

REPUBLIC OF TURKEY  
PRIME MINISTRY

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Ankara, July 7, 2006

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington DC 20431  
U.S.A.

Dear Mr. de Rato,

1. Economic performance under our program has been strong. In 2005, growth significantly exceeded expectations, while the inflation target was undershot for the fourth year in a row. The wider-than-projected current account deficit mainly reflected rising oil prices, and it was amply financed by record-high capital inflows, including sharply increased FDI. The overall fiscal deficit dropped to below 2½ percent of GNP and net public debt fell sharply.
2. In recent weeks, liquidity in global financial markets has tightened significantly, prompting turbulence in emerging market currencies and asset prices. Turkey has been among the most affected, reflecting our comparatively large current account deficit as well as adverse inflation outcomes in April and May. We prudently assume that the shift in global liquidity is sustained, rather than transitory, and are prepared to adapt our policies as needed. Already, we have reinforced our fiscal stance with measures to rein in government spending, while the central bank has acted to tighten monetary conditions substantially. We are determined to respond actively and flexibly to any future market turbulence, including by tightening policies further as needed to safeguard our program objectives.
3. As a result of sustained policy implementation, we met most program targets.
  - With regard to the *quantitative performance criteria*, the end-2005 and end-March targets for external debt and net international reserves were met, and while annual inflation remained within the inner consultation band at end-March, it exceeded the outer band at end-June. The end-2005 primary surplus realizations for the consolidated government sector and the consolidated government sector excluding state economic enterprises (SEEs) fell short of targets, mainly on account of weak performance in the social security institutions—which we have since taken steps to address—and one-off factors that worsened SEE performance. The deviation from the target excluding SEEs was very small, and, although expenditures during the first few months of 2006 were above budget, revenues have been strong.

- Key *fiscal reforms* envisaged under the program have been implemented. On April 13, Parliament approved social security legislation that unifies the three existing social security institutions. This was followed on April 19 by parliamentary approval of a law that (i) introduces parametric changes to pension formulas to make the system financially sustainable; and (ii) establishes universal health insurance. These laws were enacted on May 20 and June 16, respectively. We also completed the first phase of personal income tax (PIT) reform and passed into law the corporate income tax (CIT) reform (prior action). Furthermore, we (i) addressed social security contribution arrears and strengthened future collection capacity; (ii) created a tax policy unit at the Ministry of Finance that, once fully operational, will permit the Revenue Administration to focus entirely on tax collection; (iii) conducted a review of wage and employment conditions in the civil service; and (iv) established regulations required under the Public Financial Management and Control Law.
- Progress was also made in the area of *financial sector reforms*. We submitted legislation to Parliament that will launch a mortgage system in Turkey. We also hired financial advisors for the privatization of Halkbank and established a committee to assess the merits of further integrating financial sector supervision. Separately, the Savings Deposit Insurance Fund auctioned off all remaining non-related-party loans, with the exception of about US\$100 million of loans (accounting for 10 percent of total non-related-party loans), which were not purchased because the supporting documentation was incomplete.

4. In light of this performance, our unabated commitment to the objectives of our program, and our resolve to adhere to strong policies, as further elaborated in this Letter, we request the completion of the Third and Fourth Reviews under the Stand-By Arrangement. We also request waivers of applicability for the end-June performance criteria on the primary surplus of the consolidated government sector, the primary surplus of the consolidated government sector excluding SEEs, and the balance of the social security institutions, as the relevant data are not yet available and we expect these targets to be met. End-June inflation exceeded the upper program band, and the central bank will shortly send a letter to the government explaining the reasons for the deviation and the policy response. This letter will be forwarded to the Fund, in accordance with the inflation consultation clause. We also request waivers for the end-January and mid-February performance criteria on Parliamentary approval of the administrative and parametric social security laws, which were both passed with delay. Moreover, given that it would be impractical to assess the capacity-to-pay of millions of social security debtors, our recently-introduced installment payment facility allows clearing of existing arrears for small debtors according to simple rules. This requires a waiver for the nonobservance of the continuous performance criterion on amnesties. Finally, we request a waiver of nonobservance for the end-May performance criterion on submission to Parliament of the second stage of personal income tax reform. We are actively discussing alternatives with stakeholders and propose that the performance criterion be reset as an end-September performance criterion.

5. We are confident that the policies set out in the April 26, 2005 Memorandum of Economic and Financial Policy and supplementary Letters of Intent are adequate to achieve the objectives of our program, and we stand ready to take further measures that may become

appropriate for this purpose. We will continue to consult the Fund on the adoption of these measures and in advance of revisions to policies contained in this letter in accordance with the Fund's policies on such consultation.

### **Macroeconomic framework 2006**

6. Growth was stronger than expected in 2005, and this trend continued into early 2006, driven by continued robust private investment and consumption demand. With the recent tightening of policies and credit conditions, domestic demand is expected to slow in the second half of this year. Nevertheless, our program objective of 5 percent GNP growth for 2006 remains achievable. The pass-through from a weaker lira, however, coupled with pressure from high commodity prices, has rendered the inflation outlook considerably more challenging (see below).

7. The slowdown in domestic demand and the recent changes in the exchange rate are expected to stabilize the current account deficit this year and help reduce it in the medium term, despite adverse energy price developments. At the same time, the composition of foreign capital inflows is expected to improve further. Privatization receipts and foreign investments, especially in Turkey's banking sector, should further raise the current account's coverage by non-debt creating flows, in particular FDI. The floating exchange rate will continue to serve as an important safety valve. We will allow automatic stabilizers to work, continue to review current account developments during the year, and, if necessary, adjust our policies.

### **Monetary policy**

8. We moved to formal inflation targeting at the beginning of the year. As outlined in our December announcement, under the new framework, we set CPI inflation targets of 5 percent for this year (with a 2 percentage point uncertainty band) and targets of 4 percent for 2007–08. Under the program, progress is being monitored using a standard inflation consultation clause (Annex I).

