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Turkey
Country Economic Memorandum

Towards Macroeconomic Stability and Sustained Growth

(In Three Volumes) Volume I: Summary Report

July 28, 2003

Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

Document of the World Bank

Turkey: Country Economic Memorandum

Currency Equivalents

(Exchange Rate Effective July **28,2003)**

Currency Unit = Turkish Lira

US$1 = TL1,410,000

Government Fiscal Year

January 1 – December 31

Weights and Measures

Metric System

Abbreviations and Acronyms

AMC	- Asset Management Company	PA	- Privatization Administration
BK	- Bag-Kur	PFMC	- Public Financial Management and Control
BO	- Build Operate	PHC	- Privatization High Council
BOO	- Build Operate Own	REER	- Real Effective Exchange Rate
BOT	- Build Operate Transfer	SDIF	- Saving Deposit Insurance Fund
BRSA	- Banking Regulatory and Supervisory Authority	SIS	- State Institute of Statistics
CAR	Capital Adequacy Ratio	SOE	- State Owned Enterprises
CEM	- Country Economic Memorandum	SPO	- State Planning Organization
CPI	- Consumer Price Index	SRS	- Sustained Reform Scenario
EBITDA	- Earnings Before Interest, Tax, Depreciation and Amortization	SSK	- Social Security Organization
ES	- Emekli Sandigi	TEAS	- Electricity Generation and Transmission Company
EU	- European Union	TEDAS	- Turkish Electricity Distribution Company
EUAS	- Turkish Electric Generation Company	TEIAS	- Turkish Electricity Transmission Company
FIAS	Foreign Investment Advisory Service	TEKEL	- Turkish Tobacco Monopoly
FDI	Foreign Direct Investment		
GDP	- Gross Domestic Product	TETAS	- Turkish Electricity Trading Company
GDR	- General Directorate of Revenues	TFP	- Total Factor Productivity
GNP	- Gross National Product	TOBB	- Union of Chambers of Commerce and Industry
IA	- Istanbul Approach	TOOR	- Transfer of Operating Rights
ISE	- Istanbul Stock Exchange	TSFAS	- Turkish Sugar Factories
ISKUR	- Employment Organization	TUSIAD	- Turkish Industrialists' and Businessmen Association
MOF	- Ministry of Finance	YOIKK	- Coordination Council for Investment Climate
NPL	- Non-Performing Loans		

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TURKEY: COUNTRY ECONOMIC MEMORANDUM

TOWARDS MACROECONOMIC STABILITY and SUSTAINED GROWTH

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EXECUTIVE SUMMARY

i. Economic Context. Despite many advantages ranging from its strategic location to its dynamic population, Turkey has not achieved the high growth of leading emerging market economies. Turkey has not matched the growth rate of EU accession countries such as Hungary and Poland, or the fast growing cohesion countries such as Spain and Portugal. Macroeconomic instability has helped keep growth below potential. Analysis suggests that macroeconomic instability has played an important role—among many factors—in Turkey's inability to realize its full growth potential. Turkey has suffered from an exceptional degree of macroeconomic instability characterized by chronically high inflation and sharp swings in the business cycle. The "boom-bust" cycle has continued into the new decade with a record contraction of real GNP of over 9 percent in 2001 followed by a strong recovery with estimated growth of 7.8 percent in 2002. Today, Turkey is the only major economy in the world that continues to struggle with inflation rates of 30 percent per year or more. Fiscal imbalance has been at the root of chronic macroeconomic instability. Unsustainable fiscal policy has repeatedly put pressure on the Lira, fueled inflation and undermined financial stability. When crises have hit, contractionary macro policies have been required to restore a semblance of financial stability, worsening the real impacts of internal and external shocks. The impact of unsustainable fiscal policy on macroeconomic stability has been magnified by Turkey's open capital account and, until recently, its poorly regulated banking system. The causal linkages between fiscal imbalances and instability in Turkey suggest that the key to macroeconomic stability lies in sustained fiscal adjustment underpinned by credible structural reforms.

ii. Crisis, Response and Recovery. Turkey's exchange rate-based disinflation program—launched in a context of structural fiscal weaknesses and systemic banking sector problems—collapsed in early 2001. The Government responded quickly to the financial crisis and announced a strengthened economic program in May 2001 in response to the crisis following the collapse of the crawling peg and subsequent devaluation. Turkey's crisis response program benefited from the lessons learned by other emerging market countries facing crisis. Immediate fiscal measures were introduced to shore up the primary surplus and strengthen confidence in the sustainability of the public debt. A front-loaded program of bank restructuring was launched, backed by extensive fiscal resources. Bank restructuring was complemented by additional structural reforms in the financial sector designed to further strengthen prudential regulation, adopt internationally accepted financial reporting standards and practices, and enforce compliance. In parallel with accelerated financial sector reform, a comprehensive public sector reform program, including institutional reforms, was introduced to tackle the structural roots of Turkey's chronic fiscal imbalance. Strengthened financial and public sector reforms were placed within a medium-term programmatic framework in an effort to bolster investor confidence by demonstrating the Government's intent to address the core structural causes behind the crisis and not just the immediate symptoms. The crisis response program was backed by additional financial resources from the IMF and the World Bank. Economic activity rebounded strongly in

2002 and the recovery continued into early 2003. Real GNP growth reached 7.8 percent in 2002, exceeding program projections by a wide margin. The extent of the recovery and its basis in export growth place Turkey squarely in the category of rapid-recovery, post-crisis countries, such as Korea in 1999 and Mexico in 1995.

iii. Medium-term Agenda. It is critical for the Government to move quickly to establish its reform credentials and bolster investor confidence. Sustaining high and more fairly distributed growth over the medium-term rests on a challenging reform agenda:

- The path to macroeconomic stability lies in sustaining a high level of fiscal adjustment for the foreseeable future. Fiscal adjustment must be underpinned by structural reforms and complemented by credible macro policies. Moving credibly towards international—notably EU—standards, will help minimizing trade-offs between recession and disinflation.

- Determined action to modernize public sector institutions and to improve public governance is critical to achieving quality fiscal adjustment and durably improving the business climate. Effective government is also key to realizing Turkey's social and human development objectives through the efficient delivery of public services.

- Sustaining and expanding the growth process will depend critically on improved performance of the financial and real sectors. Wide-ranging reforms must be deepened to bolster the financial system, promote corporate restructuring, complete regulatory reforms, and accelerate privatization and market liberalization.

- Social policies need to be strengthened to ensure the robust social contract among its citizens that Turkey needs to meet the challenges of the new century and secure the social development of the country in light of the millennium development goals. Priorities for social policy include mitigating adverse consequences of the ongoing structural adjustments, raising the level of human capital, and ensuring effective operation of the labor market.

- Sustained growth will hinge on Turkey's further integration with the global economy. Structural reform is essential to maintain strong export performance, attract foreign direct investment and bolster confidence. Given continuing vulnerabilities to exogenous shocks, maintaining a policy of exchange rate flexibility will be important. Sustained progress towards EU accession would provide a strategic external anchor for Turkey's reform efforts.

iv. Risks. There are important risk factors that must be actively addressed to ensure that they don't undermine emergence of a virtuous cycle of sustained growth. Internal risk factors include: (i) public debt sustainability, (ii) incomplete reform in the financial sector, (iii) deep corporate distress following the crisis and the slow pace of corporate restructuring needed to promote competitiveness, and (iv) the potential for rigidities to develop in the labor market. Private access to financing may become a serious constraint on sustained recovery over time. External risk factors are also significant and highlight the critical importance of promoting FDI in line with the experience of other rapid-recovery post-crisis countries. Of immediate concern is the widening current account deficit. For the medium term, the expected slower recovery in the world economy, increased risk aversion of international investors, and the potential for post-war instability in Iraq are all significant risk factors for the medium term. The external financing

plan for 2003 and beyond centers on increased access to private capital. This will be a challenge under prevailing conditions in international financial markets. Increased FDI flows in the years following crisis have played a key role in sustaining recovery in other emerging markets. Turkey will have to accelerate its efforts in order to follow suit, in particular to strengthen productivity and expand its share in the strategically important, but relatively slow growing EU market.

v. Medium-term Outlook. Medium-term projections demonstrate that sustained implementation of economic reform is necessary if Turkey is to attain its macro-economic stability and growth objectives. Only sustained macroeconomic stabilization and structural reform can set Turkey on a medium-term course of disinflation, renewed growth and sustainable public debt. Thus, the medium-term projections under the program illustrate a *Sustained Reform Scenario*. Economic reform is needed to catalyze a virtuous circle whereby increasingly permanent fiscal adjustment and more effective government lead to improvements in market confidence which in turn drive down real interest rates. Lower rates combined with reforms to improve the business climate can in turn engender an increasingly robust private sector response. A sustained pick up in private sector activity that begins to generate employment will complement stronger social policies and bolster public support for the Government's reform policies. Igniting and then sustaining this virtuous circle is the key to achieving high levels of more equitable growth over the medium term. *There is no room for error.* Under an alternative low-case (muddle through) scenario, structural reforms would lose momentum, fiscal policy would become expansionary, and inflation and growth performance would likely be disappointing. With limited program credibility and a large debt rollover requirement, interest rates would remain high and private investment would be crowded out. Under this scenario, the economy would remain highly vulnerable to internal and external shocks, with significant risk of a new economic crisis. Pursuing Turkey's social agenda would become increasingly difficult. Clearly, the low-case (muddle through) scenario is not sustainable for Turkey.

vi. Under a scenario of sustained reform, the economic program is projected to achieve the Government's stabilization and growth targets. The economy would be expected to fully recover from the 2001 recession, with stable real growth of 5 percent in the 2003-06 period. Specific factors underlying sustained growth include:

- greater confidence in the policy framework,
- improved macroeconomic stability and declining real interest rates—which would stimulate private investment and consumption demand,
- an increase in productivity resulting from structural reforms,
- stronger exports performance—which would permit faster import and output growth, and
- higher external inflows, including sizeable FDI.

While sustained 5 percent growth is projected under the reform scenario, even higher growth would be needed to make real progress towards EU convergence given Turkey's demographics. This underlines the strategic imperative of determined implementation of the medium-term reform agenda. Sustained progress towards EU accession would provide a strategic external anchor for Turkey's reform efforts.

TURKEY: COUNTRY ECONOMIC MEMORANDUM

TOWARDS MACROECONOMIC STABILITY AND SUSTAINED GROWTH

SUMMARY REPORT

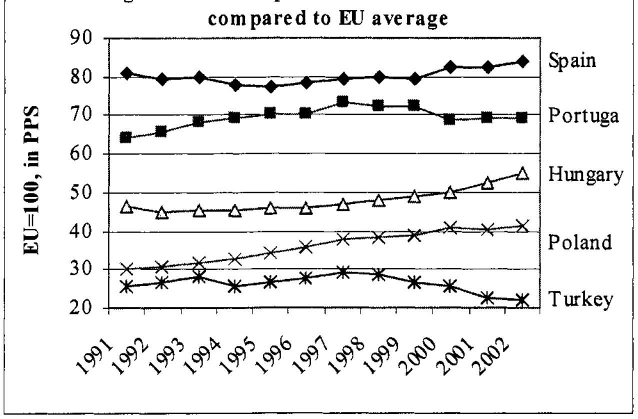
1. This report addresses key questions facing Turkish policymakers: how to sustain the economic recovery that began in 2002 following the deep crisis of 2001, how to ensure disinflation and public debt sustainability, and how to foster broad-based and equitably distributed growth in the future. After a brief review of the 2001 crisis and the Government response, the report analyzes the economic opportunities and challenges facing Turkey, and identifies policies to build on the economic recovery which began in 2002. The CEM develops a comprehensive four-point agenda for sustainable and more equitably distributed growth. The agenda encompasses: (i) macroeconomic stability, (ii) effective government, (iii) improved business environment, and (iv) stronger social policies. The report closes with medium-term macroeconomic projections to illustrate Turkey's prospects under a scenario of sustained reform and to highlight the risks to growth and macroeconomic stability should the economic program go off track.

1 ECONOMIC CONTEXT

Turkey has not achieved its growth targets

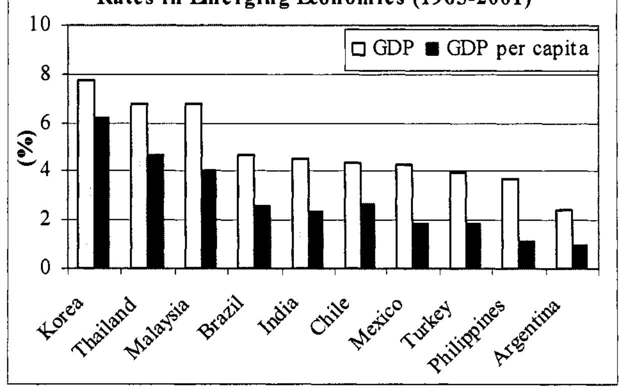
2. Despite many advantages ranging from its strategic location to its dynamic population, Turkey has not achieved the high growth of leading emerging market economies. Turkey has not matched the growth rate of EU accession countries such as Hungary and Poland, or the fast growing cohesion countries such as Spain and Portugal (Figure 1). Turkey's per-capita income

Figure 1: Per Capita GDP at PPS: 1991-2002 compared to EU average



Source: World Bank.

Figure 2: GDP & GDP Per Capita Growth Rates in Emerging Economies (1965-2001)



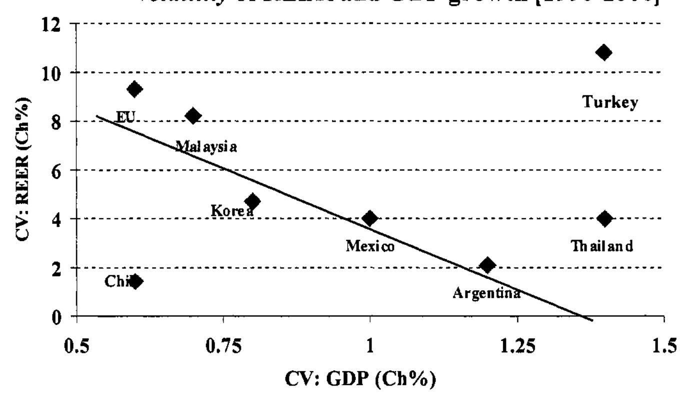
Source: World Bank.

level declined from 26 percent of the EU average in 1991 to 22 percent in 2002.[1] During the same period, Poland and Hungary made significant progress in reducing the per capita income differences with the EU. On average, the Turkish economy grew slightly under 3 percent per year over the past decade—respectable, but well below the best performing emerging economies (Figure 2).

