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Turkey: Regaining Credibility In Economic Policy

by Augusto Lopez-Claros
with
Kaushik Rudra

- By early 1999, the Turkish economy had entered a critical crossroads: loose fiscal policy and the associated inflation volatility were complicating macroeconomic management, with the authorities finding themselves in a crisis management mode, dealing mainly with the impact of various shocks (external and domestic), against the background of historically high real interest rates and a contracting economy.

- The April 1999 election changed the political landscape and led to the emergence of a broad coalition, more identified with fiscal restraint and structural reforms, particularly in the pension system and the agricultural sector, two key sources of pressure on the budget. The authorities negotiated a three-year IMF programme, the centerpiece of the reform strategy for 2000-02.

- The programme's early results are very encouraging: interest rates are sharply down; fiscal performance has been better than expected in relation to the programme's targets; and even inflation is headed down. Having accomplished much on the structural reform front in 2H99, the authorities have not slackened and their efforts in a number of areas are beginning to pay off. Particularly noteworthy in this regard are the early results of the privatisation campaign.

- While risks remain, Turkey enters the new century in a much stronger position. The prospects of a future EU candidacy, the resulting incentives for improved economic management and structural reforms, and an emerging consensus in the political establishment on the means and the ends of economic policies, will all contribute to the creation of a solid foundation for non-inflationary growth. A supportive external environment will also be a key ingredient of success.

Turkey: Regaining Credibility In Economic Policy

Augusto Lopez-Claros, +44 (0)20 7260 2389
Kaushik Rudra, +44 (0)20 7260 1767

Introduction

There seems to be a fairly broad consensus that the underlying cause of inflation in Turkey is the very weak fiscal position and that, therefore, it will be difficult to reduce inflation on a sustainable basis without addressing in a credible way the problems which have contributed in recent years to the rapid growth of the public sector's borrowing requirement. This paper presents an overview and an assessment of the authorities' economic programme for 2000. Given the central role of fiscal adjustment in bringing Turkish inflation under control, the paper examines the key elements of the fiscal programme being implemented by the authorities and focuses considerable attention on those policy areas that are seen as central to the success of the disinflation process.

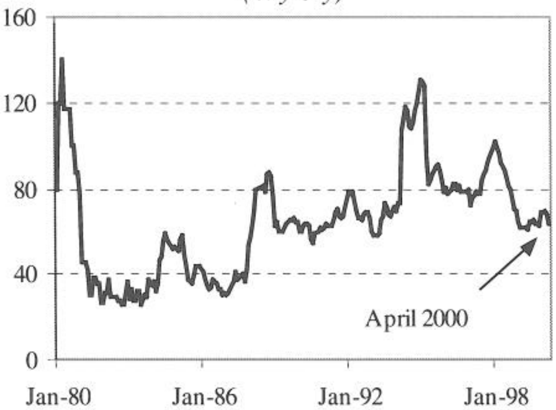
In particular, reforms of the social security system aimed at limiting the burden of pensions on the budget, and efforts underway to limit the claims on public resources made by the agricultural sector through a number of different support mechanisms. The paper also examines the implications of Turkey's high inflation environment on the banking system and reviews the authorities' privatization plans. A brief political update provides analysis of the main issues confronting the government. An appraisal of the economic programme's main accomplishments and risks in the period ahead is presented in the last section.

2. Fiscal Indiscipline As A Source Of Inflation

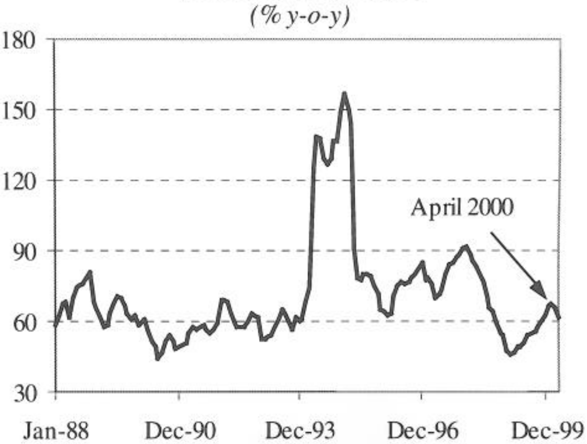
In assessing the performance of its inflation-prone members the IMF divides countries into three groups: those suffering from "chronic inflation," defined as annual inflation ranging from 20 to 80% for five or more consecutive years; "acute inflation" (at least 80% for two or more years); and "runaway inflation," or rates in excess of 200% for one or more years. While purely indicative in nature, this classification puts Turkey firmly in the upper limits of the "chronic" group, dangerously close at times (1996-97) to being shifted to membership in the "acute inflation" camp. High and highly variable rates of inflation in Turkey during the 1990s have largely reflected the persistence of large public sector deficits, fairly entrenched inflationary expectations (indexation of nominal incomes to past changes in the CPI have been a source of inertia), and a monetary policy that has largely accommodated the loose fiscal policy.

High inflation in Turkey has been at various times associated with high real interest rates, capital flight, unusually low levels of foreign direct investment, the erosion of living standards for broad segments of the population, and political instability. Furthermore, periodic financial crises have invariably resulted in the "stabilization" of inflation at successively higher levels, with average annual inflation rising gradually from some 40% in the early 1980s, to around 60% in the late 1980s and early 1990s, to 80% in the period 1996-99. Indeed, the monetization of the government's large financing requirement through increasingly higher rates of inflation may have prevented the debt/GNP ratio from spinning out of control.[1] Not surprisingly, the IMF has described Turkey's chronic high inflation as being "a plague."

Consumer price index
(% y-o-y)



Wholesale price index
(% y-o-y)



[1] *In the absence of inflation the net stock of public debt would have risen from some 30% of GNP in 1990 to close to 100% in 1999; in the event the stock of debt doubled to close to 60% of GNP during that ten year period.*

Turkey: Selected Economic Indicators 1/

	1994	1995	1996	1997	1998	1999	2000
Real GNP, % change	-6.1	8.0	7.2	8.2	3.8	-6.4	5.6
GNP, $bn	131.3	171.3	184.0	193.8	205.5	182.1	205.9
Unemployment rate, % 2/	8.1	6.9	6.0	6.4	6.3	7.0	-
CPI (average y-o-y)	105.2	89.1	80.4	85.7	84.6	64.8	-
CPI (Dec/Dec)	125.5	78.9	79.8	99.1	69.7	68.8	25.0
WPI (average, y-o-y%)	120.7	86.0	75.9	81.1	74.1	52.7	-
WPI (Dec/Dec)	148.8	65.6	84.9	91.0	54.3	62.9	20.0
Broad money, % change, eop 3/	133.3	106.4	113.1	117.6	76.0	82.6	41.1
Interest rates, % 4/							
- One-year TBs	-	108.6	115.0	105.5	101.3	85.5	37.9
- Three-month time deposits	88.0	76.0	80.7	79.5	80.1	78.4	38.6
Current account, $bn	2.6	-2.3	-2.4	-2.6	2.0	-1.4	-3.7
- In % of GNP	2.0	-1.4	-1.3	-1.4	1.0	-0.7	-1.8
- Exports, $bn 5/	18.4	22.0	32.4	32.6	31.2	29.3	-
- Imports, $bn	23.3	35.7	43.6	48.0	45.4	39.8	-
Gross reserves, $bn	8.5	13.8	17.7	19.6	20.1	23.2	
- In month of imports	3.8	4.1	4.3	4.1	4.3	5.7	-
External debt, $bn 6/	65.6	73.3	84.0	91.1	104.0	104.4	-
- o/w: medium-and long-term	54.3	57.6	63.4	68.5	76.7	74.2	-
Exchange rates							
- End of period, 000s TL/$	38.7	59.7	107.8	205.6	314.5	542.1	650.0
- Period average, 000s TL/$	29.6	45.8	81.4	151.9	260.7	429.6	607.1
Public finances, % GNP							
- Budget revenues	19.3	17.9	18.2	19.7	21.6	22.0	27.1
- Budget expenditures	23.2	22.0	26.4	27.4	29.2	34.1	39.7
- Primary balance 7/	-0.2	2.7	-1.2	-2.1	0.5	-2.8	2.2
- Overall balance	-3.9	-4.1	-8.2	-7.4	-7.6	-12.1	-12.6
- Public sector borrowing requirement	-9.1	-4.8	-13.1	-13.0	-15.8	-23.3	
- Net debt of the public sector	44.7	41.3	46.5	42.9	44.5	58.0	57.9

1/ Forecasts for 2000 are those contained in IMF program
2/ In 1999 rate is preliminary estimate.
3/ Includes foreign currency deposits and repos.
4/ For 2000, average for first 3 months.
5/ Beginning in 1996 including estimates of shuttle trade.
6/ For 1999, end-September.
7/ For consolidated public sector

An appropriate assessment of the stance of fiscal policy in Turkey needs to focus on a definition of the government that is broad enough to include the activities of not just the central government, but also the local governments, the social security funds, the extra-budgetary funds, and the operations of a large number of state enterprises that carry out quasi-fiscal operations on behalf of the government. [1] Turkey will have to register an annual primary surplus for the foreseeable future to stabilize the debt to GNP ratio.

According to the IMF, under plausible assumptions about the level of real interest rates, this annual surplus will have to be of the order of 2.5% of GNP over the medium-term. However, much of the fiscal pressure in recent years and, hence, the contribution to the emergence of primary fiscal *deficits* during this period has come not from the central government (which, except for one year, has shown a primary surplus every year since 1994), but from local governments, the social security system, the state economic enterprises and the losses accumulated by the state banks in their subsidized lending operations, particularly to the agricultural sector.

This observation has two implications. First, it underscores the urgent need for fiscal adjustment in the public sector, to generate a significant turn-around in the unfavorable debt dynamics seen throughout the 1990s. Second, it highlights

[1] *There are roughly 50 so-called state economic enterprises (SEEs) employing half a million people. Their activities (as will be discussed below) are a heavy burden on the budget.*

the fact that to the extent that the bulk of the fiscal deficit is being generated outside of the central government budget--in the operations of the pension funds, in the lending activities of the state banks--fiscal adjustment without major structural reform is surely destined to fail. We come back to this key issue below.

2.1 Getting Started...

Determined to bring inflationary pressures under control, the Turkish authorities negotiated a Memorandum of Economic Policies with the IMF in mid-1998 intended to reduce wholesale price inflation to 50% by the end of the year and to 20% by end-1999. Unable at that time to enter into the kinds of tough policy commitments implicit in the Fund's high conditionality facilities, the authorities, nevertheless, agreed to a staff monitored program (SMP)--a flexible arrangement involving no financing, but providing a useful quantitative framework for policy discussions during an 18-month period through end-1999.

Performance under the SMP was mixed at best. In particular, WPI inflation at end-1999 was 63%, close to 9 percentage points higher than the end-1998 level. A difficult external environment was clearly a key factor in explaining this poor outcome. The crisis in Russia precipitated capital outflows in late 1998, a loss of export markets in the region, and a sharp slowdown of the industrial sector. Real GNP contracted by over 6% in 1999, compared to close to 4% growth in 1998. Partly to ensure the smooth rollover of domestic debt in the presence of a large budget deficit, interest rates on one-year treasury bills remained well above 100% throughout much of 1999 and rose as high as 146% on the shorter maturities, further complicating fiscal management. Interest payments on the public debt in the 1999 budget rose to over 13% of GNP.

In addition, political uncertainties preceding the April 1999 elections and the formation of the new government thereafter contributed to a period of policy drift and fiscal loosening, with significant delays in the implementation of key pieces of structural reform which had been envisaged as part of the SMP, and significant slippages emerging with respect to the fiscal targets contained in that program.