9. Inflation moved sharply upward in April and May, driven by unexpectedly high unprocessed food prices, rising oil and gold prices, and sticky services prices. Together with the recent depreciation of the lira, this makes it likely that end-year inflation will exceed the 5 percent point target. In fact, annual inflation in June was 1½ percentage points above the 8½ percent upper limit of the inflation consultation band. To stabilize market expectations and safeguard our medium-term inflation targets, we have moved forcefully to tighten monetary conditions. Policy interest rates were increased by a cumulative 400 basis points at extraordinary sessions of the Monetary Policy Committee on June 7 and 25, and these moves were supported by open market operations to drain excess lira liquidity from the system. We stand ready to tighten monetary policy further as necessary to ensure that inflation converges back to our medium-term target path. To this end, we will use all instruments at our disposal, and indeed plan to develop additional instruments that will enhance the effectiveness of our sterilization operations.

10. Building international reserves for prudential reasons is an important objective of the central bank. Although we recently paused the daily reserve purchase auctions temporarily,

we expect to reinstate these when market conditions allow. We also retain the option of using discretionary intervention to prevent excessive exchange rate volatility.

### **Fiscal policy**

11. Fiscal discipline remains the cornerstone of our program, both for the purposes of reducing further the public debt burden and for reining in the current account deficit. The end-2005 targets were missed mainly on account of weakness in the social security system and state enterprise sector. The former we are addressing with measures to control spending and boost revenue collection, while the latter was caused mostly by one-off factors, including larger-than-expected grain purchases by the Soil Products Office (TMO). In the first five months of 2006, the central government primary surplus was higher than programmed, but with spending well ahead of plans, particularly on health and investment, most of the substantial revenue overperformance could not be saved. Although the spending overruns partly reflected spending brought-forward from later in the year, they were also driven by carryovers from 2005. As prior action for the completion of the reviews, we have adjusted our spending plans to bring back expenditures in line with the program. Specifically, we have:

- Taken further measures to bring health spending under control, including by (i) reducing the reimbursable margin on top of the cheapest generic drug in a bioequivalence group from 30 to 22 percent; (ii) merging across institutions and further rationalizing the positive list for pharmaceuticals; (iii) improving medical audit of pharmaceuticals to reduce error and fraud in prescriptions; (iv) signing a global budget protocol with the Ministry of Health, consistent with achieving the programmed health spending envelope and underpinned by payment-per-case system for Ministry of Health hospitals; and (v) introducing the payment-per-case system also for private and university hospitals (with tariffs in line with the new ones in force for Ministry of Health hospitals, except for outpatient care provided by university hospitals, for which premia are capped at 50 percent). These measures are expected to achieve YTL 2.1 billion in savings.
- Blocked YTL 1.3 billion in budget appropriations and issued an instruction to the TMO to ensure that its operations are consistent with budget allocations and programmed financing.

12. In light of Turkey's current account deficit and the less accommodating external financing situation, we have strengthened our commitment to lock in revenue overperformance so as to allow automatic stabilizers to work unimpeded. This will be achieved by introducing a ceiling on expenditures of the central government, excluding SSI transfers, but including expenditures of the SSIs (performance criterion, Annex F). If corporate income tax collection falls short of its expected post-reform levels, we have also identified offsetting expenditure measures that will be put in place by end-August. We expect that this combination of policies would enable achieving a primary surplus above the 6.5 percent of GNP target for the year as a whole. This will result in a tightening of the fiscal stance during the second half of 2006, which will help support the central bank's disinflation efforts.

13. Our efforts to improve fiscal transparency continue. As set out in the Public Financial Management and Control Law, we expanded the scope of our 2006 budget from the “consolidated budget” to the “central government budget” in accordance with international standards (We request that the fiscal performance criteria under the program be reset to be consistent with this new concept, Annex F). The new concept includes the revenues and expenditures of some regulatory, supervisory, and other institutions that were previously reflected only in terms of budgetary transfers received. We are working on presenting previous years’ fiscal figures in the new format for comparability purposes.

### **Structural fiscal reforms**

14. Tax reform is of key importance to the government. Its overarching objectives are to simplify the tax structure, broaden the tax base, and strengthen enforcement to reduce fraud and evasion. In this context, our plans in these areas are as follows:

- Following the completion of a first stage of the *personal income tax* (PIT) reform, which streamlined the tax structure, we plan to prepare a draft of a second stage of reform by mid-July, and submit this to Parliament by end-September (structural performance criterion). The reform will aim to broaden the base of the tax, including by: (i) lengthening the holding periods on real estate capital gains; (ii) curtailing the exemptions for professional income earners; and (iii) introducing anti-avoidance provisions. The reform will also make the tax simpler to administer and more progressive, including by reforming the existing system of consumption credits. The changes will be designed to enhance the overall revenue yield. Parliamentary approval of the law is expected by end-December (structural performance criterion).
- The *corporate income tax* (CIT) reform law was enacted on June 21. Effective for the fiscal year 2006, the reform reduces the headline tax rate from 30 to 20 percent, while maintaining a simple single-rate structure. At the same time, the reform strengthens anti-avoidance provisions, by tightening transfer pricing and thin capitalization rules and introducing a controlled foreign company regime. The scheme of investment tax allowances had been approved by Parliament earlier.

15. To support the overall objective of broadening tax bases and reducing distortions, we will refrain from introducing new ad-hoc incentives and sectoral tax cuts. The recent decision to lower the VAT rate on textiles was driven by our desire to provide some immediate relief for a sector under particular stress. Going forward we will avoid introducing any further rate reductions or any exemptions that undermine the structure of the VAT. To preserve the base of the income tax, we expect that mortgage interest deductibility will not be introduced.

16. We will reinforce our efforts to strengthen tax administration. To this end, we will take the necessary steps to (i) complete the functional restructuring of the Revenue Administration (RA) by end-July (an end-April 2006 structural benchmark) and (ii) make the newly established tax policy unit at the Ministry of Finance fully operational by end-July—including by assigning sufficient technical staff to undertake daily responsibility for tax analysis.

