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Turkey
Country Economic Memorandum

Towards Macroeconomic Stability and Sustained Growth

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Poverty Reduction and Economic Management Unit
Europe and Central Asia Region

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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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TURKEY: COUNTRY ECONOMIC MEMORANDUM

TOWARDS MACROECONOMIC STABILITY and SUSTAINED GROWTH

CHAPTER 1: MACROECONOMIC FRAMEWORK

1 INTRODUCTION

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 includes an analysis of the external environment for Turkey which highlights the importance of expanded foreign direct investment.

2. This chapter summarizes recent economic developments and analyzes the key policies needed to achieve macroeconomic stability and sustained growth over the medium term. The macroeconomic analysis in this chapter argues that, given the state of the economy and the amount of public sector debt that has now been accumulated, macroeconomic stability and growth can only be sustained by a deep fiscal adjustment that would not only achieve ambitious targets for the primary balance, but would also address the key sources of Turkey's prior fiscal problems. It is estimated that Turkey will need to maintain its primary surplus at the current target of 6.5 percent of GNP over the medium term to bring its debt level back to manageable proportions. International experience has shown that fiscal adjustments are usually only sustained when they are of high quality. Since Turkey's debt is only manageable with a substantial and sustained fiscal adjustment, the quality of the adjustment will be key. Quality is reflected in the use of expenditure cuts, rather than revenue increases to achieve the adjustment. It is also reflected in addressing structural fiscal problems, such as extensive contingent liabilities, inefficient public sector enterprises, and distortionary subsidy programs.

3. With the Government now needing to focus on fiscal sustainability and policy coordination, the public sector will naturally end up playing a smaller direct role in the Turkish economy. Loss making state-owned enterprises, un-funded subsidies to the agricultural and small business sectors through the state banks, and indirect subsidies to financial intermediation, are no longer feasible. Thus, the private sector must take responsibility for longer-term growth. The Government's main role should be to provide the right environment for private sector activity. Many of the conditions for sustained, private sector-led growth are in place in Turkey. Export competitiveness is strong. 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. There is no capacity constraint holding back increased consumer and private investment spending in the near term. Utilization rates are low, and the economy has the productive capacity with which to meet increased demand without fueling inflation. Growing demand will, in turn, stimulate private investment. On the other hand, private sector access to financing may

become a constraint on the recovery over time. Given the government's external debt position, the private economy has limited access to external finance and domestic financing is constrained by the ongoing restructuring in the Turkish banking sector. Thus, strictly limiting its own financing needs and ensuring the recovery of the banking sector are key objectives that the Government must focus on to sustain the recovery.

2 FINANCIAL CRISIS AND RESPONSE

4. In 2001, Turkey suffered through one of the worst economic crises it has faced in recent memory. Two overriding factors played key roles in Turkey's economic crisis. These were the build up of huge fiscal imbalances over the 1990s and the lack of attention to the accumulation of systemic banking sector risks. The poor initial condition of public finances when the original disinflation program was launched in late 1999 was combined with a weak banking sector and a slowdown in fiscal and structural reforms in mid-2000. As a result, an initial consumption boom was soon dissipated in a loss of confidence in the crawling peg exchange rate regime used as the principle nominal anchor for disinflation. A pull back by foreign creditors in the face of a widening current account deficit led to large-scale financial turmoil in November 2000. The Government responded by taking over a major private bank and extending a blanket guarantee to bank creditors. However, this exacerbated concerns about fiscal sustainability and the problems came to a head in a full-fledged currency crisis in February 2001 that forced the Government to float the Lira and bail out the banking system.

5. The government announced a crisis response program in May 2001 following the collapse of crawling peg and subsequent devaluation. The key structural and social elements of the program were (i) a macro-framework designed to restore financial stability and ensure public debt sustainability—principally through a further tightening of fiscal policy with a primary surplus target of 5.5 percent of GNP in 2001 increasing to 6.5 percent thereafter; (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 much more ambitious program of public sector reforms centered on deeper structural fiscal reforms and institutional reforms to improve public expenditure management and public governance; (iv) a renewed privatization drive in combination with further liberalization measures (particularly in energy, telecommunications and agriculture) and strengthening of the role of independent regulatory bodies to improve the climate for private investment; and (v) strengthening of social assistance to help low income groups adversely affected by the crisis. The Government secured US$10 billion in additional exceptional financing from the IFIs to help restore investor confidence and close the financing gap opened by the crisis—which caused large private capital outflows—and the bank restructuring program.

6. Macroeconomic outcomes under the crisis response program were mixed. The financial turmoil was contained, but financial markets remained fragile. The initial depreciation of the Lira was quickly absorbed into consumer prices, but inflationary pressures continued well into the year. Following the decision to abandon the peg, exchange rate related uncertainty persisted as the government was slow to reaffirm its commitment to the float and the central bank repeatedly intervened in the foreign exchange market. The exchange rate stabilized by late 2001, albeit at a more depreciated level than originally projected. Interest rates were brought down from their crisis peaks, but remained well above the original program path throughout 2001,

mainly due to higher-than-expected inflation and fears about the sustainability of the public sector debt. The primary surplus target was met, but there was continued doubt about the

medium-term sustainability of the fiscal adjustment. The combination of high real interest rates, the significant depreciation of the lira, the huge fiscal cost of bank restructuring and the 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 about 95 percent of GNP by the end of 2001. The economic recession was much deeper than projected and recovery was delayed until 2002. A serious drought exacerbated the recession with agricultural output contracting by some 6.1 percent. Overall, GDP shrank by an estimated 7.5 percent in 2001, GNP by 9.5 percent (Table 1.1 and Figure 1.1).

Table 1.1: 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 Balances (%GNP) [1/]	-2.0	2.7	5.5	3.9	6.5
Net Public Debt (%GNP)	61.0	57.7	95.0	79.8	77.2
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

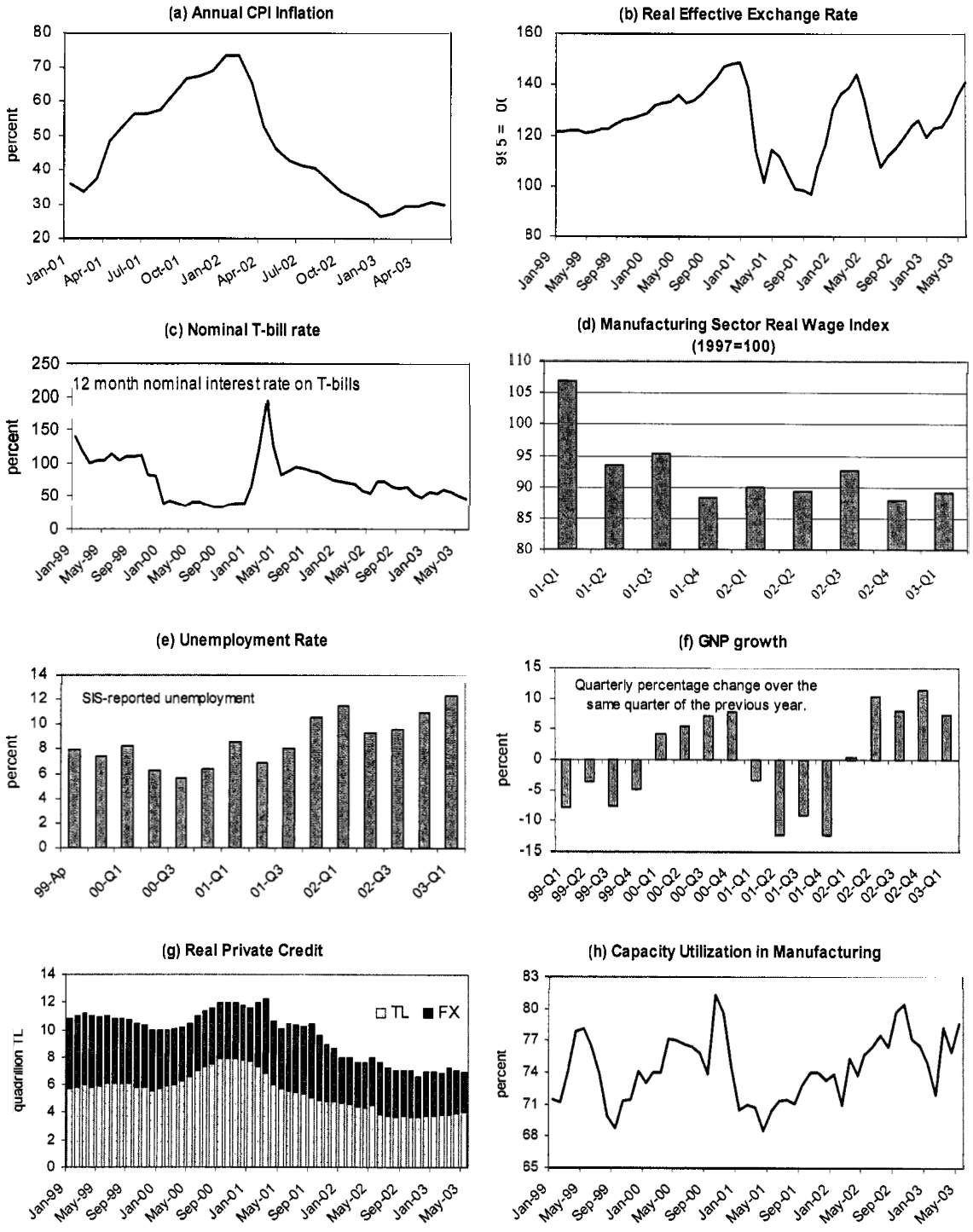
Source: Government, IMF and WB estimates.
Notes: [1/] Consolidated public sector
[2/] First quarter figure

7. In December 2001, Turkey agreed on a new, strengthened medium-term macroeconomic framework, backed by a new US$16 billion Stand-by arrangement covering the 2002-04 period, and a renewed program of structural reforms worked out in collaboration with the World Bank. The strengthened program was in response to the mixed outcomes in 2001 and the further external shock of September 11 which once more highlighted Turkey's external vulnerability. Developments in Argentina also had some limited contagion effects for Turkey during the second half of 2001. Markets reacted favorably to the renewed program and the announcement of additional international support. The exchange rate stabilized in the range of 1.3–1.4 million TL/USD, interest rates on government securities dropped below 70 percent, and Eurobond spreads fell by some 300 basis points in early 2002.

8. The economy recovered strongly in 2002 and macroeconomic targets were generally exceeded. GNP is estimated to have increased by 7.8 percent, more than double the original growth rate target of 3 percent. Of course, the strength of the recovery in 2002 largely reflected the rebound expected from a deep recession. It does not, therefore, indicate a similar rate of growth in the longer-term. The recovery was underpinned by good news on exports, which responded quickly to the real exchange rate adjustment following the February 2001 crisis. In real terms, exports rose by 7.4 percent in 2001 and a further 11 percent in 2002. Private consumption also started to recover, growing 2 percent in 2002 after a 9.2 percent decline in 2001. Private investment, which fell by 31.5 percent in 2001, stopped declining in 2002. It was down 0.8 percent for the year, but was up 22 percent on a Q4 to Q4 basis. CPI inflation was 45 percent based on annual average levels. However, on an end-year basis, CPI inflation declined to just under 30 percent. There was substantial real appreciation in 2002, though the real exchange rate remained substantially below its pre-crisis levels. The balance of payments remained strong, supported by strong export performance and tourism receipts, despite the appreciation of the CPI-based real exchange rate. This may well have been due to the sharp fall

in private sector real wages after the crisis. With the economic recovery, imports increased 16 percent in real terms, and the current account balance moved from a surplus of about 2.4 percent of GNP in 2001 to a deficit of about 1 percent of GNP in 2002.

Figure 1.1: Macroeconomic and Financial Indicators



Source: Government, IMF and World Bank

The massive capital outflow of 2001 was halted, and, in fact, the capital account balance was in surplus to the tune of 1.1 percent of GNP in 2002. Thus, overall, the balance of payments was in balance, an improvement over estimates under the original program. The Central Bank's gross foreign exchange reserves ended the year comfortably at some US$28 billion.

9. Fiscal performance fell well short of the program targets for 2002 as fiscal discipline was relaxed during the run up to the November elections. The consolidated public sector primary surplus for 2002 is estimated to have been 3.9 percent of GNP, well short of the target 6.5 percent. The main reasons for the emerging fiscal gap included: (i) an unplanned civil service wage increase; (ii) overruns in social security expenditure; (iii) delays in adjusting public goods and services prices; and (iv) a drop in tax revenues linked to expectations of a post-election tax amnesty. While higher than programmed public expenditures contributed to the recovery in 2002, the slippages will have serious implications for meeting the 2003 fiscal targets.

10. Financial markets fluctuated sharply over the course of 2002, in line with political developments. After falling below 60 percent in early 2002, domestic interest rates on benchmark government securities increased once more in May following a deterioration in the former Prime Minister's health which triggered renewed political uncertainty and the announcement of early elections scheduled for November 3. Interest rates remained fairly steady in the 70–75 percent range through the Summer and Fall of 2002. Financial markets rallied on the election results, regaining much of the ground lost to political uncertainty over the summer. Treasury borrowing rates dropped once more to the 50 percent range, considerably easing the debt burden and improving the prospects of sustaining the recovery. However, secondary market rates started to increase again in mid December as markets became increasingly concerned about the new Government's commitment to the economic program. For 2002 as a whole, domestic interest rates averaged 63.5 percent, somewhat lower than the original program projection of 69.1 percent but in line with the lower than expected inflation realization. While real interest rates (based on backward-looking annual inflation) have fallen sharply from their post-crisis peaks, they have remained in the 20 percent range since mid-2002. Net public sector debt fell from an estimated 95 percent of GNP at the end of 2001 to 80 percent by end-2002. The main factor behind the fall in the debt to GNP ratio was the real exchange rate appreciation during the course of 2002, together with the economic recovery.

11. 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. 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. 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.

3 SUSTAINING THE RECOVERY

12. In the short-term the keys to overall economic recovery are improved consumer and business confidence, because, as in previous recessions, the sharpest declines in aggregate spending were in private investment and in consumer durables spending. In the recent recession, like others before it, consumer and business confidence was shattered. In particular, in 2001 consumer spending on durables and business fixed investment both plummeted, by 30.4 and 34.9 percent, respectively. In 2002, spending on consumer durables rose slightly by 2.1 percent in real terms. But private sector fixed investment fell by a further 7.2 percent. Only in the fourth quarter of 2002 did signs of a recovery in investment spending materialize. Private fixed investment in 2002Q4 was up by 21.8 percent compared to 2001Q4. But both categories of spending remain well down from their pre-crisis levels (Table 1.2).

Table 1.2: Summary Business Cycle Statistics, 1988–2002

	Std. Deviation		Correlation with GNP	Change (2000-01)		Change (2001-02)	
	Percent	Relative to GNP		percent	Share of Δ in GNP	percent	Share of Δ in GNP
GNP	6.1	1	1	-9.5	1	7.8	1
Private consumption	5.9	0.97	0.91	-9.2	0.65	2.0	0.18
Nondurables & services	3.0	0.49	0.80	-2.9	0.13	1.8	0.11
Semi-durables	7.9	1.30	0.85	-9.0	0.10	3.1	0.04
Durable goods	22.6	3.73	0.80	-30.4	0.42	2.1	0.03
Private fixed investment	17.3	2.85	0.80	-34.9	0.76	-7.2	-0.14
Public consumption	4.8	0.80	0.73	-8.5	0.08	5.4	0.06
Public fixed investment	18.1	2.99	0.72	-22.0	0.17	14.5	0.12
Change in inventories	1.9*	..	0.50*	-1.4*	0.42	4.7*	0.92
Exports	8.1	1.34	0.34	7.4	-0.26	11.0	0.55
Imports	19.1	3.13	0.92	-24.8	-1.04	15.7	-0.67

Source: Annual national accounts data for 1987–2002 were obtained from the SIS.

Note: Residual components of the change in GNP not reported in the table are other net income and the statistical discrepancy.

*Where noted with an asterisk, the statistics for the change in inventories are for the change in inventories as a percentage of GNP, not the growth rate of the change in inventories.

13. To gain some sense of the importance of the various categories of demand in the Turkish business cycle, consider the summary statistics presented in Table 1.2. These describe the volatility of different components of the national accounts (on the expenditure side), as well as their correlation with GNP. As Table 1.2 indicates, consumer spending on durables and semi-durables is much more volatile than GNP, and much more volatile than consumer spending on

nondurables and services.[1] Private fixed investment spending is about 3 times as volatile as GNP. Another indication of the importance of spending on durables and investment goods is found by computing the share of the decline in GNP in 2001 due to different spending components. Together, consumer semi-durables and durables, along with private fixed investment, account for 128 percent of the decline in GNP. By comparison, consumer spending on nondurables, along with changes in public sector demand account for only 38 percent of the decline in GNP.

14. On the basis of data for 2002, Turkey appears to be recovering strongly from the crisis-driven recession of 2001, but there are lingering doubts about whether the recovery will be sustained and built upon in the coming year. After the economy bottomed out in the first quarter of 2002, the performance of the economy in the second, third and fourth quarters was strong, and real GNP grew 7.8 percent for the year. As Table 1.1 indicates, the recovery has mostly been due to continued good export performance (exports were up 11 percent in real terms for the year) and a sharp increase in business inventories. There were some other signs of recovery in the real economy in 2002. Production in the industrial sector was up 9.4 percent in 2002. Agricultural production was up 7.1 percent. Wholesale and retail trade also recovered strongly (up 12.8 percent) after a dismal year in 2001. Banking, not surprisingly, remains a weak sector, with the services of financial institutions slipping a further 7.1 percent in 2002.