One area in which this became fully evident was in the public sector's wage policy. Early in the year a two-year contract was negotiated with public sector workers which contained the following elements: a close to 40% up-front adjustment plus three semiannual adjustments providing for 105% indexation with respect to the CPI for the previous 6 months. Thus public sector wages are estimated to have grown by 20% in real terms in 1999 and no doubt contributed to the sharp widening of the primary deficit of the local governments and, therefore, the consolidated public sector. These wage contracts also applied to the SEEs and their half a million workers.

The authorities also had to cope with the aftereffects of the August earthquake, which put additional pressures on the public finances. In the event, at about 1% of GNP, the primary surplus of the budget in 1999 was well below the 4.1% of GNP anticipated in the SMP. Perhaps nothing underscores more graphically the difficulties of undertaking major fiscal adjustment over a brief span of time as the fact that the overall deficit of the consolidated public sector in 1999 was 12% of GNP, well above the 7.6% of GNP outcome for 1998. More worryingly, last year witnessed a spectacular increase in the net debt of the public sector, from 44.5% of GNP in 1998 to 58% of GNP in 1999, all of it accounted by the growth of domestic indebtedness and, to put these numbers in some sort of historical perspective, about 30 percentage points of GNP higher than in 1990.[2]

2.2 Elements of the 2000-2002 Fiscal Program

The basic thrust of the government's fiscal program consists of a combination of one-off revenue measures, an ambitious three-year program of privatization and structural reforms in a number of areas (e.g., social security, banking system) intended to reduce over the medium-term the onerous pressures on the budget. Policy commitments in structural areas, including the privatization program, are analyzed in section 3 below. Here we present the key elements of the fiscal package.

The principal objective is to ensure a shift in the primary position of the public sector from a *deficit* of 2.7% of GNP in 1999 to a *surplus* of 2.2% of GNP in 2000, a 5% of GNP swing.[3] The program establishes quarterly targets for this measure of the deficit, with a slight front-loading in the quarterly profile. Interestingly (and surprisingly) the program does not establish a performance criterion on the overall deficit of the consolidated public sector, conceding that this is likely to actually rise in 2000, reflecting a temporary increase in the burden of interest payments. An "indicative ceiling" of some 15% of GNP for 2000 is placed

[2] *The bulk of this debt was recorded as a liability of the central government, although it originates in the activities of the "other" parts of the public sector. As the SEEs or the local authorities, for instance, find themselves unable to roll over their debts, state guarantees are called in and the central government is forced to step in and pay.*

[3] *The IMF quotes a higher primary surplus target of 3.7% of GNP by excluding earthquake-related expenses in 2000 from their definition of the deficit. These expenses are projected to amount to 1.5% of GNP; we judge that this distinction is not essential.*

on this aggregate.[4] The program does impose a performance criterion on privatization receipts, but only for 31 December 2000, thus allowing the authorities considerable latitude in the timing of revenue collection associated with the privatization process, which envisages revenues in excess of $7 billion in the course of the year (see below).

The revenue measures contain a tax package approved by the government on 26 November 1999, the centerpiece of which was the introduction of a withholding tax on government securities issued before 1 December 1999, "to reduce the windfall gain accruing to securities holders from the reduction in inflation and interest rates in 2000."[5] Together with some additional taxes on mobile phone bills, property taxes (including on motor vehicles), the package is expected to yield some 2% of GNP. This package is being supplemented with a range of other measures with a combined yield of around 3% of GNP and including:

- Increases in withholding taxes on income from fixed assets, on interest income from deposits and repos, among others, with a yield of some 0.3% of GNP.
- Increases in VAT rates from 15 to 17% (0.4% of GNP) and in the additional VAT on tobacco and alcohol (0.4% of GNP).
- Changes in the method of computing taxable profits for corporate holders of treasury bills (1.1% of GNP).

[4] *Indicative ceilings may be breached without endangering disbursements under the stand-by, unlike "performance criteria" compliance with respect to which is essential to qualify for loan tranches.*
[5] *As quoted in the programme's Letter of Intent, dated 9 December 1999.*

Primary Balance of the Public Sector, % of GNP

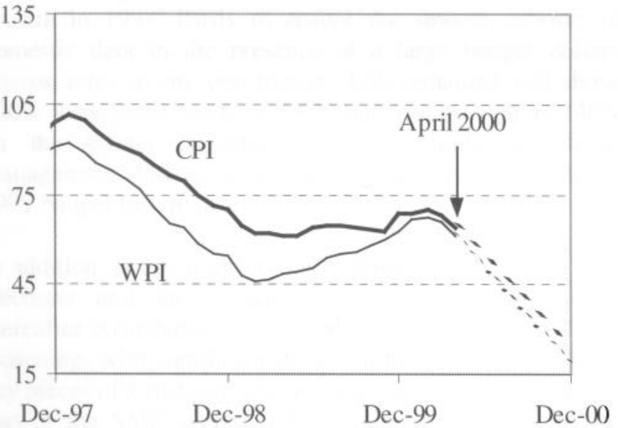
	1994	1995	1996	1997	1998	1999	2000	2001
Primary balance of the public sector	**-0.2**	**2.7**	**-1.2**	**-2.1**	**0.5**	**-2.8**	**2.2**	**3.7**
- Central government	3.4	3.4	1.2	-0.2	3.6	0.9	3.9	5.3
- Extrabudgetary funds	-1.5	-0.6	-0.2	0.1	0.0	-0.5	-0.6	-0.6
- Local authorities	-0.1	0.0	-0.1	-0.1	-0.4	-0.8	-0.6	-0.6
- State economic enterprises	-0.3	1.3	-0.1	-0.4	-1.1	-1.2	-0.9	-0.8
- Other funds	-0.6	-0.6	-0.1	-0.1	-0.4	0.0	0.0	-0.1
- Unemployment insurance scheme	--	--	--	--	--	--	0.4	0.5
- Unpaid duty losses 1/	-1.1	-0.8	-1.9	-1.4	-1.2	-1.2	0.0	0.0

Source: IMF, IBRD, and Turkish authorities
1/ For agricultural sector (see Section 4 of paper).

The program contains very little in the way of expenditure cuts, other than some 0.3% of GNP savings in non-investment outlays. In particular, defense and security related expenditures, which, at some 4 1/2% of GNP in 1999 are roughly twice the EU average, are projected to remain well protected in 2000. [1] Measures adopted in the area of pension reform (see section 3 below) are projected to reduce the deficit of the three pension funds by some 0.4% of GNP in 2000. Reductions in the level of resources made available to the agricultural sector are also expected to lighten somewhat the burden of the sector on the budget (see section 4).

CPI and WPI 2000 targets

(% y-o-y)



[1] *According to the IMF, "additional defense spending is carried out through off-budget items, such as the Defense Industry Support Fund, but its magnitude is not reported." (IMF Staff Country Report No. 98/104, September 1998). Perceptions of lack of transparency in defense spending have received unfavorable international publicity. For instance, Richard Boudreaux of the* Los Angeles Times *(9 March 2000) writes: "The armed forces report to the prime minister, not the defense minister...They take 9% of the national budget without a word of debate in Parliament and spend without civilian oversight. They control arms procurement, much of it from defense companies they own, and have extensive holdings in Turkey's automotive, cement, food and chemical industries."*

The government's fiscal program is being supported by an incomes policy which sets wages for civil servants in line with targeted inflation of 25%. In particular, wages were adjusted by 15% on 1 January and are to be adjusted again on 1 July. However, in the event that cumulative CPI inflation during the first 6 months exceeds 15%, wages will be adjusted by an additional amount equal to the difference between actual inflation and 15%.[2] It is expected that the private sector will take wage agreements in the civil service as an indication of the desirable stance of wage policy in the economy at large.

With an audit rate of about 1%, "too low to dissuade taxpayers from evading their obligations" (IMF Staff Country Report 1998), tax evasion is fairly widespread. The government is expected to establish a monitoring system by April 2000 aimed at helping in the setting up of targets to reduce an outstanding stock of tax arrears, estimated to exceed 3% of GNP in 1999.

[2] *There is some ambiguity in this area, with the Budget Law suggesting an additional 2 percentage points over and above any excess beyond 15%. Cumulative CPI inflation during the four months of 2000 reached 14.5%. An overshooting of the 15% notional target for the first half of the year is thus likely; it will be important for the government not to yield to pressures for larger wage adjustments than agreed to in the programme.*

Consolidated Budget, in % of GNP

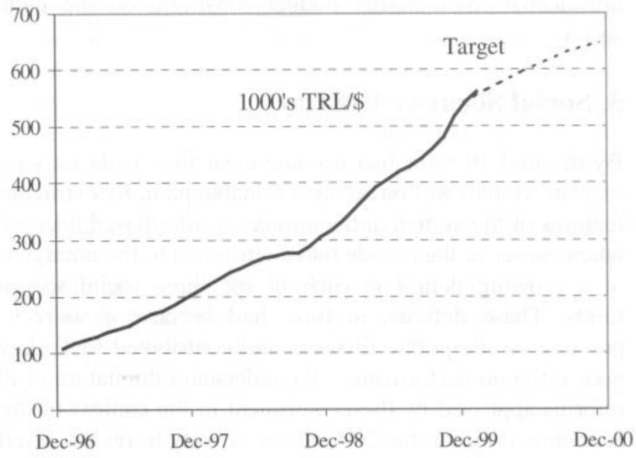
	1994	1995	1996	1997	1998	1999
Total Revenue	19.3	17.9	18.2	19.7	21.6	22.0
-Tax revenue	15.1	13.8	15.0	16.1	17.2	17.3
-- Direct	5.9	5.6	5.9	6.6	8.0	7.8
-- Indirect	9.2	8.2	9.1	9.6	9.2	9.5
Non Tax Revenue	4.1	4.1	3.2	3.6	4.4	4.6
Expenditure	23.2	22.0	26.4	27.4	29.2	34.1
-- Non interest expenditure	15.5	14.6	16.5	19.6	17.6	20.8
-- Personal	7.0	6.4	6.5	7.1	7.2	8.4
-- Other current	1.9	1.8	2.1	2.4	2.5	2.8
-- Transfers	4.6	5.1	6.2	8.0	6.1	7.8
-Investment	2.0	1.3	1.7	2.2	1.9	1.8
-Interest payments	7.7	7.3	10.0	7.7	11.5	13.3
-- Domestic borrowing	6.0	6.1	8.9	6.7	10.5	12.2
-- Foreign borrowing	1.7	1.3	1.1	1.0	1.0	1.1
Primary balance	3.7	3.3	1.7	0.1	4.0	1.2
Overall balance	-3.9	-4.1	-8.3	-7.7	-7.6	-12.1
Financing	3.9	4.1	8.3	7.7	7.6	12.1
- Foreign borrowing (net)	-1.7	-1.0	-0.9	-1.5	-1.9	-0.3
-- Receipts from loans	1.1	2.0	1.9	0.8	1.5	2.5
-- Payments on loans	-2.9	-3.0	-2.8	-2.4	-3.4	-2.8
- Domestic borrowing (net)	5.6	4.7	9.3	9.0	9.3	12.4
-- Central bank (net)	1.3	1.2	1.5	0.0	0.0	0.0
-- Treasury bills and bonds (net)	4.5	3.6	7.1	8.5	8.6	12.4
- Other	0.0	0.4	-0.1	0.2	0.2	0.0
-Memorandum item						
-- Privatization proceeds	0.1	0.0	0.0	0.1	0.5	0.0

Sources: The Treasury; IMF.