Macroeconomic instability has helped keep growth below potential

3. Analysis suggests that macroeconomic instability has played an important role—among many factors—in Turkey's inability to realize its full growth potential. Cross-country comparisons and analytical work suggest that countries that grew faster than Turkey did so in part because they achieved a greater degree of macroeconomic stability, accumulated physical capital faster, invested more in human capital, and did more to improve government effectiveness and the business climate. Of all these factors, the contrast in the degree of macroeconomic stability stands out. Turkey has suffered from an exceptional degree of macroeconomic instability characterized by chronically high inflation and sharp swings in the business cycle. Many emerging market countries have experienced large fluctuations in either growth or the real exchange rate, but Turkey experienced instability in both dimensions (Figure 3). Repeated attempts to stabilize the economy fell short, and high growth was never sustained for long. Inflation was higher and growth lower, on average, in the 1990s than in the 1980s. Income volatility doubled between the 1980s and 1990s as the standard deviation of real GDP growth increased from 2.7 percent to 5.5 percent. The "boom-bust" cycle has continued into the new decade with a record contraction of real GNP of over 9 percent in 2001 followed by a strong recovery with estimated growth of 7.8 percent in 2002. Today, Turkey is the only major economy in the world that continues to struggle with inflation rates of 30 percent per year or more.

Figure 3: Turkey: an "outlier" among comparators in *volatility* of REER and GDP growth [1990-2000]



Source: World Bank, JPMorgan; volatility measured by coefficient of variation applied to growth rates of the variables

Fiscal imbalance has been at the root of chronic macroeconomic instability in Turkey

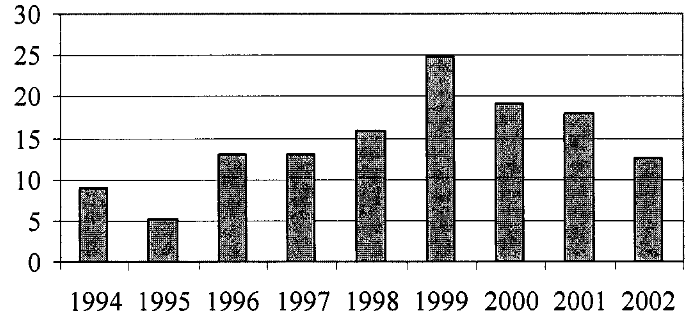
4. The 2000 CEM[2] demonstrated that fiscal imbalances are key to understanding Turkey's macroeconomic instability. Unsustainable fiscal policy has repeatedly put pressure on the Lira, fueled inflation and undermined financial stability. Fiscal policy has been unable to act as a

[1] Of course, these figures do not reflect the informal economy which is likely to be substantially larger as a percentage of GNP in Turkey relative to the EU average.

[2] Turkey: Country Economic Memorandum – Structural Reforms for Sustainable Growth, September 15, 2000, Report No.20657-TU.

smoothing influence on the business cycle. When crises have hit, contractionary fiscal and monetary policies have been required to restore a semblance of financial stability, worsening the real impacts of internal and external shocks. The impact of unsustainable fiscal policy on macroeconomic stability has been magnified by Turkey's open capital account and, until recently, its poorly regulated banking system. Short-term capital flows have fluctuated widely as investors responded to the boom/bust cycle driven by unstable macroeconomic conditions. The causal linkages between fiscal imbalances and instability in Turkey as in many other emerging markets suggest that the key to macroeconomic stability lies in sustained fiscal adjustment underpinned by credible structural reforms. (Figure 4)

Figure 4: Adjusted PSBR (% of GNP)



Source: SPO and World Bank.

2 DISINFLATION AND CRISIS

Turkey's exchange rate-based disinflation program—launched in a context of structural fiscal weaknesses and systemic banking sector problems—collapsed in early 2001

5. In 2000, an exchange rate-based disinflation program was launched in a bold attempt to rid the economy of inflation. The centerpiece of the program was a crawling peg exchange rate regime to act as the nominal anchor. The peg was supported by front-loaded fiscal adjustment. Key structural reforms in social security, infrastructure, agriculture, privatization and banking were initiated. In fact, fiscal policy was significantly tightened in 2000 and inflation began to fall, dropping to 39 percent by the end of the year. Turkey also carried out significant structural reforms under the program. These included establishment of an independent banking authority, passage of legislation for an electricity market, reform of the public pension system, a constitutional amendment to allow international arbitration, launch of an ambitious agriculture reform, establishment of a telecommunications regulator and a serious, albeit short-lived, acceleration of privatization. However, these impressive achievements were insufficient to avoid a crisis given the extent of Turkey's underlying fiscal and financial sector weaknesses built up over decades of instability and delayed reform.

6. Internal factors combined with unfavorable external developments started to undermine the exchange rate peg by mid-2000. On the external side, rising oil prices and a prolonged slide in the Euro contributed to a softening of Turkey's external accounts. On the internal front, the disinflation program was confronted with deep-rooted structural fiscal problems and a fragile banking sector burdened by huge contingent liabilities. A sharp drop in interest rates following the onset of the crawling peg—driven in part by a resurgence in short-term capital inflows—fueled a surge in demand. The economy soon began to overheat. While falling, inflation didn't come down as quickly as anticipated, generating a significant appreciation of the real exchange rate under the peg. Imports increased sharply as consumption boomed, contributing to a

deterioration in the current account which recorded a deficit of 5 percent of GNP in 2000. Domestic banks took advantage of the peg to borrow cheap foreign exchange in order to finance their expanding domestic operations including growing purchases of government securities and consumer lending. The expansion in domestic credit contributed to the consumption boom as banks quickly built up large open FX positions and aggravated maturity mismatches in their portfolios. Bank restructuring got off to a slow start and the state banks continued to be burdened with the costs of large "duty losses" from government-mandated subsidized lending to agriculture and SMEs. The average maturity of TL deposits remained extremely short as confidence in the Lira remained fragile.

7. A first bout of financial instability hit Turkey in November 2000 presaging the full-fledged currency crisis of early 2001 which short-circuited the exchange rate based disinflation program. As banks came under increasing pressure from shrinking profit margins on government securities and growing liquidity needs, isolated speculative attacks emerged in November 2000 which soon plunged the banking system into a struggle for survival. Desperate for liquidity, certain banks engaged in fire sales of government paper, causing interest rates to skyrocket and international investors to exit the market. The result was a liquidity crunch aggravated by the Central Bank's inability to inject additional liquidity into the system under the quasi-currency board rules added to the disinflation program just prior to launch of the crawling peg. The situation stabilized temporarily in December 2000 when the IMF acted to prevent a financial meltdown by announcing an additional US$10 billion in financial assistance. This additional financing was conditioned on the Government's commitment to strengthen the program in particular to accelerate financial sector restructuring and privatization. The Government introduced an explicit blanket guarantee covering effectively all banking liabilities excluding capital. While designed to contain systemic risks in the banking system, the blanket guarantee highlighted the potentially enormous fiscal costs in case of a systemic failure and made explicit this contingent fiscal liability. In the wake of these events, interest rates declined and a precarious degree of financial stability returned, but this proved to be a temporary respite. In early 2001, persistent doubts about the peg and underlying fiscal sustainability led to a full blown speculative attack against the currency. Interest rates shot up to several thousand percent, forcing the Government to abandon the crawling peg and float the Lira on February 21, 2001. The Lira immediately lost 40 percent of its value in a single day.

Exchange rate-based disinflation programs are vulnerable in a globalized world

8. The reliance on a pegged or fixed exchange rate in an environment of free capital flows and an unreformed banking system entails risks. Exchange rate anchors—while generally successful in setting inflation on a downward long-term trend in chronic inflation countries—have often been associated with currency crises. Many of the exchange rate based stabilization programs in the 1980s encountered currency crises at some stage and the economic crises that broke out in the second half of the nineties occurred in countries with fixed or managed exchange rate regimes. Currency attacks have often been accompanied by banking crises (e.g., Chile, Mexico and East Asia). The Asian experience shows that, with limited capital mobility, even a weak banking system can function reasonably well and support economic growth. However, such a system may not be able to handle massive entry and exit of short-term capital induced by capital account liberalization in the context of globalization. Exchange rate based

stabilization also generally results in sizeable real exchange rate appreciation and a deterioration of the current account which can undermine investor confidence. International experiences have shown that early moves to introduce exchange rate flexibility can minimize the extent of subsequent currency crises, as in Israel. Turkey's program featured a predetermined transition to a widening exchange rate band 18 months after the launch of the peg. However, this pre-announced exit—unique among pegged exchange rate systems—did not prevent the collapse of the peg after only one year.

3 CRISIS RESPONSE PROGRAM

The Government responded quickly to the 2001 crisis

9. The Government announced a strengthened economic program in May 2001 in response to the crisis following the collapse of the crawling peg and subsequent devaluation. The key structural and social elements of the program were: (i) a macroeconomic framework designed to restore financial stability and ensure public debt sustainability—principally through a further tightening of fiscal policy; (ii) rapid restructuring of the banking sector—especially of state banks and insolvent private banks intervened by the regulatory authority (BRSA)—based on large resource transfers from the budget; (iii) a more ambitious program of public sector reforms centered on deeper structural and institutional reforms to improve fiscal management and public governance; (iv) a renewed privatization drive—in combination with further liberalization measures focused on energy, telecommunications and agriculture—and strengthening of independent regulatory bodies to improve the private investment climate; and (iv) enhanced social assistance to help low income groups adversely affected by the crisis.

Turkey's crisis response program incorporated the experience of other emerging markets

10. Turkey's crisis response program benefited from the lessons learned by other emerging market countries facing crisis[3]. Immediate fiscal measures were introduced to shore up the primary surplus and strengthen confidence in the sustainability of the public debt. A front-loaded program of bank restructuring was launched backed by extensive fiscal resources. Bank restructuring was complemented by additional structural reforms in the financial sector designed to further strengthen prudential regulation, adopt internationally accepted financial reporting standards and practices, and enforce compliance. In parallel with accelerated financial sector reform, a comprehensive public sector reform program, including institutional reforms, was introduced to tackle the structural roots of Turkey's chronic fiscal imbalance. Strengthened financial and public sector reforms were placed within a medium-term programmatic framework in an effort to bolster investor confidence by demonstrating the Government's intent to address the core structural causes behind the crisis and not just the immediate symptoms

[3]See the background paper by Liviatan (2002) and Brahmbhatt (2001).

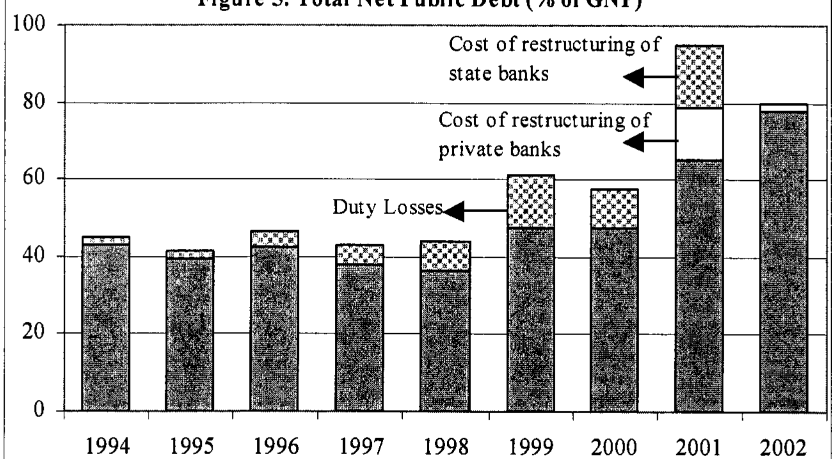
11. Initial outcomes under the crisis response program were mixed as the Government struggled to contain the fallout from the crisis and re-establish its policy credibility. The immediate financial turmoil arising from the crisis was fairly quickly contained, but at the price of a sharp increase in the public debt as the costs of bank restructuring were borne by the budget. The price spike following the initial devaluation in February 2001 was contained, but inflationary pressures persisted with inflation reaching 68 percent by the end of the year (Table 1). Following the decision to abandon the peg, uncertainty about exchange rate policy persisted for some time as the Government was slow to confirm its commitment to the float and the Central Bank repeatedly intervened in the foreign exchange market. Interest rates were brought down from their post-crisis peaks, but remained well above the projected program path throughout 2001, mainly due to the need to roll over large amounts of short-term public debt in the face of a slower than expected recovery in investor confidence. The primary surplus target of 5.5 percent of GNP for 2001 was met, but doubts continued about the medium-term sustainability of the fiscal adjustment. The economic recession turned out much deeper than projected as real GNP shrank by an estimated 9.5 percent for the year. A major factor in the recession was the sharp turnaround in the current account driven by capital outflows. The current account recorded a surplus of 2.4 percent of GNP in 2001. The combination of high real interest rates, devaluation, the huge fiscal cost of bank restructuring and deep recession caused the stock of public debt to rise significantly. The ratio of net public debt to GNP increased from 57 percent of GNP at the end of 2000 to an estimated 95 percent of GNP by the end of 2001 (Figure 5).

Table 1: Key Economic Indicators (1999-2003)

	1999	2000	2001	2002	2003 est.
GNP Growth	-6.1	6.3	-9.5	7.8	5.0
CPI Inflation (Dec-Dec)	68.8	39.0	68.5	29.7	20.0
Nominal Interest Rate	106.2	38.0	99.1	63.8	45.0
Unemployment Rate	7.1	6.6	8.5	10.6	12.3 2/
Primary Balance (% GNP) 1/	-2.0	2.7	5.5	3.9	6.5
Net Public Debt (% GNP)	61.0	57.7	95.0	79.8	77.0
Privatisation ($bn)	0.1	3.3	2.8	0.3	1.5
Current account balance (% GNP)	-0.7	-4.9	2.4	-1.0	-3.2
REER (1995=100)	123.1	136.5	112.5	125.3	138.0

1/ Consolidated public sector
2/ First quarter figure
Source: Government, IMF and WB estimates.

Figure 5. Total Net Public Debt (% of GNP)

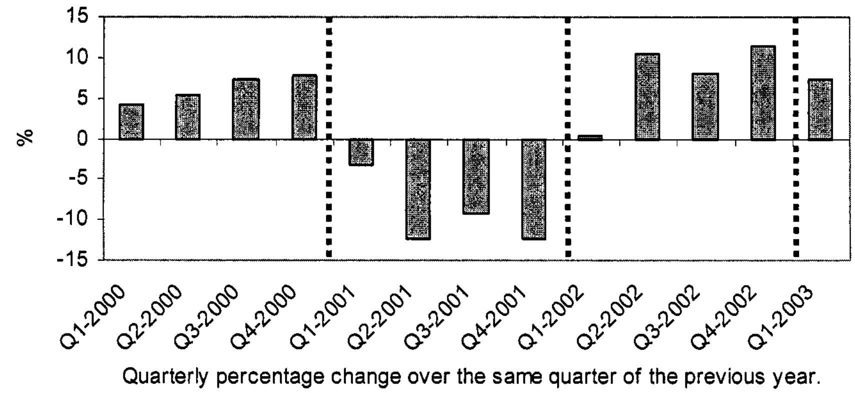


Source: Government, IMF and World Bank estimates.

