SM/08/248
Correction 1

CONFIDENTIAL

December 23, 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**

The attached corrections to SM/08/248 (7/21/08) have been provided by the staff:

Factual Errors Affecting the Presentation of Staff's Analysis or Views

Page 9, para. 10, line 3: for "its credit lines cut" read "difficulties borrowing overnight"

Page 24, Box 4, para. 3, lines 4–5: for "United States in connection" read "United States, which a few analysts saw as linked"

Page 27, para. 43, line 4: for "abandoned" read "reduced"

footnote 15, lines 2–3: for "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" read "to some extent on the status of Turkey's candidacy for the EU and the prospect of financial support from the United States"

Page 33, para. 55, line 6: for "inadequate" read "and inadequate"

Page 36, para. 60, lines 15–16: for "A prolonged" read "The appointment"

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

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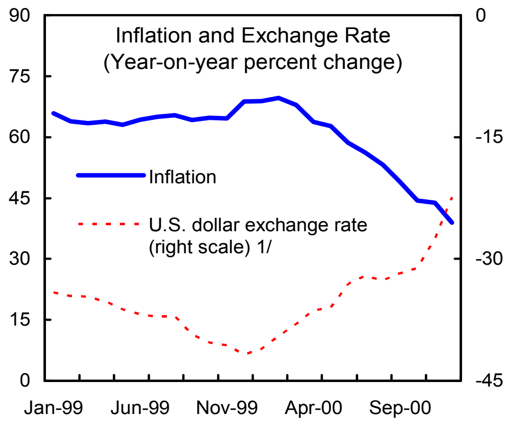
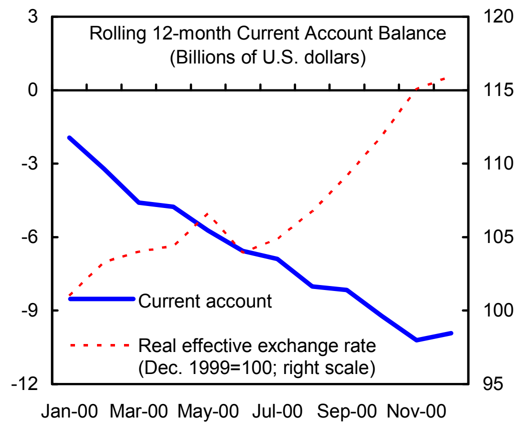


Sources: Turkstat; and Central Bank of Turkey.
1/ Positive sign denotes appreciation.



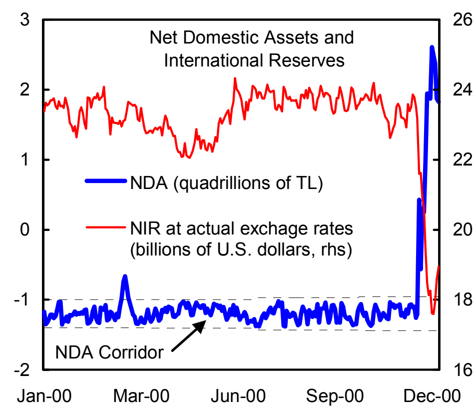
Source: Central Bank of Turkey.

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~~difficulties borrowing overnight, 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.

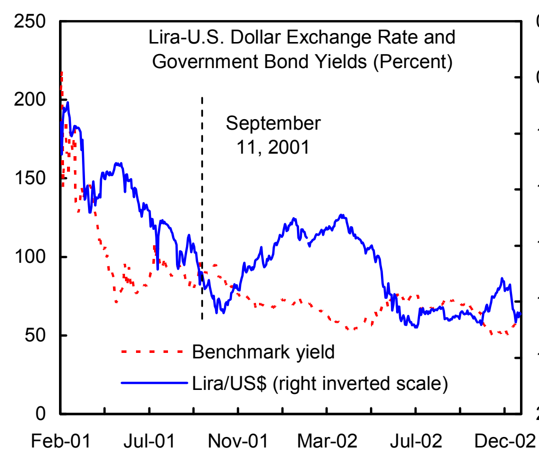
[4] The reasons behind the bank's difficulties are not completely clear. A liquidity squeeze by dominant banks and concerns about the bank's large sovereign debt exposure were both cited (Van Rijckeghem and Üçer, 2005).

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.

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~~, which a few analysts saw as linked to 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.

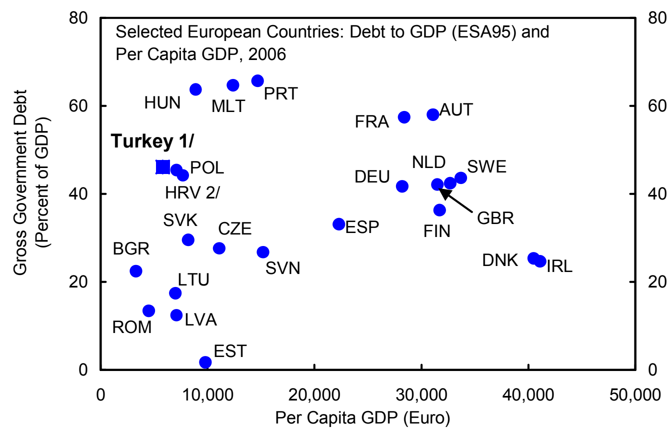
Ownership grew with the program's success, creating a virtuous cycle. A strong track record of implementation both improved debt sustainability and built market confidence. In particular, the strong recovery provided widespread benefits, broadening the support for the program within the government and 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.

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~~ reduced 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.