17. As regards our detailed plans for the RA, we have already established a full-time Reform Project team to oversee its organizational transformation. Going forward, our plans in this area will focus on: (i) unifying all enforcement activities (audit and collection of arrears) under one Vice Presidency, excluding those activities carried out within the large taxpayer office; (ii) realigning responsibilities to separate operational and support activities; and (iii) increasing the grade levels of vice presidents. We also plan to have a fully-operational large taxpayer unit by end-2006 (structural benchmark). To this end, we have (i) established a full-time project team, as a sub-group of the Reform Project team itself; (ii) developed detailed milestones and target dates for the units' organizational structure; and (iii) obtained approval of legislation establishing one additional Vice President position responsible for the large taxpayer unit. Finally, we are committed to tackle in a comprehensive way the significant revenue losses associated with fraudulent VAT refunds. To this end, we will step up tax audits of firms receiving VAT refunds and review the appropriateness of the current VAT rebate system, drawing on IMF technical assistance.

18. Social security reform is of critical importance to help rein in social security deficits and keep fiscal policy on a sustainable path.

- To ensure the administrative infrastructure is in place to implement the new social insurance parameters in a timely manner, we have developed milestones for the merger of the three social security institutions. Key steps include: (i) preparing necessary regulations; (ii) designing premium collection processes for the new institution; (iii) specifying the entitlement system for social insurance; and (iv) preparing the IT platform and testing its application.
- We will accelerate progress on other reforms to make health care more cost efficient, and to ensure that the social security deficit does not exceed 4.5 percent of GNP, including by introducing family medicine and a referral system, and ensuring that a contribution-free provision of health care services will be restricted to those who have no financial means to contribute. All these steps will be taken before introduction of universal health care at the start of 2007.
- To bolster social security revenues, we will closely monitor the implementation of the social security arrears restructuring law and the related measures to strengthen the premium collection capacity of the new social security institution. In this regard, we will outsource collection of premium arrears on a commission basis to contracted lawyers starting no later than end-September. We are also considering modalities for requiring employers to pay employee salaries over a reasonable threshold through the banking system and expect to make a decision on this by end-September.

## **Financial sector reforms**

19. We have invited the IMF and the World Bank to jointly carry out a Financial Sector Assessment Program (FSAP) for Turkey. The FSAP findings are expected to provide a useful guide for reform measures going forward.

20. The BRSA continues to bring its supervision closer to best international practice. To this end, it has implemented the organizational changes envisaged in the banking law, including the merger of onsite and offsite supervision. The BRSA has also adopted the other remaining measures set out in its October action plan, including new audit teams and further improvements in transparency and accountability. To come into line with Basle Core Principles, the BRSA will complete the drafting of supporting regulations for the banking law by end-August 2006 (the associated structural benchmark is proposed to be brought forward from end-September).

21. The consolidation of supervisory activities is also proceeding well, with the BRSA recently acquiring supervisory responsibility of non-bank financial institutions. For the next phase, we have established a committee to assess the merits of further integrating financial sector supervision, with work expected to be completed before end-2006.

22. To preserve financial stability in the face of rapid credit growth and higher financial market volatility, the BRSA has intensified its examinations and monitoring of banks, and is considering options to tighten prudential regulations. The BRSA has made public a report on banks' foreign currency positions, including off-balance sheet transactions, trends in the derivative market and banks' on- and off-shore lending in foreign currency. It is the BRSA's intention to publish such reports on a regular basis.

23. The mortgage law is an important step to further deepen financial intermediation in Turkey. To guide its successful implementation and give sufficient time to strengthen administrative systems and loan approval procedures, the following steps are enshrined in the law: (i) for the first six months following its enactment, only banks will be allowed to lend under the new law; and (ii) lending will be restricted to purchases of dwellings. Consistent with BRSA's responsibility in implementing consolidated supervision, the law will give the BRSA sole supervisory responsibility for mortgage lending by all institutions it supervises. The Capital Markets Board will be in charge of supervising Housing Finance Companies and Mortgage Finance Companies owned by non-financial companies. Supporting regulations on mortgage lending will be issued shortly after the law's passage. These regulations will set tight norms for real estate appraisal and prudent limits on loan amounts in relation to collateral value.

24. We are moving ahead with our preparations for the privatization of state banks. We recently hired financial advisors for Halkbank, and their recommendations on how to proceed with the bank's privatization have been received on June 27 (prior action). Based on this recommendation, the government will announce a detailed privatization strategy and timetable by end-July (an end-June 2006 structural benchmark), including a timetable to phase out state banks' privileges over public agencies' deposits (an end-March 2006 structural benchmark). We plan to prepare a strategy for Ziraat drawing on the experience from Halkbank.

25. The SDIF made good progress in asset resolution and its focus continues to shift towards its role as a deposit insurance agency. By end-2006, the SDIF will have developed a strategy for its operational restructuring. By end-2007, the SDIF will have disposed of all its holdings of shares in companies and other assets, including the non-related-party loans that were not sold yet. At that point, the Treasury will resolve its receivables arising from earlier bank restructurings.

### **Investment Climate**

26. Our efforts to improve the investment climate and to expand foreign direct investment are paying off. FDI reached US\$9.7 billion in 2005--an amount several times higher than historical averages—driven by significant mergers and acquisition activity, successful implementation of our privatization program, and improvements in the investment environment. To provide easy access to information to potential investors, we launched a dedicated investment portal InvestinTurkey-[www.investinturkey.gov.tr](http://www.investinturkey.gov.tr). Underscoring our commitment to further improve the investment environment, and building on the recommendations of the Investment Advisory Council, we have submitted legislation for a new Turkish Commercial Code that will strengthen corporate governance, and we intend to press forward with initiatives to further streamline registration and licensing requirements, and remove other obstacles to investment.

27. 2005 was a very successful year regarding our privatization program, with US\$8.2 billion in privatization revenues generated. The privatizations of Türk Telekom (telecommunications), TÜPRAŞ (refineries) and Erdemir (steel) have been concluded, and the remaining state-owned companies under the portfolio of the Privatization Administration will be disposed of in the coming period. In this regard, we have recently passed legislation that will pave the way for the privatization of electricity distribution companies, which we expect to commence later this year.