Strong recovery is now underway but remains vulnerable

12. Economic activity rebounded strongly in 2002 and the recovery continued into early 2003. Real GNP growth reached 7.8 percent in 2002, exceeding program projections by a wide margin (Figure 6). The recovery was led by robust export performance and exceptionally large inventory rebuilding in the first half of the year. The recovery was further buoyed by a sharp rise in public consumption and investment during the second semester reflecting accelerated government spending ahead of early elections held in November 2002. An increase in agricultural output estimated at 7.1 percent was another factor. Overall, stock building accounted for some 90 percent of 2002 growth with private consumption and government spending making significant contributions to offset declines in private investment and net factor income. The impact of strong export performance in the 2002 growth accounting was offset by even faster growth in imports as the recovery gained steam. The recovery continued into the first quarter of 2003, with GNP 7.4 percent higher than in the first quarter of 2002. Importantly, private consumption and investment led the way for the first time since the crisis, recording increases of 6.5 percent and 20.4 percent respectively. While stronger than expected growth has been due in part to base effects from the recession, the genuinely positive news is that the recovery has been export-led with exports in USD terms increasing by some 30 percent during the first five months of 2003 compared to one year ago. Strong export performance, buoyant tourism and renewed capital inflows have eased the pressure on the BOP even as imports have expanded rapidly with the economic recovery. The modest current account of some one percent of GNP in 2002 was easily financed. The extent of the recovery and its basis in export growth place Turkey squarely in the category of rapid-recovery, post-crisis countries, such as Korea in 1999 and Mexico in 1995. Turkey's recovery began three quarters after the crisis trough was reached, in line with the fastest recoveries worldwide over the past decade.

Figure 6: GNP Growth



Source: SIS

13. In contrast with the real-side recovery, financial outcomes have been more mixed. On the positive side, inflation has fallen sharply. Consumer prices increased 29.7 percent over the course of 2002, well below the program target of 35 percent. The fall in inflation was helped by the rebound of the nominal exchange rate from its crisis lows. The strengthening Lira has not yet hurt export performance as it has been counterbalanced by a very sharp drop in real wages. More problematic were slippages in the fiscal program during the run up to the November elections. A gap of about 2.5 percent of GNP emerged with respect to the 2002 primary surplus

target of 6.5 percent of GNP. Contributing factors included: (i) cost overruns in the social security system, (ii) pre-election spending (new agriculture support purchases and civil service wage increases), (iii) an unexpected drop-off in tax revenues driven by expectations of a post-election tax amnesty, and (iv) unplanned spending through earmarked accounts left over following closure of the extra-budgetary funds. A series of stop-gap fiscal measures were identified to close the fiscal gap in late 2002, but were left largely unimplemented. Despite the fiscal slippage, the stock of net public debt fell to an estimated 80 percent of GNP by the end of 2002, helped by the rebound in the real exchange rate after the 2001 overshooting[4] and higher than expected growth.

14. The new Government's grace period with the financial markets was short lived as concerns about a slow start on economic reform, hints of political tension, and the looming threat of hostilities in neighboring Iraq started to weaken investor confidence in mid-December. Ad-hoc increases in pensions in early January and other populist measures raised concerns about the Government's political will to implement tough economic reforms. The average yield of the benchmark government paper moved up to the 60 percent range and the Lira came under some pressure. Financial market volatility continued during the first quarter of 2003. However, the winding down of hostilities in Iraq and approval by the US Congress in early April of a scaled-down assistance package for Turkey (a grant-equivalent of US$1 billion, potentially convertible to up to US$8.5 billion in loans) eased some of the market tension once again.

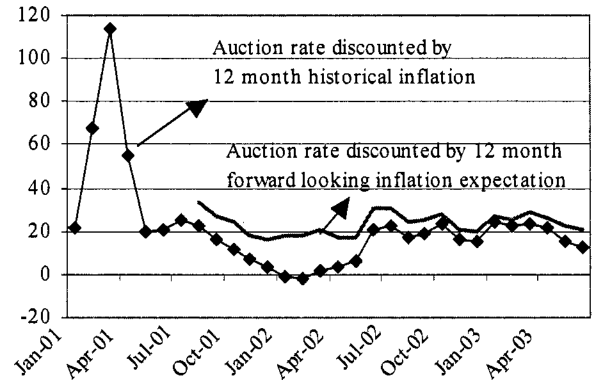
The new Government needs to build up its credibility quickly

15. In response to market developments, the Government has shown a renewed commitment to program implementation. The economic program for 2003 aims to sustain the recovery with the projected growth of 5 percent. Continued strong export performance and a return of private consumption and investment demand are expected to lead the recovery. Growth in 2003 will also be helped by strong carry over effects from the second half of 2002. Industrial production and export data suggest that the recovery continued in the second quarter, albeit probably at a slowing rate. Building on the positive outcome last year, the program targets a further reduction in CPI inflation to 20 percent by the end of the year. The authorities are counting on tight fiscal and monetary policies, a positive output gap and a stable exchange rate to bring the inflation rate down to the targeted level. The program aims to ensure sustainability of the public debt through sustained fiscal adjustment. The primary surplus is targeted to return to the program level of 6.5 percent of GNP in 2003 based on a package of fiscal measures equivalent to about 4.9 percent of GNP introduced by the Government to cover both the slippage recorded in 2002 and a number of temporary measures which expired. Together with the continued recovery, the tight fiscal stance is expected to underpin a further modest decline in the public debt to GNP ratio. On the external side, the current account is projected to weaken substantially, reflecting increasing imports, higher oil prices and flat tourism revenues following record receipts last year.

[4] A 10 percent move in the real exchange rate causes an 4-5 percentage point adjustment in the public debt to GNP ratio. The real exchange rate path is given in Table 1.

16. It is critical for the Government to move quickly to establish its reform credentials and bolster investor confidence. Sustaining the economic recovery will depend on the path of real interest rates. While interest rates have fallen from crisis peaks, they continue to include a very high risk premium (Figure 7). To reduce the risk premium, the new Government will have to bolster investor confidence by demonstrating its determination to implement economic reforms. With regard to the broader structural reform program, the Government has prepared an Urgent Action Plan for the coming year which draws on the reform progress achieved since 1999. As a further step, the Government has announced an ambitious privatization program for 2003. The key to rebuilding investor confidence and achieving the growth and inflation targets for 2003 now lies in the speed and determination with which the Government turns its announced plans into action. Sustaining high and more equitably distributed growth over time will depend on the Government's ability to meld its near-term actions into a coherent medium-term reform agenda.

Figure 7: Real Interest Rate using Weighted Average of Compound Auction Rates



Source: Central Bank and World Bank.

4 MEDIUM-TERM AGENDA

Sustaining high and more fairly distributed growth over the medium-term rests on a challenging reform agenda

17. Turkey faces difficult challenges to sustaining high growth and achieving durable macroeconomic stability. The new Government must address the structural roots of macroeconomic imbalance in order to prevent a recurrence of the "boom-bust" cycle that has characterized Turkey's economic performance over the past decade. Positive public debt and external financing dynamics hinge on rebuilding investor confidence. The medium-term agenda for sustained and equitable growth can be summarized as follows:

- The path to macroeconomic stability lies in sustaining a high level of fiscal adjustment for the foreseeable future. Fiscal adjustment must be underpinned by structural reforms and complemented by credible macro policies. Moving credibly towards international—notably EU—standards, will help minimizing trade-offs between recession and disinflation.

- Determined action to modernize public sector institutions and to improve public governance is critical to achieving quality fiscal adjustment and durably improving the business climate. Effective government is also key to realizing Turkey's social and human development objectives through the efficient delivery of public services.

- Sustaining and expanding the growth process will depend critically on improved performance of the financial and real sectors. Wide-ranging reforms must be deepened to bolster the financial system, promote corporate restructuring, complete regulatory reforms, and accelerate privatization and market liberalization.

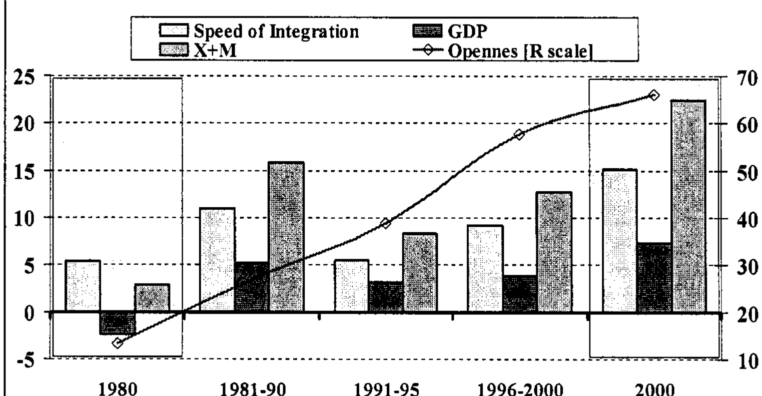
- Social policies need to be strengthened to ensure the robust social contract among its citizens that Turkey needs to meet the challenges of the new century and secure the social development of the country in light of the millennium development goals. Priorities for social policy include mitigating adverse consequences of the ongoing structural adjustments, raising the level of human capital, and ensuring effective operation of the labor market.

- Sustained growth will hinge on Turkey's further integration with the global economy. Structural reform is essential to maintain strong export performance, attract foreign direct investment and bolster confidence. Given continuing vulnerabilities to exogenous shocks, maintaining a policy of exchange rate flexibility will be important. Sustained progress towards EU accession would provide a strategic external anchor for Turkey's reform efforts.

Sustained growth hinges on a strong private sector response

18. Sustained growth depends on a strong private sector response. Given the budget constraint and disinflation imperative, traditional Keynesian mechanisms for economic stimulus are realistically not available to the Government. In the past, Turkish governments sought to foster growth through expansionary fiscal policies and direct government intervention in production, the results of which were short-lived growth spurts brought to a halt by balance-of-payments constraints or financial crises. Many of the conditions for sustained, private sector-led growth are in place in Turkey. Export competitiveness is strong.[5] The very rapid pace of opening and integration of Turkey's economy over the past twenty years has set the stage for even stronger export performance in the future (Figure 8). Turkey has yet to take full advantage of the customs union with the EU introduced in 1996. Capacity utilization rates are low, so the economy has the productive capacity with which to meet increased demand without fueling inflation. Growing demand will, in turn, stimulate private investment over time.

Figure 8 Openness
Trade to GDP has risen by more than 50 percentage points...



Source: World Bank data, EPPG calculations. ***Opennes:*** *share in GDP of exports plus imports of goods and non-factor svcs.* ***Speed of Integration:*** *Trade growth less GDP growth.*

19. Deeper structural reforms will support both fiscal adjustment and the private sector response. The structural reforms will underpin fiscal adjustment by rationalizing public expenditure, improving the efficiency of revenue collection and containing contingent liabilities.

[5] Background papers by Taskin (2002) and Taymaz (2002).

The reforms will promote private sector led growth and raise total factor productivity by improving the incentive framework, stimulating competition, and encouraging productive investment. Core structural reforms in the public sector, banking and finance, corporate sector, and labor market are analyzed in detail in this CEM. Other key elements of the medium-term structural agenda include completing the agriculture, energy and telecommunications reforms launched since 1999. These reforms were discussed in the 2000 CEM and are therefore not covered further here. Reemerging deficits in the social security system have focused attention on the urgent need for further structural reforms in this area to more effectively implement the 1999 reforms and introduce deeper changes to the system. The issues surrounding social security reform were also analyzed in depth in the 2000 CEM and the most recent developments are summarized in this report.

There are important risks to be addressed

20. There are important risk factors that must be actively addressed to ensure that they don't undermine emergence of a virtuous cycle of sustained growth. Internal risk factors include: (i) public debt sustainability—in particular the need to rollover large amounts of short-term domestic debt, (ii) incomplete reform in the financial sector and the potential for large-scale government borrowing to crowd out private investors, (iii) deep corporate distress following the crisis and the slow pace of corporate restructuring needed to promote competitiveness, and (iv) the potential for rigidities to develop in the labor market which could delay increases in labor productivity and job creation in the formal sector. Private access to financing may become a serious constraint on sustained recovery over time. Sustained fiscal adjustment is essential to free up domestic credit for the private sector. Another important mechanism to improve private credit access is the "Istanbul Approach" to out of court restructuring of illiquid, but potentially performing, corporate sector liabilities to the banking system. A related action concerns the establishment of one or more asset management companies with majority private ownership to resolve non-performing loans.

21. External risk factors are also significant and highlight the critical importance of promoting FDI in line with the experience of other rapid-recovery post-crisis countries. An immediate issue for policymakers is the widening current account deficit which is now expected to reach US$6.9 billion (3.2 percent of GNP) in 2003. While the floating exchange rate provides an automatic adjustment mechanism, the large foreign exchange component of the public debt and high domestic interest rates put constraints on the effectiveness of this adjustor. High domestic interest rates are now attracting short-term capital inflows and putting upward pressure on the Lira. Policymakers will need to ensure that this situation does not lead to an excessive buildup of short-term external debt as seen in 2000. The expected slower recovery in the world economy, increased risk aversion of international investors, and the potential for post-war instability in Iraq are all significant risk factors for the medium term. The external financing plan for 2003 and beyond centers on increased access to private capital. This will be a challenge under prevailing conditions in international financial markets. Increased FDI flows in the years following crisis have played a key role in sustaining recovery in other emerging markets. Turkey will have to accelerate its efforts in order to follow suit, in particular to strengthen productivity and expand its share in the strategically important, but relatively slow growing EU market. It remains uncertain what the medium-term consequences of developments in Iraq will be for

Turkey. Oil prices have come back down and increased regional trade as a result of lifting the UN trade restrictions on Iraq is positive for Turkey's balance of payments. On the other hand, tourism has been negatively affected.