15. There are signs that confidence is improving and that the most likely outcome for 2003 is continued growth, albeit at a more moderate pace. The modest increases in consumer durables spending, and the continued decline of private fixed investment spending indicate that consumers and firms remained wary about the state of the economy in 2002. Fixed investment spending bottomed out in the third quarter of 2002, and rose on a 01Q4–02Q4 basis by 22 percent. While construction spending remains depressed, investment in machinery has risen substantially. Still consumer durables and fixed investment spending have a long way to go to reach their pre-recession levels. It is unlikely that export performance will continue to improve at the dramatic rate observed in 2002, particularly as real appreciation of the Lira is likely to slow export growth. The increase in business inventories is a positive sign, in that it presumably reflects firms' anticipation of a continued recovery. However, the fact that most of the increase in GNP is accounted for by the inventory buildup highlights the vulnerability of the recovery. If expectations are not met, and private demand does not increase sufficiently, the recovery could be in for a hard landing.

16. It is difficult to predict movements in GNP in Turkey based on national accounts data, given that there are no obvious leading indicators to look at. Most expenditure components seem to have relative symmetric dynamic correlation patterns with GNP at the quarterly frequency.[2] This is indicated in Table 1.3. If anything, it would appear that expenditure on imports is

[1] Overall consumer spending is slightly less volatile than GNP, despite the fact that spending on semi-durables and durables is more volatile than GNP. This reflects the fact that nondurables spending is considerably less volatile than, though positively correlated with, GNP, and is by far the largest component of private consumption.

[2] A leading indicator has a skewed pattern of dynamic correlation with GNP. For example, imports appear to be a leading indicator because the correlation between imports and GNP one quarter ahead is stronger than the correlation between imports and GNP one quarter lagged.

somewhat of a leading indicator, while private fixed investment and public sector demand are somewhat lagging indicators of the business cycle. But the patterns revealed in the correlations are not particularly strong.

Table 1.3: Dynamic Correlations with GNP
(quarterly, seasonally-adjusted data, 1987-2002)

Lead time (*j*)	**-4**	**-3**	**-2**	**-1**	**0**	**1**	**2**	**3**	**4**
X variable									
Private consumption	0.38	0.54	0.70	0.83	0.94	0.80	0.62	0.45	0.26
Nondurables & services	0.40	0.51	0.63	0.74	0.82	0.74	0.65	0.58	0.49
Semi-durables	0.25	0.43	0.61	0.74	0.86	0.72	0.59	0.42	0.30
Durables	0.26	0.38	0.53	0.66	0.76	0.60	0.38	0.15	-0.08
Private fixed investment	0.40	0.58	0.72	0.80	0.84	0.75	0.62	0.52	0.43
Public consumption	0.27	0.22	0.34	0.40	0.38	0.24	0.04	-0.17	-0.28
Public investment	0.05	0.07	0.08	0.12	0.16	0.01	-0.10	-0.30	-0.42
Exports	0.11	0.13	0.14	0.13	0.15	0.10	0.06	-0.03	-0.07
Imports	0.16	0.31	0.53	0.74	0.89	0.78	0.57	0.33	0.09

Source: SIS
Note: Correlation is between X_t and GNP_t The data were seasonally adjusted using the X11 procedure in Eviews. The data were then expressed in logarithms and linearly detrended before computing the correlations.

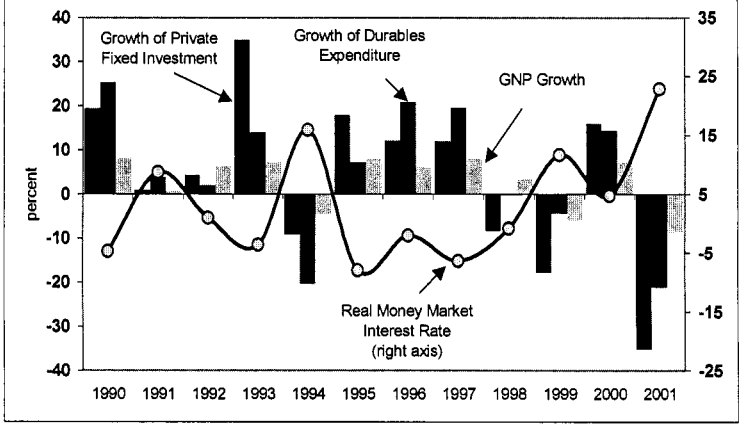
17. Can the economy accommodate increased consumer and private investment spending? On the production side the answer is unequivocally yes[3]. Capacity utilization rates, which rose sharply towards the end of 2002, have returned to relatively low levels—the economy has the productive capacity with which to meet increased demand, without inflationary pressure arising. The Government has relatively limited means at its disposal to spur private sector confidence. Given its budget constraint, the best the government can do is to maintain fiscal restraint—to help lower interest rates and build confidence in the overall economic program. On the other hand, consumer and business access to financing for major purchases and investment is an important problem. Given the Government's external debt position, the private economy has limited access to external finance. Domestic financing is also limited as a result of the ongoing restructuring in the domestic financial sector. Hence, a stronger fiscal position within the public sector is crucial in order for there to be sufficient funds for private borrowing to finance investment and durables purchases. Hopefully, the Government can pursue the fiscal adjustment and structural reforms needed to spur the improvements in confidence required sustain the recovery in 2003.

[3] See Taskin (2002), a background paper for this Report, for the automotive industry.

4 ACHIEVING MACROECONOMIC STABILITY

18. Figure 1.2 illustrates the importance of economic stability and confidence for the Turkish economy. It plots GNP growth, the growth of private fixed investment, and the growth of consumer durables and semi-durables spending against the real money market interest rate.[4] It is arguable that real interest rates are a function of private confidence in the economy, and the government's policy framework. Whether this is the case, or not, what is clear, from Figure 1.2, is that real expenditure is strongly inversely correlated with the real interest rate. Between 1990 and 2002, the correlations between GNP growth, private fixed investment growth, and consumer durables growth and the real interest rate were, respectively, –0.92, –0.83 and –0.75.

Figure 1.2: Real Expenditure Growth and Real Interest Rates in Turkey



Source: Central Bank of Turkey Data Delivery System for annual national accounts data. IMF International Financial Statistics for the money market interest rate.

19. Macroeconomic stability is important in that (i) Turkey can ill afford another fiscal crisis, and (ii) the recovery will only be sustained if confidence in the economic program increases. But macroeconomic stability is also crucial for medium-term growth. Turkey has experienced unusually volatile growth since the later 1980s which has hampered its development. In particular, it has diverted vast amounts of managerial expertise into financial management and away from decisions about technology, investments and human resources. Consider, for a moment, the decision making process for a firm considering investment in machinery or equipment. The firm must compare the merits of alternative choices for this new capital. The firm must also compare the return to the capital investment to the return on alternative financial investments and the cost of borrowing[5]. In Turkey each of these items is incredibly volatile due

[4] The real money market interest rate for year t is measured as $r_t = 100\,[(1 + R_t)/(1 + \pi_t) - 1]$, where π_t is the inflation rate of the GDP deflator between year t–1 and year t.

[5] For example, we could write the gross nominal return to physical investment as:

$$(1) \qquad 1 + R_t^K = \frac{P_{t+1}^Y MS_{t+1} + P_{t+1}^K (1-\delta)}{P_t^K}.$$

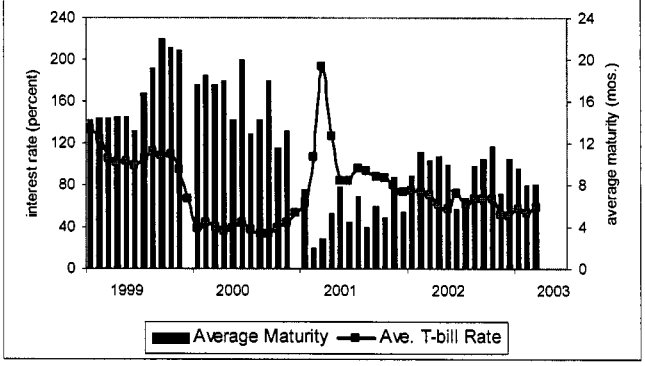
Here P^K represents the cost of a unit of capital, P^Y is the price of output, *delta* is the depreciation rate, and MS represents the marginal sales the firm generates by making the investment in new capital. The firm will compare its forecast of this return to the gross nominal interest rate (in TL), $1 + R_t$, as well as to its forecast of the gross dollar cost of borrowing:

to the economy's volatility. Historically, the exchange rate has been extremely volatile, as has inflation. Furthermore, a firm making capital investments faces extreme uncertainty about its future sales due to the volatility of the real sector. As a result, Turkish firms use an enormous portion of their managerial and technical services in financial management. They spend proportionally less assessing the relative merits of alternative physical investments. It also leads to conservative decision-making: business decisions often come down to choosing the least risky strategy, and this is often to hold FX-denominated financial assets. Firms also spend less time trying to improve productivity and more time on cash management (Box 1.1).

20. Supporting evidence for the view that uncertainty is a major concern for firms comes from a background study for this report.[6] Firms surveyed in 1996 cited devaluation, contractions in domestic demand, and rises in interest rates as by far their most significant concerns during the 1994 crisis. They also stated that they responded to the crisis most often by decreasing their borrowing requirement. Though not many cited postponement of investment as a major response, presumably this would be an important way of reducing borrowing needs. Of course, investment certainly declined sharply during the 2001 crisis.

21. There were some signs that a degree of stability and confidence was restored in 2002. Through most of 2002, treasury bill rates were on the decline, while average maturities, for the most part, lengthened (Figure 1.3). This suggests a declining risk premium on domestic currency denominated debt. Until July 2002, inflation declined faster than the nominal interest rate. If inflation expectations moved in line with observed inflation then this would imply that real interest rates remained high. And this would help explain the continued slump in investment demand. In the latter part of 2002, interest rates continued to decline while there was a renewed bout of inflation associated with the depreciation of the lira that occurred between April and July. Thus, perceived real borrowing costs may have declined. It is as yet unclear which direction real borrowing costs are moving in 2003. While T-bill rates have settled at about 50 percent range, during the first six 6 months, inflation ran at annual rates near 40 percent (Figure 1.4), suggesting that real borrowing costs have fallen. On the other hand, in the past 6 months the value of the Lira has increased

Figure 1.3: The Cost & Maturity of Domestic Borrowing



Source: Treasury and World Bank

(2) $$1+R_t^D = (1+R_t^{\$})\frac{S_{t+1}}{S_t},$$

where $R^{\$}$ is the dollar interest rate, and S is the TL/$ exchange rate. For a firm located in Turkey forecasting the TL-returns in (1) and (2) is extremely difficult.

[6]Uygur (2002), "The Two-Tier Crisis and Investment in Turkey".

suggesting that inflation may soon drop further substantially. Thus, it may be the case that implied real borrowing costs remain quite high.

Box 1.1: Volatility and Growth

Table B 1.1 shows that Turkey's economy has suffered from increasingly volatile growth in the past two decades, especially since 1990. This volatility came after a period of rapid growth and relative stability. From 1967 to 1979, real GDP grew at an average rate of 4.8 percent. During this period, the standard deviation of GDP growth was 3 percent per annum, a level of volatility similar to that experienced by Canada in the 1962-85 period.[1] Furthermore, 1979 was the only recession year in this period. In the 1980s, growth slowed to 4 percent while volatility rose slightly to 3.5 percent. In the 1990s, Turkey suffered a further decline in average growth and a dramatic increase in volatility; growth slowed to 3.8 percent while volatility rose to 5.3 percent. For 1990–2002, the average growth rate was only 3.4 percent while volatility rose to 5.8 percent per year.

Table B 1.1: Real GDP Growth in Turkey, 1967–2002 (percent)

	Average	Geometric Average	Standard Deviation
1967-79	4.8	4.8	3.0
1980-89	4.1	4.0	3.5
1990-99	3.9	3.8	5.3
1990-2002	3.6	3.4	5.8

Source: Staff calculations

Is the increase in volatility responsible for the decline in growth? The standard international evidence on this question is found in Ramey and Ramey's (1995) paper. Their evidence concerned the 1961-85 period for a sample of 92 countries as well as a smaller sample of OECD countries for the period. Both samples indicate that countries with higher volatility have lower growth, and the relationship becomes stronger when standard control variables are included. Furthermore, they concluded that government spending-induced volatility is negatively associated with growth. Overall, their evidence suggests that policy makers need to be concerned about the volatility of growth in Turkey. While there is no conclusive evidence that volatility causes slow growth, it certainly appears to be associated with it.

As Table B 1.2 shows, Turkey's increased volatility is not a worldwide phenomenon. Something specific has made Turkey move from being a country with relatively low volatility and slightly above average growth among emerging market countries, to having slightly below average growth and significantly more than average volatility.

Table B 1.2: Volatility and Growth in Emerging Economies, Real GDP growth (percent)

	1980-89			1990-01	
	Average	Std. Dev.		Average	Std. Dev.
Chile	3.5	7.1	Thailand	4.8	6.0
Philippines	1.9	5.1	Turkey	3.1	5.9
Argentina	-1.0	4.9	Argentina	2.9	5.4
Brazil	3.0	4.6	Malaysia	6.6	5.2
Korea	7.5	3.9	Korea	6.1	4.7
Turkey	4.0	3.5	Chile	5.8	3.6
Malaysia	5.8	3.4	Philippines	2.9	2.2
Thailand	7.2	3.2	Brazil	2.6	2.2
India	5.9	1.9	India	5.5	1.9

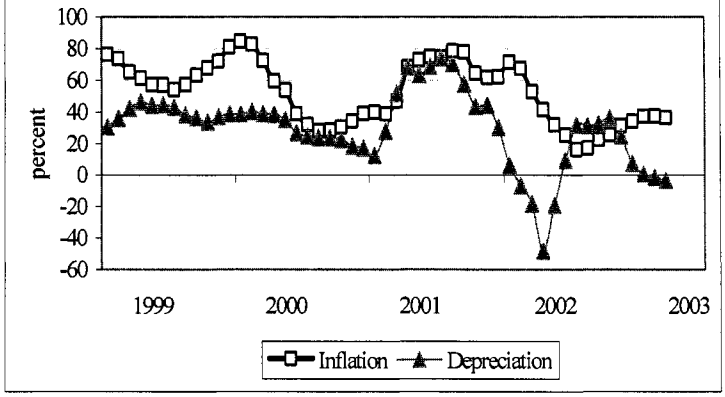
Source: CEM 2002

It is often argued that as countries develop they become less volatile as agriculture shrinks in importance. However, the 2000 CEM pointed out that agricultural production and services are both less volatile than industrial output in Turkey. On the expenditure side, private investment, consumer durables and the current account are the most volatile components. Why has growth become more volatile despite Turkey's development? One relevant factor is that Turkey's increased openness, especially in the capital account, has enhanced the impact of external shocks given the underdeveloped financial system. Another important factor is that the effects of external and internal shocks have been exacerbated by highly pro-cyclical fiscal policy.

[1] See Ramey, Garey and Valerie Ramey (1995) "Cross-Country Evidence on the Link Between Volatility and Growth," *American Economic Review*, 85, 1138–51.

22. The question for the Government is how to enhance the degree of confidence the public and investors have in its economic program. In this regard, fiscal sustainability is a key issue. The Government needs to stay the course with the size of its fiscal adjustment—otherwise the stated dual goals of reducing inflation and restructuring the financial and corporate sectors will not have credibility. Absent a fiscal adjustment of the magnitude targeted under the program, it simply would not be credible that the cost associated with restructuring could be absorbed without resort to inflationary finance. Another reason the size of the fiscal adjustment is crucial is to create room for renewed lending to the private sector. While growth in credit to the private sector is unlikely to become a leading indicator, expanded credit access will be needed to sustain the private sector-led recovery over the medium term. Over the past decade the public sector has absorbed an increasing fraction of the available domestic financing. The financial crisis in 2001 only exacerbated this situation. In addition, the crisis has reduced the willingness of external creditors to lend to the private sector. This has been factored into projections for Turkey's current account balance in the coming years: it is anticipated that only small current account deficits will be possible.[7] In this environment, it is a mathematical necessity that there be a sharp increase in domestic savings to finance durables and investment spending. A sharp increase in public savings will play an important role, especially at a time when private incomes are depressed.

Figure 1.4: Inflation and Depreciation
(backward-looking 6-month geometric averages, annual rates)



Source: Central Bank and World Bank

Notes: Inflation is computed for the CPI. Depreciation is measured for the TL/$ exchange rate.

The Role of Fiscal Policy

23. As Turkey emerges from yet another period of recession, it is important to learn from the policy mistakes made in the past. After each of the past crisis episodes Turkey has experienced, memories have been short. As part fiscal crises have moderated and tax revenues improved with renewed economic expansion, control over public finances has tended to relax. This is exemplified in the fact that public sector consumption, especially non-wage spending and public sector fixed investment, are highly pro-cyclical (Table 1.2). As a consequence, fiscal policy has tended to accentuate demand shocks rather than offsetting them. Some examples are informative:

- In the 1994-95 recession public sector investment fell by 43 percent, then it rose 80 percent through 1998. During the 1999 recession, public sector investment fell by 9 percent. In

[7] Projections for the current account deficit from 2003–07 are in the range of –0.8 to –3.7 percent of GNP.

2000, it rose again by close to 20 percent before falling by 22 percent during the 2001 recession.

- In 1994, non-wage public consumption fell by 10 percent. By 2000 it had risen by an astonishing 107 percent before falling substantially in the 2001 recession.

24. The silver lining of the current precarious fiscal position is that there is very little room for fiscal policy to become pro-cyclical during this recovery. However, as the economic situation improves further and the constraints on fiscal policy slacken even a little, it is important that policy makers display more discipline than in the past. The cyclical pattern of government spending should not be dominated by market-leading and generous wage settlements in the public sector, or pro-cyclical hiring policies and fixed investment spending that mops up any spare public funds which should go to reducing the debt. In fact, as presented in the next section, the debt dynamics would strongly argue for an over-performance of the fiscal targets in the near term. Over the longer term, government spending should shift to an acyclical stance, while social spending should gradually move to a counter-cyclical stance as the institutional basis for target social assistance programs is developed further. The public expenditure and governance reforms, and strengthening of social assistance discussed elsewhere in this report, are key reforms to support a more optimal fiscal policy mix.

25. 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. As part of disinflation efforts Central Bank is planning to introduce inflation targeting and has made necessary technical preparation. 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.

