Key elements of this reinforced strategy were the restructuring of state banks, the resolution of intervened banks, the provision of incentives for the consolidation and recapitalization of private banks, and the strengthening of the legal and regulatory environment. While most measures were already envisaged in the original program, they now entailed tighter deadlines and stronger conditionality, including on state bank restructuring and governance (which became a priority). At the same time, the crisis had changed the political dynamics, strengthening reform ownership and implementation.

51. **As a result, implementation was swift.** By May 2001, private banks and the BRSA had agreed on capital regularization plans and commitment letters (including the suspension of

dividends),[16] while state banks and eight SDIF banks were fully recapitalized through a large injection of government securities. A common and politically independent board was established for the two largest state banks, and new management appointed.[17] By June 2001, state and SDIF banks were required to reduce their vulnerability to interest rate risks and were excluded from the overnight market. Concurrently, the government conducted a debt swap that helped banks reduce their open FX positions. By end-2001, the sale or liquidation of all intervened banks was initiated and arrangements were put in place to manage their nonperforming assets.

52. **The legal and regulatory frameworks also continued to be updated.** Parliament approved amendments to the banking law (May 2001), allowing for the early issuance of a regulation on connected lending in June 2001 and reformed accounting rules in line with international standards by June 2002. Finally, to facilitate corporate debt restructuring, a voluntary framework for out-of-court corporate debt restructuring for viable but illiquid companies—the Istanbul Approach—was introduced in January 2002 and the bankruptcy law was overhauled in 2003.[18]

53. **A public support program helped restore confidence in the banking system.** Through the third quarter of 2001, adverse global economic and political developments, persistently high real interest rates, and slow implementation of prudential rules on loan provisioning and connected lending continued to undermine public confidence in the banking system. In response, under the 2002 SBA a public support program was put in place to give solvent but undercapitalized banks access to publicly funded capital (Tier 1 and Tier 2) as a last resort. The scheme included provisions to prevent the misuse of public funds, strict eligibility criteria, and three-stage audits to bring full transparency to banks' books. In the end, the scheme contributed to restoring confidence in the system and demand for public recapitalization assistance from private banks was very limited.

54. **By the end of the 2002 SBA, the banking system had been substantially strengthened.** Banking practices and the regulatory environment had gone through a sea change since 1999. State banks' income position and balance sheets had been restructured, and a far

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[16] Stricter rules on the recognition of capital deficiencies and the unlimited personal liability of many bank owners for losses from connected lending provided steep incentives for recapitalization.

[17] A third state bank (Emlak) was to be closed, with its liabilities and some of its assets transferred to one of the two other large state banks (Ziraat).

[18] A Framework Agreement among creditors established a detailed structure to facilitate orderly and fair decision-making and adopted a number of standard corporate workout principles.

reaching operational reorganization program had been initiated.[19] The core private banking system had been much strengthened and consolidated, and had witnessed the entry of new foreign players.[20] There had also been major improvements in financial supervision and regulation. The establishment of an independent regulatory agency in the BRSA and later the spin-off of the SDIF were key accomplishments. Transparency had also been enhanced with the BRSA's three stage audits forcing banks to disclose nonperforming loans and resulting in more uniform assessments of capital. Staff, however, noted that the split between banking supervision (BRSA) and nonbank financial institution supervision (Treasury) could be problematic for consolidated supervision of financial groups.

55. **The failure of Imar bank in 2003 highlighted that important challenges remained but also confirmed the improved systemic stability.** An investigation into the failure—largely due to fraud—underscored remaining weaknesses in the legal and supervisory regime. At that time, these included the exclusive right of Sworn Bank Auditors to examine banks, weaknesses in the BRSA's powers to remove and appoint Board members at intervened banks, insufficient supervisory resources, inadequate coordination of offsite and onsite supervision, and the BRSA's governance structure. However, the limited disruption associated with Imar's failure confirmed the system's newfound strength.

56. **Progress continued under the 2005 SBA but more remained to be done, especially with respect to state banks.** The 2007 FSAP gave Turkey deserved credit for its major achievements, but pointed out areas for improvement. The 2005 SBA envisaged a new Banking Law be approved in 2005 to bring the legal framework closer to international best practices in terms of licensing (fit and proper), connected lending, legal protection of supervisors, responsibility for supervision and resolution, and deposit insurance (although the FSAP noted that the law needed to be fully implemented and further legal improvements on investment criteria would be useful). The BRSA supervisory practices were also improved, although further work was needed (in particularly on the use of trigger points for supervisory action, risk modeling, assessing new lines of business and increasing coordination with foreign supervisors). The SDIF disposed of most of the assets taken over from intervened banks. State banks (an area under the responsibility of the World Bank) were put on a more commercial footing and lost privileged access to public sector deposits. However, privatization did not match the program plans in speed and scope, partly due to problems from legal challenges.

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[19] The operational restructuring included closing a housing bank (Emlak), closing 800 branches of the two largest banks, and laying off 80,000 employees.

[20] The number of banks was reduced from 80 to 49, including through the intervention of 22 banks, and by 2004 the system was adequately capitalized and profitability had been restored. Compared to 2001, the banking system CAR was 22 percent (up from 9 percent), NPLs were below 5 percent (down from 28 percent), provisioning of NPLs reached 84 percent (up from 31 percent) and ROA was 2 percent (up from -8 percent).

2007 FSAP: Summary of Recommendations

- Effective implementation of the new banking law.
- Further strengthening of the supervisory governance and practices (including granting the BRSA operational independence, improving data management and analysis, and intensifying the cooperation with key foreign supervisors).
- More timely and cost-effective handling of problem banks (including an accelerated transfer of failing banks from the BRSA to the SDIF, quicker closure, and an explicit “least cost” objective).
- Continued development of the legal and regulatory framework to cover nonbanks (i.e., insurance), new markets (i.e., mortgages, capital markets) and corporate governance (including on minority rights, accounting and auditing).
- Reduction of distortions to financial intermediation (e.g., closing regulatory arbitrage loopholes; eliminating intermediation taxes; completing state bank privatization; improving realization of collateral).

C. And It Was Central Bank Independence

57. **After the abandonment of the crawling peg, the key challenge for monetary policy was to reestablish a credible nominal anchor.** The new strategy envisaged central bank independence, an interim framework based on a flexible exchange rate regime and the control of monetary aggregates, and an explicit plan to shift “as early as possible” to full-fledged inflation targeting (IT). Given the uncertainties surrounding money demand, the CBT committed under the interim framework to raise interest rates in response to developments that could jeopardize the disinflation process, regardless of the monetary targets. This “implicit IT” regime was viewed as a transition period during which the communication, transparency and institutional setup would be gradually enhanced (Kara, 2006, and Şahinbeyoğlu, 2008). A key step was taken in May 2001, when the CBT was granted full operational independence and tasked with the primary goal of price stability. The CBT was also forbidden to finance the Treasury directly (from November 2001) and formally announced that FX resources would not be used to support any specific exchange rate target.[21]

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[21] The CBT also played a critical crisis management role. First, it took over the short-term liquidity risk from the recapitalized state banks. Second, it was the vehicle through which Fund financing was initially channeled to the Treasury. The CBT was skillful in not letting these functions interfere with its monetary program.

Monetary Conditionality, 2000–05 1/

Program	Review	Date	NIR (billions of U.S. dollars)		Adjusted Base Money (billions of Turkish lira)		Adjusted NDA (billions of Turkish lira)	
			Adj. Target	Actual	Adj. Target	Actual	Adj. Target	Actual
December 1999 SBA	3 and 4	end-March 2000	13.3	16.7	...	...	-1.2	-1.3
	3 and 4	end-June 2000	15.0	17.8	...	...	-1.2	-1.3
	3 and 4	end-September 2000	15.4	17.9	...	...	-1.2	-1.3
	5	end-December 2000	10.4	12.4	...	...	1.7	1.1
	6 and 7	end-January 2001	10.7	13.0	...	...	0.9	-0.5
	6 and 7	end-February 2001	12.6	8.1	...	...	0.0	2.4
	6 and 7	end-March 2001	12.7	4.7	...	...	0.0	5.1
	8	end-May 2001	-1.5	-0.8	5.9	5.8	9.8	7.9
	9	end-June 2001	-3.6	-3.1	6.1	6.2	13.3	12.9
	10	end-August 2001	-2.5	-1.4	7.2	6.7	17.3	16.4
	10	end-October 2001	-3.3	-0.3	7.6	7.1	21.2	17.9
January 2002 SBA	1	end-February 2002	-6.5	-4.9	8.3	7.8	26.1	24.3
	2	end-April 2002	-7.2	-4.9	8.9	8.7	27.7	25.2
	3	end-June 2002	-7.8	-5.8	9.3	9.0	28.7	26.4
	4	end-September 2002	-8.5	-5.9	10.6	10.1	31.1	28.6
	4	end-December 2002	-9.7	-4.6	10.9	10.7	33.1	28.6
	5	end-April 2003	-6.5	-6.0	12.8	11.9	32.8	31.0
	5	end-June 2003	-7.0	-3.9	13.2	13.0	34.1	29.4
	7	end-September 2003	-6.0	1.5	14.1	13.9	33.8	23.0
	7	end-December 2003	-2.0	-0.5	14.9	14.7	28.4	26.0
	7	end-March 2004	-2.0	0.8	16.1	16.9	29.6	27.3
	8	end-April 2004	-2.0	1.8	17.5	17.5	31.6	26.1
April 2005 SBA	1 and 2	end-May 2005	2.0	5.8	23.6	23.0	37.7	31.3
	1 and 2	end-June 2005	2.0	10.5	23.6	22.6	37.7	24.0
	1 and 2	end-September 2005	2.8	13.2	24.7	27.7	37.8	23.7
	3 and 4	end-December 2005	15.9	22.4	29.2	28.8	25.5	12.6