2.3 Exchange Rate And Monetary Policy

The authorities have introduced important changes in the implementation of exchange rate policy. In particular, effective 1 January 2000 the central bank has moved away from the policy of real exchange rate targeting followed during the last several years, to the introduction of a preannounced exchange rate path (see chart below) involving a depreciation of 20% in the course of the year, equal to the WPI inflation target. The path is slightly front-loaded (i.e., the rate of depreciation decelerates gradually in the course of the year) and is to be extended, on a rolling basis, at the end of every calendar quarter. This policy will continue until 1 July 2001, at which time the central bank will introduce an element of greater flexibility in exchange rate management; in particular, the lira will be allowed to fluctuate within a widening band with a total width of 7.5% by end-December 2001, 15% by end-June 2002 and 22.5% by the end of 2002.

The Turkish lira/$ exchange rate
(eop)



The above exchange rate policy will be supported by a stance of monetary policy that will aim to keep the stock of net domestic assets of the central bank roughly unchanged in nominal terms at its end-1999 level during the program period. Base money is to be created (eliminated) only in connection with balance of payments inflows (outflows) and capital inflows/outflows are not expected to be sterilized, with interest rates to be fully market determined. In this sense, the implementation of monetary policy in the program has some of the central elements of a currency board. Indeed, during the phase of programme negotiations the Fund had argued in favor of the establishment of a full currency board arrangement, a mechanism that has proved singularly effective in quickly bringing inflation down in Argentina, Bulgaria, Estonia, and Lithuania during the 1990s.

The authorities in the end opted for a somewhat weaker arrangement involving some continued nominal depreciation of the currency and an "exit strategy" after an 18-month period to commence on 1 July 2001. Concerns about the possible erosion of external competitiveness during the early phase of the currency board were apparently a key consideration preventing stronger support for the board. We judge that these concerns may have been somewhat overdone. The lira could have sustained some real appreciation of 10-15% in the course of 2000 without an unduly negative impact on the balance of payments.[1] The "hard peg" implied by a currency board would have, in our view, provided a stronger backdrop for a reduction of inflationary expectations and a more rapid and sustained reduction of inflation. It would also have involved the introduction of a harder budget constraint on the public sector.

3. Social Security Reform

By the mid-1990s it had become clear that Turkey's social security system was on an unsustainable path. Key structural features of the system and a number of ill-advised decisions taken earlier in the decade had contributed to the emergence of a growing deficit in each of the three social security funds. These deficits, in turn, had become a source of pressure on the public finances and contributed to Turkey's poor inflation performance. To understand the nature of the reforms approved by the government in the context of their economic program for 2000 it is necessary to review briefly the main features of the system whose deficiencies the reforms are intended to address. We then discuss the key measures adopted and the impact these are expected to have over the medium and long-term.

The key structural flaws of Turkey's social security system that are the source of sizable fiscal imbalances can be traced to the following characteristics:

- **No Minimum Retirement Age.** The minimum retirement age was abolished in 1992, shortly before a 1986 decision to impose a retirement age of 50 years for women and 55 years for men was scheduled to take effect. Thus the system continued to grant eligibility for retirement on the basis of both the number of years worked (set at 20/25 years for women/men, respectively), and the number of years contributions were actually made. Thus, for instance, for participants in SSK--the main pension fund covering non-farm private sector and public sector employees (other than civil servants), accounting for nearly 60% of total pensioners--workers were eligible to retire as early as 34/39 years of age if they had entered the labor force before 1981, or 38/43 if they had done so at a later date, when the minimum employment age was raised to 18 years. Consistent with these overly generous arrangements, by the late 1990s the average retirement age for SSK participants was 47/50 years. Thus, as noted by the World Bank, a man who retired at the age of 43 could, given life expectancy patterns for the Turkish population, expect to receive a retirement pension for the next 31 years. In addition, upon the death of the insured, a surviving spouse would receive a pension set a 50% of the benefit, while pensions would also be paid to other dependents depending on their individual circumstances, up to an additional 50% of the insured's pension benefit.[2]

- **Overly Generous Benefits.** Statutory contribution rates are high, at some 33.5% of wages, but the wage on which contributions are paid is capped at 1.8 times the minimum wage; this implies that the effective contribution rate is actually 12%, nearly 60% of which is paid by the employer.[3] In addition, contributors were, in fact, entitled to receive a reduced pension set at 60% of their average wage (during a particular reference period) as long as they had contributed during a minimum required 14-year period. Benefits are thus extremely generous relative to contributions. The IMF has characterized the Turkish pension system as

[1] *Indeed, this "safety" margin may be higher because of the substantial reduction in financing costs implied by the reduction in domestic interest rates, the effects of which are not easily captured in traditional indicators of external competitiveness.*

[2] *Thus, an unmarried or divorced daughter would receive this benefit for an indefinite period.*

[3] *Actually, effective contribution rates are even lower than 12% since there are problems collecting contributions and compliance rates run at around 85% for those enrolled.*

"among the most generous in the world," with average replacement ratios of the order of 80% reached relatively early on. Comparisons with other countries showed that the replacement ratios achieved by Turkish workers after 15 years of contributions "would take an Italian worker 30 years or a German worker 40 years to acquire" whereas "workers in the United States, Japan, France, the United Kingdom, or Argentina could *never* reach a pension of the same share of their contribution wage as a Turkish worker." Other features which make the system generous include receipt of a lump sum payment upon retirement equal to one month's wage for every year worked, either paid by the employer (in the case of the SSK) or the government for the other two pension funds.

- **Weak Administration.** The lack of a contributor identification number system and inadequate computerization of records introduces a number of difficulties in the monitoring of payments and in ensuring appropriate levels of compliance. Coverage rates for the two main pension funds (other than the one for civil servants) are around 50%, with millions of eligible workers simply not enrolled. For BK, the second largest fund (with a total of 3.1 million contributors) "the compliance rate is just 50% of the wage bill; only 4% of contributors are up to date on their payments, while 18% have never made a single contribution after joining."[4] Another problem which has placed a growing burden on the finances of the pension funds has been health care expenditures, which have risen by more than 100% in real terms in the last several years, reflecting the lack of effective user fees for a variety of services. Other social support payments provided by the government are not well-targeted and consist of flat amounts provided irregardless of earnings, age, and the level of pension received by the recipient and are thus an ineffective way to provide social protection.

The combined effect of the above flaws are thus responsible for the very unfavorable evolution of pension indicators provided in the table below, including the much faster rate of growth in the number of pensioners than in the number of contributors and the associated sharp fall in the dependency ratio (to 2.2 in 1999), the low coverage and poor compliance and the resulting mounting pressures on the overall financial balance of the three funds, stemming mainly from a ballooning of expenditures.[5] In the absence of corrective policies the World Bank has estimated that the 3.3% of GDP deficit registered in 1999 would rise to over 5% of GDP within a few years and into the double digit range within a generation.

3.1 The 1999 Social Security Reforms

The main elements of the law enacted last September contemplate a number of changes of which the most significant are:

- The introduction of a minimum retirement age, which, for new entrants to the pension schemes, has been fixed at 58/60 years. For existing members with less than 10 years' contribution the retirement age will be 52/56 years while for those who have been in the system longer than 10 years, a transition period will be in force.

- To support the new retirement age the law also envisages the introduction of a minimum contribution period to enable qualification to a full pension. This has been set at 19.4 years for new entrants to SSK, the main pension fund, and at 25 years for the other two funds. Transition periods have been established for those already in the system and the size of the pension is to be a function of the length of contribution, with the replacement rate (that is, the ratio of the annual pension to average lifetime earnings) set at 3.5% for each year for the first 10 years and smaller rates for subsequent years.

- Furthermore, to mitigate abuse, the reference period for pensions will be lifetime earnings, with appropriate transition periods being put in place for existing participants. Indexation mechanisms have also been made more transparent. Instead of being linked to civil servants' wages on a discretionary basis, pensions will now be adjusted monthly on the basis of the previous month's inflation. At the same time, contributions, which had been capped at 1.8 times the statutory minimum wage, will now be capped at 3 times the minimum wage; this should result in a higher level of contributions and, over time, in a higher level of pensions as well.

[4] *IMF, Staff Country Report, 1998.*

[5] *The system is particularly vulnerable to abuse because the level of pensions is a function of earnings during the last few years before retirement rather than on lifetime earnings. This had led to widespread collusion between employers and employees, involving underreporting of wages in the early stages of the contribution period and a sharp increase in reported wages during the reference period, so as to boost the pension benefit.*

Pension Indicators, 1995-2000

	1995	1996	1997	1998	1999	2000
SKK 1/						
- Number of contributors (in m)	5645	5924	6165	6876	7120	7200
-- % growth	8.8	4.9	4.1	11.5	3.5	1.1
- Number of pensioners (in m)	2338	2540	2732	2931	3157	3352
-- % growth	7.5	8.6	7.6	7.3	7.7	6.2
- Contributors/pensioners	2.41	2.33	2.26	2.35	2.26	2.15
- Balance of SKK (% of GNP)	-1.1	-1.0	-1.3	-1.0	-1.3	-
Total of 3 pension funds						
- Number of contributors	10294	10538	10858	11856	12376	12495
-- % growth	5.2	2.4	3.0	9.2	4.4	1.0
- Number of pensioners	4029	4391	4803	5254	5619	5812
-- % growth	7.1	9.0	9.4	9.4	6.9	3.4
- Contributors/pensioners	2.6	2.4	2.3	2.3	2.2	2.1
Average annual pension						
- In millions of lira	70	140	284	480	803	-
- In US dollars	1528	1732	1873	1845	1916	-
-- % growth	14.7	13.4	8.2	-1.5	3.8	-
Balance in social security funds						
- In % of GNP	-2.1	-2.6	-2.7	-2.9	-3.3	-2.8

1/ SKK is the largest pension fund in Turkey
Source: Undersecretariat of the Treasury, State Planning Office, and IMF.

- The new legislation also calls for the creation of an unemployment insurance scheme, financed by a mandatory contribution set at 7% of the pensionable wage and to be paid by employers (3%), employees (2%) and the government (2%). The system is expected to become operational in June 2000. The existing scheme providing for generous lump-sum payments for redundancies, however, remains in place.

3.2 Additional Supporting Reforms

While overdue and ambitious, the government has also indicated that this year it intends to supplement the above measures with others, aimed at addressing some remaining structural weaknesses in Turkey's system of social protection. These include: the creation of supplementary individual pension schemes, administrative measures to increase compliance and coverage within the existing system, integration of the three pension funds under a single social security agency, and the introduction of universal health care coverage. Reforms in these areas are seen as essential to safeguard the long-term solvency of the present system and to buttress the long-term effects of the measures approved in 1999.

3.3 Fiscal Implications

The main effect of the measures introduced in 1999 is projected to be felt in the long run. Because of the various transition periods built in to "grandfather" existing participants and the associated inertia, the social security funds are projected to show only modest improvements in their financial position in the short to medium-term; a 0.4% of GNP reduction in the combined deficit of the three funds in 2000 is presently projected by the authorities. Indeed, the main effect of the measures is the containment of the deficit over the long-term. A careful assessment of the fiscal implications of social security reform is sensitive to the assumptions made as regards mortality rates, GDP growth, labor force participation rates and improvements to be made in coverage and compliance.

Given the uncertainties surrounding all of these indicators, the authorities will have to keep a close watch on the evolution of the financial position of the three funds and take corrective measures to ensure that the social security system does not become a source of fiscal imbalances and does not, as has been the case thus far, become a source of strong inflationary pressure. While welcome and courageous, the measures adopted by the authorities in September of 1999 were long overdue, although the beneficial effects will not be felt soon enough to make a material difference in their present efforts to bring inflation under control.