5 DEBT AND FISCAL SUSTAINABILITY

Debt Dynamics

26. Between the end of 1995 and the end of 2001, Turkey's debt stock more than doubled in terms of the debt to GNP ratio. As Table 1.4 shows, at the beginning of the period, debt was about 41 percent of GNP, with over two-thirds of the stock being external debt. The fiscal costs of cleaning up the banking sector after the 2001 crisis have weighed heavily on the public debt burden. By the end of 2001, net public debt amounted to 95 percent of GNP. In 2002, the debt stock shrank somewhat to 80 percent of GNP, but it remained at almost twice its level in 1995, and external debt represented just 40 percent of the stock. As Table 1.4 indicates, a sizeable

fraction of the domestic debt stock is denominated in foreign currency, but this is a relatively new phenomenon. Until 2001, the vast majority of Turkey's domestic debt was denominated in local currency and was issued at fixed interest rates. The currency composition of the domestic debt began to change following implementation of a major debt swap as part of the bank restructuring in mid-2001. Now, a substantial fraction of Turkey's domestic debt is either indexed to foreign currency or denominated in foreign currency. Much of the domestic debt is now issued at a floating interest rate.

Table 1.4: The Stock of Public Debt in Turkey, 1994–2002
(percent of GNP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Domestic debt	14.0	12.2	20.5	20.4	24.4	40.9	39.1	57.2	47.7
FX-denominated/indexed	..	..	..	..	..	..	2.7	20.4	15.3
Floating rate	..	..	..	..	..	..	..	28.6	20.5
External debt	30.7	29.1	26.0	22.5	19.3	20.1	18.3	37.7	32.1
External + FX-den./indexed	..	..	..	..	..	..	21.0	58.1	47.4
TOTAL debt	44.7	41.3	46.5	42.9	43.7	61.0	57.4	95.0	79.8

Source: Treasury and World Bank
Note: '..' indicates data either not available or not calculated.

27. One approach to understanding the evolution of public debt in Turkey is to decompose the annual change in debt into various components implied by a standard model of the government budget constraint (Table 1.4)[8]. Turkey's public debt stock was relatively stable from the end of 1995 through the end of 1998. Essentially, it increased in two steps, from 43.7 to 61.0 percent of GNP in 1999, and from 57.4 to 95.0 percent of GNP in 2001. Why was Turkey's debt stable in the earlier period? And why did indebtedness rise so quickly in 1999 and 2001?

28. There is a sense in which during the 1995-98 period loose fiscal policy was being accommodated with loose monetary policy. On average during the period, the public sector ran

[8] In particular, we can write the public sector's budget constraint in local currency as:

(3) net financing = interest payments – primary balance – seigniorage

The change in debt, of course, is the same as net financing. Normally, debt is expressed either as a percentage of GNP or GDP for analytical purposes. As the appendix shows, the government budget constraint can be used to solve for the change in the debt to GNP ratio.

(4) Δ in (debt/GNP) = interest payments – primary balance – seigniorage
– growth effect – inflation effect – revaluation effect.

Equation (4) captures the idea that part of the government's effective financing comes implicitly from either a (i) growth effect, (ii) an inflation effect or (iii) a revaluation effect. These effects can most easily be understood by considering the case where net financing is zero, so that no new debt is issued in the year. Despite the fact that the government issues no new debt, the debt-to-GNP ratio can change for three reasons: (i) if there is real growth, GNP will rise so the ratio of debt to GNP will fall; (ii) if some portion of the domestic debt is not indexed to the price level then nominal debt will remain constant, while nominal GNP will rise; (iii) if the exchange rate depreciates at a slower rate than inflation, the local currency value of external or FX-denominated domestic debt will rise slower than the price level.

a very small primary surplus of about 0.1 percent of GNP although the overall fiscal balance was very negative, averaging a deficit of 11.1 percent of GNP. A substantial fraction of the public interest burden was eased by the fact that the face value of debt was being eroded through inflation and real appreciation as captured in the inflation and revaluation effects in Table 4. Turkey printed money at a relatively rapid pace in the mid-1990s. This implied seigniorage that averaged 2.7 percent of GNP. Turkey was also fortunate to have positive growth throughout the period at an average rate of 6.8 percent per annum. This contributed 1.5 percent of GNP in implicit financing. These factors combined were sufficient to keep Turkey's debt relatively stable.

Table 1.5: Public Debt Dynamics in Turkey, 1995–2001
(percent of GNP)

	1995	1996	1997	1998	1999	2000	2001	2002
Change in debt	**-3.4**	**5.2**	**-3.6**	**0.8**	**17.3**	**-3.6**	**37.6**	**-15.2**
Debt creating items								
A. Interest payments	7.3	10.0	11.0	16.2	22.1	21.9	23.5	16.3
Debt reducing items								
B. Primary balance	2.7	-1.2	-2.1	0.9	-2.0	2.7	5.5	3.9
Growth effect	1.7	1.5	2.0	0.9	-1.8	2.4	-3.9	4.8
Inflation effect	6.5	5.3	9.2	8.8	8.7	13.8	13.0	11.2
Revaluation effect	4.4	1.9	1.6	2.5	-1.2	3.8	-13.2	10.1
Seigniorage	3.0	2.4	2.9	2.4	3.2	1.8	1.4	1.5
Other (sum of below)	0.0	0.0	0.1	0.5	0.1	1.6	-18.1	-1.8
Privatization	0.0	0.0	0.1	0.5	0.1	1.6	1.9	0.1
Cost of financial sector bailout	0.0	0.0	0.0	0.0	0.0	0.0	-20.0	-1.9
Memo items:								
Official balance (B-A)	-4.6	-11.2	-13.1	-15.3	-24.1	-19.2	-18.0	-12.4
Effective service cost	4.0	7.9	-0.8	5.5	16.8	4.9	22.5	-6.8
Errors and discrepancy	7.6	5.2	-1.0	0.6	2.2	0.6	-1.2	-1.8

Source: IMF reports and team calculations.

Notes: The term 'Other' reflects the fact that there are off-budget items that require or create financing and are not included in the standard measure of the primary balance. Effective service cost is interest payments net of the inflation and revaluation effects plus the errors and discrepancy. 'Errors and discrepancy' equals the debt reducing items minus interest payments and the change in debt. The remaining fiscal costs of bank restructuring are reflected in separate entries in Table 1.4.

29. In 1999, the various factors that had helped to keep Turkey's debt in check in the 1995-98 period were reversed. The primary balance deteriorated to a deficit of 2.0 percent of GNP. This was largely due to two factors: the economy slipping into recession and the fiscal easing that occurred after the Marmara earthquake in August. The real exchange rate depreciated, implying a revaluation effect of -1.2 percent of GNP, as opposed to an average effect of 2.6 percent of GNP in the 1995–98 period. These two factors raised the financing burden by 5.5 percent of GNP compared to the 1995–98 period. Nominal interest rates remained high in 1999, despite a decline in inflation. One interpretation is that this was the result of a monetary policy stance geared at consolidating the disinflation that began in 1998. Another is that real interest rate movements were the result of a loss of confidence in the domestic debt market. Regardless of the explanation, the net impact on the *real* domestic interest burden was substantial—on the

order of 9.7 percent of GNP. The policy mix and other economic events thus created a financing nightmare: the overall balance deteriorated sharply, but none of the implicit sources of financing (inflation, revaluation and growth) helped offset this increase.[9] With seigniorage revenue already near its natural limit an enormous increase in net debt was inevitable.[10] Almost all of this new debt was raised in the domestic debt market, or through the state banks.

30. Although there was a slight improvement in the debt situation in 2000 that coincided with a rebound in the real exchange rate and resumption of growth, the economy fell into a full-scale financial and economic crisis in February 2001. Much as in 1999, this crisis played havoc with public finances. In 2001, the debt stock rose by 37.6 percent of GNP. One reason for this increase was that the Government issued new bonds in order to recapitalize failing banks. A rough estimate of the quantity of bonds issued for this purpose is around 20 percent of GNP.[11] So the direct impact of the financial crisis only explains about half the increase in the ratio of debt to GNP. In other respects 2001 was similar to 1999, but with some important differences. Unlike 1999, the primary fiscal balance did not deteriorate relative to the stance of the mid 1990s. Indeed, the government successfully implemented a sharp fiscal contraction despite the recession, with the primary fiscal balance improving to 5.5 percent of GNP. In 2001, there was a sharp depreciation of the Lira brought on by the financial and fiscal crisis. Inflation did not bring the price level in line with the exchange rate by the end of the year, so there was a sizeable real depreciation and a revaluation effect on the order of –13.2 percent of GNP (compared to 2.6% of GNP in 1995–98). The revaluation effect was so large that it completely offset the inflation effect on domestic debt, leaving Turkey with an effective debt service burden of 23 percent of GNP. As in 1999 the government faced an enormous financing challenge. With seigniorage kept to just 1.4 percent of GNP, and with sharply negative growth, the Treasury was forced to issue a great deal of new debt. Unlike 1999, when the domestic market absorbed most of the financing requirement, only about half the new debt was issued domestically as the IFIs stepped up their support. Almost all net financing obtained from the domestic market was raised by issuing debt denominated in or indexed to foreign currency.

31. In 2002, the debt picture improved, mainly due to the economic rebound. Growth returned, and was unusually strong given the depth of the preceding recession. The exchange rate appreciated substantially in real terms, after the overshooting of 2001. Interest rates moderated somewhat. Together. these factors implied a sharp reduction in Turkey's public debt from 95 to about 80 percent of GNP.

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[9] At the same time as the overall fiscal balance deteriorated by 8.8 percentage points of GNP, the growth effect became negative and deteriorated by 2.7 percent of GNP, the inflation effect shrank by 0.1 percent of GNP, and the revaluation effect became negative and deteriorated by 3.7 percent of GNP.

[10] It would have been very difficult for Turkey to increase its seigniorage revenue over the average level in the 1995-98 period of 2.7 percent of GNP. Estimates of the seigniorage Laffer curve for Turkey suggest that with stable money demand, this is very close to the maximal level of feasible seigniorage. See the 2000 CEM.

[11] The other items entry in Table 4 is –18.1 percent of GNP. This reflects 1.9 percent of GNP in privatization revenue, minus 20 percent of GNP in recapitalization costs.

6 THE QUASI-FISCAL DIMENSION OF THE PUBLIC DEBT

32. The previous section took an accounting approach to explaining the accumulation of public debt in Turkey over the period 1994–2002. This section explores the deeper root causes of the fiscal problem. It suggests that the following factors have been the key contributors to what has become a very serious debt problem (Box 1.2 and Box 1.3). Combined, these three factors have contributed a flow-equivalent fiscal cost of about 6.5 percent of GNP per year.

- Off-budget subsidies to farmers and small businesses that were channeled through the state banking system.
- Indirect subsidies to the banking system in the form of implicit and explicit guarantees to bank creditors, which created contingent liabilities that were converted to actual liabilities in the February 2001 crisis.
- Other losses incurred outside the central government budget.

Subsidies through State Banks

33. For many years the Government conducted quasi-fiscal operations through the two largest state banks, Ziraat and Halk. These banks provided subsidized loans to the private sector (Ziraat to farmers, and Halk to small and medium-sized businesses), the cost of which they have not been able to cover from their operations. For example, from 1994 through 1999, Ziraat's cost of funds was nearly twice its subsidized lending rate on average. The state banks covered their losses from subsidized lending by accumulating claims on the government referred to as *unpaid duty losses*. Essentially, these non-cash assets preserved the balance sheets of the state banks without providing them with any cash flow. Until 2001, the Government exercised little control over this quasi-fiscal operation. Losses continued to accumulate, as did interest on the existing stock of losses. As the Government was in principle liable for the losses that were reported, the state banks had little incentive to improve efficiency or seek out more profitable lending opportunities. By the end of 2000, the stock of non-cash government debt held by the state banks had reached 14.4 percent of GNP. By the end of 2001, because inflation eroded the value of some of these claims and because some claims were replaced by cash debt, the stock of non-cash government debt held by the state banks had fallen to 12.7 percent of GNP. The fiscalization of these unpaid duty losses after the 2001 crisis was a major shock which prompted passage of legislation to forbid the accumulation of further duty losses in the state banks, at least in principle.

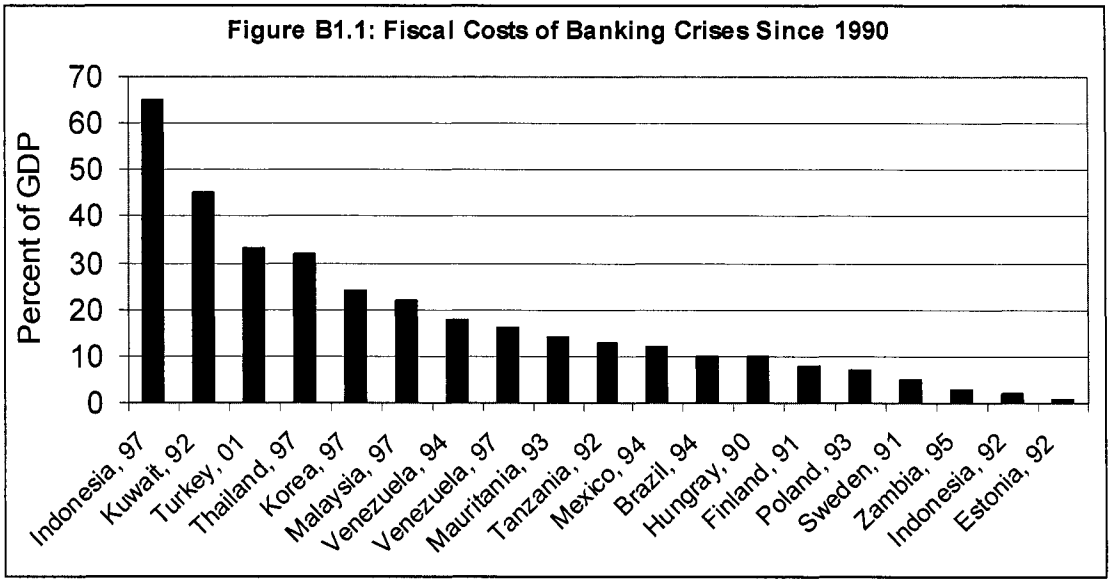
Box 1.2: Currency Crises and the Fiscal Costs of Banking Crises

In 2001, Turkey experienced a twin banking and currency crisis: the Turkish lira depreciated by almost 54 percent, while a substantial portion of the banking sector was threatened by insolvency. In this regard, Turkey shared the experience of a number of countries that have recently suffered through similar crises. An important aspect of banking crises is that they can impose large fiscal costs on a government (Figure B 1.1.). These costs arise when the government steps in to liquidate banks and pay off depositors, or when it helps to recapitalize banks that are on the brink of failure.

The link between banking crises and currency crises is established through facts and theory. First, it is frequently the case that banks in emerging markets have either open positions that expose them to foreign exchange risk, or they face foreign exchange risk indirectly through credit risk stemming from their customers' exposure. This means that severe currency crises tend to magnify existing problems in the banking sector and can raise the fiscal cost borne by the government to solve these problems. Second, theory suggests that the larger the fiscal costs the government must bear, and the lower its willingness to finance these costs explicitly through taxation or expenditure cuts, the greater the degree of currency depreciation will be.[1]

From this perspective the effects of Turkey's banking crisis on the economy are relatively easy to understand. By the end of 2000, state banks had accumulated losses amounting to about 16.4 percent of GNP. To this, the financial crisis itself added an additional 14.4 percent of GNP in 2001 and a further 1.9 percent of GDP in 2002 to the government's restructuring burden. Thus, the total fiscal cost of Turkey's banking sector woes amounts to some 33 percent of GNP. In comparison with the crises included in Figure B1, this puts Turkey in select company.

Figure B1.1: Fiscal Costs of Banking Crises Since 1990



Sources: S&P Sovereign Ratings Service, Caprio and Klingebiel (1996), Dziobek and Pazarbasioglu (1997), Polackova (1999), and World Bank estimates.

[1] See, for example, Craig Burnside, Martin Eichenbaum and Sergio Rebelo "On the Fiscal Implications of Twin Crises," in Michael P. Dooley and Jeffrey A. Frankel, eds. *Managing Currency Crises in Emerging Markets*. Chicago: University of Chicago Press, 2003.

Box 1.3: Contingent Liabilities in the Energy Sector

It is important that, in addition to public debt, the Government should carefully manage contingent liabilities in key sectors. This was not done adequately in the past and as a result a large stock of actual and potential contingent liabilities have built up including in the electricity and gas sectors.

- **Electricity.** The Treasury has guaranteed the power purchase contracts between TETAS (the state owned electricity trading company) and privately owned power plants. These contracts specify the minimum amount of power TETAS must take and the price. If TETAS is unable to use the power or unable to pay for it, the payment liability would have to be borne by the Treasury. The contracts are of two types: those with private power plants built under build-own-transfer arrangements (BOTs) and those built under build-own-operate arrangements (BOOs). The face value of all these guaranteed power purchase contracts is about US$3.0-3.5 billion yearly. If TETAS cannot use this power the Government could in theory be required to pay this amount to private power producers. Although TETAS should be able to sell most of the power from the private power producers to meet demand, there remains a risk that TETAS could fall short on the revenue required to pay for contracted power if retail prices are set too low or there is no associated obligation on the electricity retail companies to purchase power from TETAS at a price adequate to meet its costs. This is particularly important as the contracted price for much of the private power is quite high, especially for the BOTs. If TETAS incurs a loss, the contingent liability turns into a real cost for the Treasury. The situation requires close monitoring and the Government should avoid guaranteeing future power purchase contracts.