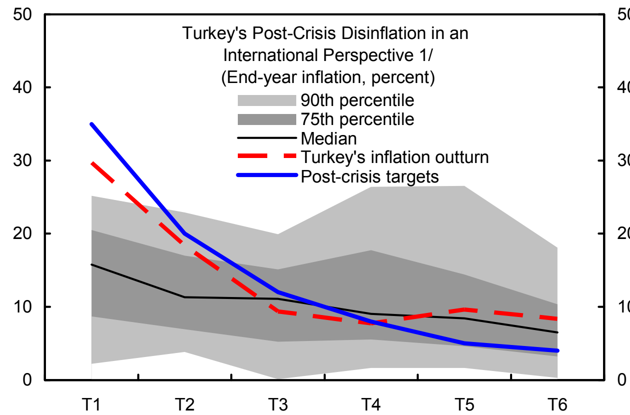
Source: IMF country reports.

1/ Shaded areas indicate missed targets. Following the adoption of formal IT, monetary target conditionality was replaced by a standard inflation consultation clause.

58. **Post-crisis disinflation was unquestionably successful from Turkey's historical perspective.** Central bank independence, renewed fiscal discipline, and a rebounding exchange rate put inflation on a declining trend. Overall, the framework worked well in its early stages—inflation declined from 69 percent at end-2001 to 18 percent at end-2003 and most base money targets were met—but it started to show strains from early 2004 when, with a stronger recovery under way and inflation finally in the single digit range, shifts in money demand became more important.

59. **However, central bank credibility was hard to establish.** Bringing inflation into the low single digits proved harder than expected. Following the adoption of formal IT in January 2006, the pace of disinflation slowed down and the official year-end targets—5 percent in 2006 and 4 percent thereafter, with a 2 percent uncertainty band—were missed. Generalized price pressures triggered by repeated supply shocks pushed inflation back in the double-digit range in May 2008 and inflation expectations moved further away from the targets, a symptom of the IT regime's imperfect credibility.

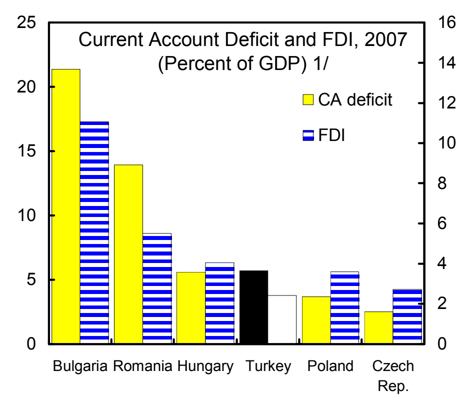
60. **Were the inflation targets too ambitious?** Having met their inflation targets for four years in a row (an outstanding performance by international standards), the authorities felt that the targets in the 2005 SBA's original macroeconomic framework, 5 percent in 2006 and 4 percent thereafter, were appropriate. These were known to be ambitious targets in light of international experience indicating that disinflation typically becomes more difficult at lower inflation rates, as staff noted at the outset of the 2005 SBA. Indeed, the newly launched regime soon came under stress. A prolonged process of appointing a new governor during March–April 2006 did not help buttress central bank credibility at a time when the inflation outlook was showing strains. The global emerging market sell-off hit the lira particularly hard between May and June 2006 and pushed inflation back to double digits for several months. Moreover, recurrent shocks to domestic food and international commodity prices further aggravated inflation pressures. These initial difficulties may have cast a long shadow over the credibility of the IT regime.



Sources: IMF, World Economic Outlook; and IMF staff calculations.
1/ The chart plots Turkey's post crisis disinflation against the distribution of episodes of disinflation from 'chronic inflation' in IMF member countries during 1980-2007. A 'chronic inflation' episode is defined as at least three years of inflation above 30 percent within a five-year period. T0 is the final year of the episode, just before inflation falls below 30 percent (for Turkey, T0 is 2001). For each country in the original sample, only the most recent episode of chronic inflation is considered. The shaded areas represent the 75th and 90th percentile of inflation across disinflation episodes.

D. Did Success Lead to New Imbalances?

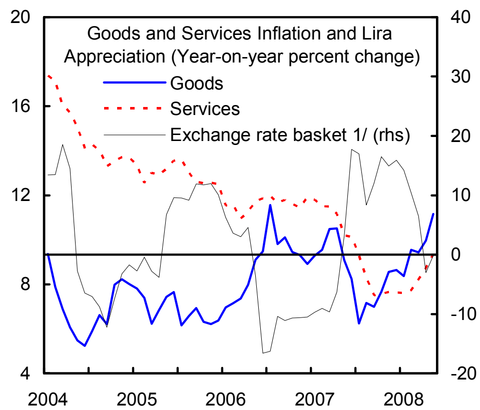
61. **Turkey's current account deficit deteriorated sharply over the course of the post-crisis programs.** The emergence of large imbalances was delayed and mitigated by the initial sharp depreciation of the lira and the contraction in activity in the aftermath of the crisis. Over time, however, a relatively large current account deficit emerged with the sustained strong economic recovery and the real appreciation of the lira. This reflected to some extent a regional trend and adverse changes in the terms of trade.



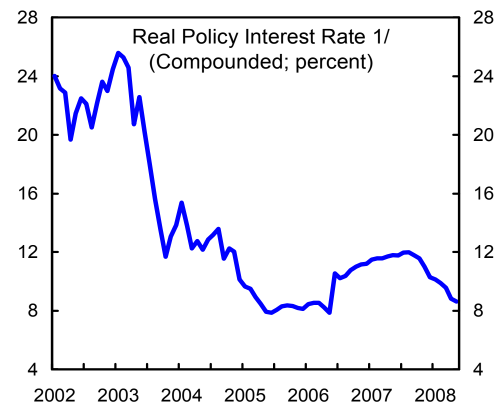
Sources: IMF, World Economic Outlook; and IMF staff estimates and calculations.
1/ Percent of revised GDP for Turkey.

62. **Inflation stabilization contributed to this deterioration, but was not the only factor.** A criticism often leveled against the IT regime in Turkey was that it forced the central bank to maintain high interest rates, attracting disproportionate capital inflows and contributing to exchange rate overvaluation—hence worsening the current account deficit. A real appreciation will, in theory, always tend to occur in a disinflation process to the extent that price inertia is

stronger in nontradables than tradables and the exchange rate pass-through is high, independently from the anchor of choice. In Turkey, this was indeed the case, with inflation in services largely exceeding inflation in goods. That said, high real interest rates in Turkey also reflect lingering high risk premia (Box 6). Arguably, a tighter fiscal stance could have contained the emergence of these imbalances, as argued by staff midway through the 2005 program. However, given Turkey's fiscal accomplishments this would have likely been politically difficult.



Sources: Turkstat; and IMF staff calculations.
1/ 50-50 dollar-euro basket. A positive value indicates an appreciation.



Sources: Central Bank of Turkey; and IMF staff calculations.
1/ Using survey-based inflation expectations.

63. **The financing mix of the current account deficit, while improved, has been less robust than in other European countries**. Relative to other countries in the region, capital inflows into Turkey have been characterized by a lower share of FDI and a higher share of short-term debt instruments, with a large share of inflows intermediated by the banking system. In this context, while the composition of external financing flows has improved over time, external financing needs have remained high (on the order of US$130 billion for 2008, some US$10 billion higher than in 2007). These developments, combined with the still relatively low reserve coverage, have left Turkey more exposed than other emerging markets to reversals in investor confidence and changes in global credit conditions. Indeed, as global liquidity shrank, Turkey's financing conditions have tightened in many areas.