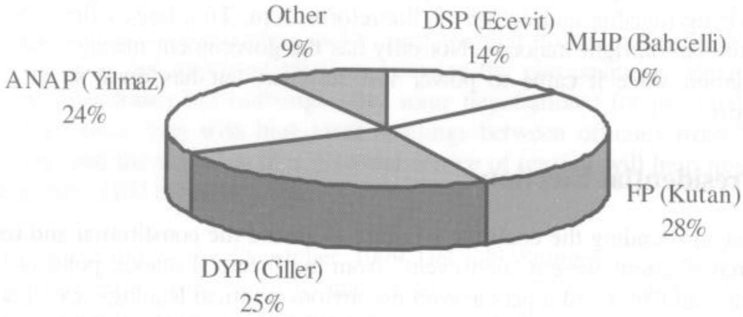
BOX 1. Turkey's Political Environment

Since December 1995, Turkey has witnessed four government changes – resulting in a weak and at times inconsistent political and policy environment. The collapse of the minority government in late 1998 led to a call for early parliamentary elections in April 1999. Although only time will tell, for now it seems that the last parliamentary elections were a watershed, ushering in an era of greater cooperation and relative political stability, thereby providing the government its first real opportunity in many years to undertake much needed reforms.

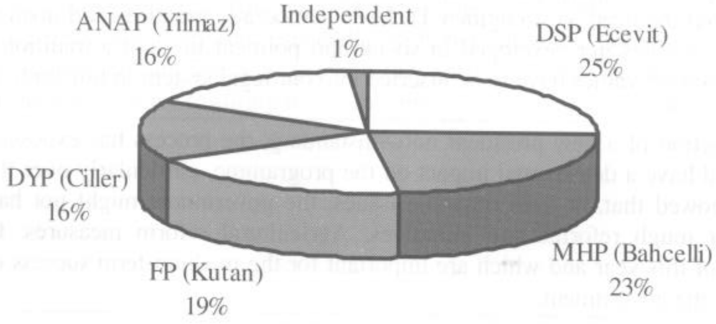
One of the main beneficiaries of the 1999 elections was Bulent Ecevit and his Democratic Left Party (DSP), which won 136 seats in the 550-seat parliament, up sharply from the 76 seats it had won in the previous elections. Mr Ecevit, who was the Deputy Prime Minister in the government which collapsed in 1995 – and the caretaker premier when PKK leader Abdullah Ocalan was arrested – benefited strongly from the nationalistic wave in Turkey following Ocalan's arrest. In his earlier capacity as the deputy premier, Ecevit had also been seen as willing to take steps to bring down inflation – which also may have helped influence public sentiments in his favour.

The other major beneficiary from the 1999 elections was Devlet Bahceli and his Nationalist Movement Party (MHP). The MHP managed to secure 129 seats – up dramatically from having no representation in the 1995 parliament (see charts below) – when they failed to reach the 10% threshold required to qualify for seats. The MHP benefited from a wave of disillusionment with two of the major parties from the previous parliament – namely Motherland Party (ANAP) and True Path Party (DYP), both of which suffered significant losses in the 1999 vote. These two traditional center-right parties saw their share in the new parliament decline by about 35% (a fall of some 93 deputies).

Distribution of seats in the Parliament, 1995



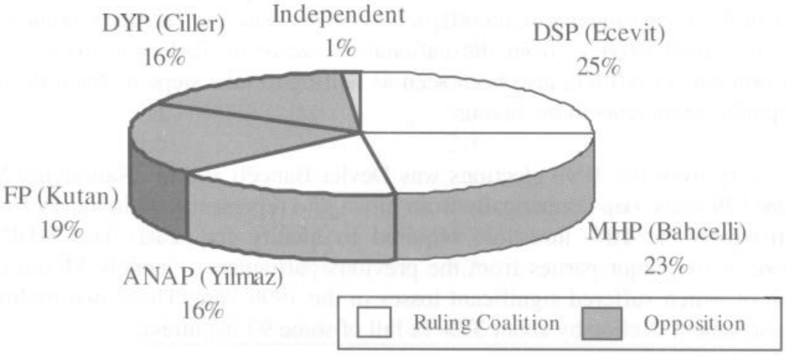
Distribution of seats in the Parliament, 1999



Total number of seats in Parliament: 550
Party leader's names in parenthesis

The current ruling coalition consists of the DSP, the MHP and the ANAP. The new administration controls about 350 seats in the 550-seat parliament, giving them about 64% of the total. This gives them a comfortable majority and, provided they remain united, should prove sufficient to ensure support for various legislative initiatives, as has already indeed happened in a number of important instances. The coalition appears to be stable – at least for now, especially given the current political dynamics. In our view, given the current distribution of forces, the three partners will be better off by working out their differences in an environment of cooperative consultation, than yielding to political infighting and, in the process, precipitating a premature election.

Ruling Coalition and the opposition



Despite being a relatively fragmented parliament, with parties from different ends of the political spectrum, the Turkish authorities have managed to hang together and deliver on the reform front. To a large extent, the coalition has behaved less like a coalition – and more like an outright majority. Not only has the government managed to pass some tough, politically sensitive reforms and legislation since it came to power last summer, but has done so at times with a swiftness and determination not seen hitherto.

Implications Of The Presidential Election

Despite the heightened drama surrounding the coalition's failure to amend the constitution and reelect President Demirel for a second term, the presidential elections were a "non-event" from the financial market point of view. Ahmet Necdet Sezer, the Chairman of the Constitutional Court and a person with no obvious political leanings, won the presidential election in the third round of voting, replacing the incumbent Suleyman Demirel as the President of Turkey. A victory for Sezer seemed highly likely after the leaders of the main parties endorsed his candidacy. In remarks made immediately following his election, Mr. Sezer emphasized the need to strengthen Turkey's democratic practices and institutions. In particular, he said: "An understanding of democracy has not developed in social and political life and a tradition of democracy has not been created. Democracy and democratic values have to be inserted into our legal system in line with the state of law."

The ultimately successful election of a new president notwithstanding, the process has exposed some potential weaknesses within the coalition that could have a detrimental impact on the programme, particularly over the medium-term. The failure to amend the constitution showed that, at least on some issues, the government might not have the necessary legislative backing for approving other tough reforms and initiatives. Agricultural reform measures, for instance, which will be discussed in the second half of this year and which are important for the medium-term success of the programme, are likely to pose serious headaches for the government.

Agricultural Reform And Domestic Politics

Agricultural reforms, which we expect will move to the center of the economic policy agenda during the second half of this year, could potentially disrupt the political environment. With over 40% of the labor force dependent on agriculture for their livelihood, agricultural reforms will clearly be politically sensitive. MHP has its roots in the Republican Peasant Nation Party (CKMP) that was founded in the aftermath of the 1960 military coup[1]. With 12 ministries under its control in the present government coalition (including the Ministry of Agriculture), MHP has considerable leverage in the formulation and implementation of agricultural policies. We are concerned that MHP, which has been trying to project a pro-reform image for itself but remains very much tied to its base of support in the agricultural sector, could oppose large-scale agricultural reforms. While these reforms are not a programme target for this year, there is a risk that inability to streamline the mechanisms of budget support to the agricultural sector could compromise the medium-term fiscal targets.

The Ocalan Affair

Resolution of the Ocalan affair is awaiting the decision of the European Court of Human Rights. Given the deep sensitivities and political ramifications, both domestic and external, we do not expect any decision over the near-term. In fact, in our view, it will likely take the better part of the next two years – during which time we expect the emotions exposed during the Ocalan arrest and trial to dampen. However, once the verdict is issued, it could result in heightened political tensions and could pose a threat to the stability of the coalition. Mr Ecevit has signaled his opposition to the death penalty (a view not shared by all members of the coalition) and is aware that the case, if mishandled, could damage relations with Europe and undermine Turkey's EU membership ambitions.

Improved External Relations

- Relations with Greece: The earthquakes in Turkey and Greece – which evoked mutually sympathetic reactions from the two governments – set the stage for improved relations between the two countries. Relations improved further when Greece supported Turkey's candidacy bid (although after some negotiations) for potential EU membership. Relations have been further solidified since then with high-level meetings between officials from both countries. In our view, improved bilateral relations and the diffusion of a potential source of tension will help improve investor sentiment and are likely to strengthen Turkey's EU candidacy bid.

- EU candidacy: The EU's decision at the December 1999 Helsinki Summit to invite Turkey to be a candidate for (potential) membership provided a strong boost to market sentiment. In its report the Commission welcomed recent positive developments, including Turkey's intention to continue its reform efforts toward complying with the Copenhagen criteria. Turkey, like other candidates, is also expected to benefit from the EU's pre-accession strategy (and funds), to stimulate and support its reforms. This will also include enhanced political dialogue, with particular emphasis on meeting the political criteria for accession, especially with regard to the issue of human rights. In our view the prospects of future EU membership are likely to prove a powerful incentive for the government to implement much needed economic and structural reforms, resulting in improvements in the credit outlook and investor perceptions.

[1] *The party was renamed as MHP in 1969. MHP was a fringe party till the last elections (gathering less than 9% of the votes in the 6 elections it has participated in), when it enjoyed remarkable success, garnering 18% of the votes.*

Fiscal Cost of Agricultural Support Policies (% of GNP)

	1995	1996	1997	1998	1999
Costs reflected in the budget	1.5	0.7	0.8	0.5	0.8
- Transfers to agricultural SEE's	0.4	0.0	0.1	0.1	0.1
- Input subsidies	0.7	0.4	0.3	0.3	0.2
- Compensation payments	0.0	0.0	0.0	0.0	0.1
- Budget allocation to SPSF for agricultural support 1/	0.4	0.3	0.3	0.2	0.4
Deficits of agricultural SEEs 2/	0.1	0.7	1.4	1.7	1.5
Credit subsidy through Ziraat	2.3	2.1	1.8	2.8	4.9
Total 3/	3.4	3.5	3.9	5.0	7.2

Source: IMF
1/ Support Price Stabilization Fund
2/ Before budgetary transfers
3/ Net of transfers to SEEs

4. Agriculture And Costs To The Budget

The agricultural sector is central to the Turkish economy; it accounts for some 15% of GDP and well over 40% of the civilian labor force. Government support to the sector takes the form of tariff protection; a complex system of price supports; subsidized loans; and the direct subsidization of agricultural inputs. According to the IMF, the annual direct cost to the budget of these schemes (other than tariff protection) has varied widely in recent years, from some 5% of GNP in 1995, to some 2 1/2 % of GNP in the recent past. While the annual transfer from consumers to producers associated with tariff protection is large (variously estimated at $3-4 bn), in this section we focus on those schemes that involve actual budgetary outlays.

4.1 Subsidized Lending

The agricultural sector receives support through subsidized loans for the purchase of inputs by farmers. By far the most important of these is the fertilizer subsidy, which is provided on an unlimited basis. Loans are provided through Ziraat Bank, the country's largest commercial bank. Rates on these loans are typically well below the rate of inflation and below the rate paid by the bank to its private sector depositors. Although there is no obligation for the government to cover the losses of Ziraat (as well as those of Halk Bank, which does subsidized lending to small and medium-sized enterprises) associated with the subsidized lending program, the government, de facto, picks up the tab in a number of ways. First, since the Treasury is the sole shareholder of the bank and subsidized lending undermines its profitability, large deficits have emerged which the government has "covered" through the accumulation of claims on the government, also knows as "unpaid duty losses."