Very truly yours,

/s/

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Ali Babacan  
Minister of State for Economic Affairs

/s/

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Durmuş Yılmaz  
Governor of the Central Bank of Turkey

Attachments



## ANNEX B: Turkey: Structural Conditionality 2006 1/

Action	PC/SB
<b>Prior Actions</b>	
Adopt fiscal measures to bring back expenditures in line with the program (¶11)	Five days before Board meeting
Parliamentary approval of corporate income tax legislation (¶14)	Five days before Board meeting
Financial advisors to finalize recommendations on how to proceed with the privatization of Halkbank (¶24)	Five days before Board meeting
<b>Fiscal Measures</b>	
1. No new amnesties of arrears on public sector receivables as defined in Annex F (¶19, LOI April 26, 2005)	Continuous PC
2. At most, 10 percent of those leaving through attrition in each state enterprise will be replaced, with limited exceptions for specialist positions and overperforming enterprises with approval by the Treasury (¶17 LOI April 26, 2005)	Continuous SB
3. Maintain excise taxes and SEE prices in line with 2006 program assumptions (¶11 LOI April 26, 2005)	Continuous SB
4. Complete functional restructuring of Revenue Administration, including reorganization of local tax offices (¶16)	This end-April 2006 SB is expected to be completed by end-July 2006
5. Establish tax policy unit at the Ministry of Finance (¶16)	SB for end-December 2005. With the establishing law passed in January 2006, the unit is expected to be made fully functional by end-July 2006
6. Submission to Parliament of second stage of personal income tax reform (¶14)	PC. End-September 2006
7. Establish a large-taxpayers unit within the Revenue Administration (¶17)	SB. End-December 2006
8. Parliamentary approval of second stage of personal income tax reform (¶14)	PC. End-December 2006
<b>Financial Sector Measures</b>	
9. Adopt a timetable for the phasing out of special privileges and obligations of the state banks (¶24)	This end-March 2006 SB is expected to be met by end-July 2006
10. Announcement of detailed state bank privatization strategies and timetables (¶24)	This end-June 2006 SB is expected to be met by end-July 2006
11. Completion of implementing regulations for the Banking Law (¶20)	SB. End-August 2006

1/ PC=structural performance criterion, SB=structural benchmark. ¶s refer to the July 6, 2006 Supplementary Letter of Intent.

Table. Turkey: Proposed Schedule of Purchases, 2005-08

	SDR millions	Percent of quota	Test date	Earliest possible purchase date
<b>Approval</b>	555,2	57,6		
<b>2005</b>				
1st & 2nd Reviews	1.110,3	115,2	30-Sep-05	
<b>2006</b>				
3rd Review	624,6	64,8	31-Dec-05	1-Mar-06
4th Review	624,6	64,8	31-Mar-06	1-Jun-06
5th Review	624,6	64,8	30-Jun-06	1-Sep-06
6th Review	624,6	64,8	30-Sep-06	1-Dec-06
<b>2007</b>				
7th Review	624,6	64,8	31-Dec-06	1-Mar-07
8th Review	624,6	64,8	30-Apr-07	1-Jul-07
9th Review	624,6	64,8	30-Aug-07	1-Dec-07
<b>2008</b>				
10th Review	624,6	64,8	31-Dec-07	1-Mar-08
<b>Total</b>	<b>6.662,04</b>	<b>691,1</b>		

## ANNEX D: MONETARY TARGETS

Table 1. Turkey: Performance Criteria and Indicative Targets for Base Money of the Central Bank of Turkey 1/

(In billions of YTL)

	Ceilings	Actual
Outstanding base money as of September 30, 2005		27.7 2/
December 31, 2005 (performance criterion)	29.2	28.8

1/ These ceilings are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

2/ Base money outturn at September 30, 2005.

1. This Annex sets out performance criteria for base money, and indicative targets for net domestic assets of the Central Bank of Turkey (CBT) and Treasury combined. These remain applicable until December 31, 2005, after which monetary policy will be monitored through consultation bands (see below).
2. Base money is defined as currency issued by the CBT, plus the banking sector's deposits in Turkish lira with the CBT. The net domestic assets (NDA) of the CBT are defined as base money less net foreign assets of the CBT. The net domestic assets of the CBT and Treasury combined are defined as net domestic assets of the CBT plus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.
3. Net foreign assets of the CBT are defined as the sum of the net international reserves of the CBT (as defined in Annex E), medium- and long-term foreign exchange credits (net), and other net foreign assets (including deposits under the Dresdner scheme of original maturity of two years or longer and the holdings in accounts of the Turkish Defense Fund, but excluding CBT's net lending to domestic banks in foreign exchange). As of September 30, 2005, net foreign assets of the CBT amounted to US\$17.5 billion, net domestic assets of the CBT YTL 24.6 billion, and base money YTL 27.7 billion.
4. Net domestic assets of the Treasury are equal to Treasury liabilities to the International Monetary Fund and Treasury foreign exchange denominated borrowing with an original maturity of less than one year. As of September 30, 2005, these amounted to US\$15.4 billion, or YTL 23.0 billion (evaluated at program exchange rates).
5. All assets and liabilities denominated in foreign currencies will be converted into Turkish lira at program exchange rates (Annex J).
6. NDA ceilings will be adjusted for any change in the definition of the aggregate to which the reserve requirement applies according to the following formula:

$$\Delta NDA = R * \Delta B,$$

where: R denotes the 6 percent reserve requirement and  $\Delta B$  denotes the change in base generated by a change in the definition of the reserve aggregate, or due to any change in the averaging period. Base money ceilings will also be adjusted to reflect these changes.

7. NDA ceilings will be adjusted for any change in the reserve requirement coefficient according to the following formula:

$$\Delta NDA = B * \Delta R$$

where: B is the level of the base to which the reserve requirement applies on the test date and  $\Delta R$  is the change in the reserve requirement coefficient and the liquidity requirement coefficient. Base money ceilings will also be adjusted to reflect these changes.

8. The NDA and base money ceilings will be adjusted downward for any waiver of reserve requirements for any additional bank intervened by the BRSA. The adjustment will be equal to the existing reserve requirement coefficient times the amount of liabilities at these banks subject to reserve requirements.

Table 2. Turkey: Indicative Targets on the Net Domestic Assets  
of the Central Bank of Turkey and Treasury Combined 1/

(In billions of YTL)

	Ceilings	Actual
Outstanding NDA as of September 30, 2005:		23.7
December 31, 2005	25.5	12.6

1/ These targets are based on the average of the stocks prevailing during the five working days including and immediately preceding each of these dates.