Capital Inflows, 2002–07

(Billions of U.S. dollars)

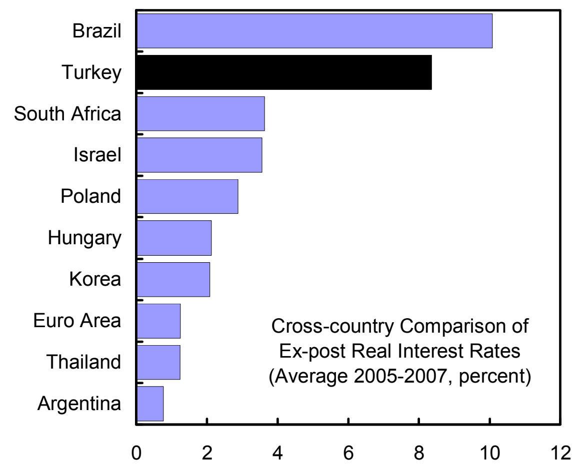
	2002	2003	2004	2005	2006	2007
Financial inflows	36.5	45.3	64.4	76.1	109.9	118.0
FDI	1.0	1.3	2.0	9.0	19.0	19.9
Portfolio equity	0.0	0.9	1.4	5.7	1.9	5.1
Portfolio debt	2.0	3.1	8.0	9.4	9.5	-2.4
LT loans to banks	-0.3	0.0	2.4	6.5	9.8	7.3
LT loans to corporates	1.1	0.7	4.8	9.5	18.6	25.5
ST debt	16.4	23.0	31.9	37.1	40.4	41.8
Other	16.4	16.3	13.9	-1.1	10.7	20.8
Memorandum item:						
Reserves (- = increase)	-6.2	-4.0	-0.8	-17.8	-6.1	-8.0

Sources: Turkish authorities; and IMF staff estimates.

Box 6. Perspectives on High Real Interest Rates in Turkey

Turkey stands out as having one of the highest level of real interest rates among its peers. Real interest rates averaged about 8 ½ percent during the period 2005–07, and have been much higher in the past. Despite recent improvements in public sector finances and significant disinflation, real interest rates have remained stubbornly high.

Interest rates are high also relative to measures of the "natural" rate of interest. A small macroeconomic model, based on the methodology developed by Laubach and Williams (2003) and Mésonnier and Renne (2007), suggests that the natural rate of interest—the real interest rate that is consistent with output at its potential level and a stable rate of inflation—for Turkey is around 4 percent on average. While real rates have historically fluctuated around this level, they have consistently stayed above the natural rate in the past five years.



These high levels of real interest rates are consistent with classical theories of economic growth predicting high real interest rates for fast-growing countries. Indeed, estimates of the marginal product of capital for Turkey, along the lines of Caselli (2007), imply rates of return on capital on the order of 13 to 17 percent.

However, these theories cannot explain Turkey's high rates relative to similarly growing countries. Countries that have similar, if not higher, real returns to capital have significantly lower real interest rates, suggesting the importance of other country-specific factors. A regression analysis indicates that the fiscal balance and the inflation rate of countries are the most significant variables that help explain the cross-sectional variance in real interest rates. Countries that have larger fiscal deficits and/or higher rates of inflation tend to have higher real interest rates.

The importance of the fiscal balance and the inflation rate in explaining variations in real interest rates underscores the role of risk premia. This is certainly true for Turkey, which has a history of high and volatile inflation and large budget deficits. While the economy has undergone successful fiscal consolidation and rapid disinflation, risk premia remain high. The estimated component of the risk premium due to higher inflation (computed as the difference between inflation expectations implied by inflation-linked bonds and survey-based inflation expectations) is 2 to 3 percent. Further strengthening of policy credibility and reduction of macroeconomic volatility is therefore required in order to reduce premia and, consequently, lower real interest rates.

V. Ex-Post Evaluation of Exceptional Access Under the 2005 SBA

64. **The 2005 SBA aimed at consolidating macroeconomic achievements and deepening structural reforms.** Despite the Fund's already large exposure to Turkey and the absence of a capital account crisis, the exceptional level of access was viewed as appropriate to bolster reserves and secure a successful graduation from Fund financial assistance. Prudent macroeconomic policies, structural reforms in the areas of tax administration and policy, social security, and the financial sector, and exceptional financing remained the main ingredients of the Fund-supported program.[22]

Key aspects of program design and conditionality

65. **The macroeconomic framework was based on the successful components of the previous program and reflected Turkey's EU accession aspirations.** The new program maintained a primary surplus target of 6½ percent of GNP (consistent with public debt declining by another 10 percentage points and towards the levels of recent EU accession countries) and the planned shift to formal inflation targeting. The program also aimed at reducing rollover concerns by increasing the Treasury's cash reserves and shifting public debt toward longer-term lira instruments.

66. **Structural conditionality was to tackle difficult reforms.** The overarching goal of reforms under the new program was to ensure fiscal sustainability on a lasting basis through both tax and expenditure reforms and the completion of financial sector reform (Table 6). On the revenue side, the program proposed (i) a new revenue administration law to improve tax compliance by creating a semi-autonomous authority and (ii) the simplification of the corporate and personal income tax policies to improve efficiency. Corporate tax rates were to be lowered to improve the international competitiveness of the tax system, while the personal income tax was to be simplified in steps. Comprehensive parametric pension reform would reduce social security deficits over time. Regarding the financial sector, measures included: a new Banking Law to further improve the supervisory regime; a plan to divest most of the assets acquired by the SDIF in the bank resolution process; and the preparation of state banks for privatization.

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[22] As of end-March 2005, Fund exposure to Turkey was SDR 13.2 billion, or 26 percent of total Fund credit outstanding to all members. In absolute terms, the magnitude of exposure was second only to Brazil's (SDR 15.4 billion) and almost 60 percent higher than Argentina's (SDR 8.4 billion). Turkey's Fund credit outstanding relative to quota (1,368 percent) surpassed that of any other member. This partly reflected Turkey's low quota relative to its economic size. As a share of GDP, Turkey's Fund credit outstanding at end-March 2005 was broadly comparable to that of Argentina.

Exceptional access policy

67. **The high level of Fund financing was seen as necessary to cover the projected balance of payments needs without letting gross international reserves fall to unsafe levels.** Turkey faced large external financing needs on the order of US$65–70 billion annually during the program period, including significant net repurchases to the Fund. Although expected private capital inflows could have met these needs, in the absence of new Fund financing gross reserves were expected to fall to very low levels, covering only 43 percent of short-term debt (at remaining maturity). The proposed level of access of SDR 6.7 billion (or 691 percent of quota), to be disbursed in 12 equal-sized tranches, together with a one-year extension of repurchase expectations due in 2006, was to ensure that the large external financing requirements were met, while allowing the net reserve position to strengthen.

68. **Fund resources would also ensure that Turkey's public debt rollover rates remained manageable.** As under the previous program, the 2005 SBA allowed for the Treasury to deposit the Fund purchases at the CBT and use these to help meet domestic public debt repayments, which were on the order of US$100 billion a year. The level of financing was expected to keep the domestic debt rollover rate at around 90 percent, which is what the authorities believed the market would find comfortable to finance.

69. **Not all four criteria for exceptional access were fully met.** The first criterion, *exceptional balance-of-payments pressures on the capital account that cannot be met within the normal limits*, was only partially satisfied. Given that half of Turkey's public debt was had a floating rate or was linked to the exchange rate, exposure to any abrupt shift in market sentiment was substantial in addition to the actual financing needs. The second criterion, *a rigorous and systematic analysis indicating a high probability that debt will remain sustainable,* was met. However, this depended critically on the realization of the program's baseline scenario. The third criterion, *the member has good prospects of regaining market access*, was not applicable as Turkey already had market access. The Treasury had already raised US$3.2 billion in the first few months of 2005, covering close to two-thirds of its annual issuance target. The final criterion, *the policy program provided a reasonably strong prospect of success*, was considered met given Turkey's strong performance under the 2002 program and the political commitment to the new program, which also included implementation of five prior actions in key areas. Given that not all four criteria were fully met, the exceptional access was proposed by invoking the exceptional circumstances clause.[23]

70. **Procedural requirements were met.** As required under the framework for exceptional access, there was early Board involvement in the period leading to the consideration of the request for the SBA in May 2005. There were several informal Board meetings during

[23] See Acting Chairman's Summing Up of "Review of Exceptional Access policy," BUFF/04/81, April 23, 2004.

September–December 2004 on access and policy content of the proposed program. The Board was provided with the necessary information, including a report assessing the financing risks to the Fund and the Fund's liquidity position. Finally, a safeguards assessment mission took place just prior to the approval of the program.