- **Gas.** BOTAS (the state owned gas company) has signed contracts for large volumes of natural gas imports on a take-or-pay basis. Under these contracts, BOTAS has agreed to take specified volumes of gas at specified prices and to pay for the gas that it cannot take. The face value of these gas contracts is about US$3 billion per year and rising over time. Projections indicate that there is unlikely to be sufficient demand for natural gas in Turkey to absorb the volumes that BOTAS has agreed to take, even assuming that gas under certain contracts is never delivered. As a result, BOTAS may be obliged to take natural gas for which there is no demand. Whether an actual loss will materialize depends on a number of factors beyond the scope of this report. However, the Government needs to monitor carefully this potential contingent liability and instruct BOTAS to not sign new gas import contracts which would aggravate the

Government Guarantees to Bank Creditors

34. After the financial turmoil of November 2000, the Government issued a blanket guarantee to the creditors, both foreign and domestic, of Turkish banks. While the central bank typically fills a lender of last resort role in the banking system, the role of deposit insurance, and more generally, government guarantees, in ensuring financial system stability has been questioned. International evidence suggests that deposit insurance can, in fact, lead to greater instability.[12] Theoretical arguments suggest that government guarantees can even open an otherwise healthy financial system to self-fulfilling speculative attacks.[13] Regardless of the advisability of providing guarantees to bank creditors, doing so creates a contingent liability to the government. In Turkey's case, this contingent liability was realized, and resulted in an estimated fiscal cost equivalent to about 18.2 percent of GNP.

[12] See, in particular, Edward J. Kane and Asli Demirgüç-Kunt "Deposit Insurance Around the Globe: Where Does it Work?" NBER Working Paper W8493, September 2001.

[13] Craig Burnside, Martin Eichenbaum and Sergio Rebelo "Government Guarantees and Self-Fulfilling Speculative Attacks," manuscript, Northwestern University, September 2001. Forthcoming, *Journal of Economic Theory.*

35. Like subsidized lending, government guarantees to bank creditors act as a subsidy to private activity. Together, these two distortions to financial intermediation contributed about 57.8 quadrillion TL (32.8 percent of GNP) to the public sector's indebtedness by the end of 2002.[14] In other words, they were directly responsible for over one third of the stock of debt. It is furthermore arguable that the exchange rate overshooting that was observed in 2001 would not have taken place in the absence of the government's contingent liabilities to bank creditors. The fiscal shock associated with the banking system bailout may well have been the underlying cause of the Lira's sharp nominal depreciation.[15]

Other Quasi-fiscal Losses

36. Table 1.6 decomposes the public sector primary balance into components. This decomposition indicates that, from 1995 through 2002, the central government ran a primary surplus with the exception of 1997. On the other hand, other entities within the public sector generated net primary losses throughout most of this period. Apart from unpaid duty losses and miscellaneous net items, the remainder of the public sector ran primary losses averaging 1.2 percent of GNP per year in the period 1995-2000. Given the real interest rates being paid by the public sector in this period, it is arguable that these losses contributed about 13 percent of GNP to the stock of debt at the end of 2001. Judging by the budget outcomes in 2001 and 2002 it would appear that the Government has now obtained better control over entities outside its direct budgetary control, namely the state-owned enterprises and state banks. However, it remains to be seen whether the Government will be able to maintain and consolidate this control over the longer term.

Table 1.6: Public Debt Primary Balances in Turkey, 1995–2002
(percent of GNP)

	1995	1996	1997	1998	1999	2000	2001	2002
Overall primary balance	2.7	-1.2	-2.1	0.9	-2.0	2.7	5.5	3.9
Central government	3.4	1.2	-0.2	3.8	1.5	4.3	4.8	2.4
Rest of public sec. (sum of ↓)	-0.7	-2.4	-1.9	-2.9	-3.5	-1.6	0.7	1.5
EBFs	-0.6	-0.2	0.1	0.0	-0.5	-0.2	0.1	-0.1
SEEs	1.3	-0.1	-0.4	-1.1	-1.2	-1.5	0.1	1.1
Local government	0.0	-0.1	-0.1	-0.4	-0.8	-0.2	0.0	0.0
Soc. Sec., U.I., etc.	-0.6	-0.2	0.0	-0.4	-0.1	0.3	0.5	0.4
Other	-0.8	-1.8	-1.5	-1.0	-0.9	0.0	0.0	0.1

Source: IMF and World Bank
Note: 'Other' includes primary unpaid duty losses, which were discussed above.

[14] This estimate combines the duty losses of the state banks and the additional cost of financial sector restructuring incurred in 2001.

[15] This argument is consistent with the fiscal theory of the price level, and recent work on currency crises. See, for example, Craig Burnside, Martin Eichenbaum and Sergio Rebelo "Prospective Deficits and the Asian Currency Crisis," *Journal of Political Economy*, 109(6), December 2001, pp. 1155–97.

Summing Up the Contributing Factors to the Debt Problem

37. Totaling up the factors that have been presented above gives a total contribution to the stock of public debt equaling 59 percent of GNP. On other words, in the absence of these factors, the stock of public debt would have been about 36 percent of GNP at the end of 2001, rather than the actual value of 95 percent of GNP. The striking thing about this calculation is that almost none of the contributing factors to the public debt buildup are items within a standard government budget. They all represent losses due to quasi-fiscal activities over which successive Turkish governments did not exercise sufficient control. This analysis points to a very basic diagnosis for Turkey's public debt problem: quasi-fiscal operations must be brought under control and this control must be consolidated over the medium term. Since the 2001 crisis, the Government has taken considerable action to reign in quasi-fiscal losses as shown in Table 1.6, but the longer term effectiveness of these measures remains to be seen. To ensure a high quality fiscal adjustment, other structural fiscal reforms will also be needed to underpin the adjustment. These reforms are discussed in more detail in the following section and in the public sector reform chapter.

7 Ensuring Fiscal Sustainability

38. Moving forward, the main question the Government faces is how to design and maintain its fiscal retrenchment. Clearly, fiscal conservatism will be necessary through the short and medium term, in order to help finance the cost of recapitalizing and restructuring the banking system and lower the public debt burden. But important design questions need to be considered: how big does the primary balance need to be, how has the strong primary balance been achieved in the last two years, and how should fiscal policy be designed to maintain it in the future?

The Sustainable Primary Balance

39. Although there is no one standard definition of sustainability, all definitions are built upon the notion that the public sector must satisfy its lifetime budget constraint, which, stated succinctly, is:

(5) initial debt = present value of future primary balances plus seigniorage.

Table 1.7 presents estimates of the primary surplus needed to maintain fiscal sustainability in Turkey based on a special case of (5) where the debt to GNP ratio is assumed to remain constant[16]. To calibrate, Table 1.7 uses end-2002 value of the ratio of debt to GNP, $b = 0.798$,

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[16] (6) $$x = \frac{r-g}{1+g} b - \frac{\pi + g + \pi g}{1+\pi+g+\pi g} m$$

where x, b and m represent the primary surplus, debt stock and monetary base, respectively, relative to GNP, and r, g and π are the real interest rate, real growth rate, and inflation rate, which are all assumed to be constant. Equation (6)

and sets the monetary base, m = 0.04. Rather than using historical inflation rates which are much higher than Turkey is targeting, the table assumes a long-run inflation rate of 5 percent per year ($\pi = 0.05$). The table presents varying assumptions regarding real growth and the real interest rate that are motivated by historical experience. Turkey's real growth averaged just under 3 percent between 1988 and 2002 (the median growth rate was higher) but the medium-term target growth rate is 5 percent, so the table uses a growth rate of between 3 and 5 percent. From 1995 to 2002, the average effective real cost of public debt service was about 11.5 percent, but real interest rates have fluctuated considerably. Table 1.7 presents results for a range of real interest rates: 7 to 17 percent.

Table: 1.7: 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	5.6	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: Staff calculations

40. The analysis presented in Table 1.7 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 5.7 percent of GNP would be required to keep the stock of debt stable at 79.8 percent of GNP.[17] Notice, however, that if growth were only 3 percent per annum, the primary surplus would need to be 7.3 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, 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 the program. Therefore, fiscal over-performance in the near term would accelerate progress towards macroeconomic stability.

Medium-term Debt Dynamics

41. Table 1.8 indicates the medium-term baseline projections for Turkey's public debt stock, which imply a decline in debt to 71.7 percent of GNP by 2008. As the inflation and depreciation rates converge towards program targets and existing debt is retired, interest flows and the inflation and revaluation effects will deviate from their long-run values, but these deviations do not account for the decline in the debt stock because, under the baseline scenario, depreciation and inflation converge fairly quickly to their assumed long-run values. The modest decline in Turkey's public debt stock in the projections results from the programmed 6.5 percent of GNP primary surplus exceeding the "sustainable" primary surplus, described above, by about 1 percent of GNP[18].

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is a special case of (5) in which the ratio of debt-to-GNP is assumed to remain constant at the level b. This is achieved by running a primary surplus of exactly the magnitude x.

[17] IMF projections as of the 4th rev of Turkey's debt dynamics assume an effective real interest cost of roughly 13 percent of the debt stock over the period 2003–08.

[18] Based on the TL appreciation since April, in the 5th program review scheduled to be completed in August 2003, 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.

Table 1.8: Projected Public Debt Dynamics in Turkey, 2003–08
(percent of GNP)

	2003	2004	2005	2006	2007	2008
Debt stock	**77.2**	**76.8**	**74.6**	**73.4**	**72.2**	**71.7**
Change in debt	**-2.6**	**-0.4**	**-2.2**	**-1.2**	**-1.2**	**-0.5**
Debt creating items						
A. Interest payments	16.9	15.0	12.5	12.4	11.7	11.7
Debt reducing items						
B. Primary balance	6.5	6.5	6.5	6.5	6.5	6.5
Growth effect	3.2	3.3	3.4	3.4	3.3	3.3
Inflation effect	5.4	3.4	2.4	1.6	1.5	1.5
Revaluation effect	1.1	0.2	0.1	0.1	0.1	0.1
Seigniorage	1.1	0.7	0.6	0.5	0.5	0.4
Other (privatization)	0.8	1.0	0.5	0.5	0.5	0.5
Memo items:						
Official balance (B-A)	-10.4	-8.5	-6.0	-5.9	-5.2	-5.2
Effective service cost	9.0	11.1	8.8	9.7	9.6	10.2
(as a percentage of debt)	11.6	14.4	11.8	13.2	13.3	14.2
Real GNP growth	5.0	5.0	5.0	5.0	5.0	5.0
Depreciation of the TL	17.8	12.0	8.0	5.0	5.0	5.0
Inflation rate	20.0	12.0	8.0	5.0	5.0	5.0

Source: Staff calculations

Note: All values are calculated based on IMF projections of the debt stock for the 4th program review in April 2003, including the exchange rate, inflation and real GNP. These assumptions are indicated in the table.

Improving the Quality of Fiscal Adjustment

42. The ultimate success of the fiscal adjustment will depend on its quality. To be specific, international evidence suggests that revenue-led fiscal adjustment is unlikely to be sustained over long periods of time. Similarly, fiscal savings generated by cuts in government investment and operations and maintenance expenditure are frequently transitory. In 2000–01, Turkey implemented a sharp fiscal adjustment that brought the public sector primary balance to 5.5 percent of GNP in 2001 from a low of –2.0 percent of GNP in 1999. However, in 2002, the primary balance shrank back somewhat to 3.9 percent of GDP. This suggests that a close examination of how Turkey has achieved its fiscal adjustment is merited. Table 1.9 breaks the public balance into its revenue and expenditure components. Most of the improvement in the primary surplus over the past three years has come from revenue increases and improvements in quasi-fiscal

Table 1.9: Fiscal Adjustment, 1999-2002 (% of GNP)

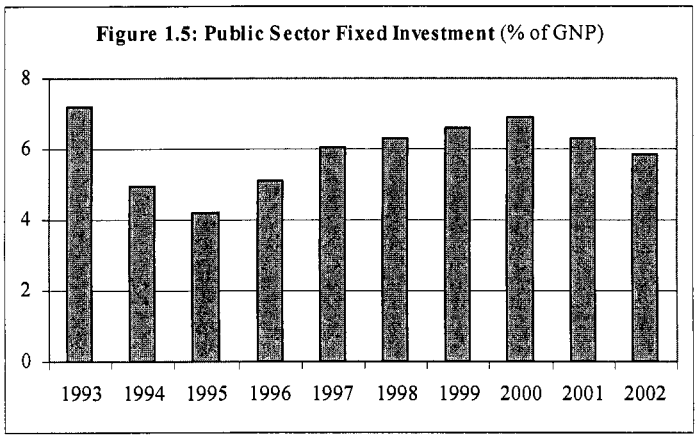
	1999	2000	2001	2002	1999-2002
Total expenditures	40.5	41.5	48.7	43.7	
Non-interest expenditures [1/]	20.0	20.8	22.2	22.8	*2.8*
Total revenues	26.2	28.6	32.3	31.5	*5.3*
PSBR	14.3	12.9	16.4	12.2	
Quasi-fiscal deficit	10.4	6.3	1.5	0.4	
Adjusted PSBR	24.7	19.2	18.0	12.6	
Net interest payments	22.0	21.9	23.5	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.

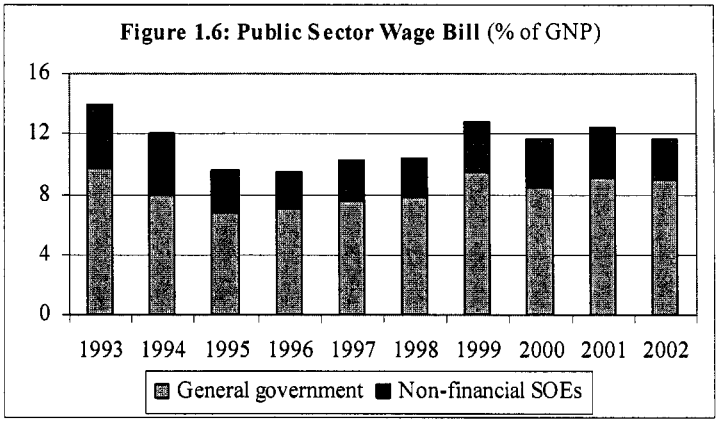
Source: Treasury, IMF and staff estimates.

balances. In fact, non-interest expenditure of the central government actually have increased significantly since 1999.

43. Is Turkey's fiscal adjustment of high quality? Of course, a sizeable adjustment was necessary, and it had to be undertaken in the short-run. As a result, it is not surprising that much of the fiscal adjustment has come from the revenue side of the budget. Nonetheless, there is reason to be concerned over the longer-term. As time passes, the Government should try to move away from one-off revenue measures to more broadly based tax reforms. Furthermore, the Government should make efforts to improve the quality of the fiscal adjustment by generating expenditure savings through structural measures. Within the budget, there are three structural priorities: (i) the public wage bill, (ii) public investment, and (iii) further reforms to the social security system in order to reduce the extent of transfers from the budget. Under the public sector reform program presented in chapter 2, a major rationalization of the public investment program has been undertaken easing the real impact of the reduction in the investment budget following the crisis (Figure 1.5). 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 1.6). 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.



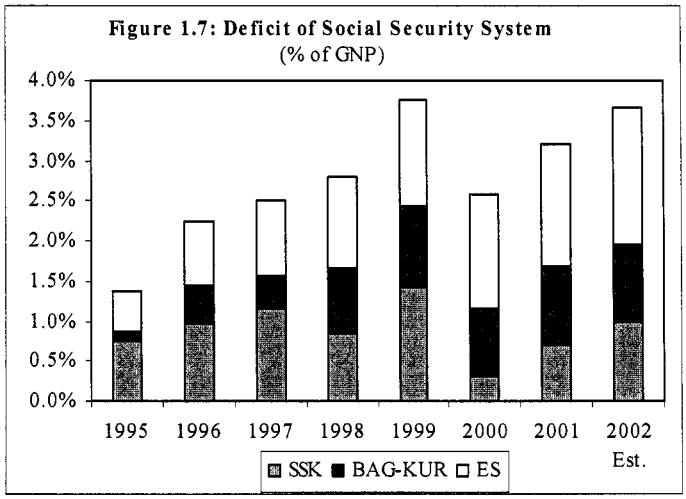
Source: SPO and World Bank.



Source: SPO and World Bank.

44. Looking ahead, further structural reforms are needed to support the fiscal adjustment. 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. After initial improvement in 2000, the fiscal position of social security system worsened considerably in 2001-02 (Figure 1.7). 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 pending 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 (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.



Source: SPO and World Bank.

Risks to Fiscal Sustainability

45. Improvements in the central government's primary surplus are necessary now that debt is about 80 percent of GNP, but are they *sufficient* to ensure fiscal sustainability? Considering the fact that it was not the primary fiscal position that was responsible for the huge increase in public sector debt between 1994 and 2002, it is clear that a strong primary fiscal position will not be sufficient. The Government must also control off-budget losses by eliminating the system of duty losses. It must also control contingent liabilities. Probably the four most important contingent liabilities the Government now faces are (i) potential further liabilities from troubled banks and corporations, (ii) future liabilities of the social security system, (iii) contingent liabilities generated during the privatization of utilities, and (iv) FX risk in the government's debt portfolio. The first source of contingent liabilities is discussed in greater detail elsewhere in this report. Clearly the banking system is an important source of risk to the government's finances given the events of 2001. The issues surrounding further reforms to the social security system have been discussed above. The sources of contingent liabilities arising from the utilities sector were discussed in detail in the 2000 CEM on Turkey.

46. The exchange rate is an important source of fiscal risk. As described in an earlier section, 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 public debt was either external or FX-denominated domestic debt. This lowers debt service cost relative to borrowing in domestic currency to the extent that, ex-post, the premium on domestic debt turns out to be higher than the rate of depreciation of the Lira. Given the Government's commitment to

disinflation and fiscal reform, this makes borrowing in foreign currency attractive, but it obviously means that the Government bears an FX risk that it would not have if it borrowed in domestic currency. To quantify this risk, consider the fact that at the end of 2000 only 37 percent of Turkey's debt stock was external or FX-denominated. With this level of FX exposure, Turkey's debt stock rose by 13.2 percent of GDP in 2001 due to the revaluation effect. If Turkey's exposure had been higher, say at the 2002 level, with 59 percent of its debt in foreign currency, the revaluation effect would have increased the debt stock by 15.9 percent of GNP. Another way of quantifying currency risk is to ask what would happen to the debt dynamics in Table 1.6, if the Lira depreciated faster by 10 percentage points in any given year. Absent a similar acceleration of inflation, the net effect would be to raise the stock of debt by about 3.3 percentage points of GNP. Given the volatility in Turkey's economy, a depreciation of this magnitude is not out of the question.