The consensus for reform must be maintained and strengthened

22. To be successful, the Government must adapt its medium-term reform agenda to the realities of Turkey's complex political economy.[6] Turkey has a long tradition of clientelistic politics characterized by top-down decision-making and populist policies aimed at resource distribution to perceived political supporters. Formal interest groups are not strong by international comparison. The underlying social situation is characterized by a young and growing population and continuing high rate of urbanization which creates strong demand for public services and investment. Pursuing macroeconomic stabilization and structural reforms in such a socio-economic context is not easy. The recovery has yet to translate into welfare gains for the average citizen and there is significant reform fatigue. None of the parties in the previous governing coalition passed the 10 percent threshold for representation in the Parliament during the November 2002 elections due to a strong protest vote. Areas of the program which are particularly sensitive include: reform of agriculture support policies, social security reform, privatization, and public employment. The new Government's fresh election mandate and comfortable parliamentary majority are powerful advantages, but it will still need to work hard to maintain and strengthen the social consensus for reform. Continuing the economic reform program with the emphasis on fiscal discipline, while pursuing a more active social agenda as described in its Urgent Action Program, will require a constant balancing act by the Government. This dilemma is evidenced in the dichotomy between the Government's written policy documents, which have a strong reform orientation; and its early actions, particularly the ad hoc pension increases and generous tax amnesty, which had a strong populist flavor. The recommendations on strengthening social policies presented in Section 8 below can help the Government square this circle. Over the medium term, enhanced efforts are also likely to be needed to introduce more participatory approaches and gradually shift towards more decentralized modes of decision-making.

5 MACROECONOMIC FRAMEWORK

Sustained fiscal adjustment is the key to macroeconomic stability

23. To achieve stability, the medium-term macro-framework must remain anchored in sustained fiscal adjustment underpinned by credible structural reforms. Turkey will need to run large primary surpluses over the medium and long term to lower its public debt burden. The analysis

Table: 2: Alternative Fiscal Adjustment Scenarios (Required Primary Surplus, % of GNP)

Real GNP Growth	Real Interest Rates 7	9	11	13	15	17
3	2.8	4.3	5.9	7.3	9.0	10.5
4	2.0	3.5	5.0	6.6	8.1	9.6
5	1.1	2.7	4.2	5.7	7.2	8.7

Source: World Bank.

[6] This paragraph draws on Gunes-Ayata (2001).

presented in Table 2 confirms the view that a very conservative fiscal position is required to maintain fiscal sustainability in Turkey. With a 5 percent real growth rate, and a 13 percent real interest rate, a primary surplus of about 5.5 percent of GNP would be required to keep the stock of debt stable at 80 percent of GNP. However, if growth were only 3 percent per annum, the primary surplus would need to be about 7 percent of GNP. Under the program projections of 5 percent growth and a primary surplus of 6.5 percent of GNP, the stock of public debt to GNP is projected to decline only slowly (para. 66), thereby indicating the need to maintain the primary surplus at this level over the medium term and beyond. To the extent that actual fiscal outcomes exceed the primary surplus target, the need to maintain such large surpluses will diminish more quickly as will the risks inherent in such a program. Therefore, fiscal over-performance in the near term would accelerate progress towards macroeconomic stability.

24. Tight fiscal policy will provide additional credibility to monetary policy—already anchored by central bank independence under legislation passed in 2001—and open the way for continued disinflation. Other complementary macro policies include: (i) continued exchange rate flexibility under the floating foreign exchange regime; and (ii) active policies to ensure competitiveness including efforts to attract FDI. There is an extensive body of research highlighting the importance of policy credibility to successful stabilization outcomes. The experience of the Central and Eastern European Accession countries (CEE10) in the second half of the nineties is instructive. In these countries, the disinflation process enjoyed considerable credibility because it was part of a broader change in economic regime geared towards EU accession. As a result, they were able to maintain positive growth on average throughout this transition period. The lesson for Turkey is that if it can move credibly towards EU standards, there is a good chance of minimizing trade-offs between recession and disinflation, at least in the medium term.

Fiscal adjustment must be high quality

25. International experience has shown that fiscal adjustments are usually sustained only when they are of high quality reflected in a reliance on permanent expenditure reduction rather than revenue increases[7]. Turkey's recent experience shows how revenue increases can lead to only temporary improvement in the fiscal position as expenditures catch up over time. Total non-interest expenditures of the consolidated budget increased from 20 percent of GNP in 1999 to an estimated 22.8 percent of GNP in 2002, a 2.8 percentage point jump (Table 3). Quality is further ensured through measures to address

Table 3: Fiscal Adjustment, 1999-2002 (% of GNP)

	1999	2000	2001	2002	1999-2002
Total expenditures	40.5	41.5	48.7	43.7	
Non-interest expenditures [1/]	20.0	20.8	22.2	22.8	*2.8*
Total revenues	26.2	28.6	32.3	31.5	*5.3*
PSBR	14.3	12.9	16.4	12.2	
Quasi-fiscal deficit	10.4	6.3	1.5	0.4	
Adjusted PSBR	24.7	19.2	18.0	12.6	
Net interest payments	22.0	21.9	23.5	16.5	
Primary balance	-2.0	2.7	5.5	3.9	*5.9*
Inflationary comp. interest paym.	9.7	9.6	11.1	9.9	
Operational balance	-12.4	-6.9	-5.6	-4.9	

[1/] Consolidated budget only.
Source: Treasury, IMF and staff estimates.

[7] For empirical evidence, Mc Dermott and Wescott (1996).

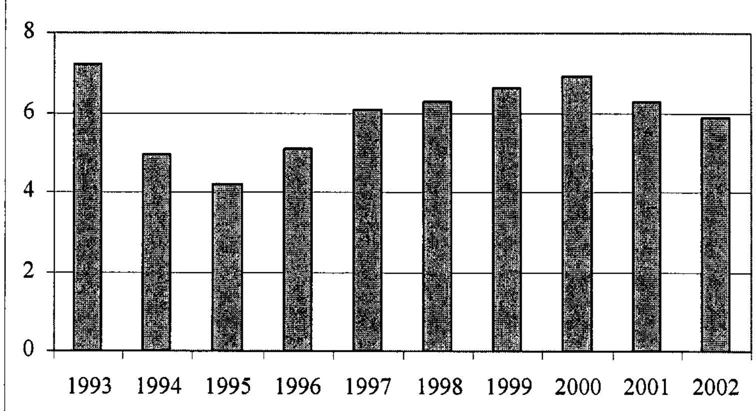
deeper structural problems which undermine fiscal discipline such as contingent liabilities, public enterprise losses, and inefficient subsidy programs. High quality fiscal adjustment is critical to convince markets that the debt burden is sustainable over the medium term and lower the risk premium on domestic debt to manageable levels[8].

26. To ensure a high quality fiscal adjustment, the Government must address the structural sources of Turkey's fiscal difficulties, not just achieve numeric targets. Important structural fiscal weaknesses must be definitively corrected. Historically, these weaknesses have included: (i) large deficits in the social security system despite Turkey's very favorable demographics; (ii) off-budget subsidies to farmers and small businesses channeled through the state banks as "duty losses"; (iii) indirect subsidies to the banking system in the form of implicit and explicit guarantees to bank depositors and creditors, which translated into an actual liability in the February 2001 crisis; (iv) losses incurred by public enterprises burdened by over-employment and charged with channeling non-transparent and untargeted subsidies to the agriculture and private enterprise sectors; and (v) lax provision of financial guarantees to local governments. Another problem has been the under developed tax system which relies excessively on distortionary commodity taxation and generates large tax expenditures through inefficient tax administration.

Important structural fiscal reforms have been implemented since 2000...

27. Real progress to tackle many of Turkey's structural fiscal problems has been made since the 2001 crisis which the new Government can now build on and consolidate. Under the financial sector reform, legislation is in place to prevent future duty losses in the state banks and private banking risks are under much stricter regulation and supervision. The agriculture reform has eliminated agriculture credit subsidies and replaced most inefficient and fiscally costly indirect subsidies with direct income support to farmers. The legal framework for competitive electricity and gas markets has been introduced which will facilitate the shift of risk from the Government to the private sector. Under the public sector reform program, the criteria for financial guarantees to local governments have been tightened and a "middle office" has been established in the Treasury to improve public liability management. The legal framework for public procurement has been upgraded to international standards. A major rationalization of the public investment program has been undertaken easing the real impact of the reduction in the investment budget

Figure 9: Public Sector Fixed Investment (% of GNP)

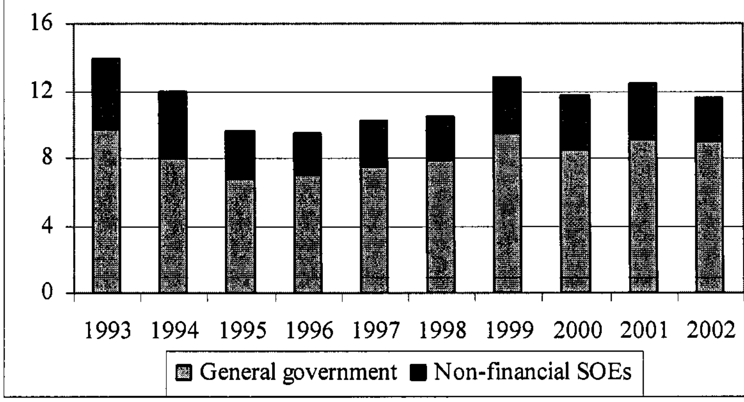


Source: SPO and World Bank.

[8] The importance of quality of fiscal adjustment has been highlighted in recent research by Alesina and Perroti (1995) and Easterly (1999).

following the crisis (Figure 9). Initial steps have been taken to rationalize public employment, including establishment of a monitoring system and reduction of redundancies in state enterprises, which has facilitated a reduction in the public wage bill (Figure 10). Progress is also being made to tackle problems with the tax system under the strategy adopted in late 2001. In many cases, these reforms will not only underpin the fiscal adjustment effort, they will also promote development of a stronger, more resilient private sector.

Figure 10: Public Sector Wage Bill (% of GNP)

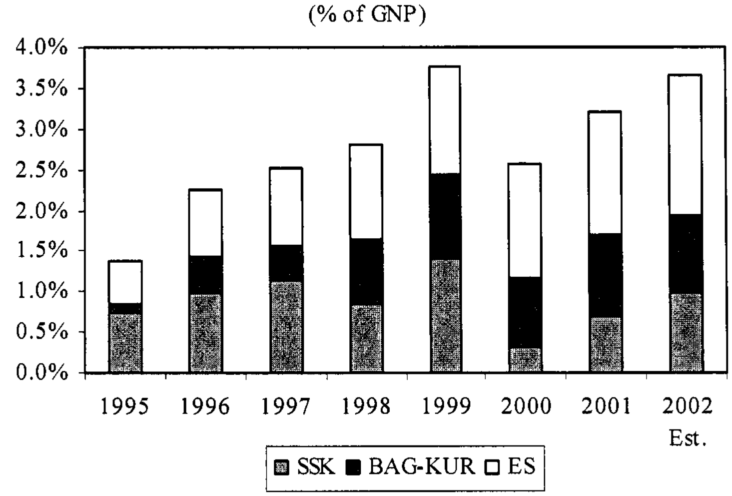


Source: SPO and World Bank.

...But the medium-term agenda remains extensive

28. Looking ahead, further structural reforms are needed to support the fiscal adjustment[9]. Continuation of the public investment and public employment rationalization programs can support further fiscal adjustment in these areas. However, the most pressing task is to tackle re-emerging problems in the social security system. While parametric reforms to the public pension system adopted in 1999 raised the pension age and linked benefits to lifetime contributions, the fiscal sustainability of the social security system has not yet been secured[10]. After initial improvement in 2000, the fiscal position of social security system worsened considerably in 2001-02 (Figure 11). With the ad-hoc pension increase introduced in January, the deficit could well approach 5 percent of GNP in 2003. The first reform priority is to enact legislation to underpin institutional and administrative reforms designed to improve collections and expenditure management, contain health expenditure, consolidate the legal basis for the unemployment insurance fund, and facilitate implementation of the 1999 reforms. A second priority is to introduce further institutional reforms to reorganize the social protection system by function

Figure 11: Deficit of Social Security System
(% of GNP)



Source: SPO and World Bank.

[9] World Bank Policy Research Report, 1994.

[10] See the CEM 2000 for the detailed analysis of 1999 pension reform.

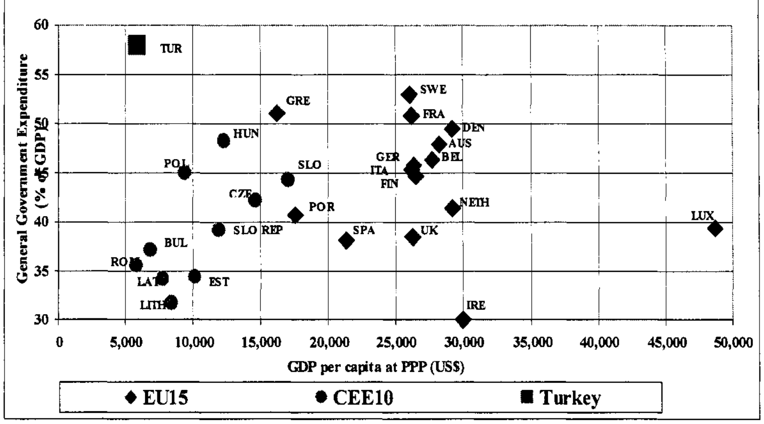
(pensions, health insurance, social assistance, and employment services), together with a new phase of parametric reforms notably in Emekli Sandigi—the pension fund for civil servants. A third priority is to improve management of the system, particularly financial management including credible efforts to address the massive buildup of contribution arrears. While the prospects of generating additional short-term fiscal savings relative to the program baseline may be limited, decisive action in these key structural areas (public investment and wage bill, and social security reform) can have a major impact on the quality of fiscal adjustment and hence on real interest rates.

6 PUBLIC SECTOR REFORM

Public sector reform is needed to underpin sustained fiscal adjustment and promote more effective government

29. Turkey's public sector is large relative to both current EU members (EU15) and the Central and Eastern European Accession countries. Turkey's total expenditure and non-interest expenditure in percent of GDP have increased over the period 1995-2001 while the EU15 and CEE10 both experienced a decline in general government spending. In 2001, Turkey's general government expenditure reached an extreme 58 percent of GDP; a clear outlier (Figure 12). The main factor has been the increase in the interest burden following the February 2001 crisis, but non-interest expenditures have steadily increased as well. While general government expenditure in a few of the EU15 countries (like Sweden and France) was above 50 percent in 2001, these countries were able to sustain this with a much higher per capita income compared to Turkey.

Figure 12: Per Capita Incomes & General Government Expenditure in the European Union, Cohesion & CEE Accession Countries, & Turkey, 2001



Source: World Bank.