Program performance

71. **Performance under the program was strong, but inflation and the current account deficit exceeded program projections, partly due to external developments** (Figure 4). Most program objectives were met, some—such as the reduction in the public debt ratio—by large margins. However, inflation exceeded program projections, owing to supply shocks and inertia in service prices. Also above projections was the current account deficit, reflecting rising oil prices and the real exchange rate appreciation. The program's overall fiscal targets were mostly met, although at times due to expedient measures. As discussed above, this left Turkey's fiscal credibility dependent on meeting the program's primary surplus target rather than embedded in a sounder institutional framework.

72. **Despite much improved external financing conditions and reserves accumulation, the program did not turn precautionary.** By the first review in January 2006, gross reserves were already US$14 billion higher than the end-2007 target. In addition, the composition of capital inflows improved—actual FDI inflows were four times higher than the expected amounts during 2005–06. Despite these positive developments, the authorities preferred to continue making purchases under the SBA over concerns that a stop followed by a resumption would draw negative market reactions and undermine external stability. This possibility could not be ignored given the economy's continued large debt servicing needs and current account deficits.

73. **The program's reliance on structural conditionality was slightly above average for a program with exceptional access.** However, the number of conditions was sharply reduced relative to the 2002 SBA. Furthermore, most conditions fell under the Fund's core areas of expertise. Most of the measures were to ensure fiscal sustainability and a healthy banking sector and thus would be considered in line with the 2002 conditionality guidelines. In addition, the relatively large number of conditions reflected the need to break down broad measures into smaller tasks, thus making them easier to operationalize (Box 7). For example, both tax administration and health expenditure reforms were covered by an increasing number of detailed conditions as staff tried to accommodate additional measures that became known during the course of program implementation.

Structural Conditionality in
High Access Arrangements, 2002–08

(Average number of conditions per 12 months of arrangement)

	Total per 12 Months	*Of which: 1/*		
		SBs	SPCs	PAs
Argentina, January 2003	26	12	14	0
Argentina, September 2003	22	7	14	0
Brazil, 2002	11	10	0	0
Columbia, 2003	14	13	2	0
Dominican Republic, 2003	36	13	8	15
Turkey, 2002	34	17	5	12
Turkey, 2005	25	14	5	5
Uruguay, 2002	23	11	6	6
Average	23	12	6	5

Sources: SM/06/247; and IMF country reports.

1/ SB: structural benchmark; SPC: structural performance criteria; PA: prior action.

Institutional Classification of Structural Conditionality:
Turkey and High Access Fund Programs, 1999–2003

Country	Program Approval Date	Average Number of Conditionalities per Program Year 1/		
		Core 2/	Shared 3/	Non-Core 4/
Turkey	Dec-99	8	19	7
Turkey	Feb-02	12	14	8
Turkey	May-05	12	7	6
Uruguay	Mar-02	4	17	2
Brazil	Sep-02	4	4	2
Argentina	Jan-03	13	12	2
Argentina	Sep-03	9	11	1
Colombia	Jan-03	3	3	4
Dominican Rep.	Aug-03	12	19	2

Source: MONA Database.

1/ Includes prior actions, structural performance criteria and structural benchmarks.
2/ A conditionality is classified as "core" if it falls under the Fund's core areas of expertise (for example, fiscal, monetary, exchange rate, and external sector policies).
3/ A conditionality is classified as "shared" if the expertise is shared between the Fund and the World Bank (for example, reforms to the financial sector and to promote private sector development).
4/ A conditionality is classified as "non-core" if it falls outside the Fund's core expertise (for example, poverty-related measures, civil service reform, and public enterprise reform).

74. **Most of the program's structural conditions were met, but often with significant delay**. For example, the timetable for the phasing out of special privileges and obligations of the state banks and establishing a large tax payer unit within the Revenue Administration were both adopted with a one-year delay. Similarly, parliamentary approval of the pension reform legislation was struck down by the Constitutional Court in December 2006. A revised proposal was passed by Parliament only more than a year later. Staff dealt appropriately with these unforeseen difficulties. The completion of reviews was often delayed to maintain engagement while continuing to provide incentives for reform.

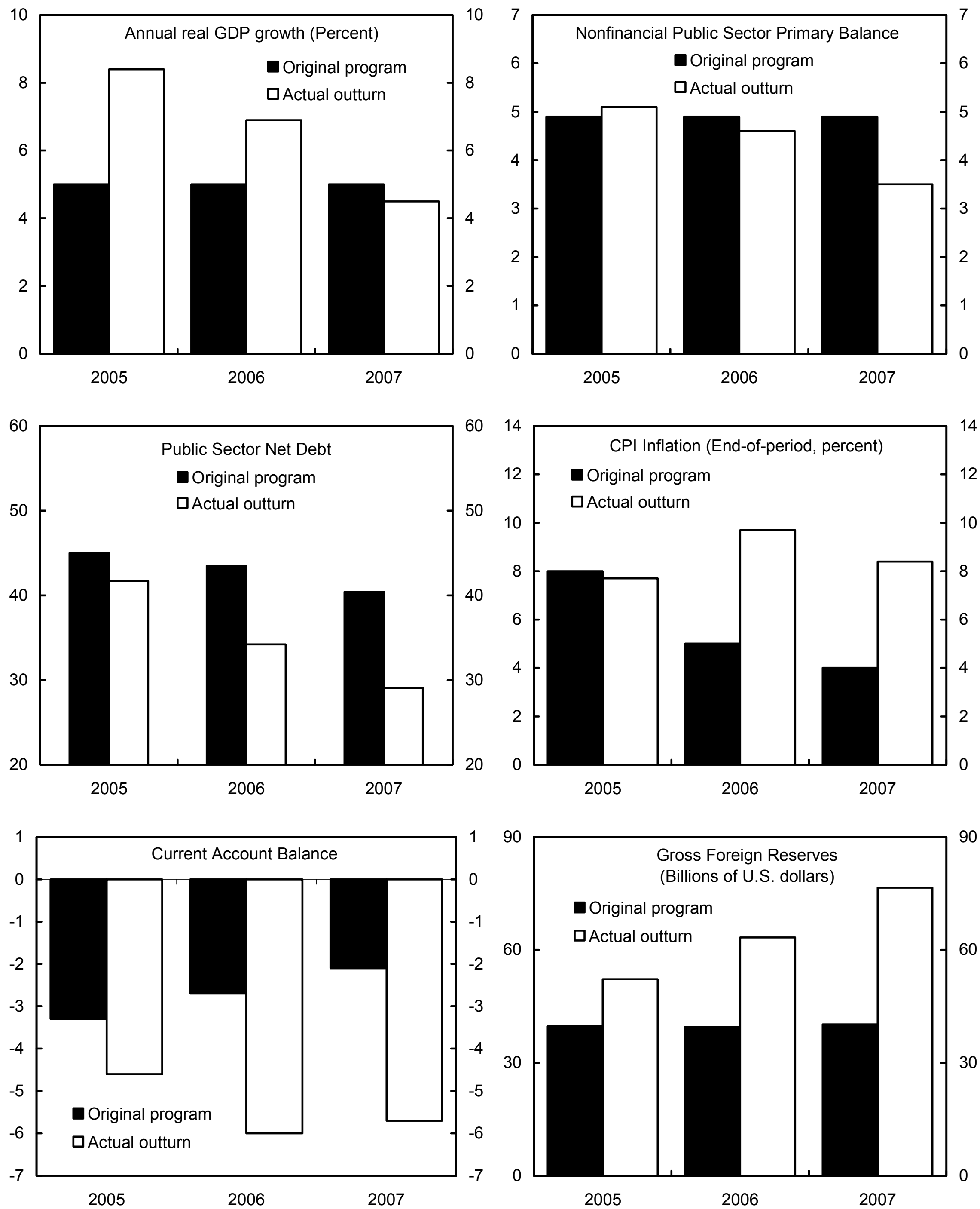
VI. Conclusions and Lessons for Future Fund Engagement

A. Comparing Failure and Success

75. **Over nine years of program engagement, Turkey went through a major crisis and a remarkable economic revival.** A prolonged period of monetary instability, lack of fiscal discipline, and poor banking practices culminated in the 2001 crisis, which left in its wake a huge public debt burden and a distressed banking system. Since the crisis, sound macroeconomic policies and political stability have engendered brisk economic growth, low inflation, falling public debt ratios, and a healthy banking system. Through this process and with the assistance from the Fund, economic institutions have improved markedly, in particular with the establishment of independent agencies in charge of monetary policy and bank supervision.

76. **The Fund shares responsibility for the demise of the early stabilization program but deserves credit for contributing to the post-crisis success.** Slow implementation of structural reforms, reluctance to adjust fiscal policy (despite staff's insistence), and bad luck

Figure 4. Turkey: Macroeconomic Performance under the 2005 SBA 1/
(Percent of GDP, unless otherwise indicated)



Source: EBS/08/48.