### Consultation mechanism on the 12-month rate of inflation

The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the State Institute of Statistics), are specified as follows:

	March 2006	June 2006	September 2006	December 2006
Outer band (upper limit)	9.4	8.5	7.8	7.0
Inner band (upper limit)	8.4	7.5	6.8	6.0
<i>Central point</i>	7.4	6.5	5.8	5.0
Inner band (lower limit)	6.4	5.5	4.8	4.0
Outer band (lower limit)	5.4	4.5	3.8	3.0

Inflation prospects will be an important part of each review under the arrangement. In line with our accountability principles, we are committed to report to the public the reasons for any breach of the outer bands, and our policy response. In this vein, should the observed year-on-year rate of CPI inflation fall outside the outer bands specified above, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the CBT will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

## ANNEX E: TARGETS FOR NET INTERNATIONAL RESERVES

Table 1. Turkey: Performance Criteria and Indicative Floors on the Level of  
Net International Reserves

(In billions of U.S. dollars)

	Floor on level of NIR	Floor Adjusted for Privatization Outcome	Actual	Memo item: NIR of the CBT
Outstanding stock as of September 30, 2005:			13.2	28.6
December 31, 2005 (performance criterion)	14.0	15.9	22.4	37.5
March 31, 2006 (performance criterion)	17.2	19.7	32.4	45.7
June 30, 2006 (performance criterion)	19.9	24.3	30.7	...
September 30, 2006 (performance criterion)	20.3			...
December 31, 2006 (performance criterion)	22.6			

1. For program purposes, net international reserves is defined as net international reserves of the CBT minus (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year.
2. Net international reserves of the CBT comprise its gross foreign assets excluding encumbered reserves less its gross international reserve liabilities plus the net forward position of the central bank, denominated in U.S. dollars. Encumbered reserves are reserves that are not readily available.
3. For the purpose of the program, gross foreign assets are all short-term foreign (convertible) currency denominated claims on nonresidents, monetary gold valued at the September 30, 2004 average London fixing market price of US\$414 per troy ounce, foreign bank notes, balances in correspondent accounts, and any reserve position in the IMF. At present encumbered reserves consist of foreign asset holdings in accounts of the Turkish Defense Fund (amounting to US\$0.31 billion on March 31, 2006). Reserve assets as of March 31, 2006 amounted to US\$60.33 billion (evaluated at program exchange rates).
4. Gross international reserve liabilities include all foreign currency-denominated liabilities (or TL/YTL-denominated liabilities indexed to any exchange rate) to residents and non-residents with an original maturity of up to and including one year (including reserves against foreign currency deposits of the banking sector), claims from central bank letters of credit, overdraft obligations of the central bank, and central bank liabilities arising from balance of payments support borrowing irrespective of their maturity. Government foreign exchange deposits with the CBT are not treated as an international reserve liability. On March 31, 2006 reserve liabilities thus defined amounted to US\$14.66 billion (evaluated at program exchange rates).

5. The net forward position is defined as the difference between the face value of foreign currency-denominated or indexed central bank off-balance sheet (forwards, swaps, options on foreign currency, and any future contracts) claims on nonresidents and foreign currency obligations to both residents and nonresidents. As of March 31, 2006 these amounts were zero.

6. As of March 31, 2006 the sum of: (i) Treasury liabilities to the International Monetary Fund and (ii) Treasury foreign exchange denominated borrowing with an original maturity of less than one year amounted to US\$13.29 billion.

7. All assets and liabilities denominated in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at the program cross exchange rates specified (Annex J).

8. The projected Net International Reserves path from the fourth quarter of 2005 to the fourth quarter of 2006 is based, inter alia, on the following projections for foreign exchange receipts resulting from privatization:

	Privatization receipts, in \$ millions, cumulative from 2005 Q4
2005 Q4	800
2006 Q1	2,800
2006 Q2	3,700
2006 Q3	4,200
2006 Q4	5,200

9. Privatization receipts are defined in this context as the proceeds from sale or lease of (all or a portion of) entities and properties held by the public sector, including the Privatization Authority and the Savings Deposit and Insurance Fund, that are deposited in foreign exchange at the Central Bank of Turkey, either directly, or through Treasury.

10. In the event that realized foreign exchange receipts resulting from privatization depart from projected receipts, the NIR floor for each quarter will be revised upward (downward) by the excess (shortfall) of cumulative realized receipts compared to the projected cumulative receipts in paragraph 8 above.

## ANNEX F: FISCAL TARGETS

### A. Primary Balance of the Consolidated Government Sector

Table 1. Turkey: Performance Criteria and Indicative Targets on the Cumulative Primary Balance of the Consolidated Government Sector and Consolidated Government Sector Excluding SEEs.

	Floor (In millions of YTL)
Cumulative primary balance from January 1, 2006, to:	
March 31, 2006 (performance criterion)	7,550
June 30, 2006 (performance criterion)	17,250
September 30, 2006 (performance criterion)	29,250
December 31, 2006 (performance criterion)	34,050
Cumulative primary balance (excluding SEEs) from January 1, 2006, to:	
March 31, 2006 (performance criterion)	7,250
June 30, 2006 (performance criterion)	16,350
September 30, 2006 (performance criterion)	27,550
December 31, 2006 (performance criterion)	31,350

1. The primary balance of the *consolidated government sector* (CGS), Table 1, comprises the primary balances (primary revenue minus noninterest expenditures) of: the consolidated budget or central government;<sup>1</sup> the 3 extra budgetary funds (EBFs) identified below; the three social security institutions (SSIs) identified below; the unemployment insurance fund; and the 23 state economic enterprises (SEEs) identified below. A second set of performance criteria excludes the SEEs. The floors on the primary balance of the CGS will be monitored:

- a) For the consolidated budget/central government from above the line on a modified cash basis (including both special revenues and special expenditures). In this definition, reported transfers to social security institutions will be replaced by cash transfers reported by the social security institutions.
- b) For the EBFs from above the line on a modified cash basis, counting non-transferred shared tax revenues, to the extent these are not already recorded as reserves by other elements of the CGS.