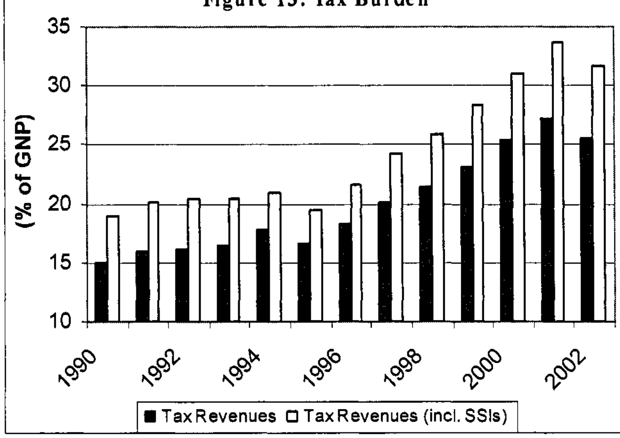
A comprehensive public sector reform program is under implementation

30. Turkey's public sector reform program aims to support sustained fiscal adjustment and create the conditions for transparent and effective government. The program strives to break the vicious circle of inadequate public sector management leading to ever increasing public indebtedness that fuels financial sector weakness through dependency on high return government securities which in turn inflates the public debt burden. The public sector reform program focuses on three critical areas, each of which has a medium-term dimension:

- Structural fiscal reforms focused on tax policy and administration and public employment;
- Policy and institutional reforms to improve the transparency and efficiency of public expenditure management (PEM) including action to:
  - Improve budget preparation and execution, policy formulation, and the operational performance of public agencies,
  - Upgrade public accounting, procurement and audit standards to achieve international standards of financial accountability, and
  - Ensure prudent public liability management; and
- Broad based institutional reforms to improve the quality of public sector governance.

31. The complexity and lack of transparency of the Turkish tax system exacerbated by tax policy instability and the distorting effect of high and unstable inflation rates have been highlighted in several detailed studies. Much of the complexity and instability arises from the ad hoc addition of special taxes, surcharges and levies in response to the ongoing struggle to contain the budget deficit. Over the past decade Turkey has steadily increased its revenue effort. Including social security contributions, total tax revenues rose from 18.9 percent to 31 percent of GNP between 1990 and 2002 (Figure 13). However, this revenue effort has multiplied the disincentives to growth inherent in the structure of tax system. Partial inflation indexation, in combination with differential nominal tax rates and investment incentives across financial instruments, has created highly distorted real effective tax rates across financial instruments and business investments. An over-reliance on transaction and commodity taxes arising from weaknesses in direct taxation has had a negative equity impact and hindered a shift in the burden of taxation towards upper income groups. Tax administration is also an issue. Investors have identified concerns with bureaucratic red tape, delays in processing applications for licenses or investment allowances and VAT refund claims, and corruption as negative factors for investment and business operations in Turkey. The problems of tax administration are exacerbated by Turkey's tradition of tax amnesties which the new Cabinet has unfortunately continued with a broad-based amnesty introduced in early 2003.

Figure 13: Tax Burden



Source: MOF and World Bank.

32. In January 2002, the Government adopted a medium-term tax strategy to improve the Turkish tax system and reduce marginal tax rates. Sustained implementation of the tax strategy will promote growth by improving the stability, transparency and equity of Turkey's tax system. The chief objectives are to minimize tax distortions, broaden the tax base and improve the efficiency of tax administration, all leading towards a reduction in marginal tax rates. Indirect taxes have been simplified under the strategy through the Special Consumption Tax enacted in June 2002 which replaced the two highest VAT rates and the increasingly complex array of

excise taxes. Further legislation enacted in April 2003 has addressed a number of issues in the system of direct taxation including: (i) harmonizing taxes on investment income at the declaration stage; (ii) rationalizing and simplifying the system of investment incentives; (iii) reforming the system of income tax credits for wage earners; and (iv) simplifying taxation of corporate earnings and dividends. This legislation simplifies and consolidates the direct tax regime and brings Turkey's personal and corporate income tax regimes closer to OECD standards and international best practice. The tax strategy includes a major overhaul of the tax administration encompassing institutional improvements, automation, transparency, compliance, taxpayer services and tax audit. It is designed to align Turkey progressively with best practice in other OECD countries. The planned functional reorganization will reorient the MOF's General Department of Revenues from a structure based on administration of individual taxes to one based on the core functions of tax administration including taxpayer registration, taxpayer services, collections, audit, legal, information technology, and human resources. The Government is also considering the option of upgrading the General Directorate of Revenues to the status of a separate under-secretariat in line with the practice of most OECD countries.

33. A comprehensive approach to public employment supports quality fiscal adjustment. In 2002, Turkey began to implement a more comprehensive public employment program. The current focus of the program is on strengthening monitoring of civil service employment and accelerating retrenchment of redundant labor in the state enterprise sector. A ceiling on civil service employment in the central government agencies is in place and has been expanded to cover civil servants in the local administrations. The limit on replacement hiring in the SEEs has been tightened to 10 percent of attrition and no replacement hiring is authorized for SEEs requiring finance from the budget. A comprehensive monitoring mechanism to track compliance with these policies is being established. A total of nearly 46,000 redundant SEE workers were identified in early 2002 and this number is being reduced, mainly through voluntary separations, under an agreement with the trade unions. Further retrenchment of public employment is expected over the medium term. The ceilings on civil service employment will also need to be maintained and the monitoring system improved. Ensuring effective coordination among the relevant agencies and the necessary political will for tough measures will be important issues in sustaining the public employment program over time.

34. The key elements of Turkey's strategy for public expenditure management (PEM) reform are laid out in the *Strategic Framework for Public Expenditure Management Reform* prepared in 2001 in the context of the Public Expenditure and Institutional Review carried out jointly with the World Bank. This strategic framework is the result of many years of internal discussion in Turkey about modernization of public expenditure management. The PEM strategy is articulated around three priorities:

- <u>Reform the processes for budget preparation and execution</u>. Better budget management involves steps to: (i) improve the transparency and comprehensiveness of the budget in line with international standards, (ii) strengthen the credibility of the budget preparation process, (iii) build capacity for policy formulation at all levels of government, and (iv) realize concrete improvements in the operational performance of line ministries and agencies through a progressive shift to performance budgeting. The cornerstone for improved budget management will be set by the Public Financial Management and Control (PFMC) law expected to be enacted by late-2003. The law will harmonize and

modernize budgetary practices across all of general government, reduce fragmentation and provide for a comprehensive presentation of the budget, allow for the establishment of modern internal control systems in the spending agencies in line with EU norms, and unify external audit under the auspices of the TCA. As part of the effort to improve budget preparation, impressive progress has been made in 2002 and 2003 to rationalize the public investment program and further actions are envisaged in 2004 under the plan prepared by the SPO. Initial steps have been taken to introduce strategic planning into the budget process and to improve operational performance of line agencies. It will be important to deepen these efforts as Turkey moves in a phased manner to full performance budgeting.

- Upgrade public accounting, procurement and audit functions to improve financial accountability. Strengthening financial accountability encompasses legal changes to introduce international fiduciary standards, as well as institutional changes to build capacity to implement the new standards and shift from formalistic ex ante control to effective ex post monitoring. Key milestones to date include enactment of the new Public Procurement law in 2002 and establishment of the independent Public Procurement Agency charged with overseeing its implementation. Preparation of new public accounting standards is also underway with the objective of introducing modified accrual accounting for all general government agencies in line with GFS standards. This will involve a massive training effort which will require significant resources to be sustained. The audit reform centers around transformation of the TCA into a true modern supreme audit institution. This is a serious collective action challenge which will require strong political support from the new Government.

- Ensure prudent public liability management. More effective public liability management involves measures to establish clear lines of borrowing authority and transparent reporting of public liabilities, as well as institutional measures to build up the capacity for modern fiscal risk management. The foundation for better liability management was laid by the Public Debt Management law enacted in 2002 which also established a "middle office" for debt and risk management within the Treasury. Under this framework, the Treasury is gearing up to address broader fiscal risks (e.g., BOT and similar take-or-pay schemes in the utilities sectors and the blanket guarantee on bank liabilities) and financial risks (e.g., foreign exchange exposure) in its debt and guarantee portfolio. The key now lies in vigorous implementation of the debt law and full functionality of the middle office.

35. Actions to improve public sector governance aim to reduce political influence over economic management and upgrade the quality and effectiveness of government action. The agenda includes implementation of a national anti-corruption strategy and comprehensive civil service reform. A national strategy to enhance transparency and good governance in the public sector under the slogan *"A Transparent and Clean Turkey: Together Hand in Hand"* was announced in January 2002. The objective of the strategy is to provide a comprehensive framework which establishes clear priorities and benchmarks, and empowers and energizes public opinion to fight corruption. The strategy covers five core areas: public administration, the judicial system, the political system, civil society and the competitive private sector. It

complements on-going regulatory reforms in the enterprise and financial sectors, as well as the financial accountability agenda discussed above. The Government is counting on the active involvement of national NGOs. One of the major national NGOs, TESEV, has completed two diagnostic surveys on corruption covering households and the business community respectively, and has completed preparations for a third survey covering civil servants. The core actions under national anti-corruption strategy have been reflected in the Urgent Action Plan of the new Government. A ministerial committee for enhancing transparency and improving good governance was established in March 2003. The committee will monitor implementation of the anti-corruption strategy in the context of the Urgent Action Plan.

36. Under its Urgent Action Plan, the new Government intends to adopt a civil service reform strategy by the end of 2003. As part of the preparation process, the authorities have initiated a broad-based functional review of government. The functional review has two objectives. First, it will help the Government to decide what type of organization or combination of organizations should undertake any given public service function within what type of legal framework. Second, it will help individual public entities figure out the best business process design including organizational structure and staffing requirements. The timetable for preparation of the civil service reform is ambitious and the Government will have to move quickly to complete the functional review process and related actions. These initiatives are essential building blocks towards a comprehensive overhaul of Turkey's public administration.

7 BUSINESS ENVIRONMENT

A positive business environment attracts investment and ensures competitiveness

37. Structural reforms to improve the business environment are an essential component of Turkey's economic reform program. The core objective of these reforms is to fuel growth through productivity increases driven by private investment, enhanced competition and efficient financial intermediation. As in other areas, substantial progress has been achieved since the initial disinflation program was launched in 1999, particularly in terms of financial sector reform and improvements to the regulatory framework. Looking ahead, medium-term priorities for improving the business environment center around five core pillars:

- deepening financial sector reform
- promoting corporate restructuring
- completing regulatory reforms
- accelerating privatization and market liberalization
- attracting high levels of FDI

A healthy financial sector will support macro stability and fuel private investment

38. In response to the 2001 crisis, the authorities have redoubled efforts to reform the banking system, but important challenges remain. An independent bank regulatory and supervisory authority, the BRSA, was established in 2000. Prudential regulations have been upgraded in line with EU and Basle norms. Insolvent private banks have been intervened and resolved, and a full scale re-capitalization of the banking system has been carried out. In line with the experience of other emerging market countries by banking crises, the fiscal cost of bank restructuring has been very high (Table 4). However, there continue to be market perceptions that some private banks may still not be adequately capitalized. This perception is due to a combination of factors: (i) a significant amount of new equity under the re-capitalization exercise came from asset valuation due to inflation accounting, (ii) a new regulation eliminated the requirement that loans extended to connected parties are deducted from the capital base, and (iii) the large portfolio of government securities held by banks is assigned zero default risk weighting. Further regulatory actions may be indicated to address these factors including the possible option of assigning some risk-weight to government securities. Private banks are also confronted with a lack of profitability in general, large portfolios of connected lending and continuing maturity mis-matches. Under the circumstances, further consolidation in the sector is likely. Managing the transformation to a banking sector capable of efficient financial intermediation will require further improvement of the institutional and incentive framework. Further action is also needed on the state banks and completing their restructuring and privatization process will require sustained political support. Development of the non-bank financial sector is another important issue on the medium-term agenda.

Table 4: Fiscal Cost of Bank Restructuring
(As of end of 2002)

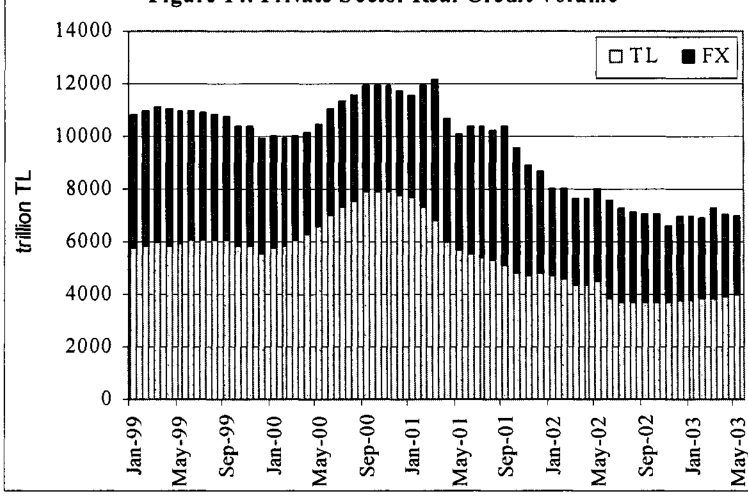
	TL trillions	% of GNP
State Banks	**29,022**	**16.4**
Ziraat	15,385	**8.7**
Halk	12,627	**7.2**
Emlak	710	**0.4**
Vakif	300	**0.2**
SDIF Banks	**28,784**	**16.3**
Grand Total	**57,806**	**32.8**

Source: BRSA and World Bank

[1/] GNP 2001 has been used since most of government securities were issued in 2001.

39. Although econometric analysis does not indicate evidence of credit rationing following the 2001 crisis, the stock of credit to the economy has fallen sharply in real terms (Figure 14). This post-crisis contraction in private credit is consistent with the experience of other emerging market economies. Generally,

Figure 14: Private Sector Real Credit Volume



Source: Central Bank and World Bank.

resumption of bank credit is not a leading indicator and only follows output recovery[11]. For example, in Mexico, credit growth turned positive only some seven years after the 1994 crisis. While a timely rebound in credit would help sustain the economic recovery, the Treasury's financing requirement will remain very large for the foreseeable future and the financial deepening expected from macroeconomic stabilization and the banking reforms will take time to materialize. In the interim, it is important to avoid artificial measures to encourage bank lending. If necessary, certain temporary measures directed to firms rather than banks could provide relief. Possible measures include: (i) schemes that give firms a limited amount of government backed financing for a temporary period, (ii) automatic roll-over of small SME loans, and/or (iii) a trade finance scheme. Given that SMEs finance themselves primarily by using trade credit, measures such as allowing receivables to be protected in bankruptcy and allowing borrowing against invoices and accounts receivable may be more important in relaxing the credit constraints on these firms.