1/ "Original program" indicates projections made in the original program request document, with shares of GDP adjusted to reflect the March 2008 national accounts revision.

Box 7. Structural Conditionality in Fund-Supported Programs

The breadth of Turkish economy's structural weaknesses was detected early in the 1999 SBA which included an extensive array of reforms. The 1999 program aimed to rationalize agricultural support policies, change the parameters of the costly pension system, strengthen budget preparation, execution and control, improve the tax system and its administration, undertake an ambitious privatization program, and strengthen the banking system and banking regulations. All of these reforms were geared to ensure fiscal sustainability in the medium-term, which was at the heart of Turkey's macroeconomic malaise. Over the course of successive programs, structural conditions remained concentrated in these areas although their relative importance changed.

Success of these broad-ranging structural objectives was often thought to have required a detailed roadmap to ensure meaningful implementation. During the course of the 1999 program, the number of conditions rose. In 2001, the program included 90 structural measures, some with submeasures, spanning into areas that were not all within the Fund's traditional expertise (EBS/02/136). For example, it included actions in communication strategy and social dialogue, albeit to increase domestic ownership of planned reforms. The SBA approved in 2002 remained laden with structural conditions having almost twice as many prior actions, structural benchmarks and performance criteria per year as an average SBA.

This intensification of program conditions in Turkey took place in the context of an overall declining appetite for conditionality in Fund-supported programs. In response to wide criticism to increased, and often intrusive, use of structural conditions in Fund-supported programs, the Managing Director issued an interim guidance note in September 2000 aiming at streamlining conditionality, which was later approved by the Executive Board in 2002 as the new conditionality guidelines. The new guidelines required parsimony in the use of conditions and stipulated that conditions must be critical to the achievement of program goals creating greater room for national authorities in the design.

Those involved in decision-making explained "Turkey exception" by the absolute criticality of these reforms to achieving long-lasting macroeconomic stability under difficult political conditions. Several staff and Turkey officials interviewed for this report suggested that conditionality was helpful in providing the authorities with an external anchor to achieve macroeconomic targets and advance structural reforms. Others, however, believed that an "excessive" number of conditions had caused distraction and undermined credibility (because of the associated waivers). That said, while conditions remained somewhat extensive, they were drastically reduced as implementation and macroeconomic conditions improved.

doomed the 1999 stabilization program. While the program may have succeeded with faultless implementation, its design, reflecting a multiplicity of constraints, was inherently fragile. In particular, given the state of the banking system, the peg was a risky strategy. It should be noted, however, that some of the adjustments initiated under the 1999 program helped achieve the targets of the post-crisis stabilization. After the crisis, Fund resources were instrumental to easing rollover needs and buying time for an orderly return to market access. Fund staff's advice and the use of the Fund-supported program as a commitment device were critical in supporting the authorities' disciplined macroeconomic policies and politically difficult structural reforms.

77. **Would the post-crisis program have succeeded in 1999?** With the benefit of hindsight, a much larger access to Fund resources and the possibility to employ them for budget support would have most likely bought some time to lower interest rates. This, in turn, would have reduced the need for a strong nominal anchor, allowing for a more flexible monetary regime and limiting the tensions stemming from the needs of the banking system. That said, given the wavering political commitment to reforms at the time of the program, it is far from obvious that more resources would have addressed the underlying vulnerabilities that were the ultimate cause of the crisis. On the contrary, they could have even reduced the incentives for fiscal consolidation and structural reform.

78. **Turkey's experience through failure and success provides several insights for future Fund engagement:**

- ***Ownership and political stability.*** Political commitment to sound policies was the key ingredient of past successes and will be critical for the challenges ahead, with or without a successor Fund-supported program. Turkey's experience indicates that a Fund-supported program can strengthen policy discipline in a politically difficult environment only in the presence of strong ownership. Notwithstanding extensive conditionality, the lack of political commitment undermined implementation under the 1999 program. After the crisis, the commitment of the government's new economic team and, later, a new single-party majority ensured a more consistent program implementation, which was key to restoring confidence and ensuring a successful stabilization.

- ***Access to Fund resources.*** Exceptional access was a critical element for the success of the post-crisis stabilization programs. Identifying a specific source of external financing needs (the government's large rollover needs) allowed Fund resources to be surgically directed to a key vulnerability (the potentially unstable debt dynamics), buying critical time to implement critical reforms until confidence was restored. In contrast, absent large balance of payment needs, access under the 1999 program was small relative to the underlying vulnerabilities and the use of resources was restricted by the program design, limiting their effectiveness.

- ***Constraints on program design.*** The collapse of the crawling peg underscored the tensions between, and the different timelines of, macroeconomic policies and structural reforms. While potentially explosive debt dynamics demanded urgency, the design and implementation of structural reforms was naturally more phased. This tension, which made the 1999 program inherently fragile, was also present after 2001 but was attenuated by increased urgency and stronger ownership on one side and increased access on the other. In particular, a high level of access allowed for increased flexibility in program design—especially, a less rigid monetary framework—and thus reduced the vulnerabilities arising from structural deficiencies (especially, in the banking sector) while the latter were addressed under the program.

- ***Post-emergency reform agenda.*** As the recovery took hold, the structural reform agenda was refocused but, in retrospect, this fell short of what could have been allowed for by the improving economic conditions. Since 2006, staff did insist on discussing a new fiscal responsibility framework to replace the "6½ percent rule" and anchor fiscal policy in the long run. However, while the authorities eventually agreed to introduce a new medium-term framework, they failed to anchor it with legislation.

- ***External relations.*** The Fund's carefully crafted communication strategy with the Turkish press contributed to the success of the program. This strategy aimed to update the public with timely and frank assessments without raising sensitivities. Early coordination with the authorities ensured that there were no mixed signals. In 2006, the Fund organized a unique outreach event in the form of a workshop for Turkish reporters at the Joint Vienna Institute to explain the Fund's institutional mandate and its role in Turkey in order to promote a better understanding of the program among wider audiences. This strategy, in which the resident representative's office played a key role, contributed to the relatively good standing of the Fund in Turkey.

- ***Bank-Fund relationship.*** The World Bank and the Fund generally agreed on strategy in the areas that complemented each others' programs (e.g., fiscal reform, bank restructuring, and privatization). Coordination was particularly fruitful with regard to revenue administration and social security reforms (some of the authorities who worked in this area pointed out that they saw the two institutions as one). However, Bank-Fund communication and coordination (including with regard to conditionality and the timing of reforms) needed improvement in the area of banking reforms.

79. **Despite Turkey's remarkable achievements, considerable vulnerabilities remain.** Public debt dynamics could still be shocked by large—but not completely unreasonable—increases in the growth-interest rate differential. The large current account deficit and its financing structure leave Turkey exposed to sentiment reversals. In addition, sharp exchange rate adjustments might lead to losses in the corporate sector, which by most accounts has accumulated substantial open FX positions, with repercussions for the banking system.

80. **Further risks lie ahead.** As the 2005 SBA came to an end, surging oil prices continued to widen an already large current account deficit and, along with high food prices, produced strong inflationary pressures. Growth faced headwinds, as domestic political tensions resurfaced, investor and consumer confidence deflated, and the post-crisis growth momentum waned. The ongoing global credit tightening added to domestic uncertainties. These risks are likely to hang over the Turkish economy in the times ahead.

81. **These pressures will test macroeconomic policy.** On the fiscal front, the key test will be to balance further debt reduction with growth-enhancing initiatives without the backing of an explicit institutional constraint. Renewed spending pressures and initiatives such as the tax amnesty adopted soon after the expiration of the 2005 SBA underscored the risk of discretionary fiscal policy. On the monetary front, after surging inflation prompted in June 2008 an upward revision to the inflation targets, the challenge will be to strengthen the credibility of the policy framework and restart the disinflation process.

82. **At the same time, Turkey's agenda of fiscal structural reforms is unfinished.** In particular, progress with reforms in other areas was not matched by equally decisive advancement in strengthening fiscal institutions. Critical fiscal areas that would benefit from further reform are:

- ***Tax administration.*** Tax administration reform should continue, including steps to (i) vest full authority for tax administration in the Revenue Administration, particularly for audit; (ii) improve core business processes (e.g., registration, taxpayer services, tax audit, and arrears collection); (iii) better match field office staffing to taxpayer compliance risks; and (iv) introduce strategies to reduce taxpayer fraud and the informal economy.

- ***Medium-term fiscal framework***. Adoption of a stronger institutional mechanism, such as a rules-based framework, would help ensure long-term fiscal sustainability and anchor fiscal expectations. For such a framework to be effective, however, it would have to be supported by broad political consensus (SM/05/394).