<sup>1</sup> In table 1, the targets for March and June 2006 are set for the consolidated budget, while those for September and December 2006 are set for the central government. All realization data however will be on the latter basis.

- c) For the SSIs, and the unemployment insurance fund from above the line on a cash basis.
- d) For the SEEs, from below the line as described in paragraph 6.

2. For the purposes of the program, the primary revenues will exclude interest receipts of the central government (including on tax arrears, although combined penalty/interest charges associated with tax payments will be counted as primary revenues), SEEs, and of the unemployment insurance fund (UIF), profit transfers of the Central Bank of Turkey (CBT) and net special revenues of the Turkish mint, proceeds from the sale of assets of the CGS (privatization proceeds or transfers thereof), and state bank dividend payments. Late payment penalties of the UIF will be included as primary revenues. Revenues of the CGS from sales of immovables will be included up to an aggregate cap of YTL 500 million. Interest receipts of EBFs and SSIs will not be excluded. As well, the floor on the primary balance will be adjusted upwards for any increase in revenues arising from changes in the revenue sharing agreement between any components of the CGS and other elements of the public sector, including local authorities. For the purposes of the program, revenues of the CGS will exclude payments-in-kind and other nonmonetary forms of payments.

3. For the purposes of the program, primary expenditure of the CGS will exclude any payments related to bank recapitalization and to the restructuring of private and state banks. Privatization-related expenditure of the Privatization Fund will not be excluded. Current carryover appropriations are not included as expenditures when constructing the program targets, while spending against such appropriations will count as primary expenditures for the purposes of calculating both primary and overall balances.

4. Net lending of any component of the CGS will be considered as a non-interest expenditure item. (If this net lending is negative, it will be considered as a non-interest revenue item.) Payment of guaranteed debt by treasury on behalf of non-CGS components of the public sector will not be treated as net lending up to the baseline reported in Annex G.

The targets for September and December have been altered to account for the broadened coverage of fiscal monitoring implicit in the government's move from "consolidated budget" to "central government." The latter aggregate includes on a gross basis the revenues and expenditures of 25 formerly autonomous institutions and 8 regulatory bodies that were formerly captured only via transfers to/from the consolidated budget.

The 25 formerly autonomous institutions that received transfers from the consolidated budget are:

1. Student Selection and Placement Center,
2. Ataturk Institute of Culture, Language and History
3. Turkey and Middle-East Public Administration Institute -TODAİE
4. The Scientific and Technological Research Council of Turkey
5. The Turkish Academy of Sciences
6. Turkish Justice Academy
7. General Directorate of Mineral Research and Exploration
8. Agency for Workshops in Penalty and Correction Institutions and Prisons

9. General Directorate of Higher Education Credit and Hostels Institution
10. General Directorate of State Theaters,
11. General Directorate of State Opera and Ballet,
12. Turkish Accreditation Agency,
13. Turkish Standards Institute,
14. National Productivity Center,
15. Turkish Patent Institute,
16. National Boron Research Institute
17. Turkish Atomic Energy Agency
18. Undersecretariat for Defense Industries
19. Small and Medium Industry Development Organization
20. Export Promotion Center
21. Turkish Cooperation and Development Agency
22. Authority for Protection of Special Environmental Areas
23. Southeastern Anatolia Project Regional Development Administration
24. Privatization Administration
25. General Directorate of Electrical Power Resources Reconnaissance and Development Administration

The 8 regulatory bodies that made transfers to the consolidated budget are:

1. Radio and Television High Council,
2. Telecommunications Authority
3. Capital Markets Board,
4. Banking Regulation and Supervision Agency,
5. Energy Market Regulatory Authority
6. Public Procurement Agency,
7. Turkish Competition Authority,
8. Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Agency.

5. These institutions were collectively in deficit, and their inclusion in the CGS thus implies a reduction in the annual primary surplus of YTL 1.091 billion, and a reduction in the overall balance of YTL 0.774 billion (the difference relating to YTL 317 million in interest revenues of the 33 new agencies). In addition, the revenues and expenditures (YTL 690 million) of university-affiliated health, social and cultural centers, which were not included in the consolidated budget, are included in the central government budget.

6. Finally, the central government reflects on a gross basis both the tax revenues to be shared with local governments and funds and the transfers of these monies. Transfers are effected one month after collection, and in the transitional year of 2006, central government statistics cover 12 months of shared revenues on the revenue side, but only 11 months of these monies on the expenditure side. This then raises primary surplus targets by YTL 1.168 billion (the amount of December 2005 shared revenues).

**Table. Mapping "Consolidated budget" to "central government," 2006 revised program.**  
(in billions of YTL)

		Primary Revenues 1/	Primary Expenditures	Primary bal.
<b>1.</b>	<b>Consolidated budget</b>	<b>140.083</b>	<b>109.355</b>	<b>30.728</b>
+ a	Operations of new institutions being brought into the fiscal monitoring aggregate (which formerly appeared only indirectly in the budget, in that their operations were partially financed by budget transfers).	2.164	5.157	-2.993
+ b	Operations of the university sport, health, and cultural centers (which charge fees and pay teacher bonuses out of these monies, none of which were previously recorded in the consolidated budget)	0.690	0.690	0.000
- c	Transfers to / from consolidated budget	1.200	3.185	-1.985
+ d	Revenue sharing with local governments (formerly omitted from both revenues and expenditures)	14.313	13.145	1.168
= 2.	Subtotal	156.050	125.162	30.888
<b>3.</b>	<b>Central government</b>	<b>156.191</b>	<b>125.386</b>	<b>30.805</b>
4. = 3.-2.	Residual (may reflect institutions which were excluded from the consolidated budget but will be included in the central government as departments of other budget agencies (rather than as independent agencies))	0.141	0.224	-0.083
Memo items:				
5.=a+b-c+d.	<b>"Real" increase (excludes revenue sharing)</b>	<b>1.795</b>	<b>2.886</b>	<b>-1.091</b>
6.	Interest revenues and expenditures of the new institutions	0.317	0.000	0.317
7.	Effect on overall revenues, expenditures, and balance (excludes revenue sharing)	2.112	2.886	-0.774

1/ Program definition.