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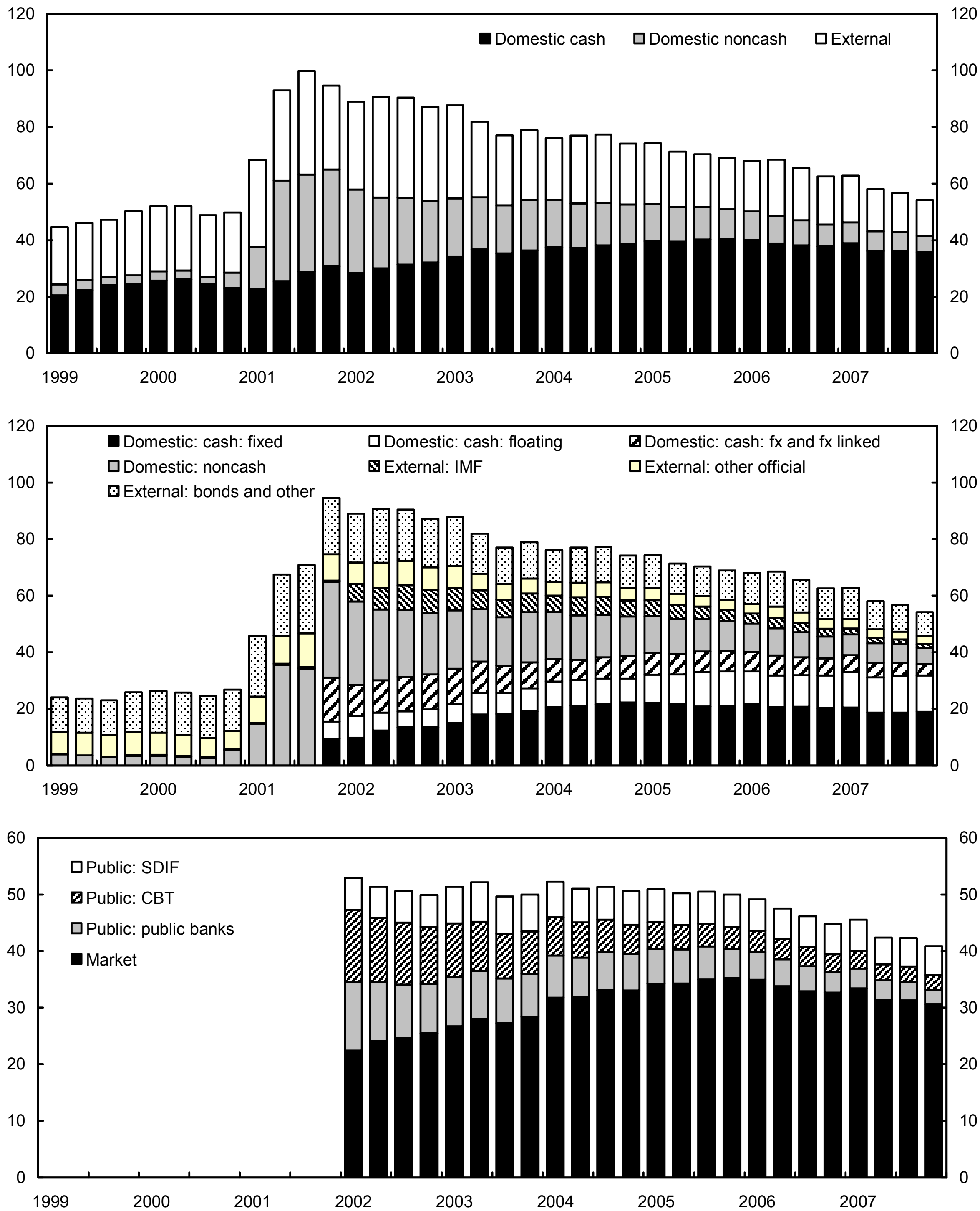
[15] Confidence, of course, also depended on international developments. Markets perceived that the degree of access to international financial support depended ~~on both Turkey's relationship with the United States following the September 11 terrorist attacks and the status of Turkey's candidacy for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

Figure 3. Turkey: Central Government Debt, 1999–2007

(Percent of prerevision GNP)



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

and a far 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, and 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.

[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]

[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

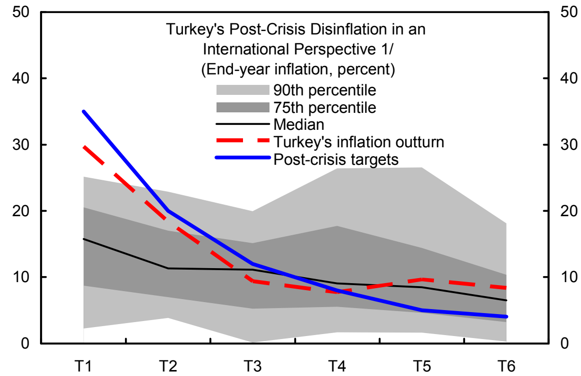
Source: IMF country reports.

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.

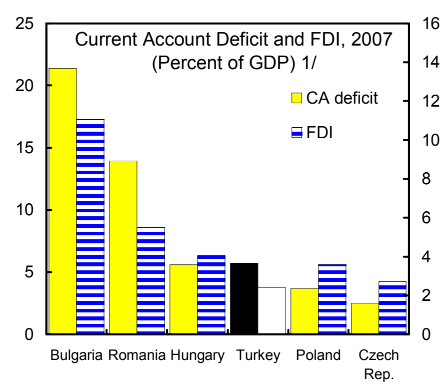
60. **Were the inflation targets too ambitious?** Having met their inflation targets for four years in a row (an outstanding performance by international standards), the authorities felt that the targets in the 2005 SBA's original macroeconomic framework, 5 percent in 2006 and 4 percent thereafter, were 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~~The appointment process of 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