83. **The question for the Fund is how to best assist Turkey in entrenching sound policies and strengthening stability.** As pointed out in this report, commitment to sound policies will be critical for the challenges ahead, with or without a new Fund-supported program. In that context, graduation promotes greater ownership of government policies and may be politically popular. It also allays the concerns about "program fatigue" manifested in several interviews for this report. If the authorities chose to follow this option, Fund involvement through post-program monitoring (PPM) would be appropriate, given the outstanding access and vulnerabilities. However, PPM—by design—will not provide an effective external anchor for the authorities' policies.

84. **A successor arrangement could provide distinctive advantages but would also involve some risks.** First, given renewed domestic political uncertainty and jittery international financial markets, a new (possibly precautionary) SBA would provide additional insurance against a disorderly external adjustment, help anchor confidence, and catalyze continued external private financing. Second, a new SBA would provide a framework for sound macroeconomic policies and a commitment device that would help the authorities gather support for their policy effort. However, a new arrangement would not come without risks. First, absent strong ownership, a new arrangement may prove ineffective in anchoring policymaking, especially with regard to critical structural reforms. Second, continued program engagement may play a substitute role for the improvement of necessary economic institutions, reducing the incentives for reform.

85. **Any successor arrangement would have to include an exit strategy hinging on structural reforms aimed at completing Turkey's institutional architecture, especially in the fiscal area.** If there is a new Fund-supported program, formal structural conditions should therefore focus on a handful of key issues, which would foster ownership and be in line with Fund-wide efforts to streamline conditionality. However, absent strong ownership of the reform agenda, a new program will unlikely succeed in assisting Turkey to finally achieve long-lasting stability.

Table 1. Turkey: Selected Economic Indicators, 1999−2007

	1999	2000	2001	2002	2003	2004	2005	2006	2007
					(Percent) 1/				
Real sector									
Real GNP growth rate	-6.1	6.3	-9.5	7.9	5.9	9.9	7.6	6.9	4.5
Private consumption growth rate	...	...	-9.2	2.1	6.6	10.1	8.8	4.6	4.6
Private gross fixed investment growth rate	...	...	-34.9	-5.3	20.3	45.5	23.6	15.0	2.7
GNP deflator growth rate	55.8	50.9	55.3	44.4	22.5	9.5	5.3	9.3	8.1
Nominal GNP growth rate	46.3	60.4	40.5	55.8	29.7	20.3	13.4	16.9	12.9
CPI inflation (12-month, end-of period)	68.8	39.0	68.5	29.7	18.4	9.4	7.7	9.7	8.4
PPI inflation (12-month, end-of-period) 2/	62.9	32.7	88.6	30.8	13.9	15.3	2.7	11.6	5.9
Unemployment rate	...	...	10.4	11.0	10.3	10.3	10.2	9.9	9.9
Average nominal treasury bill interest rate	106.2	38.0	93.6	64.6	45.1	24.7	16.2	18.1	...
Average ex-ante real interest rate	32.0	-9.5	35.5	30.5	33.9	15.3	6.0	8.6	...
					(Percent of GNP, unless otherwise indicated) 3/				
Central government budget									
Primary balance	2.5	4.8	5.2	2.4	4.9	5.3	5.5	5.6	3.3
Net interest payments	13.1	15.7	22.8	18.1	16.0	12.3	7.6	7.2	6.9
Overall balance (authorities' definition)	-10.6	-10.4	-16.2	-14.6	-11.3	-6.8	-1.4	-0.8	-2.1
Consolidated public sector									
Primary balance	-0.2	3.2	6.0	4.1	6.1	7.2	6.7	6.1	4.6
Net interest payments	22.1	16.0	22.6	17.6	15.4	11.7	7.9	6.7	6.5
Overall balance	...	-12.8	-16.6	-13.5	-9.2	-4.5	-1.2	-0.6	-1.8
Net debt of public sector (authorities' definition)	61.0	57.1	90.4	78.4	70.3	64.0	55.6	45.1	38.3
Share of FX debt (percent total public debt)	...	...	56.7	58.1	46.3	41.5	37.6	36.3	36.0
External sector									
Current account balance	-0.7	-4.9	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.5
Exports of goods and non-factor services	24.4	26.2	36.1	31.0	30.1	30.5	29.3	30.3	29.8
Volume growth (goods only, percent)	1.9	9.2	15.7	17.2	19.1	15.0	10.1	12.0	10.9
Imports of goods and non-factor services	26.2	30.8	31.7	30.1	31.3	33.8	34.0	36.6	35.8
Volume growth (goods only, percent)	-12.7	28.2	-23.8	26.1	24.6	22.2	11.8	9.8	11.1
Trade balance	-5.6	-10.9	-2.6	-4.0	-5.9	-7.9	-9.3	-10.1	-9.4
Gross external debt	55.0	59.0	93.1	77.3	56.4	50.1	46.7	50.6	44.4
Net external debt	33.6	39.3	64.3	52.8	37.6	32.0	27.3	26.6	24.0
Foreign direct investment (net)	0.1	0.1	1.9	0.5	0.5	0.7	2.4	4.7	4.0
Short-term external debt (by remaining maturity)	18.9	21.7	22.6	19.3	17.3	17.2	16.4	17.9	14.5
Monetary aggregates									
Nominal growth of M2Y broad money (percent)	100.7	40.2	87.5	25.4	13.0	22.1	24.5	24.1	10.4
					(Billions of U.S. dollars, unless otherwise indicated)				
Privatization proceeds 4/	0.1	3.3	2.8	0.5	0.2	1.3	3.8	...	...
Net external financing of central government	1.4	4.1	8.4	6.7	-0.7	-2.7	-4.1	...	...
Amortization	6.0	6.2	-6.7	-11.4	-8.7	-11.7	-14.1	...	...
Gross borrowing	7.4	10.3	15.0	18.1	8.0	8.9	10.0	...	...
Of which : Eurobond issues	5.0	7.5	2.2	3.3	5.3	5.8	6.5	...	...
GNP (billions of Turkish lira, prerevision) 5/	78.3	125.6	176.5	275.0	356.7	428.9	486.4	575.8	650.2
GDP (billions of Turkish lira, postrevision)	104.6	166.7	240.2	350.5	454.8	559.0	648.9	758.4	856.4

Sources: EBS/03/47; IMF Country Report 04/227; IMF Country Report 05/412; IMF Country Report 07/363; EBS/08/48; Turkish authorities; and IMF staff estimates.

1/ Prerevision data prior to 2006. Postrevision data for 2006–07.
2/ Wholesale producer price index prior to 2003.
3/ Based on prerevision GNP.
4/ Privatization revenue received by fiscal authorities.
5/ 2007 GNP calculated using the 2006 ratio of prerevision GNP to postrevision GDP.

Table 2. Turkey: Indicators of Fund Credit, 2000–13 1/

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Outstanding Fund credit (end of period)														
Billions of SDRs	3.2	11.2	16.2	16.2	13.8	10.2	7.2	4.5	5.5	3.7	1.9	0.6	0.0	0.0
Percent of quota	333	1165	1685	1682	1437	1063	600	380	465	307	157	47	0	0
Percent of exports of goods and nonfactor services	8	29	38	32	22	14	9	5	5	3	1	0	0	0
Percent of GDP 2/	2	9	10	7	5	3	2	1	1	1	0	0	0	0
Percent of public sector external debt	7	20	25	25	22	18	13	8	10	7	4	1	0	0
Percent of overall external debt	4	12	17	16	13	9	5	3	3	2	1	0	0	0
Percent of end-period foreign reserves	18	72	78	68	57	28	17	9	10	7	3	1	0	0
Repurchases of Fund Credit														
Billions of SDRs	0.1	0.9	4.9	1.2	3.2	5.3	5.1	3.4	1.2	1.9	1.8	1.3	0.6	0.0
Percent of quota	7	90	510	127	328	546	427	283	104	158	149	110	26	0
Percent of exports of goods and nonfactor services	0	2	12	2	5	7	6	4	1	2	1	1	0	0
Percent of GDP 2/	0	1	3	1	1	2	1	1	0	0	0	0	0	0
Percent of public sector external debt service	1	9	37	11	23	33	33	25	11	19	18	15	8	0
Percent of overall medium- and long-term external debt service	0	5	22	6	16	22	19	11	4	6	4	3	1	0
Percent of start period foreign reserves	0	5	32	6	13	21	14	8	3	4	3	2	1	0
Percent gross public sector external financing 3/	0	22	35	14	35	23	34	24	9	21	19	12	5	0
Net Fund Resource Flows 4/														
Billions of SDRs	2.5	7.7	4.4	-0.7	-3.0	-4.2	-3.6	-3.0	0.8	-2.1	-1.9	-1.4	-0.6	0.0
Percent of quota	259	798	455	-70	-312	-440	-305	-252	65	-175	-158	-114	-26	0
Percent of exports of goods and nonfactor services	7	20	10	-1	-5	-6	-5	-3	1	-2	-1	-1	0	0
Percent of GDP 2/	1	6	3	0	-1	-1	-1	-1	0	0	0	0	0	0
Percent of public sector external debt service	33	80	33	-6	-22	-27	-24	-22	7	-21	-19	-16	-8	0
Percent of overall medium- and long-term external debt service	16	42	20	-3	-15	-17	-14	-10	2	-6	-4	-3	-1	0
Percent start period foreign reserves	14	42	29	-3	-13	-17	-10	-7	2	-4	-3	-2	-1	0
Percent gross public sector external financing 3/	18	193	19	-4	-15	-9	-11	-9	2	-9	-7	-5	-2	0

Source: IMF staff estimates and projections (from various IMF Country Reports).