These nearly doubled in 1999, bringing the stock to over 12% of GNP, or close to half of the outstanding stock of cash debt of the government. Indeed, these unpaid duty losses were the main factor behind the increase in the public sector borrowing requirement, from 15.8% of GNP in 1998 to 23.3% of GNP in 1999, according to the IMF.[1] To mitigate the bank's losses the government has mandated that all of its revenues, as well as those of other units within the public sector, be deposited with Ziraat, at an interest rate of 5%, implying an annual resource transfer of close to 1% of GNP. These quasi-fiscal operations may be decomposed into two main components: (i) direct credit subsidies on the total stock of subsidized credits; and (ii) interest payments on the stock of unpaid duty losses. The IMF estimates that these have risen from some 1.8% of GNP in 1997 to 4.9% of GNP in 1999.

4.2 Support Prices

In 1999, there were about 19 commodities for which a price support mechanism was in place, financed either directly from the budget or, indirectly, via so-called State Economic Enterprises (SEEs) and Agricultural Sales Cooperatives and their Unions (ASCUs)-- organizations that execute price support policies on behalf of the government. In recent years there has been a trend to shift the costs of price supports away from the central government budget to the SEEs and ASCUs. For instance, of the 19 commodities receiving in 1999 some form of price support, only 3 were officially supported (cereals, tobacco and sugar beet).

The effect of this has been to keep budgetary expenditures for agricultural support policies broadly stable in relation to GNP (0.4% in 1999) but to spread the (rapidly growing) total cost to other levels of the public sector. It is estimated that the total direct cost of price support policies was about

[1] *International Monetary Fund, Staff Country Report, No. 00/14, February 2000.*

1% of GNP in 1999. The costs of agricultural support through the SEEs are financed through a combination of tax arrears, arrears in contributions to the social security funds, occasional write-offs and, as with subsidized lending, the assumption of debt by the treasury.

The latter involves additional costs for debt service which are carried from one year to the next and which have to be added to the carrying costs of the unsold surplus production. The deficit of the agricultural SEEs in 1999 is estimated to have reached some 1.5% of GNP, more than twice the level of 1996. Quite aside from the rapidly growing cost, the net effect of agricultural support policies has been to turn the country into a net exporter of heavily supported commodities (such as cereals, sugar) while Turkey simultaneously imports other commodities (such as dairy products, and beef) in which it has a clear comparative advantage.[2] These policies have been characterized by the OECD and the World Bank as self-defeating, having contributed to substantially worsen productivity in the sector, widen regional income disparities and led to a loss of state control over their costs. Indeed, they have often played the role of a "social welfare program" for about one third of the Turkish population.

4.3 Reform Measures In The 2000 Program

The authorities intend to move away from the above inefficient and costly system of price support policies, to a system of well-targeted direct income transfers to farmers, based on acreage rather than type of commodity produced. It is expected that, over the long run, such a system would remove a major source of distortion in the economy, improve income distribution and enhance productivity in the sector. Equally importantly, it would gradually phase out the heavy costs of these programs to Turkish taxpayers--costs which, in recent years, have ballooned out of control.

The programme of agricultural reforms is being supported by the World Bank through policy based and project lending operations expected to amount to some $4bn over a three year period. It is envisaged that this year the focus of reforms will be on the implementation of a number of pilot projects intended to facilitate the identification and formulation of a simple and transparent system of income support. It is expected that by 2002 the whole sector will have moved to this new system, with the financing for it mainly coming from reductions in commodity-specific subsidies. The World Bank will also help finance the creation of a $250m fund to provide severance payments, redeployment, and training to affected farmers and it will assist the government in transforming the ASCUs into independent private cooperatives. The eventual privatization of the agricultural banks is also part of the programme's medium-term strategy.

While such a change remains the ultimate objective, the authorities have agreed to a range of measures intended to set in motion a gradual process of expenditure control. These measures include:

- A narrowing of the spread between support prices for cereals and the projected world market price, to "no more than 35% of the projected c.i.f. world price, and reduced further in 2001."[3] Given that the direct cost to the budget of this particular subsidy is not big the implied savings are relatively small. As regards sugar beet, the support price "will be increased in line with targeted inflation but the increase will be no less than 75% of the 12-month CPI up to August 2000," when the support price for 2001 is expected to be announced. TSFAS (Turkish Sugar Factories, the state economic enterprise that carries out the support activities in the sector on behalf of the government), will operate in a way that limits its losses to "a fixed amount set by the government in light of budgetary considerations."

- More importantly, the government has also indicated its intention to "gradually phase out the credit subsidy to farmers." In particular subsidies sustained by Ziraat and Halk Bank are expected to be halved, to 0.6% of GNP in 2000, a measure which is to be achieved by changes in the mechanism for the determination of subsidy lending rates.

We judge that the above measures, while perhaps falling short of the kinds of reforms that are necessary to put the sector back on a path of sustained reduction of claims on public resources, are nevertheless important first steps. While the overall goal of moving to a system of direct income transfers to poor farmers is sound, the present costly and inefficient system of price supports remains essentially unchanged. The government has made commitments to reduce the cost of support for cereals and sugar beet, but the implied fiscal savings are small and the program contains no commitments to reduce the list of commodities the prices of which are supported through a broad range of quasi-fiscal

[2] *In the case of wheat, the difference between the support price and the international price has widened from $16 per ton in 1996 to $80 per ton in 1999--reflecting minor changes to the support price against a massive drop in international prices and a large accumulation of stocks. Price supports have also created tensions in bilateral trade relations with certain trade partners as when, for instance, the Turkish authorities have not allowed the import of wheat because of the existence of large stocks and thus distorted patterns of trade.*

[3] *Letter of Intent of the Government of Turkey, December 9, 1999.*

operations through SEEs and ASCUs. The losses associated with the operations of these entities are large and have introduced a number of distortions in the management of public resources and in the financial system.

The subsidized lending program needs to be permanently phased out. Present attempts to limit the quasi-fiscal cost of interest rate subsidies by introducing complex (and seemingly ad-hoc) mechanisms for the determination of subsidy rates should be seen as purely temporary measure which will not alter in a fundamental way the extremely distortionary relationships which have emerged over time between the farm sector, the treasury and the institutions carrying out support activities on behalf of the government. Over the medium-term there is no alternative to increasing interest rates to commercial lending levels, to clean up/regularize Ziraat's claims on the treasury and to require it to pay market rates on its stock of public sector deposits. At a subsequent stage, Ziraat should be privatized and the government should get out altogether of the business of lending to agriculture.

5. The Banking System And Financial Intermediation

The banking system has suffered from the usual problems seen in other high inflation economies. Reflecting high inflationary expectations, interest rates have tended to be high too, and volatile. This has forced the private sector to endeavor to finance their activities out of profits, foreign currencies or a combination of the two. Depositors/savers, on the other hand, have preferred short-term instruments with high liquidity. The absence of long-term instruments has hampered the development of bank lending, both as regards maturity and level.

Bank intermediation is very low by international standards; at about 21% of GNP total banking system credit to the private sector is well below that in Chile (55%), the Czech Republic (56%), Malaysia (94%), and South Africa (63%). It is roughly comparable to levels in Colombia, Peru and Poland. It is less than one-third the OECD average. The level of dollarization is high, with about 41% of broad money in 1999 being made up of foreign exchange deposits by residents. For private banks, more than 60% of deposits are denominated in foreign exchange.

Operating in a high inflation environment has pushed banks to move away from traditional activities to arbitrage operations, mainly involving the day-to-day management and funding of holdings of government securities. Banks have actively sought foreign sources of funding, as they are able to earn large returns on their net open foreign exchange positions. While benefiting from the very high level of real interest rates on government securities, which have averaged well over 25% in the last three years, the net open positions have left the banks vulnerable to capital losses in the event of unanticipated falls in the exchange rate.

Conscious of these risks, the central bank has sought to reduce them, by pursuing a policy of real exchange rate targeting or, beginning this year, pre-announcing a path of nominal depreciation. High inflation has also contributed to the development of widespread bank branch networks, to gain access to zero-interest sight deposits. The last several years have also witnessed the development of an active repo market; investors use it as a close substitute for bank deposits and banks as a source of funding for purchases of government securities. According to the IMF, the recent "explosive growth of the repo market has worsened the maturity mismatch of banks and increased their off-balance sheet exposure."[4]

The Turkish banking system, consisting of some 75 banks, is highly concentrated. The five largest banks account for about 50% of total deposits (a somewhat lower figure for assets) and three of these are state banks. The liquidity and profitability of the state banks has tended to reflect the fact that they engage in substantial subsidized lending operations to particular sectors (see below), such as agriculture (Ziraat Bank, by far the largest of the state banks), housing (Emlak Bank) and small and medium-sized enterprises (Halk Bank).

These quasi-fiscal operations coexist with other activities such as deposit taking and loan origination in which they compete with the private banks. Some of the losses incurred by these banks in their directed lending operations are recognized by the treasury as obligations, also knows as "duty losses." The level of obligations actually recognized and the interest these will accrue in the future is the subject of contentious annual negotiations; not surprisingly, the asset structure of the state banks is dominated by the presence of Treasury receivables and government securities and the ultimate profitability of the state banks is largely a reflection of administrative decisions rather than market activities.

A recent IMF assessment of the Turkish banking system states that reporting standards "fall short in a number of areas."[5] Indeed, a serious weakness in Turkey's banking

[4] *The growth of the repo market has been encouraged by tax and regulatory provisions; repos are free from reserve and liquidity requirements. They are also exempt from a withholding tax on interest, which applies to bank deposits.*

[5] *In particular, the report refers to the fact that: "banks need not mark their securities portfolios to market;" and that, therefore, reported earnings can*

system is the relatively weak role played by the central bank in banking supervision, with the lead role being played by the Treasury.

5.1 Reforms Envisaged in the 2000 Program

This year's economic program envisages a number of measures intended to tackle some of the formerly mentioned distortions and weaknesses. For instance:

- A new supervisory authority--the Banking Regulation and Supervision Agency-- has been created to merge the functions being performed in this area by the Treasury and the central bank. The Banks Act, which created this new supervisory authority in June 1999, was subsequently amended to address some important remaining flaws, including giving the Agency a much greater degree of autonomy. (It remained, formally, under the jurisdiction of the Council of Ministers.) With its Board having been appointed at end-March, the BRSA is expected to be fully operational by end-August. From then on the politically sensitive issue of commercial bank licensing will no longer be a responsibility of the Council of Ministers but will revert to the BRSA.

- The Banks Act was also to be amended to "strengthen the prudential standards for bank lending to owners and to single related parties." This was seen as being particularly important since most of the largest private banks own smaller banks and are themselves owned by large industrial groups. Thus, the ratio of loans to large owners is projected to fall to 65% of capital by end-year and modifications to capital adequacy ratios and foreign exchange exposure limits are also envisaged by 1 July; indeed the relevant Council of Ministers decree to this effect has already been approved. Other steps are also expected to be taken in the course of 2000 to strengthen prudential regulations and the regulatory environment for the banking system; the aim is to rapidly bring the banking system to EU standards in the prudential area.

- The program foresees a gradual improvement in the financing of the duty losses of the state banks associated with their subsidized lending operations. There are two aspects to reforms in this area. First, the coverage and financing of *new* subsidies as part of the regular annual exercise of support to the agricultural sector. Second, the interest payments due on the outstanding stock of accumulated duty losses. The program envisaged a gradual removal of credit subsidies, by linking the interest paid on these to a market related rate; however, because of the larger than anticipated decline in nominal interest rates in the early part of the year, it is conceivable that no new duty losses will be accumulated in the course of 2000. The government will continue to serve the outstanding stock of duty losses by gradually linking the interest paid on these to a market-related rate.

While not part of this year's programme, the government has stated its intention to privatize the state banks. A phased strategy is envisaged involving, initially, making these banks legally independent from the SEEs. This would be followed by financial restructuring and cleaning up of the banks' balance sheets, to be followed in turn by privatization. Of these banks Ziraat is likely to pose the most difficult problems on account of its size and the many functions it has traditionally performed for the state, such as being its main paying agent.