40. Further strengthening of the institutional and incentive framework will propel the transformation to a modern banking sector in Turkey. International experience demonstrates that bank re-capitalization efforts which pay inadequate attention to factors that can undermine the effectiveness of regulatory/supervisory environments and impediments to bank profitability are doomed to be repeated. On the institutional side, bank supervision tends to be much more effective when it is free from political intervention and reinforced by private discipline. Therefore, the most critical issue for Turkey is to consolidate the independence and operational capacity of the BRSA. Important steps have been taken to improve the incentive structure of the Turkish banking system since the crisis but more actions will be needed to complement macroeconomic stabilization efforts. Of particular importance is the need to introduce a well designed deposit insurance scheme in line with EU norms to replace the blanket guarantee introduced in 2000. Care must be taken to ensure that the deposit insurance scheme does not undermine private incentives for improved bank performance. Phasing out distortionary banking transaction taxes under the tax strategy will be another important step to improve profitability, particularly as disinflation progresses.

Governments are not good at providing financial services

41. Restructuring and privatization of the state banks—which make up over 30 percent of banking system assets-is critical to the long-term success of the banking reform. International evidence indicates that state ownership of banks has negative consequences for financial development and economic growth. As part of the reform program, one state bank, Emlak, has been closed through merger with Ziraat, the main state bank. Another state bank, Vakif, has initiated its privatization process but will require further portfolio restructuring for this to be successful. The largest state banks, Ziraat and Halk, have been re-capitalized with government securities at market terms thereby eliminating their accumulated stock of duty loss claims on the Treasury. An independent board has been appointed to manage Ziraat and Halk in accordance with commercial principles, and to streamline their operations in preparation for privatization. Significant progress has been made in closing unprofitable branches and reducing redundant labor. An important factor in facilitating privatization of Ziraat and Halk is to shrink their size. About 60 percent of the combined asset portfolio of Halk and Ziraat is made up of government

[11] Park and Lee (2003).

assets, with loans making up less than 20 percent. It may be possible to spin off part of this government portfolio into a money market mutual fund or other financial vehicle(s). An additional critical step will be to limit the state banks' role in provision of subsidies. Legal safeguards against future duty losses are in place which require that any subsidies are transparently provided through the budget. Another key issue for privatization is the future strategic direction of the state banks. As Ziraat Bank is expected to move towards full service banking, it will compete with the SME client base of Halk. Therefore, consideration should be given to ensuring viable strategies for these two banks prior to privatization. Decisive actions will make privatization of the state banks a more realistic goal. A clear strategy and timetable will prevent a long and drawn-out privatization process and minimize the chances that the process is derailed by political interference.

Non-bank financial institutions are important to balanced financial sector development

42. A modern financial system features a dynamic balance of bank and non-bank financial intermediation. Both types of intermediation are important and they are complements, not substitutes. Banks, securities markets, and a range of other types of intermediary and ancillary financial firms like insurance, leasing, factoring and venture capital companies, and mutual and pension funds all contribute to an efficient and developed financial sector able to successfully meet the full range of financing needs of individuals, business and the public sector. Non-bank financial institutions (NBFIs) provide alternative financial services. NBFIs improve general system-wide access to finance, facilitate longer term investments, and match funding sources with investments based on appropriate risk/return characteristics. A recent World Bank study on NBFIs and capital markets provides a road-map on the development of non-bank financial markets in Turkey[12]. The study highlights the need to: (i) mobilize savings effectively from both domestic and foreign investors; (ii) build an institutional investor base by promoting the development of insurance, private pension funds and the mutual fund industry; (iii) develop securities markets through deepening and enhancing the efficiency of existing markets and market infrastructure; (iv) develop other non-bank sources of finance such as leasing, factoring and venture capital; and (v) strengthen confidence in financial markets by improving corporate governance, accounting and auditing standards and practices and by further strengthening the regulation and supervision of financial markets.

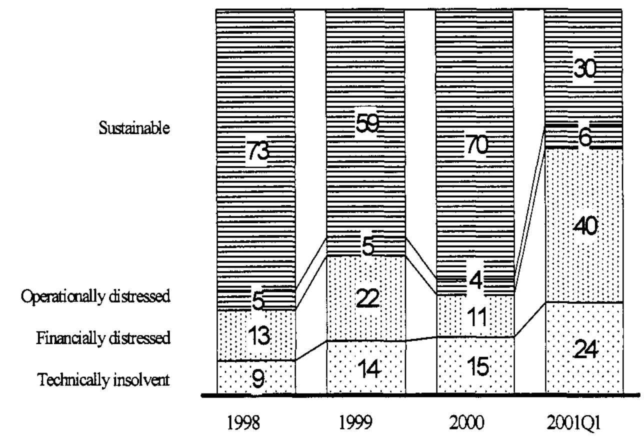
Corporate restructuring will strengthen the private sector response

43. Comprehensive corporate restructuring is a continuing priority in dealing with the aftermath of the 2001 crisis and sustaining the recovery. Many firms failed during 2001 as the crisis hurt all sectors—industry, construction, trade and services. Firms were hit by falling demand coupled with rising financial charges stemming from high real interest rates, the high cost of servicing debt denominated in foreign exchange and associated foreign exchange losses. Net earnings of Istanbul Stock Exchange (ISE) listed companies were down 80 percent for 2001. For listed companies, interest coverage ratios fell and levels of corporate leverage rose in 2001-02. While the burden was particularly acute for small and medium enterprises, many mid-cap to larger firms are in distress as well (Figure 15). Corporate distress must be addressed to sustain

[12] Non-Bank Financial Institutions and Capital Markets in Turkey, April 2003.

the recovery. This is also a window of opportunity for deeper restructuring to strengthen the competitiveness of Turkey's corporate sector and open the way to productivity gains over the medium term. Lessons from the recent crises in East Asia, Mexico and elsewhere indicate that an effective corporate resolution strategy should include measures to: (i) segment problem companies; (ii) implement a voluntary workout program; (iii) improve the bankruptcy framework including allowing for pre-packaged bankruptcies that would recognize voluntary workouts in the courts; (iv) ease tax, legal, and regulatory impediments to restructuring; (v) establish an asset management company or companies; and (vi) ensure adequate credit access for SMEs. The resolution strategy should be tailored to address the need for deeper restructuring of Turkey's corporate sector where large financial/industrial groups play a very prominent role and many sub-sectors are characterized by oligopolistic structures that hinder competition. In parallel with restructuring, structural reforms are needed to improve corporate governance in line with international standards.

Figure 15: Distressed Companies, 1998-2001 Q1 (ISE Listed Companies)



Source: TOBB

44. In June 2002, a voluntary corporate workout program, known informally as the Istanbul Approach (IA), was introduced. Introduction of the IA was timed to coincide with completion of the bank re-capitalization program. Newly capitalized banks should, in principle, have the proper incentives to restructure potentially performing loans and to collect every penny possible on provisioned loans, as improvements in loan classification and collection will be directly reflected in increased profits and bank capital. To promote the IA, a number of tax incentives have been introduced. Banks will be eligible for incentives under the program for an initial period of three years and the Government retains the option of extending the program. Experience in most crisis countries indicates that a systemic workout process may well take several years to complete. Moreover, it is difficult to get the workout just right the first time, given the unstable economic conditions that normally exist when the workouts are concluded. Therefore, the process has to allow at a minimum for a second round or modifications of some workouts a couple of years into the process, once economic conditions have stabilized. As of end-June 2003, a total of 299 firms had entered into the IA representing US$4.8 billion in loans and 46,333 jobs.

45. The Istanbul Approach will need to be complemented by a broader array of structural measures to promote deeper corporate restructuring. These include facilitating access to credit for small and medium-size enterprises—including development of NBFIs and commercially sound credit guarantee schemes—and taking a more pro-active approach to foreign direct investment—thereby facilitating new entry. Also important is accelerating the privatization program—including a careful review of state enterprises to assess their need for workouts and restructuring. In addition, there is a need for improved corporate governance encompassing

accounting reform, enhanced corporate disclosure, as well as strengthened independence for boards of directors and better protection of minority shareholder rights. Of critical importance are steps to upgrade the legal framework for bankruptcy and facilitate resolution of non-performing loans. The bankruptcy law was amended in July 2003 in line with international standards which will strengthen incentives for companies to participate in the IA and improve the broader business environment by facilitating exit. Further amendments to the law to introduce a pre-packaged bankruptcy option are scheduled to be enacted later in 2003. To make asset management and recovery more effective, it may be a good idea to split the asset management function from the BRSA's Savings and Deposit Insurance Fund (SDIF) which deals with failed banks. Private asset management companies are probably also going to be needed. To promote competition, the Competition Board will need to shift from passive to active competition policies in line with EU practice. Deeper corporate restructuring will also be driven by the programmed tightening of prudential rules on connected lending by banks scheduled to reach EU standards over the next seven years. This will require banks to build up a new client base and compel corporations to look outside their own financial/industrial groups for resources to finance investment.

Regulatory reforms are critical for a well functioning market economy

46. Regulatory reforms are essential to the development of a well functioning market economy. International experience has demonstrated the importance of strong regulatory frameworks anchored by independent regulatory bodies in key areas such as competition policy, finance and network infrastructure. Effective regulation also involves transparent processes for regulation-making; consultation with interested parties; plain language in drafting, publication and other ways of making rules accessible; clear lines of accountability; and appeal processes that are predictable and consistent. Regulatory reforms had been slow to emerge in Turkey until the last few years, with some important exceptions such as the Competition Board and Capital Markets Authority. Weaknesses in the regulatory framework played a key role in Turkey's chronic macroeconomic instability, disappointing performance in attracting FDI, and accumulation of contingent government liabilities.

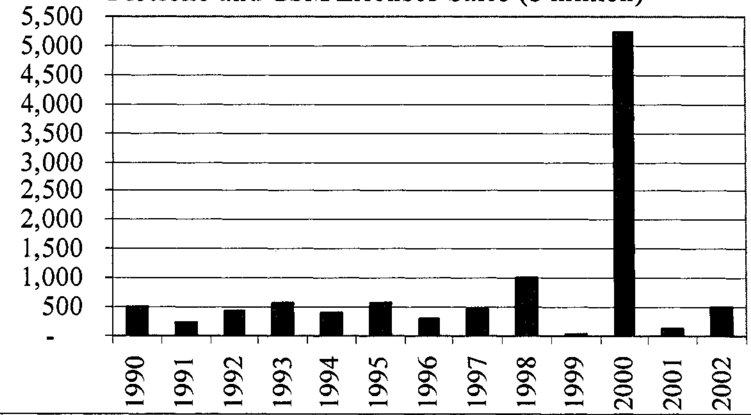
47. The depth of the 2001 crisis and prospects of eventual EU accession have created a window of opportunity for deepening regulatory reforms in Turkey which the new Government must build upon. Turkey has increasingly favored the "independent regulator" model in line with OECD and EU practice as part of its strategy to separate ownership, policy formulation and regulatory oversight. Such agencies are particularly important in Turkey's environment to ensure impartial and effective regulation isolated from political influence. Since 2000, regulators have been established in the banking, energy and telecommunications sectors, together with an independent oversight board for public procurement. These agencies have been established by specific legislation which defines their roles, objectives and powers. They are accountable to the Parliament and independently funded from license fees, permits and levies. The principles on which the regulators are based are generally sound, and demonstrate commitment to de-politicized economic management. The transparency and accountability of the regulators will be enhanced under the PFMC law which will subject their budgets to Parliamentary approval and include them under the audit mandate of the TCA. It will be critical to the new Government's credibility to sustain this reform effort and respect the independence of the new regulatory

boards. This renewed commitment will help secure the levels of private investment needed to underpin growth by demonstrating Turkey's determination to level the playing field for all investors as part of the improved business environment.

Accelerated privatization will strengthen reform credibility and support private sector development

48. Privatization in Turkey has lagged behind other emerging countries in Latin America, Asia and Eastern Europe (Figure 16). In 2002, state enterprises continued to account for 20 percent of total manufacturing industry value-added and 3.3 percent of total non-agricultural employment. The Privatization Administration (PA) is responsible for carrying out the privatization program under the authority of the High Privatization Council (PHC), a group of ministers chaired by the Prime Minister. The program has suffered from many flaws. A requirement that the PHC approve all transaction, regardless of size, has led even small divestitures to be recycled several times—significantly lowering their value and reducing transparency. The prevailing cross subsidy mechanism between profit making companies and loss makers in the PA's portfolio removes incentives for the managers of loss makers to restructure these companies and improve operational performance. As a result, the PA has effectively become a large state holding group—a function it is not equipped to handle. Privatization of telecommunications and state banks has remained the responsibility of line ministries, inter-ministerial committees or of the company managers and directors themselves, who have little incentives to sell these assets. Privatization has been viewed by the authorities primarily as an important revenue source, particularly during crises, thereby subordinating the more important objective of making Turkish industry more efficient and competitive. Not surprisingly, this approach has contributed to delays and de-capitalization of state enterprises, while facilitating resistance to privatization.

Figure 16: Turkey: Privatization Under PA Portfolio and GSM Licenses Sales ($ million)



Source: Privatization Administration and World Bank.

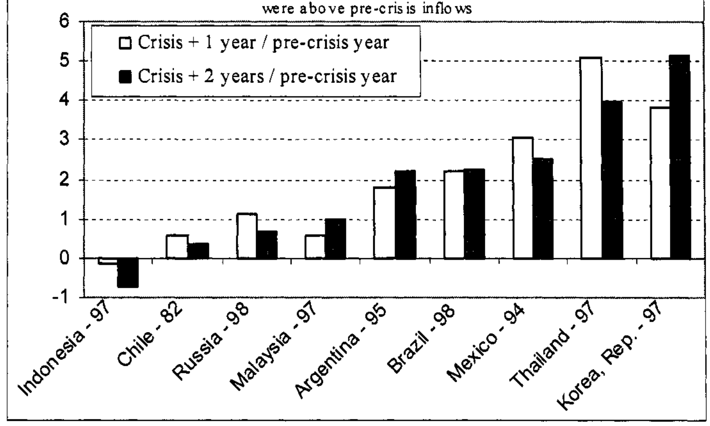
49. Determined action to improve and de-politicize the privatization process will help strengthen the new Government's reform credentials. Accelerated privatization is needed in order to reduce SOE losses, pay down the public debt and transfer productive assets to the private sector. Equally important, progress on privatization is essential to ensuring the irreversibility of the reform program and convincing investors that the fiscal adjustment is permanent. The Government has announced an ambitious US$4 billion privatization program for 2003, but credibility will depend on implementation. As a first step, the PA's mandate should be broadened to include a "fast track" privatization process for non-strategic companies

in its portfolio which would not require PHC approval of the actual transactions. In parallel, the cross subsidization mechanism should be terminated to improve transparency and incentives for SEE managers. The PA should be given a free hand to tackle its inventory of loss-making companies through mergers and liquidations. Finally, future privatizations should not be carried out by line ministries and the authorities should take full advantage of the PA's experience and technical abilities. The on-going reforms to promote market forces in energy, telecommunications and agriculture will help secure the efficiency gains expected from privatization. Accelerated privatization will have social implications. The Government will need to ensure sufficient funds cover all severance payments and other benefits due to workers laid off through privatization. Active labor market programs such as retraining and reinsertion should be enhanced to provide additional support to these workers.