47. Turkey's debt dynamics are fragile and vulnerable to important risk factors including contingent liabilities, FX risk and of course interest rate risk. The high degree of exposure to FX and interest rate risk will be a constraining factor on monetary and exchange rate policy over the medium term. The risk analysis emphasizes the importance of staying the course with fiscal adjustment. Credible fiscal policy will reduce fiscal dominance over time and increase the effectiveness of monetary and exchange rate policy instruments as well.

8 THE MEDIUM-TERM AGENDA FOR GROWTH

48. Turkish policy makers face a challenging agenda for sustaining growth. The 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. Over the longer-term the public sector will play a smaller role in the Turkish economy. There is little room in the budget for a state owned enterprise sector that generates losses to be covered by the budget or for direct or indirect subsidies to the private sector. At the same time, the government can, and must, play a positive role in making it possible for the private sector to achieve high levels of growth. The Government must also use its limited resources more effectively to meet Turkey's social needs. 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.

49. 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. 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 earlier in this chapter (para. 44).

CHAPTER 2: PUBLIC SECTOR REFORMS[1]

1 INTRODUCTION

50. Turkey's public sector is large relative to OECD comparators such as Spain and Portugal (Table 2.1), and public spending has greatly exceeded available resources, while service delivery has lagged. The underlying problems with the structure and management of the public sector in Turkey have been analyzed in detail in the 2000 CEM on Structural Reforms for Sustainable Growth and the Public Expenditure and Institutional Review. As shown in these reports, central to the problem are: (i): weak fiscal fundamentals driven in part by extensive government intervention throughout the economy, and (ii) an under performing system of public sector

Table 2.1: Size of General Government in the OECD (as % of GDP)

	1996			1999		
	Revenue [1/]	Expenditure [2/]	Deficit/Surplus	Revenue [1/]	Expenditure [2/]	Deficit/Surplus
Australia [3/]	33.1	36.3	-3.2	33.3	34.4	-1.1
Austria	48.2	54.1	-5.9	47.3	50.9	-3.6
Belgium	47.7	53.2	-5.5	48.2	50.5	-2.3
Canada [3/]	42.8	46.7	-3.9	43.4	44.4	-1
Denmark	55.3	58.7	-3.4	55.1	54.4	0.7
Finland	51	56.6	-5.6	48.7	49.2	-0.5
France	47.5	53.8	-6.3	48.1	52.1	-4
Germany	43.9	49.1	-5.2	44.5	47.6	-3.1
Greece	44.9	52.5	-7.6	50.2	52.0	-1.8
Italy	44.3	52.6	-8.3	45.2	48.4	-3.2
Japan [3/]	31.7	36.5	-4.8	31.6	42.7	-11.1
Netherlands	43.8	48.3	-4.5	44.2	45.8	-1.6
Portugal	37.4	43.2	-5.8	38.9	42.8	-3.9
Spain	39	44.6	-5.6	n.a.	n.a.	n.a.
Sweden	56.8	62.5	-5.7	57.2	57.7	-0.5
Switzerland [3/]	33.6	37.3	-3.7	34.4	37.7	-3.3
TURKEY [4/]	**28.5**	**33.9**	**-5.4**	**36.0**	**46.5**	**-10.5**
United Kingdom	37.3	43.0	-5.7	39.1	39.1	0
United States [5/]	32.4	35.2	-2.8	32.8	34.3	-1.5

Source: OECD Historical Statistics, 1970-1999

[1/] OECD definition of total revenues is taxes on production and imports, property income receivable, current taxes on income and wealth receivable, social contributions and other current transfers.

[2/] OECD definition of total expenditures is the current disbursements plus gross capital formation, acquisitions less disposals of non-produced non-financial assets and net capital transfers.

[3/] The figures in the second part of the table are for 1998

[4/] Data for Turkey from PEIR esimates

[5/] The figures in the second part of the table are for 1997.

management. The impact of many years of weak fiscal discipline and poor expenditure management is also reflected in the composition of public expenditure. The share of public spending on interest payments and wages and salaries in Turkey is much greater than in almost all of its OECD counterparts and priority areas such as education are under-funded. This difference is inconsistent with the objectives of sustained economic growth and equity.

[1] This chapter draws on the PFPSAL-II and PFPSAL-III documents and from inputs of the Bank team working on public sector reform in Turkey.

51. Turkey's public sector reform strategy has three prongs: The first prong encompasses structural fiscal reforms to underpin fiscal adjustment. To date, the program has emphasized (i) tax reform to improve equity, reduce distortions and broaden the tax base and (ii) public employment policies to address over-employment. These efforts complement broader structural reforms in improving the quality of fiscal adjustment including financial sector reform, overhaul of agriculture support policies, introduction of markets for electricity and gas (aimed inter alia at eliminating the need for government guarantees), and privatization. Given the re-emergence of large deficits in the social security system, the structural fiscal reforms under public sector reform program will need to be expanded to include a new round of social security reforms as presented in Chapter One. The second prong of the public sector reform program involves structural and institutional reforms to modernize public expenditure management (PEM) through actions to improve budget preparation and execution, enhance the transparency of financial management, and ensure prudent public liability management including containment of contingent liabilities. These PEM reforms are laid out in the *Strategic Framework for Public Expenditure Management Reform* prepared in July 2001 as part of the PEIR and PFPSAL program. The third prong of the public sector reform program focuses on institutional reform to improve public sector governance. In this context, a national anti corruption strategy under the slogan *A Transparent and Clean Turkey: Together Hand in Hand* was adopted by the Government and published in March 2002. The third prong includes a civil service reform component.

52. There has been significant progress in the enactment of the legal framework needed to underpin the public sector reforms. A Public Procurement Law based on the UNICTRAL model was enacted in January 2002 moving Turkey towards compliance with EU requirements, and the independent Public Procurement Agency established under the law is now fully operational. The Public Finance and Debt Management Law was enacted in March 2002 creating the foundation for a comprehensive risk management framework. Implementation of medium-term tax strategy is moving forward with enactment of a unified special consumption tax in mid-2002 and enactment of a first legislative package for the direct tax reform in March 2003. A Public Financial Management and Control (PFMC) Law was submitted to Parliament in August 2002 which seeks to provide for a comprehensive presentation of the budget, modernize budget preparation and execution, allow decentralization of financial control to spending agencies and unify external audit under the TCA.

53. While there has been good progress in enacting the legal framework, implementation has been slower than expected in several core areas. Areas where concrete results have been achieved include tax policy reform, public employment, rationalization of the public investment program and improvement of public liability management. What is most critical in the eventual success of the public sector reform program is a political commitment to and coordination of the reform process. None of the ministerial or high-level committees set up under the original public sector reform program was operational during the previous government in 2002. The new Government has taken a somewhat different approach in incorporating the core elements of the public sector reform into its Urgent Action Plan and assigning clear responsibility for each element to specific agencies. A ministerial committee for enhancing transparency and improving governance was established in March 2003, which will steer relevant actions of the both the urgent action plan and national strategy in this reform area. More detailed information on the status of the public sector reform program is presented in the remainder of this chapter.

2 STRUCTURAL FISCAL REFORMS

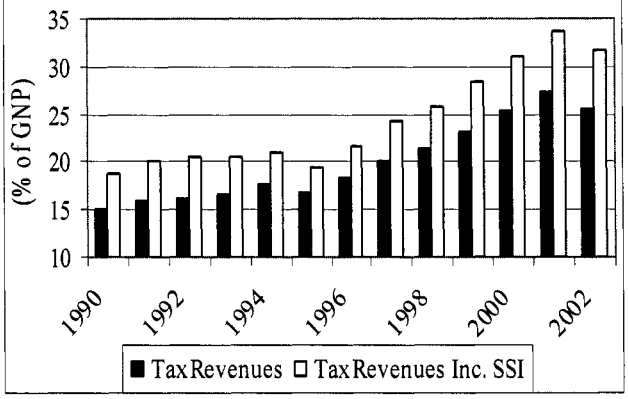
Tax Reform

54. The rationalization of Turkey's tax system is a key building block in moving towards a sustainable fiscal stance. The complexity and lack of transparency of the Turkish tax system, which is exacerbated by tax policy instability coupled with high and unstable inflation rates have been highlighted in several detailed studies [2] [3]. Much of the complexity and instability arises from the addition of special and additional taxes and surcharges in response to the ongoing effort to contain the budget deficit. In addition, in the high inflation environment, partial inflation indexation in combination with differential nominal tax rates and investment incentives across financial instruments have created highly distorted real effective tax rates across financial instruments and real business investments. Small businesses and low income employees face a high tax burden. Finally, 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.

Tax Policy

55. Over the past decade Turkey has steadily increased its revenue effort. Total public revenues (tax and non-tax revenues) collected by the central government, including social security contributions, have increased from 21.3 percent of GNP in 1990 to 37.6 percent of GNP in 2002. Total tax revenues (including local administrations and social security contributions) rose from 18.9 percent of GNP to 31.7 percent over the same period (Figure 2.1). The tax revenue available to the central government (consolidated budget) can be divided into three groups: taxes on income, taxes on consumption and other taxes. The taxes on income are the personal income tax (PIT), the corporate income tax (CIT), and the payroll tax that funds social security. Total taxes on income are the primary source of tax revenues, rising from about 10 percent of GNP in 1990 to 14.5 percent of GNP by 2001 (Figure 2.2). How does the tax performance of Turkey compare with other groups of countries over 1990 through 2000? Box 2.1 shows a comparison of central government tax revenues in

Figure 2.1: Turkey: Tax Performance



Source: Ministry of Finance and World Bank

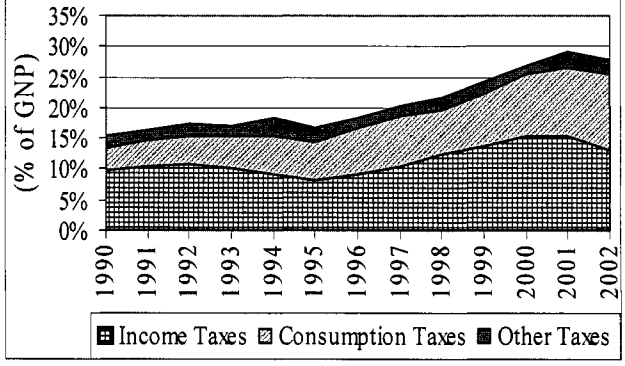
[2] Liam Embrill, Victoria Summers et al, *Turkey: The Agenda for Tax Reform – The Next Steps,* IMF, Fiscal Affairs Department (September 2000), and Sheetal K. Chand, David Robinson and Jose da Silva-Lopes, Turkey: *Reform of the Financial Sector Taxation,* IMF (March 1990). Ismail Arslan and Sweder van Wijnbergen, *The Investment and Export Incentive System in Turkey*, World Bank, December 1995.

[3] Foreign Investment Advisory Service, *Turkey: A Diagnostic Study of the Foreign Direct Investment Environment,* International Finance Corporation and World Bank, February 2001, and FIAS, *Turkey: Administrative Barriers to Investment,* (June 2001).

Turkey and other countries. This analysis confirms that the revenue effort in Turkey has grown significantly over the last decade such that Turkey has relatively high revenue effort in its per capita income group. Turkey is currently at the lower end of the upper middle-income countries in terms of per capita income level.

56. The tax effort in Turkey has been raised through exploiting short-term opportunities rather than sound structural changes that ensure revenue growth in an equitable and efficient manner over the long-term. Increases in revenue effort in recent years have largely been achieved through ad hoc special taxes (such as a high excise on mobile telephone services, high withholding taxes on the inflationary component of interest income) and non-tax revenues, rather than through major improvements in the structure and collection of the core taxes. A large proportion of the increase in income tax revenues was achieved through taxation of the high nominal (and high real) interest revenues on government securities and large increases in social security contributions. The increase in tax revenues on interest income is transitory and will decline as inflation rates and nominal interest rates decline; and the increase in social security tax rates is self limiting. Outside of the special tax (banking and insurance tax) on the banking sector, broader interest income has been subject to limited taxation or exempted, while interest deductions by corporate sector have allowed the deduction of the inflation component with some limited exceptions. In the last few years, the authorities have increased excise taxes, notably those on petroleum products, in some cases with significant negative externalities and distortions. Distributional effects of consumption taxes are negative on low income groups. Due to pressing fiscal requirements, consumption taxes have been increased significantly and their share in GNP increased from 3.7 percent in 1990 to 11 percent in 2001.

Figure 2.2: Turkey: Breakdown of Tax Revenues incl. SSI



Source: Ministry of Finance and World Bank.

Box 2.1. International Perspectives on Tax Effort in Turkey

Turkey is classified as an upper middle income country with its per capita income falling at the lower end of this group. The revenue effort of Turkey improved significantly through the 1990s. Current revenues of the central government rose to 26.7 percent of GDP by 2000, up from an average of 19.3 percent over the 1990-2000 period. When compared to lower middle-income countries, this revenue effort is markedly above the current revenue average of the lower group of 13.6 percent, of GDP. By 2000, the current revenues in Turkey had risen significantly above the average for all upper middle-income countries of 21.3 percent. The current revenues of the central government in Turkey are comparable to those in high-income OECD countries and in the Europe and Central Asia region, in general, but they still fall below the average current revenues of 34.2 percent of GDP in the member countries of the European Monetary Union. When compared with a range of other relatively large countries within the upper middle-income group, the revenue effort of Turkey is similar to Brazil, Chile, Malaysia and South Africa, but significantly higher than that in Mexico.

When the core taxes are analyzed across the various groups of countries, the tax effort of Turkey at 10.3 percent of GDP with indirect taxes on goods and services is higher than in most countries and comparable to the countries in the European Monetary Union. Direct taxes are composed of both taxes on income, gains and profits and taxes and social security taxes (typically payroll taxes). The combined direct tax effort of Turkey in 2000 of 13.9 percent is significantly above the average in the upper middle-income group of 7.2 percent and similar to the average effort in Europe and Central Asia of 11.6 percent, but not as high as in the high-income OECD countries and especially the European Monetary Union countries where the direct tax effort to 21.7 percent of GDP. Of the selected upper middle- income countries, only Brazil has a higher social security tax effort, but South Africa has a higher combined direct tax effort of 13.9 percent.

In general, these tax effort data show that Turkey has the potential to collect significantly higher shares of GDP in combined direct taxes as per capita income levels rise in the future, particularly through growth in formal sector employment and real wages as has occurred in high-income countries, if the tax structures are appropriate to achieve this.

Table B 2.1: Central Government Tax Revenues (Share of GDP, %)

	Current revenue	Taxes on income, gains and profits	Social security taxes	Taxes on goods and services
Turkey (2000)	26.7	8.3	5.6	10.3
Lower middle income countries	13.6	2.7	0.4	4.2
Upper middle income countries	21.3	4.1	3.1	6.8
Europe and Central Asia	26.1	4.1	7.5	9.8
High income OECD countries	26.2	8.0	7.0	7.0
European Monetary Union	34.2	9.2	12.5	9.1
Selected upper middle income countries:				
Brazil	24.1	4.1	7.6	5.2
Chile	22.6	4.0	1.5	10.3
Mexico	14.8	4.8	1.9	8.0
Malaysia	26.0	8.9	0.3	5.9
South Africa	25.8	13.4	0.5	8.9

Source: Ministry of Finance, Treasury and World Bank

57. The prospects for sustainable increases in the revenue effort from the current already high levels are limited. Turkey has a difficult tax base out of which to collect taxes relative to the typical OECD country. It has a high share of employment in the agricultural sector (about 45 percent), a large share of employment is at the minimum wage (about 40 percent) and it has relatively large employment in the informal sector. Low-income taxpayers are already bearing a significant burden through indirect taxes, social security payments and the income tax. Tax rates are already fairly high and such that further rate increases will not be very productive. For example, raising the VAT rate from 18 percent to 20 percent will only raise about 0.7 percent of GNP, assuming the same level of administrative effectiveness as currently prevailing. Given the 2001 recession and Turkey's generous tax incentives, a large share of corporations are experiencing tax losses. Loss carry forwards are dampening recovery in corporate tax revenues even though the economy has started to rebound. In the short-term, these loss carry forwards will also dampen the effects of reducing the investment allowances and bringing a truer measure of economic income into the tax base.

58. In light of the problems outlined above, core objectives for tax policy reform emerge. Tax structures should be amended to: (i) reduce tax distortions, complexities and uncertainties, particularly in tax treatment of capital income, both in the context of the current inflationary environment and in a medium-term environment of stable prices; (ii) increase tax policy transparency and stability in order to enhance investor confidence and lower the perceived costs of investment; (iii) enhance equity—shift the tax burden away from low wage employees, and (iv) move towards an internationally competitive tax environment in the context of EU accession. If the tax structure, particularly of the income tax is amended such that broad measures of income are made subject to tax (along with a reduction in the burden on low income wage earners), then there is still significant potential for further improvements in income tax revenues as the economy grows which can provide scope for rebalancing the tax structure. Comparison of the direct tax yield from social security payroll taxes, individual and company taxes show that these revenues can grow to yield in excess of 20 percent of GDP as per capita income levels grow to higher levels. This emphasizes the importance of structuring the core taxes on income and consumption to capture the future growth in these tax bases. Restructuring the taxation of corporate and capital income towards taxing a broader and truer measure of profits and gains would come about if investment tax incentives are moderated and more investment income is brought into the tax base.

Tax Administration

59. Reforms are urgently needed to improve the efficiency and effectiveness of Turkey's tax administration in order to broaden the tax base and increase collections at current or lower tax rates. The tax administration is one of the larger administrative services in Turkey with more than 1,000 offices throughout the country and a staffing level of more than 40,000. It is responsible for collecting the bulk of government revenues. However, the General Directorate of Revenues (GDR) is placed at a relatively low level within in the organizational structure of the Ministry of Finance as one of six general directorates. The importance is not sufficiently recognized in the organizational structure of the Ministry and the tax administration lacks a sufficient number of senior management layers. The organizational structure for tax administration should be upgraded in line with the practice in other OECD countries (Table 2.2). The complex organizational structure of tax administration headquarters, with a large number of

individual units structured around different types of tax with some elements of a functional organization, has proven to be an impediment to building managerial capacity in the key operational functions of tax administration. Moving to a more streamlined and functional organization at the headquarters level is the first condition for strengthening operational capacity. The restructuring and consolidation of the regional and local office network will then be required to properly implement the modernized compliance management strategies. These institutional reforms will facilitate the GDR's efforts to develop appropriate strategies, performance benchmarks, and monitoring instruments to improve its enforcement and service capacity.