1/ Based on an expectations basis. Quota was increased effective November 1, 2006 from SDR 964 million to SDR 1191.3 million.
2/ Based on postrevision GDP.
3/ Consolidated government and Central Bank of Turkey. Includes reserve accumulation before repurchases.
4/ Net purchases less repurchases and charges.

Table 3. Turkey: Indicators of External Vulnerability, 1999–2007

	1999	2000	2001	2002	2003	2004	2005	2006	2007
CPI inflation (end year)	68.8	39.0	68.5	29.7	18.4	9.4	7.7	9.7	8.4
Overall balance public sector (percent of GNP) 1/	...	-12.8	-16.6	-13.5	-9.2	-4.5	-1.2	-0.6	-1.8
Net debt of the public sector (percent of GNP) 1/	61.0	57.1	90.4	78.4	70.3	64.0	55.6	45.1	38.3
Export volume of goods (percent change)	1.9	9.2	15.7	17.2	19.1	15.0	10.1	12.0	10.9
Import volume of goods (percent change)	-12.7	28.2	-23.8	26.1	24.6	22.2	11.8	9.8	11.1
Current account balance (percent of GNP) 1/	-0.7	-4.9	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	-7.5
Capital account balance (billions of U.S. dollars)	6.6	6.8	-14.6	1.2	7.1	17.8	43.7	42.7	48.4
Of which : foreign direct investment	0.1	0.1	2.8	0.9	1.2	2.0	8.7	19.0	19.9
foreign portfolio investment	0.2	-5.2	-4.6	-1.2	1.1	6.1	10.4	4.0	-0.2
Gross official reserves (billions of U.S. dollars)	24.3	23.2	19.8	28.1	35.2	37.6	52.2	63.3	76.5
Months of imports of goods and nonfactor services	5.3	4.0	4.5	5.5	3.9	3.4	4.1	4.8	4.8
Percent of broad money	32.2	27.4	26.7	34.3	32.5	27.4	30.5	31.4	28.3
Gross total external debt (billions U.S. dollars)	103.0	118.8	113.6	129.7	144.3	160.8	168.8	205.5	247.2
Percent of GNP 1/	55.0	59.0	93.1	77.3	56.4	50.1	46.7	50.6	44.4
Percent of exports of goods and nonfactor services	219.5	225.2	218.4	229.1	200.8	174.9	159.0	168.8	166.8
Gross short-term external debt (billions of U.S. dollars) 2/	35.3	43.7	32.6	35.2	41.1	52.0	59.4	72.9	80.7
Percent of gross total external debt	34.3	36.8	28.7	27.1	28.5	32.4	35.2	35.4	32.6
Percent of gross official reserves	145.6	188.4	164.7	125.4	117.0	138.3	113.9	115.1	105.5
Debt service ratio (percent) 3/	33.8	36.9	41.9	38.1	35.1	27.2	26.4	26.1	28.8
REER appreciation (CPI based, period average)	3.9	10.9	-17.6	11.4	8.9	5.1	11.5	0.4	9.5
REER appreciation (CPI based, end of period)	5.3	15.9	-21.2	7.8	12.1	1.8	19.7	-6.6	18.9
Capital adequacy ratio (percent)	...	17.3	15.3	25.3	30.9	28.8	24.2	22.1	19.0
State banks	...	7.9	34.0	50.2	56.3	41.5	40.9	31.2	20.6
Private banks	...	18.3	9.0	19.6	23.5	22.3	17.2	17.5	17.0
Foreign banks	...	29.4	41.0	48.4	60.8	56.0	40.2	26.9	23.1
Nonperforming loans (percent of total)	9.7	11.1	29.3	17.6	11.5	6.0	4.8	3.8	3.5
Real broad money (percent change) 4/	18.9	0.8	11.2	-3.3	-4.6	11.7	15.3	13.5	6.2
Real credit to the private sector (percent change) 4/	-10.7	24.5	-27.5	-16.5	20.1	38.5	33.6	28.6	16.2
Banks' net foreign asset position (billions of U.S. dollars)	-2.9	-5.4	-0.1	-0.4	0.3	-0.1	-0.1	0.2	-0.3
EMBI Global bonds spread (basis points)	420.0	800.0	707	693	309	265	223	207	239

Sources: IMF Country Report 04/227; IMF Country Report 05/412; IMF Country Report 07/363; EBS/08/48; Turkish authorities; and IMF staff estimates.

1/ Based on prerevision GNP.
2/ By residual maturity.
3/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).
4/ Deflated by the CPI.

Table 4. Turkey: Banking Sector Structural Conditionality in the 1999 SBA

Measures	Timing	Remarks	Status
Reduce limit on net FX open position to 20 percent (¶41)	Sep. 1999		√ Done under the SMP.
Introduce mechanism for determining subsidy interest rate by Halk and Zirat banks	Dec. 1999	PA	√
Amend Bank Act in line with LOI (¶53-56)	Dec. 1999	PA	√
Introduce new loan classification and provisioning rules (¶54)	Dec. 1999	PA	√
Modify CAR and foreign exchange exposure limit rules to apply on a consolidated basis (¶54)	Dec. 1999	PA	√
Appoint Board of the BRSA	Mar. 31, 2000	PC	√
Prepare and deliver enforcement and compliance reports on remedial actions for 13 banks subject to enhanced supervision under Article 14 of Banks Act.	Apr. 15, 2000	PC	Missed—1st Review noted deadline would be missed by a few days because of delays in completion of external auditing.
Finalize MOU with each solvent, but undercapitalized bank, specifying a recapitalization plan for increasing CAR to 8 percent by end-June 2000.	Apr. 15, 2000	PC	“
Determine solvency of 3 banks classified as potentially insolvent; take over by SDIF if found insolvent.	Apr. 15, 2000	PC	“
Complete financial restructuring of all 8 banks taken over by SDIF before end-December 1999 on least cost to SDIF and subject to requirement that all liabilities protected (excluding owners and subordinated debt holders).	Apr. 15, 2000	PC	Missed—expected on April 10, but was effectively not completed until Dec. 7.
Provide SDIF financial means to undertake full recapitalization of banking system	Apr. 15, 2000	PC	Missed—Review noted that an agreement was reached on April 7, but given time needed to issue securities, a delay of several days in the execution of the payments was expected.
Amendment of accounting rules to require consolidated accounting and proper valuation of securities	Apr. 2000	SB	Partially met—Securities valuation regulation issued on May 18, 2000. Quarterly consolidated accounting delayed. 2nd Review expected it to be met by end-June; World Bank was providing TA.
Implementation of the CAR and foreign exchange exposures limits on a consolidated basis	Jun. 2000	PC	√ All regulations need to implement this were introduced.
Introduction of penalties for foreign exchange position in excess of prudential limits	Jun. 2000	PC	√ In early May the CBT introduced 100% reserve requirement on positions in excess of limits.
Issue regulations on internal risk management systems and amend the capital adequacy rules to take into account market risks	Jun. 2000	SB	Delayed until Jan. 2001 due to consultations with banking community.
Full operation of the Board of the BRSA	Aug. 2000	PC	√

Source: IMF country reports.