The recent fall in interest rates should significantly boost bank profitability in 2000, as banks continue to receive large interest payments on high-yield securities issued in the course of 1999 but see their funding costs on a downward trend. As inflation continues to come down strong real credit growth should contribute to an expansion of banks' loan portfolios. These two factors, combined with on-going efforts on the part of the authorities to improve the regulatory environment, should provide banks a unique opportunity to streamline costs, restructure, and bring their operations more in line with industry standards in the EU. The programme has made a good start in addressing some of the thornier issues in Turkey's banking system; the authorities will need to persist in keeping bank restructuring at the center of the reform agenda.

be overstated; the "lack of inflation accounting obscures the measurement of banking sector profitability"; "the incomplete consolidation of the operations of foreign subsidiaries creates an opportunity for circumventing prudential regulations, notably on foreign exchange exposure"; and "the level of non-performing loans is probably understated as there are divergent approaches to provisioning."

Balance of payments
(In millions of dollars)

	1994	1995	1996*	1997*	1998*	1999*
Merchandise exports (FOB)	**18390**	**21975**	**32446**	**32647**	**31220**	**29326**
- Exports FOB in trade returns	18106	21636	23225	26261	26973	26588
- Shuttle trade	0	0	8842	5849	3689	2255
- Transit trade	284	339	379	537	558	483
Merchandise imports (FOB)	**-22606**	**-35187**	**-43028**	**-48005**	**-45440**	**-39773**
Trade balance	**-4216**	**-13212**	**-10582**	**-15358**	**-14220**	**-10447**
Other services and income (Credit)	**11691**	**16094**	**14628**	**21273**	**25802**	**18748**
- o/w: Travel	4321	4957	5650	7002	7177	5203
- Interest	890	1488	1577	1900	2481	2350
Other services and income (Debit)	**-7936**	**-9717**	**-10930**	**-13419**	**-15325**	**-14840**
- o/w: Travel	-866	-911	-1265	-1716	-1754	-1471
- Interest	-3923	-4303	-4200	-4588	-4823	-5450
Private unrequited transfers (net)	**2709**	**3425**	**3892**	**4552**	**5568**	**4813**
- Workers' remittances	2627	3327	3542	4197	5356	4529
- Other	82	98	350	355	212	284
Official unrequited transfers	**383**	**1071**	**555**	**314**	**159**	**362**
Current account 1/	**2631**	**-2339**	**-2437**	**-2638**	**1984**	**-1364**
Capital account	**-4194**	**4643**	**8763**	**8737**	**448**	**4671**
- Direct investment (Net)	559	772	612	554	573	138
- Portfolio investment (Net)	1158	237	570	1634	-6711	3429
- Other long-term capital	-784	-79	1636	4788	3985	345
-- o/w: Drawings	3349	4126	6048	9905	11505	11036
-- Repayment	-5448	-5667	-5685	-6095	-8174	-10560
- Short-term capital (net)	-5127	3713	5945	1761	2601	759
Net errors and omissions	**1769**	**2354**	**-1781**	**-2755**	**-1985**	**1899**
Overall balance	**206**	**4658**	**4545**	**3344**	**447**	**5206**
Change In reserves	**-206**	**-4658**	**-4545**	**-3344**	**-447**	**-5206**
- *IMF*	340	347	0	-28	-231	520
-*Reserve position in the Fund*	0	0	0	0	0	-112
- *Official reserves*	-546	-5005	-4545	-3316	-216	-5614

Source : SIS, Central Bank of Turkey.
1/ Including suitcase trade beginning in 1996.

Projected Privatization Receipts: 2000-2002

	2000	2001	2002
Privatization cash receipts	7.6	6.0	4.0
- (In $bn)			
of which:			
-- Privatization Administration	3.1		
-- Other entities	4.5		
-Privatization projects 1/			
-- GSM telephone licenses	2.5		
-- Sale of 20% share in Turk Telecom	0.8		
-- POAS: 51% stake	1.3		
-- Tupras:oil refinery	1.1		
-- Turkish Airlines	0.3		
-- Energy sector companies	0.5		
-- Other (residual)	1.1		
-Total	7.6		
Memorandum item:			
- Amount allocated for domestic debt reduction	6.3		

1/ Indicative figures only. Assumes that, in most cases, cash disbursements would be spread over a period of several years.

6. Privatization and Public Enterprise Reform

Public enterprises continue to play a central role in Turkey in virtually all sectors of the economy, including transport, telecommunications, electricity, banking, and mining, to name a few. Progress in this area is seen as central to the modernization of the Turkish economy. First, privatization revenues could begin to make an important contribution to budgetary revenues and this will help bring the budget deficit under control. Second, a strengthened privatisation program will lead to less state involvement in purely commercial/industrial activities and thus reduce the burden of subsidies on the budget.

Lastly, it will deepen the capital markets by encouraging wider ownership of shares. Since privatisation has come to be seen as a key component of policies aimed at improving resource allocation, Turkey will have to modernise the legal and institutional framework for privatisation, to bring it more in line with EU norms and those now prevailing in some of the more successful transition economies in the region. Adequate legal underpinnings and a framework for public accountability will be key elements of such reforms. Of particular concern to foreign investors potentially interested in participating in the privatization process has been the need to allow for the possibility of international arbitration in the event of disputes between the state and private entities--particularly important in the privatization of infrastructure projects, such as public utilities.

In August 1999, parliament approved amendments to the constitution that will allow international arbitration in concession contracts. Prior to this measure Turkey's Administrative Court had authority to review concession agreements between the state and a private entity. The Court had consistently rejected contracts that allowed for the possibility of international arbitration in the event of litigation, viewing such clauses in contracts as interference with Turkish sovereignty. The Court's stance was itself symptomatic of broad-based political opposition to the privatization process.

This, in turn, had undermined international interest in Turkish state assets and was undoubtedly one of the reasons why foreign direct investment had remained at such low levels. Total sales from privatization in the 10-year period to 1997 amounted to about $4.6 billion. Of this amount about $600 million was collected in 1997, equivalent to 0.3% of GNP, well below the 4% of GNP announced by the authorities in the context of the 1997 budget. FDI in 1998 was roughly equivalent in dollar terms to that in Lithuania, a country with a GNP 1/20th that of Turkey's.

The above notwithstanding, the attitude to privatization has gradually softened in recent years and the government has found ways, particularly beginning in 1998, to push the process forward in various ways. During the period 1998-99 revenues from privatization reached over $2 billion, reflecting the tender of a 51% holding in the state bank Etibank and a 12.3% holding in Isbank, and the sale of 2 GSM licenses (for a total of $1 billion). A large number of other smaller companies spread over several sectors were also sold during this period.

Turkey: Key Economic Forecasts

	1997	1998	1999	2000	2001
Inflation, % eop 1/	99.1	69.7	68.8	25.0	12.0
Real GNP growth 1/	8.2	3.8	-6.4	5.6	5.2
GNP, $bn	193.8	205.5	182.1	205.9	...
Current account, % of GNP	-1.4	1.0	-0.7	-1.8	-1.6
Trade balance, % of GNP	-7.9	-6.9	-5.7	-7.1	-7.2
Consolidated budget balance, % of GNP 1/	-7.6	-7.1	-12.1	-12.6	-6.0
Primary balance, % of GNP 1/	-2.1	0.5	-2.8	2.2	3.7
Net debt of the public sector, % of GNP 1/	42.9	44.5	58.0	57.9	56.6
External	22.5	20.4	19.4	...	...
Domestic	20.4	24.1	38.6	...	...
o/w: Cash debt of central government 2/	15.8	17.9	23.8	...	...
Treasury bill rate 3/	105.2	115.7	106.2	...	...

Source: IMF

1/ Program targets for 2000-01

2/ Roughly 20-22% of this was estimated to be owed to non-residents in 1999.

3/ Average across maturities ranging over 3-12 months, net of tax.

The authorities have set for themselves impressive privatization targets during the period 2000-2002, amounting to close to $18 billion. Ambitiously front-loaded, this programme envisages the sale of 20% of Turk Telecom to a strategic investor, the leasing of two additional GSM licenses, and the sale of a 30% stake in Turkish Airlines. The government will also offer the transfer of management rights for several electricity distribution and power plants, as well as the sale of of a minority interest in Tupras, the main oil refinery.

The government also has concluded the sale of a 51% stake in POAS, the petroleum distributor, for $1.2 bn. Other smaller enterprises under the control of the Privatization Agency in the petrochemicals, iron, textile, tourism and other sectors are also projected to be sold in 2000. If successfully implemented, the 2000 privatization programme would generate more revenues in one year than those collected during the previous decade. A summary of the government's privatization program is presented in the table below.

Actual programme implementation thus far in 2000 has been extremely good, with the number of deals concluded in the first 4 months of the year coming to well over half of the annual target, including the sale of a GSM license for $2.5 bn, nearly 4 times the minimum price originally set by the government. Since a full 83% of privatisation revenues are to be allocated to debt reduction, the success of the privatisation campaign has important implications for the ultimate achievement of the fiscal programme's targets. Beyond the revenue likely to be collected this year, perhaps the most important factor to emerge is the enormous change in attitudes toward sales of public sector assets which appears to have taken place in the last two years. More than most other elements in the programme, this is likely to have very favourable consequences for foreign investment inflows, transfer of technology, and the modernization of the Turkish economy.

7. Summary And Conclusions

At the end of 1999 the macroeconomic picture in Turkey was fairly complex. We identify some of the bright spots first and then go on to highlight some of the possible risks. On the bright side:

- The government had successfully negotiated an ambitious programme with the Fund, building upon a staff monitored program (SMP) negotiated in mid-1998. The programme was approved by the IMF board in late December 1999 and envisages a fairly drastic reduction in inflation, from the 69% level reached at year-end to 25% by the end of 2000. If achieved, this would imply the best inflation performance since the early 1970s. The program seeks to bring inflation down by tackling Turkey's perennial budget deficit, itself a function of the large burden of interest payments on government debt (some 13.3% of GNP in 1999, most of it domestic). This is to be done by dealing aggressively with some of the structural weaknesses that have contributed to put pressure on the public finances in recent years.

- The government has approved landmark legislation intended to redress serious deficiencies in Turkey's pension system, which had no minimum retirement age, had short contribution periods, and was characterised by generous indexation mechanisms and, predictably, was beginning to put huge strains on the budget. In 1999 the deficit of the pension funds amounted to over 3% of GNP and, in the absence of the measures approved, was projected to grow quickly in the years to come. While the short-term impact of the reforms is not expected to be large, it has put the social security system on a much better actuarial position.

- The government is also embarking on an ambitious privatisation campaign that is projected to generate in excess of $7.5 billion in cash receipts this year, much of it to be directed to the Treasury to reduce the public debt. The privatisation programme has made an impressive start and, on present trends, the government should be able to meet what was seen by many as an onerous target. A host of other revenue measures and a supportive incomes policy are all intended to shift the primary balance of the public sector from a deficit of some 2.8% of GNP in 1999 to a surplus of 2.2% of GNP in 2000, a fiscal adjustment equivalent to some 5% of GNP.

- The above programme has been made possible in part because the government enjoys a majority in parliament and there seems to be growing realisation across the political spectrum that Turkey's desire to join the EU is incompatible with macroeconomic instability and that, therefore, priority attention must be given to improving macroeconomic management. Last December the EU took an important step to bring Turkey closer in by giving it the status of a "candidate" for future membership. Furthermore, Turkey has had no problems accessing the international debt markets and is expected to easily place some $5-6 billion in 2000, partly a tribute to perceptions of the dynamism of its private sector.