FDI can help spur recovery and growth

50. International experience highlights the importance of FDI to spurring recovery and sustaining growth. In recent years, nearly all countries experiencing crisis saw net FDI inflows remain positive through the crisis and subsequent years, unlike short-term capital flows such as portfolio investment. With the exceptions of Chile, Indonesia, and Malaysia, net FDI flows in the year subsequent to the onset of crisis were higher relative to GDP than in the year immediately preceding the crisis (Figure 17). The policy environment appears to explain an important part of the differences in relative FDI performance. Countries that introduced economic reforms in general and in particular geared toward FDI inflows—such as Brazil, Mexico, Korea and Thailand—witnessed sustained increases in FDI inflows in the post-crisis period. FDI plays a strategic role beyond recovery from crisis. Competition pressures from foreign firms can promote product innovation, the overall diffusion of new technology, investment in new plants and sales growth. Increased FDI can play a crucial role in broader corporate restructuring through exposure to advanced organizational and managerial skills. Studies indicate that FDI stimulates growth through spill-over effects and enhances export performance. FDI should also be encouraged for projects oriented to domestic markets and be linked to local enterprise development. The benefits of FDI are not automatic and depend on the overall policy environment and quality of institutions. Important factors include the prevalence of rule of law, transparent administrative practices, effectively combating corruption, good corporate governance, sound competition policy, and protection of labor rights and the environment. More and more research argues that absorptive capacity in the host country is crucial. Pro FDI policies need to be complemented by appropriate human capital development and R&D policy to maximize the benefits.

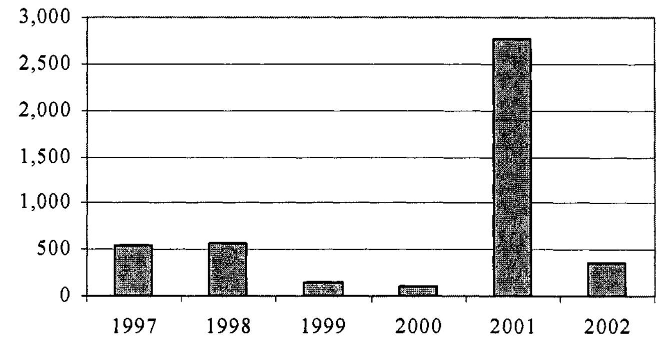
Figure 17: Post-Crisis FDI:
Ratio of FDI inflows: 1 and 2 years after crisis relative to 1 year prior to crisis, ratios of FDI share to GDP, ratio over 1 indicates post-crisis FDI inflows were above pre-crisis inflows



Source: World Bank

51. Turkey has begun to develop an FDI strategy, but this does not yet address all of the challenges to realizing significant FDI inflows (Figure 18). Initiatives are required to: (i) improve the institutional environment by streamlining administrative procedures and de-politicizing the privatization process; (ii) engage in investment promotion activities to improve Turkey's image with foreign investors; and (iii) build on Turkey's locational advantages such as its abundant labor force, developed infrastructure and geographic location. Turkey is making progress towards an improved environment for foreign investors. Based on recommendations by Foreign Investment Advisory Service (FIAS), a consultative process has been set up with the private sector through the Coordination Council for Investment Climate (YOIKK), which is chaired by a cabinet minister. A new FDI law was enacted in June 2003 to upgrade the legal framework and legislation has been prepared to establish an investment promotion agency. The Government can build on this momentum by: (a) activating the Investor Council consisting of high-level representatives of the international business community; (b) initiating a full-scale review of commercial law and competition policy in Turkey to identify and address important obstacles to FDI, and (c) developing a strategy to facilitate the flow of "greenfield" FDI to SMEs.

Figure 18: FDI (US$ million)



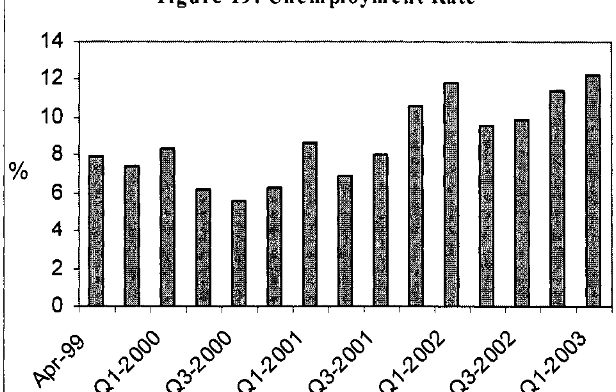
Source: Treasury and World Bank.

8 SOCIAL POLICIES

Social costs of the financial crisis have been high

52. The cumulative social costs of stagnation and crisis have been very high. Per capita GDP contracted by 13 percent between 1998 and 2001. The officially recorded unemployment rate rose from 6.4 percent in 1998 to 8.5 percent in 2001, and rose further to 10.6 percent during 2002 and 12.3 percent in the first quarter of 2003 (Figure 19). The unemployment rate increased again in the first quarter of 2003 despite the recovery. Agriculture and services, the two sectors most likely to employ the poor, shed large numbers of workers. In 2001 there were about 3 million fewer people employed in these sectors relative to the peak in 1999. Real wages in manufacturing remained relatively constant through 2000 as nominal wage increases kept pace with inflation, but then declined sharply in 2001. In the fourth quarter of 2001, real wages in manufacturing fell by a stunning 20 percent compared to the same period in the

Figure 19: Unemployment Rate



previous year. While the fall in real wages has helped maintain Turkey's external competitiveness, the associated household welfare loss has been large. World Bank estimates suggest that in 1994 some 6 percent of the urban population were below a food poverty line, but by 2001 the percentage had jumped to approximately 17 percent. The primary coping strategy of the poor has been to reduce consumption, particularly of food. There are also indications that education expenses have been reduced and some children withdrawn from school. The Southeastern region has been particularly affected. Although it accounts for less than 7 percent of the population, about 25 percent of the urban food poor live in this region.

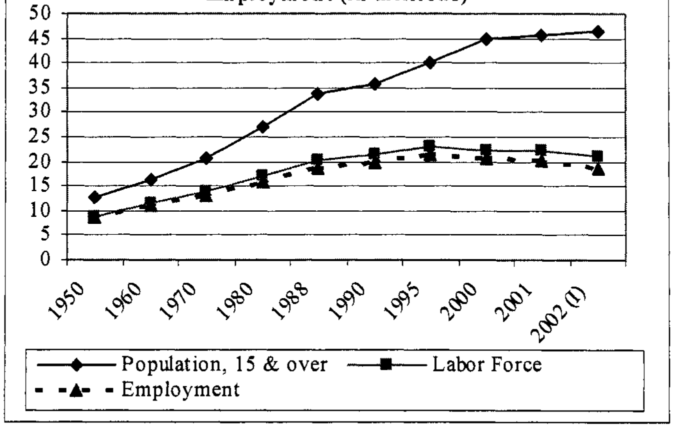
53. The new Government is working to strengthen the social dimension of the program, but faces obstacles in the burgeoning social security deficit and heavy debt burden. Benchmarks for public spending on health, education and social protection have been set by the Goverment. This policy has succeeded in maintaining, and even increasing, the overall level of social expenditure. However, this result has been due primarily to large overruns in social security expenditure which have masked important shortfalls in other social protection programs. Targeted social assistance spending fell short of the targets in key areas in 2002, including the DIS program for farmers and the social assistance programs funded by the Social Solidarity Fund (SSF). The Government is now moving to correct some of the shortfalls in social protection and improve the institutional framework, however, its initial steps to introduce ad hoc increases in pensions exacerbated the problem. Permanently shifting the balance of social programs more in favor of poor and vulnerable groups will take more time and effort, as well as substantial political will. To strengthen the institutional framework, the authorities are preparing legislation to reform the SSF and institutionalize the DIS program. The Government is also aiming to increase targeted social spending in 2003, but this will depend on measures to contain cost overruns in the social security system. On-going quality improvements to education under the basic education reform program need to be maintained and policy reforms to underpin improvements in the health system are an urgent priority. More effective measures to ease labor adjustment costs also need to be developed including a review of the unemployment insurance scheme introduced in 1999. Over the medium term, the need to service the public debt burden will pose a continuing challenge to ensuring adequate funding of social programs. The public debt will also be an obstacle to improvements in the distribution of income as tax collections are used to meet obligations to government bondholders.

The engine of job creation must be the private sector

54. The private sector must be the source of job creation in Turkey over the medium term. Permanent fiscal adjustment will require a sustained retrenchment in public employment given a public sector wage bill that consumes 24 percent of central government expenditure. In comparison, Australia allocates only 2.4 percent of expenditure for wages, while even France with a traditionally large public sector allocates only 16 percent. What is striking over the last three years of economic stagnation is that the opposite has happened as public sector employment increased by 5 percent between 1999 and 2001, while private employment decreased by 6 percent. Under the public sector reform program, the Government has now begun a serious effort to restrain public employment. Another stand-out feature of the Turkish labor market is the large and growing gap between the labor force (adult population who are either employed or looking for work) and adult population. In 2001, of the 46 million adults only 22

million were in the labor force and of these 20 million were employed, according to the labor force survey (Figure 20). Half the adult population (conventionally defined as persons above 15 years of age) were not employed and not looking for work. Possible explanations for the low labor participation include women dropping out of the work force, undercounting of employment in a growing informal sector, and discouraged job seekers dropping out of the labor force.

Figure 20: Adult Population, Labor Force and Employment (in millions)



Source: SIS

Eliminating constraints on employment creation is important

55. Policies play an important role in employment creation. Labor market policies geared to promote formal private sector employment enhance equity and complement other pro-growth reforms aimed at macroeconomic stability, a sound financial system and a competitive corporate sector. In many countries, labor laws provide employment protection particularly for vulnerable groups such as women and the young. At the same time, strict labor laws can affect employment creation or, alternatively, in countries with inadequate enforcement, stricter labor laws can unintentionally lower worker protection by promoting growth of the informal sector. Labor costs relative to productivity also impact employment prospects; if labor costs are high relative to productivity then employment prospects will be reduced. Payroll taxes are a key factor in determining overall labor costs and provide the most direct link between social security reform and job creation. Many OECD countries, including Turkey, have begun to use active labor market policies to promote employment. There is now a reasonably large literature which provides guidance on how these programs can be used effectively.

56. Turkish labor law provides very strong employment protection on paper, but enforcement is a question mark and in practice the system may provide strong incentives to the informal sector. A comparison of employment protection laws in 26 OECD countries finds that Turkey (along with Greece) has provided the greatest degree of formal protection for workers. This comparison does not take into account the new Labor Law enacted in June 2003[13]. Turkey's employment regulations stand out on two aspects: (i) notice and payment required for severance pay, and (ii) in the regulation of temporary workers. The severance pay regulations imply that a typical worker with 20 years tenure is entitled to 26 months severance pay. Only Portugal among the 26 OECD has a stricter requirement. On regulation of temporary workers, Turkey's regulations are rated very strict because fixed-term contracts are allowed only for so-called objective reasons such as the task itself being of temporary duration. Temporary employment is generally restricted to seasonal and agricultural work. Of the countries rated by the OECD, only Greece has similarly restrictive criteria on the use of temporary workers. Temporary work

[13] The impact of the new Labor Law will be analyzed as part of the on-going Labor Market Study.

agencies are not allowed at all in Turkey, again with the exception of agricultural work. Here too, Greece and Turkey have the strictest regulation.

57. While there is strong evidence of wage and employment flexibility, Turkey's very strict employment protection laws may well be having adverse employment effects particularly for the most vulnerable segments of the population. Employment protection rules are meant to enhance job security by making dismissal costly to the employer. In many countries these laws do tend to reduce layoffs in downturns, but they also reduce hiring as the economy recovers. Stricter employment protection legislation, all other things being equal, also leads to longer average unemployment duration, lower labor force participation rates and positive employment effects for skilled primary age males, but lower employment for women, young people, and less-skilled workers. Perhaps most importantly in Turkey, there is extensive anecdotal evidence that the labor laws are not effectively enforced and statistical data indicate that informal employment is widely tolerated. Under these circumstances, tightening the legal framework for employment protection may well have the unintended consequence of channeling employment from the formal to the informal sector where wages are low and workers have limited or no effective legal protection.

Policies are need to improve labor productivity and maintain competitiveness

58. Wage levels in Turkey remain competitive but rising social security contributions represent a serious medium-term risk. The impact of wages on competitiveness can be measured through productivity and also by comparing with other countries. Labor productivity in Turkey (measured by value added) is roughly comparable to Hungary and Poland, but well below the levels reached in Korea, Portugal or Spain (Table 5). Labor costs on the other hand are below Hungary and Poland, and well below other comparator countries except for Mexico. The ratio of value added to labor cost provides a measure of competitiveness. This ratio was very high in Turkey in the 1980s reflecting low wage levels. Although it has declined since then, labor in Turkey is still competitive relative to other countries. Employer-paid social security contributions have risen steadily as a share of labor costs in Turkey, averaging 36 percent during 1996-2000, a 16

Table 5: Productivity and Wages in Selected Countries

	1980-85	1986-90	1991-1995	1996-2000
Value added per worker in industry ($)				
Turkey	6,771	11,311	15,062	12,819
Hungary			10,610	12,992
Korea	9,504	15,974	32,638	42,747
Poland			9,765	13,693
Portugal			28,324	29,474
Spain	22,889	41,530	59,775	57,099
Labor cost per worker ($)				
Turkey	1,902	2,583	6,377	4,917
Hungary		5,573	6,475	6,929
Korea	4,431	7,914	14,459	15,708
Mexico	3,069	2,354	4,340	4,104
Poland			4,114	5,948
Portugal	4,119	6,254	11,644	14,872
Spain	9,819	16,655	24,929	23,907
Value added/Labor cost				
Turkey	3.636	4.879	2.394	2.607
Hungary			1.556	1.875
Korea	2.143	2.033	2.243	2.721
Poland			2.436	2.302
Portugal			1.869	1.982
Spain	2.343	2.491	2.397	2.388

Source: OECD

percentage point increase over the 1980-85 period. Employer contributions as a percentage of labor costs are now equal to the level of Spain and higher than all other countries in the sample. This comparison highlights the risks to formal job creation posed by growing social security taxes and points once again to the critical need for further overhaul of Turkey's social insurance system.