## Extrabudgetary funds

7. The three EBFs included in the definition of the performance criterion are the Defense Industry Support Fund, the Privatization Fund, and the Social Aid and Solidarity Incentive Fund.

## State economic enterprises

8. The 23 SEEs whose primary balances will be included in the definition of the performance criterion are: TTK (coal), T. ŞEKER FAB (sugar), TMO (soil products office), TEKEL (tobacco), TCDD (railways), BOTAŞ (natural gas), TEDAŞ (electricity distribution), EÜAŞ (electricity generation), TETAŞ (electricity trade), TEİAŞ (electricity transmission), TPAO (petroleum exploration and extraction), ETİ Maden İŞL., MKEK, TKİ, ÇAYKUR, DHMİ, PTT, PETKİM, THY, TİGEM, KIYEM, TDI, and DMO.

9. The primary balance of these SEEs will be monitored as the sum of net financing minus accrued interest made by the SEEs. Net financing will be monitored as: net financing from the banking system (excluding pre-export financing from Eximbank) plus net external borrowing (excluding normal trade financing), plus the change in net arrears to and net advances from the private sector and to/from the non-CGS public sector (including subsidiaries and joint ventures), plus net interest payments undertaken by the Treasury. The net change in arrears on tax liabilities will be excluded.

10. Net financing from the banking system (excluding pre-export financing from Eximbank) is defined as the change in all claims of these institutions on the SEEs listed above, including loans and capitalized interest arrears, less the change in deposits and repos of SEEs in these institutions, as reported by these SEEs. Changes in claims and deposits

denominated in foreign currency will be valued at the average of the exchange rates between the Turkish lira and each corresponding currency prevailing during the quarter in question. As of December 31, 2005 the stock of net banking claims on SEEs as defined above stood at YTL 1612 million, valued at the exchange rates on that day.

11. Net external borrowing is defined as the receipt of external loans (including guaranteed debt and on-lending, and excluding normal trade financing) less amortization (excluding repayments of guaranteed debt and on-lending undertaken by the Treasury), valued at the exchange rate at the time of transaction. As of December 31, 2005 the stock of external loans stood at YTL 8155 million, valued at the exchange rates on that day.

### **Social security institutions**

12. The three social security institutions (SSIs) included in the definition of the performance criterion are SSK, Bağ-Kur, and Emekli Sandığı. The deficits of the SSIs will be covered by transfers from the central government budget, and they are thus expected to be in primary balance.

### **Adjusters**

13. The floor on the primary surplus of the CGS will be adjusted upwards for any increase in the expenditure arrears of the SSIs. Arrears of the SSIs are defined as the sum of (i) overdue pension payments; (ii) medicine payments overdue by more than 45 days for both imported and domestic medicine (from the date of invoice receipt); (iii) other payments overdue by more than 30 days and payments to hospitals overdue by more than 60 days (from the date of invoice receipt). In the case of Bağ-Kur they exclude the arrears to the common retirement fund. The stock of arrears for Bağ-Kur stood at YTL 0 million; for SSK stood at YTL 0 million; and for Emekli Sandığı stood at YTL 0 million on December 31, 2005. These stocks of arrears will be used for the purpose of calculating the adjustor.

14. The floors for the primary surplus of the CGS will be adjusted upward:

- a) For any issue of noncash debt other than for bank recapitalization and securitization of duty losses and for the restructuring of the Agricultural Sale Cooperative Units and military foreign financed in-kind spending;
- b) For any off-balance sheet expenditure of any component of the CGS (excluding military foreign financed in-kind spending).
- c) For cumulative interest receipts of the Defense Industry Support Fund in excess of YTL 100 million.

15. The floor on the primary surplus of the CGS will be adjusted upwards (downwards) in line with the projected surplus (deficit) of the primary balance of any fund or entity that is incorporated in the CGS after January 1, 2006.

16. The floor on the primary surplus of the CGS will be adjusted by the primary balance projected at the time of approval of the program for any state economic enterprise (included

in the performance criterion) when there is a change of control due to privatizations. The adjustor will be calculated as the difference between the primary surplus generated by the company while in public control and the annual projection. This adjustor does not apply to Türk Telekom or TÜPRAŞ in 2006.

## **B. Primary Spending of the Central Government and the Social Security Institutions**

Table 1. Turkey: Performance Criteria on the sum of the Cumulative Primary Spending of the Central Government (excluding transfers to Social Security Institutions) and the Social Security Institutions

	Ceiling (In millions of YTL)
Cumulative primary spending from January 1, 2006 to:	
September 31, 2006	123,350
December 31, 2006	168,650

17. The ceilings in Table 1 are established on the sum of (i) the primary spending of the central government, excluding transfers to social security institutions, measured as in paragraph 1.a of Section A above; and (ii) the primary spending of the social security institutions, measured as in paragraph 1.c of Section A above.

### **Adjusters**

18. The ceiling on primary spending will be adjusted symmetrically to compensate for any over- or underperformance in collections of the revenue bases subject to sharing with local governments and extrabudgetary funds.

## **C. Overall Balance of the Consolidated Government Sector**

Table 1. Turkey: Indicative Floors on the Cumulative Overall Balance of the Consolidated Government Sector

	Floor (In millions of YTL)
Cumulative overall balance from January 1, 2006 to:	
March 31, 2006	-3,650
June 30, 2006	-4,050
September 30, 2006	-5,900
December 31, 2006	-6,900

19. The overall balance of the consolidated government sector (CGS), Table 1, comprises: (i) the primary balance of the CGS as previously defined in this annex; (ii) the net interest payments of the central government (excluding in 2006 those combined penalty/interest charges associated with tax payments and already included as primary revenues); the UIF and the SEEs; (iii) the interest payments of SSIs and EBFs; (iv) transfers of profits from the CBT and net special revenues of the Turkish Mint to the consolidated central government; (v) state bank dividends payments; and (vi) expenditures under the risk account (net lending).

20. The monitoring of the different components of the overall balance will be as indicated in paragraph 1 of this Annex.

21. All definitions and adjusters specified earlier in this Annex to apply to the primary balance of the CGS will also apply to the overall balance of the CGS. In particular, the overall balance will be adjusted for the overall balance of any new government funds and institutions established after January 1, 2006.