- More difficult to quantify but equally important in our view is growing evidence of an emerging political consensus on the need for sustained structural reforms. This has been evident in a number of ways in the recent past. From the authorities' response to last summer's earthquake, when, in the middle of a national emergency, the government decided, nevertheless, to push forward with pension reform legislation, to a fundamentally different attitude to privatisation, freer of the biases of the past, when an undue concern with "national sovereignty" considerations had turned Turkey into an unattractive location for foreign investment. The macroeconomic climate is becoming more stable, Turkey seems to be headed in a path of convergence to the EU, the political classes seem to have recognized that there are political benefits to be had in sound macroeconomic management and this may, in the end, be the real story of 2000.

On the risks side:

- It is always tough to do major fiscal adjustment in a short span of time. Some gains were already supposed to have been made in the course of 1999 in both improving the budget position and reducing inflation. But, pre-election fiscal loosening in the first part of 1999 and, later on, the earthquake, contributed to the poor results shown in the table above. Not only was there a significant worsening of the fiscal balance (from 7.6% of GNP in 1998 to over 12% of GNP in 1999), but inflation got stuck around 70% and real interest rates, around 25%, reached some of the highest levels in the decade. While progress made in other areas (as per the bullets above) made the successful negotiation of the IMF programme possible, the government's overall fiscal performance does raise questions about their ability to deliver during 2000 and beyond, when additional adjustment will be called for, to stabilize the public debt to GNP ratio.

- Against this background, the inflation target looks onerous and the authorities have at times betrayed publicly their own doubts about its achievement. The cumulative growth of the WPI in the first four months of 2000 amounted to 16.3% (against a 20% year-end target), while for the CPI it was 14.5% (against a 25% year-end target.) Our own view is that the WPI target (which is the basis for setting the pace of depreciation of the lira) will be missed, perhaps by some 5-9 percentage points. The table below shows that in order for the target to be achieved, average monthly WPI inflation during the period May-December would have to be 0.4%, an unlikely event. The table presents an alternative, purely indicative, scenario for the evolution of WPI inflation, consistent with deceleration through the year but reflecting the poor inflation performance of the first two months. The outlook for the CPI is brighter and our alternative scenario shows a small overshoot with respect to the end-year target in the programme. A clear risk in both scenarios is the extent of inflation inertia in the economy, which is difficult to anticipate given Turkey's long history of chronic inflation. What seems certain is a sharp drop in measured inflation and inflation expectations and an associated permanent downward shift in the entire structure of interest rates.

- The privatisation programme is ambitious, particularly against the relatively slow progress made in this area through end-1999. To the extent that the government falls short of the envisaged targets, other adjustments to the fiscal program will have to be made. In this case the authorities may have to move more aggressively on the expenditure side, where the present programme contains very few meaningful, binding commitments. We question the advisability of a fiscal adjustment programme overwhelmingly centered on revenue measures, many of them of a one-off nature. In this respect, the government may have to develop a measure of political consensus to reduce defense expenditure and to fully incorporate its various components into the budget. Lack of transparency in this area is not consistent with sound macroeconomic management; it also will set Turkey apart from partners in the EU in terms of overall management of public resources.

- Finally, there are the usual political risks. The consensus seems to be that the coalition is fairly strong and that it will sustain a certain amount of stresses; for instance, as it did in connection with the recent presidential elections, or the likely fate of PKK leader Ocalan, whose case awaits a decision of the European Court of Human Rights. Other exogenous events (such as the Russia crisis in 1998, the earthquake in 1999) are obviously more difficult to predict; to the extent that the fiscal position is still weak, the budget--and hence the economy's recovery--will remain vulnerable to possible shocks.

So, the government has an enormous task ahead of itself, this year and over the medium-term. However, the initial market's response to the program has been extremely positive. Yields on government securities have come sharply down and the government seems to be quite serious about making 2000 a banner year for good economic policies. The IMF thinks that the economy will grow by over 5% this year and has done much to buttress the credibility of the government's programme by putting some of its own credibility behind the $4 billion three-year loan.

Our own sense is that if, as the year goes by, it becomes increasingly clear that the authorities are making sustained good faith efforts to fulfil the programme but are otherwise not on track to meet the tough inflation targets, the Fund will bend over backwards to accommodate, if need be, some changes to the programme and will go out of its way to reassure the markets that "the direction of change" is appropriate. Surely this is the appropriate response, provided the deceleration in inflation is seen to reflect sustained improvements in the public finances. Thus, assuming a broadly stable external environment, we expect considerable additional progress on the macroeconomic front in 2000 and thus the laying of a more solid foundation for noninflationary growth over the medium term.

Turkey: Inflation in 2000

	Actual inflation		Cumulative inflation	
	WPI	**CPI**	**WPI**	**CPI**
End-1995, y-o-y	65.6	78.9		
End-1996	84.9	79.8		
End-1997	91.0	99.1		
End-1998	54.3	69.7		
End-1999	62.9	68.8		
End-2000 target			20.0	25.0
Baseline scenario				
Monthly inflation, y-o-y				
January	5.8	4.9	5.8	4.9
February	4.1	3.7	10.1	8.8
March	3.1	2.9	13.6	11.9
April	2.4	2.3	16.3	14.5
May 1/	*0.4*	*1.1*	*16.8*	*15.8*
June	*0.4*	*1.1*	*17.2*	*17.0*
July	*0.4*	*1.1*	*17.7*	*18.3*
August	*0.4*	*1.1*	*18.1*	*19.6*
September	*0.4*	*1.1*	*18.6*	*21.0*
October	*0.4*	*1.1*	*19.1*	*22.3*
November	*0.4*	*1.1*	*19.5*	*23.6*
December	*0.4*	*1.1*	*20.0*	*25.0*
Alternative scenario				
Monthly inflation, y-o-y				
January	5.8	4.9	5.8	4.9
February	4.1	3.7	10.1	8.8
March	3.1	2.9	13.6	11.9
April	2.4	2.3	16.3	14.5
May 1/	*1.8*	*1.8*	*18.4*	*16.6*
June	*1.5*	*1.5*	*20.2*	*18.3*
July	*1.5*	*1.3*	*22.0*	*19.8*
August	*1.2*	*1.1*	*23.4*	*21.2*
September	*1.5*	*1.3*	*25.3*	*22.7*
October	*1.2*	*1.3*	*26.8*	*24.3*
November	*1.0*	*1.1*	*28.1*	*25.7*
December	*1.2*	*1.2*	*29.6*	*27.2*

1/ Actual inflation figures through April; forecasts through December.

Box 2. Turkish Debt Markets

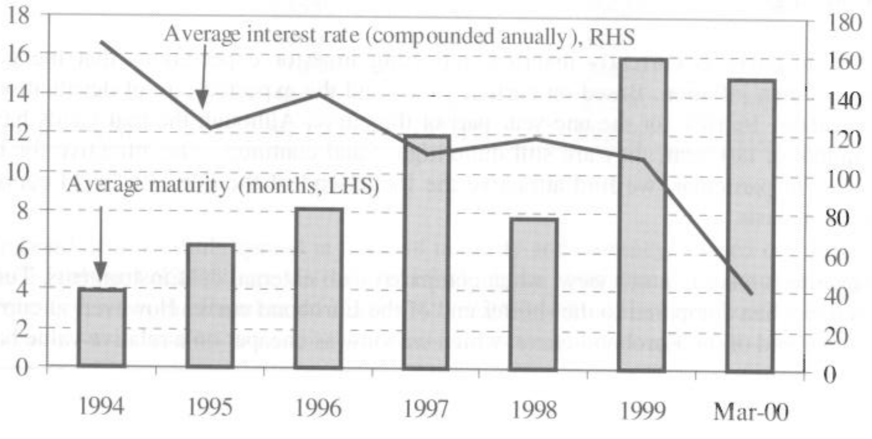
- As of March 2000, the total stock of outstanding domestic debt was TL 26,679 trillion or about 34% of GNP (see table 1). This entire amount is comprised of securitized debt, most of which are bonds. With growing confidence in the programme in general and the disinflationary process underway in particular, the authorities have managed to extend the maturity profile of the domestic debt. The average maturity has increased from about 3.9 months in 1994 to about 14.9 months as of March 2000 (see figure 1). This is also illustrated in the table below where we find a rapidly growing trend in the share of bonds in total securitized debt.

Table 1: Turkey - Total Domestic Debt
Billion TL

	1995	1996	1997	1998	1999	2000 (Mar)
Total Domestic Debt	1,361,008	3,148,986	6,283,425	11,612,886	22,920,145	26,679,145
- Securitized Debt	1,143,068	2,777,993	5,945,802	11,612,886	22,920,145	26,679,145
- Cash	733,254	1,923,829	4,642,884	9,511,785	20,197,511	23,561,249
-- *Bonds*	220,955	603,485	2,267,893	3,815,843	16,960,758	21,763,250
-- *Bills*	512,299	1,320,344	2,374,991	5,695,942	3,236,753	1,797,999
- Non Cash	409,814	854,164	1,302,918	2,101,101	2,722,634	3,117,896
-- *Bonds*	290,814	646,669	1,302,918	1,956,137	2,722,634	3,117,896
-- *Bills*	119,000	207,495	-	144,964	-	-
- Unsecuritized Debt	217,940	370,993	337,623	-	-	-
-- *By Central Bank Law*	25,940	40	-	-	-	-
-- *Central Bank Advances*	192,000	370,953	337,623	-	-	-
Total Domestic Debt (% of GNP)	17.3%	21.0%	21.4%	21.9%	29.3%	34.1%
GNP	7,854,887	14,978,067	29,393,262	53,012,781	78,242,496	-

Source: Lehman Brothers
1/ Calculated using 1999 GNP

Figure 1: Turkey - Average Maturity and Cost of Borrowing on Domestic Debt



- Since the earthquake last summer, when yields on domestic debt spiked sharply to 108%, yields have come down rather dramatically. Investor confidence in the authorities' programme was enhanced significantly with the announcement last December of a pre-announced exchange rate path. Combined with fiscal measures taken to tackle the large fiscal imbalances, this has helped enhance the credibility of the programme. Both these factors have played a key role in helping to bring down yields on domestic debt instruments.

- The government plans to roll over about 75% of the debt falling due in 2000[1]. They hope to finance the balance mainly through privatisation receipts and by accessing the international capital markets. Since yields on other Turkish debt instruments--particularly Eurobonds--have also come down relatively sharply, it makes sense for the government to switch out of domestic into external financing, as has been done since last summer.

- Turkey has about TL 29,800 trillion in domestic debt service in 2000[2]. Of this, about TL 16,400 trillion is interest, with the balance made up of principal repayments. Per the amortization schedules, significant amounts of debt fall due in May and September 2000; we would expect to see increased issuance during these periods.