Table 2.2: Organization of National Tax Administrations in OECD Countries

Country	Tax administration outside of MOF	Tax administration part of MOF
Australia	Australian Taxation Office	
Austria		Head of section "Tax and Customs" directly reporting to Minister of Finance. Tax administration reporting to head of section
Belgium		Head of tax administration reporting to General Secretary of MoF. General Secretary reporting directly to Minister.
Canada	Canada Customs and Revenue Agency	
Denmark	Central Tax and Customs Administration	
Finland	Finnish Tax Department	
France		Tax administration reporting to Deputy Minister of Finance
Germany	Tax administration primarily organized at subnational level	
Hungary	Tax and Financial Control Administration (APEH)	
Ireland	Revenue Commissioners	
Japan	National Tax Agency	
Korea	National Tax Administration	
Mexico	Tax Administration Service	
Netherlands	Tax and Customs Administration	
New Zealand	Inland Revenue Department	
Norway	Directorate of Taxes	
Spain	State Agency of Tax Administration	
Sweden	National Tax Board	
Switzerland	Tax administration primarily organized at subnational level	
United Kingdom	Board of Inland Revenue	
United States	Internal Revenue Service	

Source: IMF and World Bank.

60. Strengthening tax audit capacity stands out as a crucial priority. Although tax audit is a key element of compliance management and thus an important tax administration responsibility, the audit function in Turkey is largely outside the control of the GDR. Efforts must be made to integrate and better coordinate the tax audit function in the tax administration. This will require substantially increasing the capacity of the GDR to determine criteria for audit selection based on risk assessment and the development of a more comprehensive large taxpayer audit approach. Options should be explored to fully integrate large taxpayer audits into the tax administration.

The audit of large taxpayers requires substantial experience and advanced knowledge of audit techniques and large taxpayer evasion and avoidance techniques. Building of sufficient audit capacity will take time to achieve and efforts towards this objective should start now.

61. A number of other reform challenges will need to be addressed in the design of the tax administration reform strategy. The GDR needs to develop a proper internal audit function. Internal audit still plays only a marginal role in the structure of GDR and a clear separation between internal and external audit responsibilities is lacking. This is a major issue of concern as according to international experience the risk of corruption tends to be particularly high in revenue administration. Risk analysis in revenue administrations in other countries highlight the audit function as a particular corruption risk area due to the frequent direct contact between taxpayers and tax officials. Controlling this risk requires clear separation of external from internal audit responsibilities and creation of a special internal audit unit reporting directly to the tax administration director general. In the taxpayer service area, the GDR has been preoccupied by issuing rulings on request of individual taxpayers and a proactive approach to taxpayer service delivery has not been developed. However, the implementation of self-assessment and promotion of voluntary compliance requires a well targeted and diversified taxpayer service program. Modern tax administrations also have developed service pledges and clear and ambitious service standards which can be easily monitored. To reach a level of taxpayer services which corresponds to good practice among OECD countries, a dedicated taxpayer service function will be required in the GDR. Finally, the problem of arrears collection from state-owned and municipal enterprises has not been sufficiently addressed. This is more than a pure tax administration reform issue. It requires cooperation with ministries and other institutions responsible for state owned and municipal enterprises, and a clear government decision to eliminate the protection of public enterprises from tax collection enforcement.

62. As part of the tax reform agenda, the institutional arrangements for tax policy making in Turkey must be revisited. In contrast with the vast majority of OECD countries (the only notable exceptions being Belgium and the United Kingdom), the Ministry of Finance has no organizational unit responsible for tax policy formulation. Responsibility for tax policy is dispersed among numerous departments in GDR and overlaps with administrative responsibilities for implementation. The quality of tax policy making also is negatively affected by the fact that the existing capacity for tax modeling and revenue forecasting is inadequate. A reorganization of the tax policy function is required. The MOF does not intend to separate the responsibility for tax policy from implementation or to create a tax policy function outside the GDR. Therefore, the organizational reform of the GDR must include consolidation of overall tax policy responsibility in the tax policy unit and strengthening of this unit as part of the functional reorganization. The tax policy unit needs to develop the capacity to analyze and forecast tax revenues based on samples of actual tax payer information. This is of critical importance to reform of the complex tax incentives offered business sector and tax treatment of financial instruments and institutions.

Medium-term Tax Strategy

63. The Government adopted a medium-term strategy for improving the tax system in Turkey in January 2002. The overarching objective of the strategy is to improve the stability, transparency and equity of the tax system through measures to minimize tax distortions, broaden

the tax base and improve the efficiency of tax administration. This will allow an equivalent amount of revenue to be raised at lower marginal tax rates thereby promoting economic growth. The strategy builds on the 1998 tax reform and draws on earlier analysis of the tax system by the Bank, IMF and Foreign Investment Advisory Service (FIAS). The tax strategy lays out a series of coordinated actions over the course of the 2002-04 period to address certain serious tax policy and administration issues facing Turkey. The priority objectives are summarized in Box 2.2.

Box 2.2: Tax Strategy Priorities

Tax Policy

- Simplify and consolidate the indirect tax structure with a VAT with a standard rate and two low rates (1 percent for agriculture and 8 percent for other basic consumption goods). Introduce a unified Special Consumption Tax that will consolidate the current range of excise and specific taxes into a single tax charged on a limited range of luxury goods. A threshold will be established for obligatory filing of VAT returns. Earmarking of revenues will be abolished and all revenues from earmarked taxes will be brought into the budget .
- Simplify and consolidate the direct tax regime in line with OECD standards and international best practice. Convert tax rebate for wage earners into a tax credit to simply administration and reduce tax burden on low income wage earners. Move to income tax base to a more global measure of income and away from a reliance on final withholding taxes. Minimize tax exemptions and exceptions.
- Harmonize real effective tax rates across all types of financial instruments and maturities.
- Phase in the full indexation of the corporate and business income taxes (real interest deduction to replace nominal interest deduction). Reduce the scope of investment incentives, consolidate into a single investment allowance rate across sectors and geographic regions, and gradually eliminate withholding tax on these allowances. Make the incentive system more transparent and automatic.
- Overhaul the tax regime for free trade zones to remove unintended direct tax losses and limit indirect tax losses through transfer pricing. Terminate the corporate tax and payroll tax exemptions. Provide reduced corporate tax rate only on condition that separate subsidiaries are established and inward trading is below 15 percent of sales.
- Adjust taxation of financial leasing in line with internationally generally accepted accounting practices.

Tax Administration

- Reorganize the GDR to introduce functional structure in line with OECD practice.
- Revise payment scheme for managers and key technical staff and design a bonus and incentive system which allows more competitive total remuneration for these positions.
- Upgrade the tax policy department within the GDR.
- Strengthen tax audit management capacity within the MOF by establishing an audit coordination unit and upgrade the role of the audit department in the GDR. Prepare a coordinated annual auditing plan. Develop databases for tax audit planning and the use of information from the tax identification number (TIN) system for effective auditing. Design a more comprehensive large taxpayer audit strategy and improve knowledge and database on large taxpayers and their business transactions.
- Develop a strategy for taxpayer services and improvements in relations between taxpayers and the GDR.
- Upgrade internal audit function for the tax administration reporting directly to the head of GDR.
- Design and implement program to reduce tax arrears.
- Upgrade the management information systems throughout the GDR.

64. Implementation of the medium-term tax strategy is progressing well. On the tax policy side, a unified Special Consumption Tax (SCT) to consolidate a range of excise and specific taxes into a single consumption tax charged on a limited consumption and luxury goods was enacted in June 2002. The first legislative package to address issues in the direct taxation was enacted in April 2003. This legislation: (i) harmonizes taxes on investment income at the declaration stage; (ii) rationalizes the system of investment incentives; (iii) reforms the system of

personal income tax credits; and (iv) introduces a partial dividend deduction to integrate and lower the double taxation of distributed corporate earnings. This legislation brings Turkey's personal and corporate income tax regimes closer to OECD standards and international best practice. However, in a number of important areas, further steps will be needed in the future including introduction of a single tax rate schedule for wage and non-wage incomes and global declaration by all individual taxpayers. A second package of direct tax reform legislation is under preparation which aims to minimize geographical, sectoral, and other investment incentives—including rationalizing benefits in Free Trade Zones. The authorities are also working to develop proposals to harmonize taxation of financial income at the withholding stage to address significant distortions between the real withholding tax rates on different instruments. For example, deposits in Turkish lira are more heavily taxed than deposits in foreign currency. Legislation on inflation accounting which will reform ad hoc inflation adjustments in the tax system has been prepared.

65. The strategy also tackles tax administration issues 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. Implementation of the tax administration reforms has proceeded somewhat more slowly than originally envisaged, in large part due to the elections. In addition, the general tax amnesty announced by the new Government in early 2003 poses an important challenge for the tax administration in terms of ensuring the credibility of future tax collection, despite the authorities' public commitment against future amnesties. In a positive step, the audit coordination committee has been established and a coordinated audit plan for 2003 has been prepared and approved. Resources have been included in the 2003 budget to enhance the audit capacity of the GDR. Effective implementation of the audit plan will help discourage future tax evasion, but broader efforts and organizational changes will be required to bring tax administration up to international norms. The new functional structure within the GDR was largely agreed in mid-2002 and new management positions were established. However, full implementation of the functional reorganization has been delayed and is now scheduled to be completed by end-2003, at which point the GDR will start to extend this structure to the local level as well. The functional reorganization will reorient the GDR 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 HR. As part of the functional structure, the tax policy unit of GDR will be upgraded.

Public Employment Program

66. The comprehensive public employment program is part of the longer-term strategy to modernize the public sector and ensure medium-term fiscal sustainability. The retrenchment in SEE employment supports the policy of a non-inflationary, sustained shift in the overall SEE balance from deficit to surplus. While reducing SEE employment is always difficult and entails social costs, the fiscal adjustment it supports will reduce crowding out and promote the strategically important objective of private sector investment and job creation. Under the program, a system of quarterly monitoring has been established which provides a clear picture of public employment across the general government. The stricter policies on public employment introduced in 2002 are being maintained and strengthened in 2003. These include: (i) a cap on the total number of civil servants in the central and local government—the ceiling on new hiring

in the consolidated budget in 2003 has been reduced to 35,000; and (ii) a limit on replacement hiring in the SEEs equal to 10 percent of attrition and no replacement hiring for SEEs requiring finance from the budget. A system of quarterly monitoring has been established which provides a clear picture of public employment across the general government (Table 2.3). Using company-specific information, an assessment of 45,800 SEE redundancies was completed in April 2002. A circular on implementation of the redundancy program was issued in May 2002 after consultations with the trade unions. As of end-June 2003, the identified redundancies reduced by 28,102, essentially through voluntary retirements. The Government now expects the remaining identified redundancies to be phased out by December 2003. A new government regulation lifting all existing restrictions on retirement of public sector workers was published in March 2003. For this well-targeted attrition, no replacement hiring is being allowed and the resulting unfilled positions are being eliminated. The Government is also undertaking coordinated efforts to ensure that adequate funding is in place for the lump-sum severance payments due to retiring and laid-off workers.[4] This is particularly important for loss-making SEEs which cannot cover these payments from their own cash flow.[5] Implementation of the SEE redundancy program is being tracked under the quarterly monitoring system.

Table 2.3: Public Sector Employment 1/

	2001		2002	
	Number	% of Total	Number	% of Total
Consolidated Budget	**1,903,473**	**71.6**	**1,897,067**	**73.0**
Civil Servants	1,700,000	64.0	1,691,458	65.1
Workers	203,473	7.7	205,609	7.9
SEEs	**415,332**	**15.6**	**383,064**	**14.7**
Civil Servants	10,079	0.4	9,715	0.4
Workers	405,253	15.2	373,349	14.4
State Banks	**47,979**	**1.8**	**32,558**	**1.3**
Civil Servants	3,250	0.1	307	0.0
Workers	44,729	1.7	32,251	1.2
Social Security Institutions	**77,854**	**2.9**	**75,536**	**2.9**
Civil Servants	70,341	2.6	68,016	2.6
Workers	7,513	0.3	7,520	0.3
Local Administrations	**213,428**	**8.0**	**211,702**	**8.1**
Civil Servants	104,587	3.9	102,941	4.0
Workers	108,841	4.1	108,761	4.2
TOTAL	**2,658,066**	**100.0**	**2,599,927**	**100.0**
Civil Servants	1,888,257	71.0	1,872,437	72.0
Workers	769,809	29.0	727,490	28.0

Source: Ministry of Finance chaired Public Employment Committee and World Bank.
1/ "Workers" category include contracted personnel.

[4] With the introduction of the new unemployment insurance scheme, the Bank has recommended to the authorities to consider a fundamental restructuring of the severance payment system over the medium term.
[5] Experience to date under the Bank's PSSP project provides a rough upper bound for severance payment costs of up to US$20,000 per worker.

67. Looking ahead, a key issue for the Government under the public employment program will be to set overall objectives for the appropriate level and structure of public employment in Turkey. The policies in place so far are a useful start but generally have a short-term focus. The public employment program will soon need to be put in a broader strategic perspective. Important input into this strategy formulation will be provided by the functional review of government currently underway (para. 82). In the SEE sector, following implementation of the on-going redundancy and privatization programs, a determination will be needed as to which enterprises should remain in the public sector (and why) and what employment policy these firms should follow.

3 STRUCTURAL AND INSTITUTIONAL REFORMS TO UPGRADE PUBLIC EXPENDITURE MANAGEMENT

68. The key elements of the Government's multi-year strategy for public expenditure management (PEM) reform are laid out in its Strategic Framework for Public Expenditure Management Reform. The framework is structured into three priority areas in support of three core objectives. The objectives, commonly referred to in international practice as levels 1-3, are: *strengthening* aggregate *discipline* (level 1), *building capacity for policy formulation* (level 2), and *improving the performance of public agencies* (level 3). The three priorities for PEM reform are to:

- Reform the processes for budget preparation and execution. This 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-oriented budgeting.
- Upgrade public accounting, procurement and audit functions to ensure adequate financial accountability. This 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.
- Ensure prudent public liability management. This involves legal 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.

Budget Reform

69. The Public Financial Management and Control (PFMC) Law scheduled to be enacted by end-October 2003 will form the cornerstone of the legal framework for modern public expenditure management in Turkey. By establishing clear linkages between policies, programs and (comprehensive) budgets within a consistent medium-term macro-framework, the PFMC law and related reforms will provide the framework for *institutionalising* the fiscal adjustment process in Turkey. In this sense, the PEM reforms directly complement the structural fiscal

reforms which provide the actual instruments of fiscal adjustment. As a modern public finance act, the PFMC law will define and enable:

- A well defined framework of responsibility and accountability for all relevant aspects of public finance management
- Aggregate fiscal discipline through political commitment to a comprehensive and transparent medium term fiscal framework consistent with overall macroeconomic stability
- Strategic decision making on policies and projects within the constraint imposed by the medium term fiscal framework
- The introduction of strategic planning principles within public administration units to ensure that their resource requests are aligned with policy objectives and key performance goals of such units
- The gradual shift from a system of central (external) financial control to a system of financial control that is internal to public administration units
- Improved operational efficiency of public administration units through effective internal financial control and audit, greater flexibility in managing resources and a greater performance orientation in resource allocation.

70. The transparency and credibility of Turkey's government budget is improving although the process has proved to be somewhat more difficult and complex than initially envisaged. Progress can be summarized as follows:

Budgetary and extra-budgetary funds. All budgetary funds and extra-budgetary funds (EBFs) were closed in the 2002 budget with the exception of the Support Price Stabilization Fund (DFIF), linked to the restructuring of the agriculture sales cooperative unions (ASCUs), and five EBFs. Off-budget earmarking has been substantially scaled back in the 2003 budget. However, a more permanent solution is needed to terminate the system of earmarked expenditures linked to the closed funds and incorporate their revenues into the general revenue base. This will be accomplished through legislation which is expected to be enacted by end-June 2003. For the remaining EBFs (excluding the SDIF which is covered under the financial sector reform program), the following measures have been included in the PFMC law: (i) submission of EBF budgets to Parliament for approval, (ii) audit of EBF accounts by the TCA, and (iii) monthly reporting of EBF operations on a consolidated basis with the central government. These measures will go into effect following enactment of the law.

71. Budget classification. Introduction of the new Government Finance Statistics (GFS) compatible budget classification will improve budget transparency by allowing for a comprehensive and consistent presentation of the budget across all general government agencies with a complete functional breakdown of expenditure. The new GFS budget classification being rolled out in the consolidated budget agencies for the 2004 budget cycle and will become fully operational for the entire general government in the 2005 budget. In order to ensure that this timetable is adhered to, the MOF issued in July 2003 an action plan and circular showing objectives, actions, and dates from the start of 2003 to the completion of the GFS reform.

72. Budget preparation. Important steps have been taken to improve the credibility of the budget preparation process. The framework for these actions was established by a High

Planning Council (HPC) decision issued in June 2001 to accompany the Prime Minister's Budget Call. The HPC decision provided a macro-fiscal framework for 2002 budget preparation consistent with the primary surplus target and established indicative ceilings for both the recurrent and investment budgets for ministries and line agencies based on an indexation formula applied to the actual budget allocations that each ministry and line agency received in 2001. As a further step, the Prime Minister's Budget Call for the 2003 budget included individually specified indicative ceilings for each ministry and line agency.