#### **D. Overall Balance (before transfers) of the Social Security Institutions**

Table 1. Turkey: Performance Criteria and Indicative Floors on the Cumulative Overall Balance (before transfers) of the Social Security Institutions

	Floor (In millions of YTL)
Cumulative overall balance (before transfers) from January 1, 2006 to:	
March 31, 2006 (indicative target)	-6,100
June 30, 2006 (performance criterion)	-12,000
September 30, 2006 (performance criterion)	-18,400
December 31, 2006 (performance criterion)	-24,300

22. The overall balance (before transfers) of the social security institutions (SSIs), Table 1, comprises the balances of SSK, Bağ-Kur, and Emekli Sandığı. It excludes additional payments made to pensioners in lieu of phased-out tax rebates (up to YTL 1.772 billion).

#### **E. Amnesties and Public Sector Receivables**

23. Amnesties will be understood as a reduction in the net present value of a public receivable, without any reference to individual ability to pay, or attempt to enforce individual payment. A public receivable will be understood as an obligation to general government (GFS definition) or to a state economic enterprise or state bank.

24. This performance criterion will not apply to companies in the Privatization Administration's portfolio.

## ANNEX G: PROGRAM BASELINE FOR TREASURY NET LENDING

Table 1. Turkey: Program Baseline for Treasury Net Lending

	Baseline (In millions of US\$)	Baseline (In millions of YTL)
Cumulative net lending from January 1, 2005 to: December 31, 2005	770	1,100
Cumulative net lending from January 1, 2006 to: March 31, 2006	95	140
June 30, 2006	180	265
September 30, 2006	265	390
December 31, 2006	335	490

1. Net lending (risk account) by Treasury to other (non-CGS) components of the public sector is defined as the sum of guarantee payments made by Treasury on behalf of these entities minus repayments obtained by Treasury from them.
2. Other components of the public sector include: extrabudgetary funds not in the CGS, revolving funds, associations or foundations, state economic enterprises not in the CGS, state banks (including Eximbank and Iller bank), special provincial administrations, municipalities, municipal enterprises, build-operate-transfer projects, and build-operate projects.
3. Repayments include those obtained in cash directly from municipalities. Repayments, obtained through claw-back mechanisms, either directly, by withholding of transfers of tax shares from the MoF, or indirectly, via withholding of transfers to be made by Iller Bank, and proceeds from privatization, direct or indirect, are not included as repayments.
4. For the purposes of program monitoring, the flows in U.S. dollars will be converted at the average YTL/US\$ exchange rate between test dates.

## ANNEX H: SHORT-TERM EXTERNAL DEBT CEILINGS

Table 1. Turkey: Performance Criteria and Indicative Ceilings on the Stock of Short-Term External Debt Outstanding

	Ceilings (In millions of US\$)
December 31, 2005 (performance criterion)	1,000
March 31, 2006 (performance criterion)	1,000
June 30, 2006 (performance criterion)	1,000
September 30, 2006 (performance criterion)	1,000
December 31, 2006 (performance criterion)	1,000

1. The limits specified in Table 1 apply to the stock of debt of original maturity of one year or less, owed or guaranteed by the consolidated government sector (as defined in Annex F). The term “debt” has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt or Borrowing in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979 as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000). Excluded from this performance criterion are external program financing, sales of treasury bills denominated in Turkish lira or foreign exchange to nonresidents in either the domestic primary market or the secondary market, normal import-related credits, reserve liabilities of the Central Bank of Turkey, and forward contracts, swaps, and other future market contracts. Debt falling within the limit shall be valued in U.S. dollars at the program cross exchange rates specified in (Annex J).

## ANNEX I: MEDIUM- AND LONG-TERM DEBT CEILINGS

Table 1. Turkey: Performance Criteria and Indicative Ceilings on Contracting and Guaranteeing of New External Debt

	Limits (In millions of US\$)
Cumulative flows from end-December 2004	
December 31, 2005 (performance criterion)	16,000
Cumulative flows from end-December 2005	
March 31, 2006 (performance criterion)	8,500
June 30, 2006 (performance criterion)	14,000
September 30, 2006 (performance criterion)	18,000
December 31, 2006 (performance criterion)	21,500

1. The limits specified in Table 1 apply to the contracting or guaranteeing by the consolidated government sector (as defined in Annex F) of new, nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (adopted by the Executive Board of the International Monetary Fund on August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. The term “nonconcessional” means containing a grant element of less than 35 percent on the basis of the currency-specific discount rates based on the OECD commercial interest reference rates in place at the time at which the contract is entered into, or guarantee issued.

2. Excluded from this performance criterion are credits extended by the IMF, adjustment lending from the World Bank, and other external program financing, long-term liabilities of the Central Bank of Turkey and sales of treasury bills and bonds denominated in TL/YTL or FX to nonresidents in either the domestic primary market or the secondary market. Also excluded from this performance criterion is debt or the guaranteeing of debt if the proceeds from that debt have been used to retire other debt as part of a liability management operation that results in an improvement of the debt profile, either through a lengthening of maturity or a reduction in net present value of the debt stock; this could include direct swaps of one debt instrument for another and new debt issues whose proceeds are used to retire other debt; to qualify for exclusion from the PC, the debt that has been retired pursuant to such liability management operations must have a maturity date at least one year past the contract date of the new debt that has been undertaken.

3. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee is issued.

## ANNEX J: PROGRAM EXCHANGE RATES

Table 1. Cross Exchange Rates for Program Purposes

	TL value	YTL value	U.S. dollars per currency unit
Program exchange rates			
U.S. dollar	1,497,696	1.497696	1.0000
Euro	1,845,162	1.845162	1.2320
Japanese yen	13,469	0.013469	0.0090
Swiss franc	1,186,643	1.186643	0.7936
U.K. pound	2,707,645	2.707645	1.8086

1. This table sets out the program exchange rates referred to in earlier Annexes. They shall apply to the performance criteria/indicative ceilings or floors for the period May 31, 2005–May 31, 2008. Currencies not specified here will be converted at the representative exchange rates reported to the IMF as of September 29, 2004.
2. Constituent currencies of the euro shall be converted into euro at the official European Union conversion rates and then converted into the U.S. dollar value.