Table 2: Domestic Debt Service, 2000
Billion TL

	Principal	Interest 2/	Total 1/
January	1,937,720	1,801,788	3,739,509
February	1,881,904	2,347,637	4,229,541
March	1,697,191	1,619,111	3,316,303
April	1,894,997	2,493,706	4,388,703
May	2,489,157	1,922,693	4,411,850
June	998,452	1,031,325	2,029,776
July	228,030	901,412	1,129,442
August	1,957,103	2,339,868	4,296,972
September	400,751	166,814	567,565
October	-	1,082,892	1,082,892
November	-	480,248	480,248
December	-	167,178	167,178
Total	**13,485,305**	**16,354,673**	**29,839,978**

Source: Lehman Brothers
1/ As of March 20, 2000
2/ Interest payments are presented net of taxes

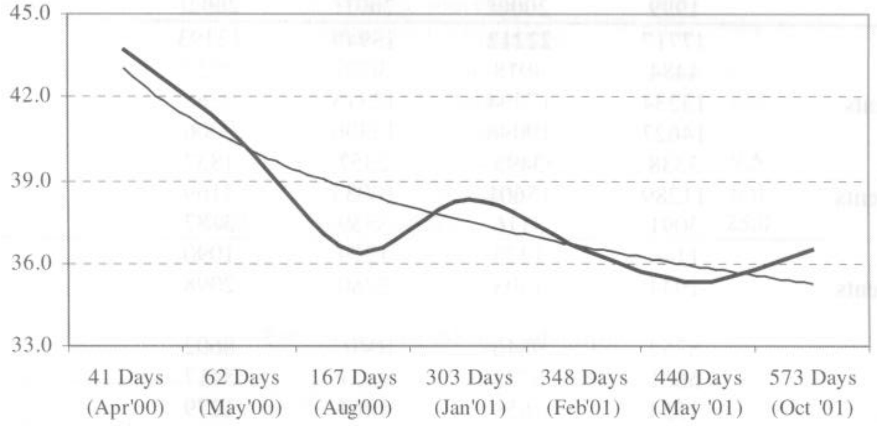
Box 2: Domestic Debt Strategy

- Turkey's domestic yield curve is currently inverted, reflecting investor expectations that the government would be successful in bringing down inflation. Based on current yields and the expected rate of devaluation of the Turkish lira, we get real yields of about 16-18% for the one-year part of the curve. Although the real yields have come down fairly sharply since the middle of last year, they are still quite high – and continue to be attractive for both local as well as international investors. In particular, we find attractive the longer-end of the domestic yield curve – which we see as cheap on a relative value basis.

- The relative value picture is mixed, in our view, when compared with external debt instruments. Turkish domestic bonds continue to be attractive when compared to the shorter end of the Eurobond curve. However, at current yields, we would perhaps favor the longer end of the Eurobond curve, which we view as cheaper on a relative value basis.

[1] *In an effort to reduce reliance on domestic borrowing, in January 2000 Turkish officials noted plans to refinance 75% of domestic debt due this year, making up for the difference through tax revenues, state-asset sales and Eurobond receipts. This would "help the government keep this year's debt at the same proportion of gross domestic product as last year," according to a senior treasury official.*
[2] *Based on debt outstanding as of March 2000.*

Figure 2: Turkey - Domestic Yield Curve
March 2000, Compounded Yields



External Debt Markets

- As of the beginning of April 2000, Turkey's total outstanding Eurobond debt stood at about US$17 bn. The total outstanding external debt (end of Q3, 1999) was equal to US$104 bn, of which about half is comprised of medium- to long-term public sector debt. While the overall public debt stock has remained broadly stable in dollar terms, private sector debt has more than doubled since the end of 1996.

Table 3: Turkey's Outstanding External Debt Profile
US$ mm

	1996	1997	1998	1999 1/
Total Outstanding	**84076**	**91262**	**103861**	**104380**
- Medium & Long-term	63559	68628	76625	74179
-- Public Sector	51600	50158	52191	49965
-- Private sector	11959	18470	24434	24214
- Short-term	20517	22634	27236	30201
Total External Debt (% of GNP)	**46.2%**	**47.4%**	**50.8%**	**57.3%**

1/ 1999 Q3
Source: Treasury, Republic of Turkey

- The stock of Eurobond debt is evenly spread in terms of maturity and currency.[3] Based on our estimates, Eurobond debt service for this year is about US$3 billion, virtually all of which are obligations of the public sector. More than a third of this fell due in February, when the Republic of Turkey 02/25/2000 (100 billion yen) bond matured.

[3] *The US$17 billion stock of Eurobond debt comprises of US$8.5 billion (Euro/DEM), US$5.4 billion (USD), US$2.8 billion (Yen) and US$0.2 billion (GBP).*

Table 4: Turkey's Projected External Debt Service
US$ mm

	1999	2000f	2001f	2002f
Total Payment	**17717**	**22212**	**15949**	**12193**
- Interest Payments	4484	4918	3636	2927
- Principal Repayments	13234	17294	12313	9266
- Loan	14627	19096	12390	9006
-- Interest Payments	3338	3495	2357	1837
-- Principal Repayments	11289	15601	10033	7169
- Bonds	3091	3116	3559	3187
-- Interest Payments	1146	1423	1279	1090
-- Principal Repayments	1944	1693	2280	2098
Of which:				
Public Sector	8752	9846	10407	8602
- Loan	5661	6733	6851	5417
-- Interest Payments	1554	1650	1487	1279
-- Principal Repayments	4107	5083	5364	4138
- Bonds	3091	3113	3556	3185
-- Interest Payments	1146	1420	1276	1087
-- Principal Repayments	1945	1693	2280	2098

Source: Treasury, Republic of Turkey

- Turkey's total external debt service for 2000 amounts to about US$22.2 billion, of which principal repayments amount to roughly US$17 billion. The principal repayments can be broken down into four components – official creditors (29%), commercial banks (18%), international bonds (14%) and other private creditors (39%). In addition to principal repayments, we expect the current account deficit in 2000 to be of the order of US$3.7 bn or 1.8% of GNP, up from a deficit of US$1.4 billion in 1999. As a result, we expect Turkey's total external financing needs to be about US$21 billion (see table 5). Provided the IMF programme remains broadly on track, we do not expect Turkey to have undue difficulties in financing this gap. Turkey should be able to receive some US$7.5 bn from official (mostly bilateral) sources. In terms of private capital inflows (mainly direct and portfolio) we expect Turkey to receive close to US$2 billion. With an improved economic outlook the direct investment component, in particular, should increase significantly from last year's low levels. Further, given the privatization pipeline for this year, the government should have no problems raising the envisaged US$7.6 bn contained in the programme. With better-than-expected privatization deals (POAS, Tupras and the third GSM license) in the first four months of this year, Turkey appears well on track to achieve the total privatization target. Additionally, Turkey will likely receive in the neighborhood of US$10 bn from commercial banks and other private creditors.[4] The financing gap after taking into account the above-mentioned sources will likely be covered by tapping the international capital markets; the authorities hope to access about US$6.0 bn in 2000. This is not unreasonable, given that they managed to raise close to US$5.0 billion last year (against a target of US$3.5 billion) and have already raised close to US$3.5 bn year-to-date.[5]

[4] *Institute of International Finance estimates.*

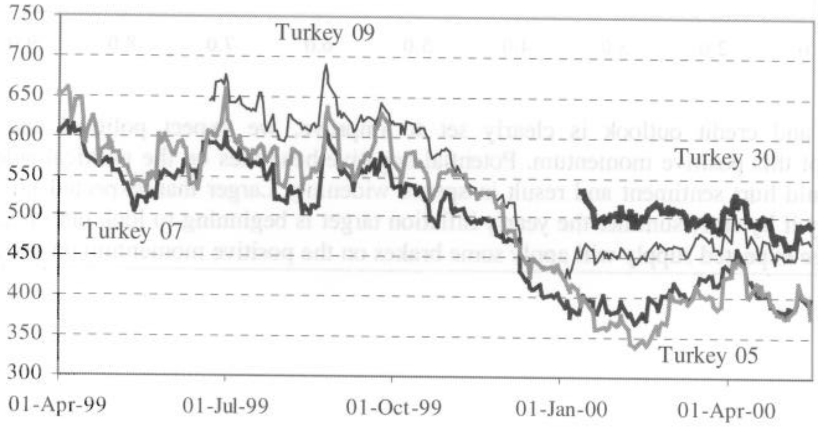
[5] *Turkey has so far secured US$ 3.5 billion this year through three issues; i.e. a 30-year global bond of US$ 1.5 billion, a 10-year Eurobond of one billion euros, a 3-year bond samurai bond of 35 billion yen and a 5-year Eurobond of 600 million euros.*

Table 5: Turkey's External Financing Equation for 2000
US$ billion

Financing Requirements		Financing Sources	
Principal Repayments	-17.3	Official Sector Financing	7.5
		Private Sector Inflows	17.5
Current Account Balance	-3.7	-Direct & Portfolio 1/	2.0
		-Commercial Banks &	
		-Other Private Creditors	9.5
		-Eurobond Financing	6.0
Total	**-21.0**	**Total Sources**	**25.0**

1/ Excluding privatization
Source: Lehman Brothers

Turkey Eurobond Spreads (bp)

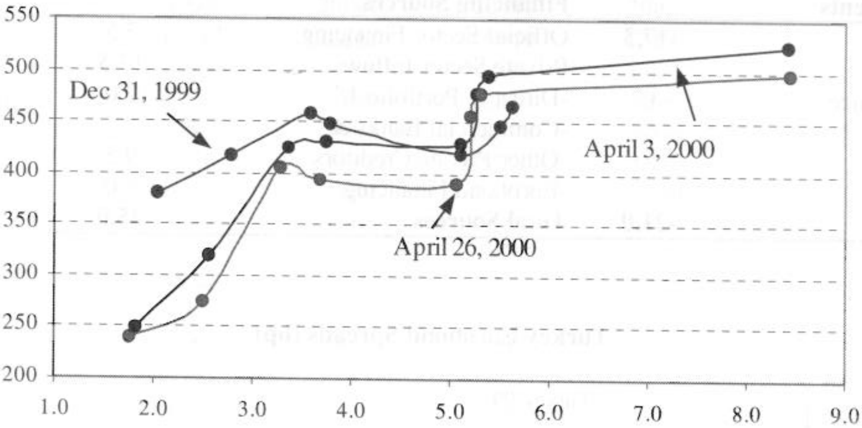


- Moving forward, we expect Turkish external debt instruments to perform very well – and we maintain our strategic overweight in Turkey. We have been overweight Turkey since the middle of 1999, when the government embarked on the present reform path. We further increased our overweight in December in anticipation of the EU candidacy announcement as well as the approval of the IMF programme – which proved to be the right call. Going into February, we reduced our exposure to Turkey to a tactical market weight. Although, we continued to like Turkey's fundamental credit outlook, our decision to reduce our exposure was based purely on market technical factors including investor profit taking on the back of strong spread performance. This again proved to be the right call – with Turkey underperforming the overall market on concerns around presidential politics. We increased our position to a strategic overweight once again for the month of March on the back of some spread widening – as well as in anticipation of positive news on the privatization front. In our view, the numbers through April (particularly on the fiscal front) show a clear improvement and provide early evidence of the potential for sustained fiscal adjustment. Finally, assuming Turkey continues to deliver on the reform and privatisation agendas –we expect the rating agencies to upgrade Turkey by as much as two notches – by the end of the second quarter. In our view, since this is not completely priced in, it will likely result in additional spread tightening.

External Debt Strategy

- We recommend the Republic of Turkey 09s and the 30s – which we view as cheap on a relative basis. We expect the yield curve, which is very steep currently to flatten out over the next few months. As fundamentals improve, we expect the entire curve to continue to tighten but the two-above mentioned bonds would likely outperform the rest of the Eurobond curve. Over the next few months, we expect positive headlines on the economic front combined with heightened expectations of a ratings upgrade to continue to reinforce the tightening bias.

Turkey Eurobond Yield Curves
(X axis duration, Y axis spreads)



- While the economic and credit outlook is clearly set to improve, we expect political and technical factors to counterbalance some of this positive momentum. Potential negative headlines on the political side, including delays in the reform process could hurt sentiment and result in spread widening. Larger than expected inflationary inertia could play a role, particularly if by early summer the yearly inflation target is beginning to look out of reach. On the technical side, the relatively large expected supply will apply some brakes on the positive momentum on spread compression.

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