59. Labor market programs can be useful in assisting job seekers and alleviating the social costs of adjustment in Turkey, but the cost effectiveness of these programs must be carefully monitored. Active programs seek to assist the unemployed in finding work while passive programs aim to provide a safety net. Over the last few years, Turkey has begun to implement both active and passive labor market programs. Active labor market policies can broadly be classified into three types. Job search assistance and employment services to match employers and potential employees have been relatively the most cost effective program, mainly because the costs are low. However, they tend to be most helpful to people who are likely to have found jobs anyway. Training programs whether for the long-term unemployed, retraining in the case of mass layoffs, or training for youth tend to be significantly more expensive than job search assistance and no more effective. The rates of return on training programs are often low. Job creation programs include employment or wage subsidies, public works programs and micro-enterprise programs. Employment or wage subsidies tend to have unintended consequences (such as subsidized workers replacing unsubsidized ones, or employers firing subsidized workers once the subsidy period ends). Public works programs are among the most heavily funded in the OECD. Evaluations show that these programs can have a desirable short term effect in raising employment but they generally do not have a long-term impact in reducing unemployment. They are thus best thought of as a short run anti-poverty measure. There is little evidence available on the cost effectiveness of micro-enterprise programs.

60. An important leg of Turkey's passive labor market policy is the recently introduced unemployment insurance scheme. This was established in June 2000 and has enrolled approximately 5 million workers. Individual accounts are created to which workers transfer 1 percent of their salary while employers contribute 2 percent and the state 1 percent. Workers can draw on their account when they are separated from their jobs. Despite the increase in unemployment with the crisis, only about 60,928 workers are receiving payments as of May 2003 because of the requirement that contributions have to be made for 600 days before workers can start receiving payments. The unemployment insurance scheme overlaps with the mandated severance payment system and the way is open to phase out mandated severance payments. The shift of the main pillar of unemployment protection from the old severance payment system to the unemployment insurance scheme should promote labor adjustment in response to changing economic conditions. However, this requires that the unemployment insurance scheme become more effective. Given the large surplus building up in the Unemployment Insurance Fund, it is essential that there is a comprehensive review of the future use of the fund with the intention of ensuring that it is brought into balance with due regard to the existing employment benefit policies. A prerequisite for more effective functioning of the unemployment insurance scheme—and indeed any active labor market policy—is the establishment law for the Turkish Employment Organization (ISKUR) adopted by Parliament in July 2003 as part of the broader legislative package to underpin the institutional and administrative reform of the social security system.

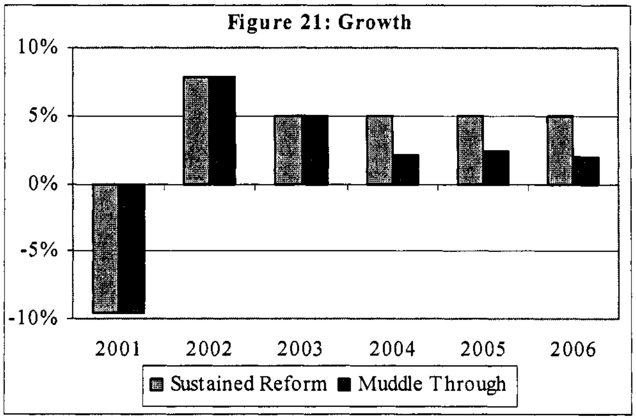
9 MEDIUM-TERM OUTLOOK[14]

61. Medium-term projections demonstrate that sustained implementation of economic reform is necessary if Turkey is to attain its macro-economic stability and growth objectives. Only sustained macroeconomic stabilization and structural reform can set Turkey on a medium-term course of disinflation, renewed growth and sustainable public debt. Thus, the medium-term projections under the program illustrate a *Sustained Reform Scenario*. Economic reform is needed to catalyze a virtuous circle whereby increasingly permanent fiscal adjustment and more effective government lead to improvements in market confidence which in turn drive down real interest rates. Lower rates combined with reforms to improve the business climate can in turn engender an increasingly robust private sector response. A sustained pick up in private sector activity that begins to generate employment will complement stronger social policies and bolster public support for the Government's reform policies. Igniting and then sustaining this virtuous circle is the key to achieving high levels of more equitable growth over the medium term. Under a low-case (muddle through) scenario, structural reforms would lose momentum, fiscal policy would become expansionary, and inflation and growth performance would likely be disappointing. With limited program credibility and a large debt rollover requirement, interest rates would remain high and private investment would be crowded out. Under this scenario, the economy would remain highly vulnerable to internal and external shocks, with significant risk of a new economic crisis. Pursuing Turkey's social agenda would become increasingly difficult.

62. Under a scenario of sustained reform, the economic program is projected to achieve the Government's stabilization and growth targets. The economy would be expected to fully recover from the 2001 recession, with stable real growth of 5 percent in the 2003-06 period (Figure 21). Specific factors underlying sustained growth include:

- greater confidence in the policy framework,
- improved macroeconomic stability and declining real interest rates—which would stimulate private investment and consumption demand,
- an increase in productivity resulting from structural reforms,
- stronger exports performance—which would permit faster import and output growth, and
- higher external inflows, including sizeable FDI.

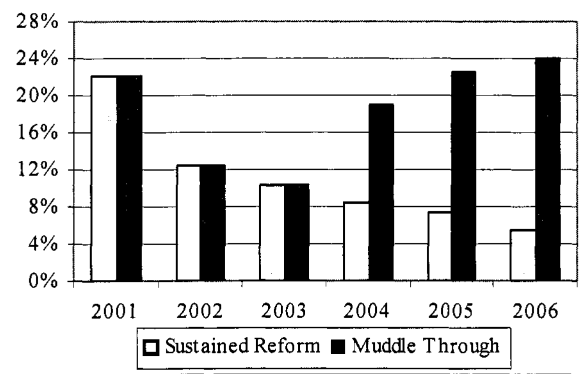
Figure 21: Growth



Source: World Bank

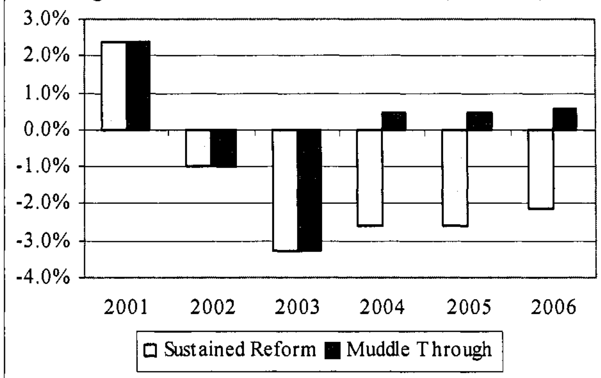
[14] Sustained reform scenario is consistent with baseline projections for the fourth IMF program review completed in April 2003. However, BOP figures have been updated for further developments through May 2003. Based on the TL appreciation since April, in the 5th program review scheduled to be completed in August, the projected public debt to GNP ratio for end-2003 is expected to be adjusted downward to about 70 percent compared to 77 percent in the 4th review baseline. If realized, this downward adjustment would improve the medium-term debt path provided the exchange rate adjustment is maintained.

Figure 22: PSBR (% of GNP)



Source: World Bank.

Figure 23: Current Account Balance (% of GNP)



Source: World Bank

63. Achieving high and stable growth rates over the medium term will depend on the continuation of disinflation and structural reforms. Under the sustained reform scenario, high quality fiscal adjustment will yield a permanent reduction in the PSBR (Figure 22). This will underpin the projected stabilization of the net public debt stock below 75 percent of GNP by 2005. High quality fiscal adjustment will also support the projected decline in CPI inflation to single digits by 2005. The viability of the sustained reform scenario depends critically on the availability of additional external financing from private resources and higher privatization proceeds (reflected in part by steadily increasing levels of FDI) in the next 2 to 3 years to accommodate import demand associate with sustained growth as shown in the BOP projections (Figure 23).

64. While sustained 5 percent growth is projected under the reform scenario, even higher growth would be needed to make real progress towards EU convergence given Turkey's demographics. This underlines the strategic imperative of determined implementation of the medium-term reform agenda including:

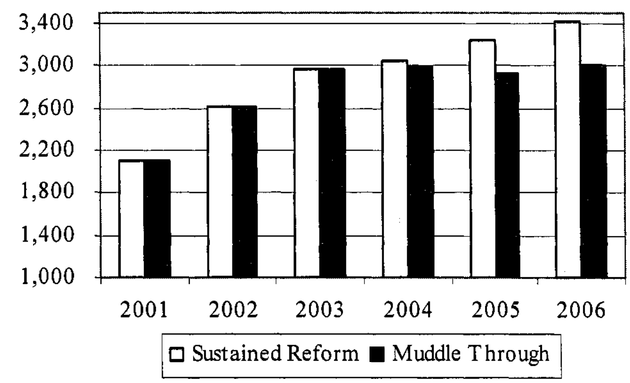
- deepening structural fiscal reforms;
- continuation of the on-going institutional reforms to improve public expenditure management;
- sustained implementation of structural reforms in banking, energy, agriculture and telecommunications;
- accelerating privatization with a focus on public utilities and the state banks; and
- stronger social policies including more investment in human capital and labor market policies which ensure competitiveness and promote employment.

65. A muddle-through approach to economic reform will not work given Turkey's vulnerabilities to internal and external shocks and the imperative of improving investor confidence. Under a low-case (muddle through) scenario where structural reforms would lose momentum starting from 2003, the key conditions for sustainable fiscal adjustment would not be met. Budget revenues would be expected to decline as the recovery stalled, while expenditure would grow under the assumption of expansionary fiscal policy. The PSBR would deteriorate

and progress in taming inflation would begin to unravel. Turkey's creditworthiness would deteriorate and the economy would remain highly exposed to shocks. Turkey's public sector debt burden would increase to very high levels over the medium-term. A combination of poor fiscal performance, low growth, and high interest rates would produce an unsustainable path for public debt. The return of inflation and higher interest rates would squeeze out private investment. The economy would be forced to generate current account surpluses to service external debt in the absence of fresh capital inflows. Under these conditions, annual GNP growth in 2003-06 would be projected to average no more than 2 percent. This scenario would have very negative welfare implications (Figure 24). By 2006, projected per capita income would be about 20 percent less than in the sustained reform scenario. Clearly, the low-case scenario is not sustainable for Turkey.

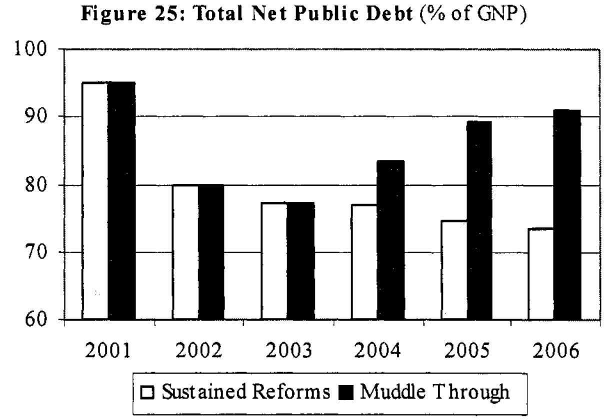
66. Realizing the improvements in stability and growth projected under the sustained reform scenario will depend on unwavering commitment and determined implementation of the program. Further improvements in confidence will be required to generate the reduction in real interest rates needed to underpin the recovery and ensure public debt sustainability. Under the sustained reform scenario, the public debt to GNP ratio, which fell from 95 percent of GNP in 2001 to some 80 percent in 2002, is projected to fall further to under 75 percent over the 2003-06 period (Figure 25). Realizing this outcome hinges on sustained recovery, a fall in interest rates from current levels, and a primary surplus on the order of 6.5 percent of GNP. The scenario also assumes accelerated privatization with cash privatization revenues of US$2.1 billion in 2003 and an average of US$2 billion annually over the 2004-06 period. The sustained reform scenario further assumes that the Government establishes effective control over contingent liabilities. The four most important contingent liabilities are: (i) potential further liabilities from troubled banks and corporations; (ii) future liabilities of the social security system; (iii) contingent liabilities in the energy sector; and (iv) FX risk in the public debt portfolio. One important mitigating factor is the structure of the public debt with nearly half of the Treasury's external debt held by bilateral and multilateral creditors and about one half of the domestic debt held by public entities which can facilitate short-term rollover. However, care must be taken to ensure the liquidity and financial autonomy of these

Figure 24: Per Capita Income (US$)



Source: World Bank

Figure 25: Total Net Public Debt (% of GNP)



Source: World Bank

public entities given that illiquidity of the state banks was a key factor in the lead up to the 2001 crisis.

67. Medium-term prospects also depend on developments in Turkey's balance of payments and external environment. First and foremost, sustained recovery will hinge on continued strong export performance building on Turkey's traditional strengths and developing new sources of comparative advantage. Moreover, the debt dynamics are vulnerable to external financing and movements in the real exchange rate. The government has shifted a great deal of its domestic debt portfolio to foreign currency denominated securities. At the end of 2002 about 59 percent of the Treasury's debt was either external or FX-denominated domestic debt. Therefore, debt sustainability depends on relative stability of the real exchange rate over the medium-term. While the current level of international reserves provides some cushion, Turkey faces very large external financing needs. Turkey has to generate ample capital inflows to: (i) underpin the floating exchange rate regime; (ii) finance the moderate current account deficits projected to accompany growth; and (iii) service repayment of external debt including IMF loans. Gross external financing requirements are projected at nearly US$22 billion per year over the 2003-06 period under the sustained reform scenario. A key priority is to increase the volume of FDI to improve the structure of Turkey's external finances and strengthen the dynamic for increased productivity, competitiveness and employment. Accelerated privatization and a range of structural reforms will be needed to improve the outlook for FDI flows. Given the likelihood that Turkey will remain exposed to external shocks for some time, continuation of the policy of exchange rate flexibility under the float will be important. Sustained progress towards EU accession would provide a strategic external anchor for Turkey's reform efforts.