73. Public Investment Program. A Public Investment Review was carried out on an urgent basis by SPO in October 2001 with support from the Bank. The review confirmed that the average completion time is excessively long, reflecting a lack of prioritization among projects. In 2001, the average completion time was 12.5 years (more than 30 years in the agriculture sector), a sharp increase from 9.2 years in 2000 given the impact of the Lira devaluation and higher than expected inflation. Scarce funds are distributed among an excessive number of projects which leads to inefficiencies in project implementation. The PIP has traditionally included projects that will not be implemented immediately (the so called "trace allocations"), which hampers the credibility of the program. The 2002 PIP rationalization cut the average completion time to 8.5 years, a 32 percent reduction, which significantly exceeded the 20 percent benchmark set by the HPC. The 2002 PIP: (i) phased large projects with the view to focusing on priority subprojects; (ii) excluded from the investment program numerous projects with "trace allocation"; (iii) terminated a large number of uneconomic projects; and (iv) reduced by more than half the number of new multi-year projects included in the 2002 investment program. Most of the new multi-year projects were emergency projects (e.g. flood prevention) or projects of a social nature. Overall, 353 individual projects and 649 subprojects were dropped from the PIP and the rationalization has reduced the total cost of the PIP by TL 36.9 quadrillion.

74. An action plan for further rationalization of the public investment program over the 2003-04 budget cycles prepared by SPO was adopted by the High Planning Council in October 2002. The plan includes quantitative targets for further reductions in average project completion time of at least 3 percent per year starting from the 8.5 year baseline established in 2002. It also

Table 2.4: Public Sector Investment, 1996-2003 1/
(current prices, trillion TL)

	Number of Projects	Total Value of Projects	Total Expenditure by the end of previous year	Initial Allocation	Actual Investment 2/	Actual Investment 3/ (in percent of GNP)	Average Time of Completion 4/	New Projects	
								Total	Multiyear
1996	5221	8,155	2,629	467	545	3.6	10.8	1449	459
1997	5332	16,597	4,788	1,008	1,298	4.4	10.7	1428	577
1998	5556	34,084	9,657	2,135	2,378	4.4	10.4	1,574	714
1999	5458	57,126	17,380	3,560	3,649	4.7	10.2	1,186	305
2000	5321	86,219	26,125	5,905	6,183	4.9	9.2	1,176	249
2001 5/ 6/	5047	142,919	45,885	7,167	7,570	4.3	12.5	1,234	286
2002 7/	4414	166,797	66,021	10,590	11,047	4.0	8.5	1,066	128
2003	3851	187,110	80,372	12,464		3.5	7.6	1,032	134

1/ Excludes local administrations.
2/ 2002 figure is provisional.
3/ The ratio for 2003 represents the share of initial allocations in GNP.
4/ Average time of completion is calculated as the amount of time required to finish up the remaining stock completely, assuming that no other projects are taken into the investment program in the following years and an appropriation and expenditure is made of the magnitude of the current year level.
5/ Initial 2001 Total Value and Total Expenditure figures are deflated by a factor of 1,3584 (1,603/1.18) to adjust for crisis impact.
6/ Includes supplementary budget allocation of TL 280 trillion.
7/ Annual allocation includes TL 555 trillion from Law 3418 revenues.
Source: SPO

outlines steps to strengthen the role of formal cost/benefit analysis in the project approval process and establish a framework for project monitoring and evaluation. An assessment prepared by SPO confirms the reduction in the average completion time to an estimated 7.6 years in the 2003 PIP along with a continued reduction in the number of projects (Table 2.4).

75. Budget reforms are also underway to build capacity for policy formulation and improve the performance of public agencies. The SPO has issued guidelines for strategic planning by key line ministries and departments including guidelines for costing policies. The Government will also initiate policy reviews by selected line ministries and agencies to derive clear statement of objectives and expenditure priorities in preparation of 2004 budget. This will be complemented by action to revive the role of ministerial departments responsible for policy reviews with support from SPO. The next step is to finalize these guidelines and implement them in a phased manner across central government in order to effectively link planning, policy and budgets. The Government has been carrying out a pilot program since 2002 for a group of line ministries and agencies willing to volunteer for reforms that will provide them with greater discretionary control over inputs linked to adoption of effective internal controls and commitment to improved performance. The pilot agencies have been provided access to resources consistent with their performance plans in the 2003 budget. Based on the lessons from the pilot, a plan to expand the program will be prepared by October 2003

Financial Accountability

76. Modernization of Turkey's system of public financial accountability in line with international standards is an urgent PEM priority. As detailed in the August 2001 CFAA, some of the basic building blocks are in place: an established legal framework; reliable, albeit fragmented, accounting processes; regular reporting of financial results; an apparently independent Supreme Audit Institution, the Turkish Court of Accounts, which reports to Parliament; a relatively open system of accountability and plenty of skilled personnel. However, deeper analysis reveals significant problems and lack of systemic coherence. Complex institutional relationships, multiple sources of public funds, heavy emphasis on ex ante controls and inadequate reporting to the legislature reduce transparency and weaken financial management. Accounting and procurement legislation have not kept up with evolving international standards. Similar to the budget, the audit system is fragmented with many bodies besides the TCA carrying out activities analogous to external inspection and audit.

77. Accounting. Efforts to upgrade the public accounting system are steadily gaining momentum under the PFPSAL program after many years of limited progress. The *say2000i* automated accounting system is operational in virtually all of the approximately 1,500 sites of the MOF's General Directorate of Public Accounting across Turkey. Under this internet based system, the MOF's central accounting data base contains data on all individual transactions wherever they occur in the system. The initiative to introduce modified accrual accounting in compliance with GFS requirements is making progress. The PFMC law will replace the existing public accounting law (No. 1050) and provide MOF with permanent authority to issue budget coding and accounting standards for all general government agencies. The MOF has prepared a regulation referring to accounting policies and principles, and containing framework accounting standards and a framework chart of accounts consistent with GFS. This framework chart of accounts will be adapted to meet the specific requirements of individual agencies while

maintaining full compliance with GFS standards.[6] The new chart of accounts is being piloted within consolidated budget agencies including several joint pilots with the GFS budget classification. Following approval by TCA, the new accounting regulation will be published in the official gazette by mid-2003.[7] Based in part on the experiences from the pilots, the timetable for the accounting reform has been revised and is now as follows: (i) introduce modified accrual accounting in consolidated budget entities in 2004, (ii) begin introduction of the full accrual basis in entities outside the consolidated budget in 2004, and (iii) introduce full accrual accounting for consolidated budget entities by 2007. The government accounting standards board to be established through the PFMC law will be responsible for transforming the framework standards included in the accounting regulation into full-fledged accounting standards over time.

78. Procurement. Turkey has moved decisively over the past year to upgrade its public procurement legislation and practices in line with international standards. The new public procurement law was enacted in January 2002. The new law is based on the UNCITRAL model and moves Turkey in the direction of compliance with EU standards. The independent Public Procurement Agency (PPA) established under the law to oversee public procurement and ensure enforcement of the new procurement standards is fully operational. Although the new Government initially considered delaying implementation of the law or amending key provisions, in the end, the new procurement standards came into force on January 1, 2003 as scheduled. The Government is now working on a set of technical improvements to the law as well as new procurement legislation for SEEs in the public utilities sectors consistent with the relevant EU directive.

79. Auditing. Effective financial accountability requires extensive modernization of Turkey's public audit system. The objectives are two fold: (i) clarify institutional responsibilities, promote improvements in audit quality in line with international standards and support the shift from ex-ante controls to ex-post monitoring in harmony with the efforts to improve operational performance; and (ii) expand the scope of TCA audits to cover the entire general government including local administrations, autonomous agencies, SSIs, remaining EBFs and revolving funds, with the overall objective of transforming TCA into an effective SAI. These objectives will be facilitated by enactment of the PFMC law. With regard to audit quality, the law will clarify the roles and responsibilities of the line agencies, the MOF and the TCA. The law will establish a framework for decentralizing internal audit to the line agencies in line with EU requirements. It will allow the TCA to discontinue involvement in budget execution and focus on ex-post audits, including performance audits. With regard to the transformation of TCA, the law will: (a) include all consolidated budget agencies under TCA's annual audit; (b) subject TCA's own accounts to external audit with reports submitted to the Parliament; and (c) expand the scope of TCA audits to cover the entire general government. As with any major institutional reform, the transformation of TCA into a modern SAI must be carefully designed to build consensus with the public administration. The TCA is committed to undertake internal reforms to align its institutional structure with international standards for SAIs, to upgrade its

[6] The new chart of accounts is based on an economic classification. The coding for the functional, institutional and financial classifications are being built into the accounting software running under say2000i.

[7] This will be a framework chart of accounts which will be adapted by MOF to meet the specific requirements of individual agencies while maintaining overall consistency with GFS standards.

audit capabilities, and to reach consensus with the other government audit bodies on implementation of the reform. A draft action plan for the TCA's internal reform has been prepared and will be improved, including through a peer review by auditors from other European SAIs. The action plan is expected to be adopted by the Government and TCA by October 2003.

Public Liability Management

80. The new law on Public Finance and Debt Management, enacted in March 2002, has established the foundation for a comprehensive risk management framework in Turkey. The new law: (i) confirms that the Treasury is the single borrowing authority for the central government; (ii) creates a more transparent framework for the issuance of government guarantees; and (iii) establishes a risk account in the budget, starting with the 2003 budget, to cover the expected fiscal cost of called guarantees and unexpected losses from other fiscal risks. In accordance with the law, more stringent regulations for the issuance of government guarantees and for borrowing by SEEs were issued in April 2002. The Treasury has established a new office (the "middle office") for public liability and risk management. The circular on establishment of the middle office and a Public Debt Committee to set policy within the Treasury, originally published in September 2002, was reissued in January 2003 with a strong emphasis on the risk control function of the middle office. The latter has launched monthly fiscal risk monitoring notes for the Treasury Management, and is currently implementing systems to formulate strategic risk benchmarks and medium-term borrowing scenarios for the portfolio of direct government debt. The middle office has established a valuation model for contingent liabilities and a tool for the formulation of strategic portfolio benchmarks and medium term borrowing scenarios. The Treasury published in late April 2003 its first Quarterly Fiscal Risk Report covering risks coming from both its direct debts and contingent liabilities. This new report is the main vehicle for the dissemination of the Treasury's liability management strategy to other Government agencies, the legislature, investors, and the general public. A review of the government guarantee portfolio was completed in May, providing a preliminary valuation. The new structure for public liability management is expected to be fully operational by the end of 2003. By that time, the Treasury will have produced an operational valuation of Turkey's portfolio of explicit contingent liabilities and an updated list of its implicit contingent liabilities. On the basis of these assessments, the Government will be in a position to issue its public liability strategy as an annex to the planned medium-term expenditure framework (Box 2.3)[8].

[8] Liability management related issues have been explored in detail in the World Bank Publication edited by Polackova Brixi and Schick (2002).

Box 2.3: The Management of Fiscal Risks in Turkey

Over the past 20 years most OECD countries and many emerging economies have introduced wide-ranging reforms in the area of public liability management. First and foremost, these changes affected the management of direct government debt. Public financial managers have been given greater operational flexibility and portfolio management practices pioneered by the private sector have been adopted. With regard to management of off-budget liabilities, the best practices are fewer and more recent. New Zealand led the way in the mid-1980s by adopting accrual-based accounting and budgeting standards practiced by the private sector; Canada (1986) and the USA (1989) have introduced comprehensive risk controls for government guarantees. Most countries, including many emerging economies, have integrated the management of guarantees with the management of direct debt, however, only few of them (e.g., USA, Netherlands, Sweden) are applying mark-to-market valuations for their guarantee portfolio. Also in the USA and now in other OECD countries, actuarial valuation methods have been introduced for government insurance schemes. In most countries, other categories of contingent liabilities are still tracked and reported only in nominal terms, and their issuance and management are generally not fully transparent.

The 2001 crisis revealed serious deficiencies in fiscal risk management practices in Turkey. In response to these challenges, the Government has initiated wide-ranging reforms in public finance management, municipal sector, financial system, energy, agriculture and other relevant sectors all of which will improve fiscal risk management. Reforms focus on two large classes of risk: those present in the direct debt portfolio and those coming from off-budget liabilities. Public finance management is being strengthened significantly by the promotion of systemic legal acts such as the Law on Public Debt and Risk Management (April 2002), and the Public Finance Management and Control Law (scheduled to be adopted by end-October 2003).

Important institutional and technical changes for better public liability management (PLM) are also under way:

- Within the Treasury, a Debt Management Committee has been created, providing senior management with a tool to formulate an integrated approach to public liability management, and a Deputy General Directorate in charge of Risk Management ("Middle Office") has been established to conduct public debt analysis and monitor all fiscal risks. The Middle Office has implemented a guarantee valuation tool which compares favorably to the best international practices. For direct debt, the Middle Office is building quantitative benchmarks to measure refinancing, currency and interest rate risks more effectively
- The Treasury has strengthened guarantee management procedures by introducing a guarantee ceiling and a risk account. The guarantee ceiling covers most types of guarantees.

Many PLM reforms currently underway in Turkey compare well to best international practices, while in some other areas Turkey still follows traditional, less effective practices. Institutional strengthening of the Treasury will help prioritize a more strategic approach to debt creation. Guarantee design now aims to constrain overall government exposure and apply more rigorous financial criteria to the local beneficiaries of such guarantees. The Treasury is also adding to its arsenal of state-of-the-art technical tools. It now implements the same guarantee valuation model which was introduced in Sweden over 2000-2002—very few OECD countries operate valuation tools of equal sophistication. In sum, progress in technical modernization of Turkey's liability management has been impressive.

Remaining challenges primarily lie in the consolidation and strengthening of institutional mandates for PLM in Turkey, as well as pursuing the broader public finance management agenda. Priorities include:

- Introducing a medium-term fiscal framework and accrual budgeting procedures that help reveal the true cost of contingent liabilities;
- Matching the Treasury's improved risk management capacity at the budget execution stage with similar improvements in capacity at the budget formulation stage (MOF) and at the audit stage (TCA).
- Strengthening risk management practices of the guarantee beneficiaries (municipalities, SEEs, public banks); municipal sector reform, if properly designed and implemented, holds great promise of improved PLM practices within the broader public sector.

4 PUBLIC SECTOR GOVERNANCE

81. A national strategy to enhance transparency and good governance in the public sector was published in March 2002 under the slogan *"A Transparent and Clean Turkey: Together Hand in Hand"*. The objective of the strategy is to provide a comprehensive framework for improving governance and reducing political influence over the economy which establishes clear priorities and benchmarks, and empowers and energizes public opinion to fight corruption. Priorities under the national anti-corruption strategy are summarized in Box 2.4. The basic structure and actions of this strategy have been reflected in the UAP of the new Government. The ministerial committee for enhancing transparency and improving good governance was established in March 2003. The committee will steer relevant actions of both the UAP and national strategy in this reform area. The ministerial committee will prepare regular implementation reports for the national strategy within the context of the UAP. Among a comprehensive set of substantive actions is the Law on "Freedom of Information for Citizens", which has already been drafted and sent to agencies for comments. This law is expected to be passed by October 2003. Legislation establishing a code of conduct for civil servants and public administrations is expected to be passed by end-July 2003. The Government is counting on the active involvement of national non-governmental organizations (NGO) to improve public awareness about good governance. One of the major national NGOs, Foundation for Economic and Social Studies (TESEV), has completed two diagnostic surveys co-sponsored by the Bank on corruption covering households and the business community respectively. Work on a third survey covering civil servants was delayed by the elections.

Box 2.4: Priorities under the National Strategy to Enhance Transparency and Good Governance in Turkey's Public Sector

- Accelerating the completion of ongoing work, within the framework of public administration reform, for institutional improvement and financial management.
- Implementing amendments to the Law on the Contents of a Declaration of Wealth, Bribery and Anti-Corruption (No. 3628) in order to make these declarations public and to require mandatory audits and public access to the declarations for all elected officials.
- Enacting regulations to ensure that inspections of campaign financing, income and the expenses of political parties and election candidates are made available to the public. Amending the existing Law on Political Parties to require that political parties and candidates make a public declaration of contributions from individuals and legal persons above a fixed amount. The High Elections Board will be responsible for publishing and auditing this information.
- Implementing amendments to the Law on the Prevention of Money Laundering Law (No. 4208) to expand the list of criminal activities giving rise to illegitimate profits and to restructure MASAK in order to provide investigative powers to MASAK experts in specific areas.
- Creation of an Inspection and Audit Services Class and passage of an Inspection Law to put into effect inspection standards, to allow for a complete restructuring of all inspection and auditing units, and to implement changes to appointment procedures to allow for fixed-term appointment of presidents. Amending the Civil Service Law (No. 657) to include a specific employment category for inspection and auditing services.
- Establishing specialised courts to facilitate quick resolution of corruption cases.
- Founding specialised units within the security forces and under the supervision and inspection of the Chief State Prosecutor to investigate corruption cases.
- Implementing ethic agreements in Turkey.

82. Civil Service Reform. Sustained improvements in public governance will hinge in large part on effective reform of the civil service. Indeed, civil service reform features prominently in the national anti-corruption strategy and features in the UAP. Civil service reform is vital to raising the quality of public services and ensuring the quality of the fiscal adjustment. The Government has already initiated work on a *norm* cadre system to establish benchmarks for staffing in public agencies which is now operational within the Ministry of Education. There is widespread acknowledgement that a more complete, medium-term approach is needed in order to adapt the civil service to the changing role of government in Turkey and to internalize the on-going reforms to PEM. In addition to questions about the size and composition of the civil service in a changing Turkey, the reform will need to address issues such as distorted salary incentives, career development requirements and inadequate operational budgets in most agencies. In February 2002, a ministerial committee was established to oversee the preparation of a civil service reform strategy and carry out a full functional review of government in preparation for further decisions about what functions to retain within government and what to devolve to the private sector. Preparations for the functional review were initiated in mid-2002, but then delayed by the run-up to elections. The functional review has now been re-launched under the responsibility of SPO and the report will be submitted to the Government in July 2003. Responsibility for preparation of the civil service reform strategy has now been confided in the UAP to the State Personnel Presidency under the overall direction of a Deputy Prime Minister. A timetable of end-2003 has been set for the preparation and adoption of the civil service reform strategy by the Council of Ministers.