Table 5. Turkey: Consolidated Government Sector, 2000–07 1/

(Percent of GNP)

	2000	2001	2002	2003	2004	2005	2006	2007
Public sector primary balance	3.2	6.0	4.1	6.1	7.2	6.7	6.1	4.6
Central government primary balance	4.8	5.2	2.4	4.9	5.3	5.5	5.6	3.3
Primary revenue	29.4	31.0	27.1	27.9	27.5	28.9	28.5	27.1
Tax revenue	23.5	24.7	21.9	23.1	23.4	24.6	23.9	23.5
Personal income tax	5.4	7.3	5.1	4.7	5.0	5.0	5.0	5.3
Corporate income tax	2.2	2.5	2.3	2.7	2.5	2.5	1.9	2.1
VAT	7.1	7.1	6.7	6.6	7.1	7.1	7.2	6.7
SCT	0.3	0.4	2.2	6.2	6.2	6.9	6.4	6.0
Other	8.4	7.5	5.6	2.9	2.6	3.2	3.3	3.4
Nontax revenue (program)	5.9	6.3	5.2	4.8	4.1	4.3	4.7	3.6
Primary expenditure	24.6	25.8	24.7	23.0	22.2	23.4	22.9	23.8
Personnel and social contributions	7.7	8.2	8.0	8.1	7.8	7.7	7.4	7.6
Goods and services	3.6	3.9	3.9	3.3	3.2	3.1	3.3	3.4
Health	0.6	0.8	0.8	0.8	0.7	0.8	0.9	1.0
Defense and security	1.9	2.0	2.0	1.6	1.4	1.3	1.3	1.2
Other	1.2	1.1	1.1	1.0	1.1	1.0	1.0	1.2
Transfers and net lending	11.1	11.1	10.0	9.4	9.2	10.5	10.1	10.8
Agricultural subsidies	0.3	0.6	0.7	0.8	0.7	0.8	0.8	0.9
Social security institutions (deficit and other)	2.6	2.9	4.1	4.5	4.5	4.9	4.3	5.1
Revenue shares	4.5	4.7	2.9	2.0	2.4	2.6	2.5	2.6
Other, capital, and net lending	3.7	2.9	2.3	2.2	1.6	2.2	2.5	2.2
Capital expenditure	2.2	2.6	2.8	2.2	1.9	2.1	2.1	2.0
Rest of public sector	-1.6	0.8	1.7	1.3	1.9	1.2	0.5	1.3
EBFs	-0.2	0.1	-0.1	0.2	0.1	0.2	-0.3	0.2
SEEs	-1.5	0.1	1.1	0.6	1.1	0.3	0.3	0.5
Unemployment insurance fund	0.3	0.6	0.3	0.3	0.4	0.3	0.4	0.4
Revolving funds	0.1	0.1	0.1	0.3	0.2	0.2	0.2	0.1
Local government	-0.2	0.1	0.2	-0.2	0.2	0.2	-0.2	-0.1
Social security institutions	0.0	-0.1	0.0	0.0	-0.1	0.0	0.2	0.1
Memorandum items:								
Central government overall balance (authorities' definition)	-10.4	-16.2	-14.6	-11.3	-6.8	-1.4	-0.8	-2.1
Total revenue	30.4	33.1	28.9	28.3	28.7	31.4	30.1	29.2
Primary revenue (from above)	29.4	31.0	27.1	27.9	27.5	28.9	28.5	27.1
Interest revenue	0.6	0.4	0.7	0.4	0.9	1.8	0.8	0.6
Program adjustments	0.5	1.6	1.1	0.0	0.3	0.7	0.8	1.4
Total expenditure	40.9	49.3	43.5	39.6	35.5	32.8	30.9	31.3
Primary expenditure (from above)	24.6	25.8	24.7	23.0	22.2	23.4	22.9	23.8
Interest expenditure	16.3	23.3	18.8	16.4	13.2	9.4	8.0	7.5
Program adjustments	0.0	0.2	0.0	0.2	0.1	0.0	0.0	0.0
General government debt (EU basis)	...	105.6	93.9	85.9	77.2	69.8	60.7	51.1
Net public debt (authorities' definition)	57.1	90.4	78.4	70.3	64.0	55.6	45.1	38.3
Gross debt	68.1	107.3	93.4	83.2	77.4	71.9	63.4	54.5
Central government domestic	41.0	69.2	54.5	54.5	52.3	50.3	43.7	39.3
Central government external	21.7	31.6	33.7	24.8	21.5	17.8	16.3	12.0
Rest of public sector	5.4	6.5	5.1	4.0	3.6	3.8	3.5	3.2
Gross assets	-11.0	-16.9	-15.0	-12.9	-13.4	-16.3	-18.3	-16.2
Central government	-0.7	-0.5	-1.8	-1.3	-1.8	-3.8	-4.3	-3.1
Rest of public sector	-1.3	-2.2	-2.1	-2.1	-1.9	-2.4	-1.9	-1.9
Unemployment insurance fund	-0.3	-1.2	-1.8	-2.5	-3.1	-3.7	-4.1	-4.7
Central bank	-8.8	-12.9	-9.2	-6.9	-6.5	-6.3	-7.9	-6.4
GNP (billions of Turkish lira, prerevision) 2/	125.6	176.5	275.0	356.7	428.9	486.4	575.8	650.2
GDP (billions of Turkish lira, postrevision)	166.7	240.2	350.5	454.8	559.0	648.9	758.4	856.4

Sources: Turkish authorities; and IMF staff estimates

1/ Central government based on revised data consistent with current coverage and reporting practices.
2/ 2007 GNP calculated using the 2006 ratio of prerevision GNP to postrevision GDP.

Table 6. Turkey: Compliance with Structural Conditionality Under the Stand-By Arrangement, 2005–08

	PC or SB 1/	Status
By end-April 2005 (original SBA request)		
No new amnesties of arrears on public sector receivables as defined in Annex F.	PC	Met beginning at 5th review.
At most, 10 percent of those leaving through attrition in each state enterprise will be replaced, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury.	SB	Not fully met until 3rd-4th reviews.
Maintain excise taxes and SEE prices in line with 2005 program assumptions.	SB	√
Parliamentary approval of pension reform legislation.	PC	Met with delay at 3rd-4th reviews.
Parliamentary approval of the administrative social security reform law.	SB	Met with delay at 3rd-4th reviews.
Put in place secondary legislation required under the Public Financial Management and Control Law.	SB	Met with delay at 3rd-4th reviews.
Parliamentary submission of legislation strengthening state enterprise governance.	SB	Not met.
Develop a quantitative framework for monitoring health expenditure and assessing medium-term trends.	SB	√
Prepare legislation to reform the personal income tax.	SB	Not met.
Establish a large-taxpayers unit within the Revenue Administration.	SB	Met with delay at 6th review.
Complete comprehensive review of civil service wage and employment structure.	SB	Met with delay at 3rd-4th reviews.
Parliamentary approval of Banking Law.	PC	Met with delay.
Adoption of state bank specific strategies by both the government and the boards of the state banks.	SB	Met with delay at 1st-2nd reviews.
Adopt a timetable for the phasing out of special privileges and obligations of the state banks.	SB	Met with delay at 5th review.
Publication by BRSA of its planned reforms taking into account the findings of the Imar inquiry.	SB	Met with delay at 1st-2nd reviews.
SDIF to sell all remaining non-related party loans by auction.	SB	Met with delay at 3rd-4th reviews.
Launch of first IPO for Vakifbank.	SB	√
Set up a committee to assess whether integrated financial sector supervision is warranted, with findings to be presented by end-March 2006.	SB	Met with delay at 3rd-4th reviews.
Completion of implementing regulations for the Banking Law.	SB	Met with delay at 5th review.
By end-July 2006 (3rd and 4th reviews)		
Establish Tax Policy Unit at Ministry of Finance.	SB	Met with delay at 5th review.
Adopt legislative changes to streamline the structure of the personal income tax by unifying the schedules for wage and nonwage income and reducing the number of tax brackets.	SB	Met with delay at 3rd-4th reviews.
Complete functional restructuring of Revenue Administration, including reorganization of local tax offices.	SB	Met with delay at 5th review.
Submission of draft legislation for second stage of personal income tax reform.	PC	Waived.
Approval of second stage of personal income tax reform.	PC	Partially met with delay.
Announcement of detailed state bank privatization strategies and timetables.	SB	Met with delay at 5th review.

Table 6. Turkey: Compliance with Structural Conditionality Under the Stand-By Arrangement, 2005–08 (concluded)

	PC or SB 1/	Status
By end-April 2007 (6th review)		
Parliamentary approval of legislation authorizing copayments for medical treatments and pharmaceuticals.	PC	√
Replace no more than 50 percent of civil servants leaving through attrition.	SB	√
Publish report that quantifies existing tax expenditures.	SB	Met with delay at 7th review.
Extend family medicine program to 22 regions.	SB	Partially met with delay at 7th review.
Put in place a unified tax declaration form for SSI and Revenue Administration.	SB	Not met.
Put in place a legal framework requiring large employers to pay salaries through bank accounts.	SB	Met with delay at 7th review.
Introduce a risk-based audit system for VAT refunds.	SB	Met with delay at 7th review.
Secure parliamentary approval of the insurance law.	SB	√

Source: IMF staff.

1/ Performance criteria (PC) or structural benchmark (SB).

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