CHAPTER 3: BANKING SECTOR

1 INTRODUCTION

83. Over the last decades, public policy contributed to the deterioration of the Turkish banking system which led to the 2001 crisis. Problematic policies included large public sector borrowing requirements, weak monetary policy which fueled chronic high inflation, use of tax advantages to favor government debt, deposit insurance that undermined market discipline, lax prudential regulation and supervision, and undercapitalized state banks. Generous deposit insurance and a lax regulatory and supervisory environment encouraged risk taking. Connected lending, high exposure concentrations, and large foreign exchange positions allowed banks to increase risk, while lenient prudential regulations allowed these risks to remain hidden. In response to the 2001 crisis, Turkey has taken a number of serious financial sector reform actions. These encompass: (i) significant reform of prudential regulations; (ii) strengthening of regulatory and supervisory authority; (iii) restructuring of private and public banks; (iv) re-capitalization of the banking system; and (v) debt re-structuring for the corporate sector. The government's financial sector reform program has been supported by the FSAL, and PFPSAL operations. The Bank team has also carried out three major banking reviews since late 1998 which contain a thorough review of the events that contributed to the crisis and the impact of the crisis on the financial sector.

84. Today, the Turkish banking system is undergoing rapid change as part of the banking reform program. As of the end of 2002, there were 54 banks of which 40 were deposit taking institutions and 14 were investment and development banks. As given in Table 3.1, around 32 percent of total banking assets are held by the three state banks, and another 3- percent by foreign and investment banks. With the June 2002 takeover of a large private bank (Pamukbank) by the Savings Deposit Insurance Fund (SDIF), the share of banking assets under SDIF control reached to 4.4 percent, leaving 56.2 percent in private banks. Audits of the banking sector carried out in 2002 revealed that non-performing loans (NPLs) in the private banking system constituted 23.7 percent of total loans at the end of 2001, instead of the 6.8 percent published previously. The audits also showed a dramatic drop in bank profitability. As a result, BRSA assessed that banks faced an overall capital shortfall of close to US$ 1 billion, excluding Pamukbank, as of the end of 2001.

85. This chapter addresses four main issues related to the financial sector reform program. These are (i) private bank restructuring and recapitalization, (ii) state bank restructuring and privatization, (iii) credit crunch issue in the short run, and (iv) changes in the incentive structure of financial institutions and increasing the level and quality of financial intermediation in the long term. The chapter summarizes recent developments in each of these areas and analyzes the challenges facing the authorities in completing the reform and restoring the banking system to its key role of intermediating financial resources for growth.

Table 3.1: Turkey: Banking System - Selected Indicators

	1998	1999	2000	2001	2002
Banking System					
Total assets (in Trillion TL)	40,988	79,763	117,649	182,265	212,681
CAR in %	12.4	9.1	17.3	16.8	25.4
NPL/total loans	6.7	9.7	9.2	12.6	17.6
Provisions/NPLs (%)	44.2	61.9	59.8	65.7	64.1
ROA	1.9	-0.4	-0.8	-1.9	1.7
Share in assets (%)	100.0	100.0	100.0	100.0	100.0
Private Banks					
Total assets (in Trillion TL)	23,596	42,165	56,179	99,946	119,471
CAR in %	12.0	9.0	18.3	10.9	19.7
NPL/total loans	6.9	3.5	3.5	5.3	8.9
Provisions/NPLs (%)	41.2	62.2	63.0	46.1	53.0
ROA	2.8	3.8	2.3	1.2	2.2
Share in assets (%)	57.6	52.9	47.8	54.8	56.2
State Banks					
Total assets (in Trillion TL)	14,150	27,104	40,655	57,676	67,831
CAR in %	8.6	11.8	7.9	26.8	50.2
NPL/total loans	5.3	9.1	11.1	29.0	37.4
Provisions/NPLs (%)	30.2	35.1	30.3	66.0	73.9
ROA	0.5	1.0	-0.4	0.0	2.4
Share in assets (%)	34.5	4.0	34.6	31.6	31.9
SDIF Banks					
Total assets (in Trillion TL)	667	5,480	12,912	11,736	9,310
CAR in %				30.0	-7.5
NPL/total loans	49.7	61.9	41.4	64.9	69.4
Provisions/NPLs (%)	80.9	75.3	80.3	89.1	60.5
ROA	-19.0	-46.5	-17.9	-43.6	-2.5
Share in assets (%)	1.6	6.9	11.0	6.4	4.4
Foreign and Investment Banks					
Total assets (in Trillion TL)	2,576	5,014	7,903	12,908	16,068
CAR in %	21.0	20.3	29.4	29.5	45.6
NPL/total loans	2.1	2.1	1.8	6.6	4.3
Provisions/NPLs (%)	54.0	51.0	51.8	81.0	69.3
ROA	5.8	6.8	4.1	3.3	5.3
Share in assets (%)	6.3	6.3	6.7	7.1	7.6
Memo items					
CPI	84.6	68.8	39.0	68.5	29.7
M2/GNP		51.3	44.6	58.8	38.1
Total Bank assets/ GNP	57.2	71.3	77.1	87.9	77.8
Private Credit/GDP	22.0	21.4	22.8	21.8	16.8
Real credit to the private sector, percantage change	-6.6	-14.6	23.8	-26.2	-9.1
Average nominal treasury bill interest rate	106.0	106.2	38.0	99.1	62.7
Av. Ex-ante interest rate on debt/ CPI		32.0	-9.5	32.8	61.7
Spread on Turkish dollar Eurobonds (in Basis Points)	548.0	550.0	443.0	718.0	654.0

Source: BRSA,IMF and World Bank.

86. Regarding private bank restructuring and recapitalization, there has been good progress in the development and implementation of an effective strategy to resolve bank insolvencies. As a result of the audits, the bank balance sheets are now much more transparent. The recapitalization program for private banks has led the banks to increase their capitalization. Looking ahead, two concerns remain. First, the banking system is still undercapitalized even after the recapitalization exercise. While regulatory capital appears high, the low level of economic capital calls for cash injections. The concern arises from (i) the high level of related-party loans, (ii) fixed assets which represent 39 percent of total shareholder's equity, (iii) equity participations and affiliated assets which represent more than 46 percent of shareholder equity, (iv) zero risk weighing for government securities which is almost as large as the loan portfolio and (v) over 30 percent non-performing loans, of which only 50 percent are reserved for. A calculation of "free capital" that excludes affiliated investments, fixed assets, and the unreserved part of non-performing loans indicates that free capital of Turkish private banks is much lower than the regulatory capital adequacy ratio. Second, the banks need to restructure their large non-performing loan portfolio. Part of the solution is the Istanbul approach (described in the Corporate Sector chapter) which is a cornerstone of the Government's efforts to revitalize the private sector. It is not clear if the Istanbul approach will prove adequate to deal with the problem completely. It may be helpful to provide additional incentives to encourage quick restructuring. Possible measures include further tax relief to banks for provisioning or restructuring loans and accounting relief to corporations for recognizing foreign exchange losses. These should be temporary measures to support the ongoing economic recovery and growth. Another approach would be to create one or more asset management companies, which may be a more effective way of removing non-performing loans from banks' portfolio. Efforts to create an AMC are on-going. Similarly, progress on asset management and recovery of banks taken over by SDIF has been slow, partly because the SDIF is responsible for asset management which is not ideal. The process could be speeded up by transferring non-performing assets to a new private asset management company to be created.

87. There has been significant progress in state bank restructuring and privatization yet important challenges remain. Until July 2001, nearly a third of the banking system assets were accounted for by four state banks: Ziraat, Halk, Emlak and Vakif. Emlak has been liquidated, Ziraat and Halk were recapitalized and are being managed by a new independent board on commercial principles. Strategic studies of Ziraat have shown that the bank cannot prosper by financing agriculture alone, and will need to become a full service rural bank to be profitable in the long run. While a similar study for Halk will be undertaken, there are serious questions whether there will be a separate market niche for Halk since it would face competition from Ziraat, including for rural SME clients. Therefore, consideration should be given to ensuring viable strategies for these two banks prior to privatization. Both banks need to go through pre-privatization financial restructuring since their very large holdings of government securities (60 percent of asset portfolio, compared to 17 percent in loans) makes them unattractive to potential buyers. Spinning off the portfolio of government securities into a money market fund would shrink the size of these institutions and speed up the privatization process. Vakif, which was initially thought to be in better condition, was put up for sale. However, the bank was not privatized because it has significant non-performing loans (35 percent), holds too many non-banking assets such as real estate and tourism-related assets, and lacks clear ownership and therefore has no legal freedom to sell assets or recapitalize. Since Vakif is a large bank (7 percent of banking system assets), it requires urgent restructuring to make its privatization

feasible. Privatization of state banks is very important in creating an efficient, growth-promoting financial sector. The critical issue is to maintain the momentum that has been built up and continue with privatization efforts. An important step would be to reduce Government's reliance on these banks for financing. In the transition to better fiscal discipline, development of a broader institutional investor base for government securities may help ease the burden on the state banks.

88. There has been a significant contraction of bank credit after the crisis. An empirical analysis of whether this was caused by supply (banks being unwilling to lend) or demand (due to lower levels of economic activity and high lending rates) was carried out. The results suggest that there was no credit crunch, i.e., the demand for bank credit was lower than the supply, although capital regulations did reduce supply to some extent, and households and SMEs were relatively more likely to be credit constrained. Thus, it is very important to avoid artificial measures to encourage banks to channel credit to undeserving firms in an effort to put an end to a perceived credit crunch. If necessary, certain temporary measures directed to firms rather than banks could provide relief. These measures could include: (i) schemes that give firms some government backed financing in the one or two years following the crisis, e.g., equal to a fraction of taxes paid in the previous few years, (ii) automatic roll-over of small SME loans, or (iii) a trade finance scheme. Perhaps more importantly, it is often overlooked that SMEs finance themselves primarily not from banks but mostly by using trade credit. Thus, measures such as allowing receivables to be protected in bankruptcy and allowing borrowing against invoices and accounts receivables are likely to be much more important in relaxing the credit constraints of SMEs than any measures directed at bank credit.

89. Further changes in the incentive structure of financial institutions and increasing the level and quality of financial intermediation will be important to sustain growth over the medium term. Political commitment to the reform process is key to sustaining the reforms already made and continuing the reform efforts. Although there are many sophisticated players in the financial system, Turkey's financial system is not deep relative to the size of the economy. One would expect to see higher ratios of money supply to GNP, greater credit to the private sector, and lower interest margins. One of the most important reasons for the low level of intermediation in Turkey is crowding out by public borrowing. Unless the state eases pressure on the banking system to finance its large budget deficits, a financial system that promotes growth cannot be expected to emerge. Reliance on the banking system for deficit financing is also impeding the privatization of public banks which is necessary for an efficient financial sector. If the move towards fiscal discipline and a low inflation environment can be sustained, the banking system's role will take on a much greater importance. In the transition to such an environment, however, there are also important risks. Banks will have to start behaving commercially, expanding their credit portfolio and avoiding the potential risks that accompany such credit booms. At present, most of banks' interest income comes from government securities. To offset the income losses due to lower inflation and the move away from government securities, banks will have to improve their profitability. This requires the remaining regulatory and excess taxation burdens on the banking sector to be phased out. Liquidity and reserve requirements—together with transactions taxes on foreign exchange, stock market and other individual transactions—need to be decreased. Such distortions lead banks to book their assets off-shore. Indeed, some of the larger foreign banks keep only one fifth of their Turkish assets and liabilities in Turkey. A credit bureau may also be helpful in allowing the banks to better evaluate credit risk. Currently, the

Central Bank only collects information on loan defaults. Finally, the current deposit insurance scheme of blanket coverage distorts incentives for the banks. The move to a limited deposit insurance system has been delayed to allow for improvements in the financial health of the banking sector. Design features of the new insurance system, e.g., coverage limit, co-insurance, and risk-based premiums[1], will be important in reducing the moral hazard inherent in such systems.

Table 3.2: SDIF Banks and Their Resolution Process

Banks that were taken over by the SDIF		Merged Banks (those listed below merged into the bank that is underlined)	Sales	Liquidations	Banks Remaining Under the SDIF
Turk Ticaret	Nov. 6, 1997	***Sumerbank***	Bank Ekspres	Turk Ticaret	Bayindirbank[1/]
Bank Expres	Dec 12, 1998	- Egebank	Sumerbank	Imarbank	Pamukbank
Interbank	Jan 7, 1999	- Yurtbank	Demirbank		Imarbank
Egebank	Dec 22, 1999	- Yasarbank	Sitebank		
Yurtbank	Dec 22, 1999	- Bank Kapital	Milli Aydin B.		
Sumerbank	Dec 22, 1999	- Ulusal Bank			
Esbank	Dec 22, 1999	***Bayindirbank***			
Yasarbank	Dec 22, 1999	- Etibank			
Etibank	Oct 27, 2000	- Interbank			
Bank Kapital	Oct 27, 2000	- Esbank			
Demirbank	Dec 6, 2000	- EGSBank			
Ulusal Bank	Feb 28, 2001	- Toprakbank			
Iktisat Bankasi	March 15, 2001	- Iktisat Bank			
Sitebank	July 9, 2001	- Kent Bank			
Bayindirbank	July 9, 2001				
Kentbank	July 9, 2001				
EGS Bank	July 9, 2001				
Toprak Bank	Nov. 30, 2001				
Pamukbank	June 19, 2002				
Imarbank	July 9, 2003				

Source: BRSA
Note: [1/] Bayindirbank is being restructured as a bridge bank which will perform asset management function.

2 PRIVATE BANK RESTRUCTURING AND RECAPITALIZATION

90. Turkey has made very significant progress in bank restructuring efforts. These can be grouped under three headings (i) problem bank resolution, (ii) recapitalization of private banks, and (iii) asset management and recovery.

91. *Problem Bank Resolution.* An important component of the 1999 reform program was the development of an effective and orderly strategy to deal with problem banks. Despite the financial volatility of the 1990s, problem bank resolution had been slow. In 1994, three small banks were closed and sent into liquidation. From 1997 to early 1999, ownership of three more banks was transferred to the SDIF. Reform efforts accelerated in 1999. Immediately after legal changes were made to the Banking Act, through Law No. 4491, the authorities intervened in six deeply insolvent banks. This law authorizes the SDIF to participate in financial restructuring arrangements, exempts some of its operations from taxes, duties and levies, allows it broad freedoms in restructuring operations, and provides legal protection and rights for SDIF.

[1] BRSA issued a new regulation on May 15, 2003 to introduce risk based premium system for deposit insurance.

92. As a result of the 2001 crisis, the financial condition of private banks deteriorated sharply, necessitating further interventions by the SDIF. By July 2003, additional banks were transferred to the SDIF, bringing the number to 20 banks representing over 6 percent of total assets of the banking system (See Table 3.2.). Twelve of the intervened banks were merged under three transition banks. One of these transition banks and four others were sold to the private sector and foreign investors. Turk Ticaret and Imar Bank have been under liquidation.. The remaining banks are still under SDIF ownership. As of December 2002, the initial cost of restructuring SDIF banks—before any asset recovery—was about 16 percent of GNP (See Table 3.3 for a breakdown of fiscal costs of bank restructuring). This rapid bank resolution process was the result of a serious commitment to reform and the reforms made to the Banking Act.

93. *Bank Recapitalization.* As the financial structure and profitability of private banks deteriorated sharply in the aftermath of the crisis, the authorities embarked on a restructuring program in parallel with the problem bank resolution to ensure the overall soundness of the banking system. The Turkish program included resolving non-performing loans and recapitalizing the banks, limiting their foreign exchange open positions[2], and encouraging mergers. The bank recapitalization process had three phases. In the first phase, bank balance sheets were audited (first by banks' contracted independent auditor, second by a different set of independent auditors for compliance with principles of independent audits, and finally by BRSA teams). After these audits, the banks' NPLs were clearly identified. As Table 3.4 illustrates, by end 2001, non-performing loans represented nearly 34 percent of the total loan portfolio in the Turkish banks.

Table 3.3: Fiscal Cost of Bank Restructuring (as of end of 2002)

	TL trillion	% of GNP
Public 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
Total	57,806	32.8

Source: BRSA.
Note: GNP 2001 has been used since the most of government securities issued in 2001.

94. The second stage entailed bank recapitalization by owners up to 8 percent capital adequacy ratio (CAR). After the completion of the audit results, Pamukbank, owned by the Cukurova group and one of the top five banks, was found to be seriously insolvent. The authorities considered and then rejected an application by Yapi Kredi Bank, also owned by the Cukurova group, to take over Pamukbank. Excluding these two banks, the capital shortfall was determined to be on the order of US$ 1 billion. Over 80 percent of this amount was provided by the bank owners themselves. In the final stage, those that could not meet the 8 percent CAR requirement were able to qualify for SDIF support if they met the necessary conditions. According to the rules, for banks with CARs that were positive but less than 5 percent, SDIF was authorized to invest direct capital not more than the additional capital that will be put up by the shareholders to increase the CAR to 5 percent. This option was limited to banks having an asset share of over 1 percent of total banking assets in order to encourage mergers.

[2] After the crisis, the incentives introduced by the floating exchange rate regime led to a narrowing of foreign exchange short positions. Voluntary domestic debt swap operation also contributed to the reduction of FX open positions in the private banks. In fact, private banks' open FX positions declined to US$0.8 billion in 2002, down from US$ 8.4 billion in 2000.

Table 3.4: Evolution of Non-performing Loans and Reserves	
December 1999	
Net NPL (TL Billion)	886,030
Gross NPL (TL Billion)	2,327,294
Net NPL / Total Loans (%)	4.4
Gross NPL/ Total Loans (%)	11.7
December 2000	
Net NPL (TL Billion)	1,459,563
Gross NPL (TL Billion)	3,959,774
Net NPL / Total Loans (%)	4.6
Gross NPL/ Total Loans (%)	12.4
December 2001	
Net NPL (TL Billion)	6,530,473
Gross NPL (TL Billion)	12,798,377
Net NPL / Total Loans (%)	17.2
Gross NPL/ Total Loans (%)	33.7
October 2002	
Net NPL (TL Billion)	6,317,022
Gross NPL (TL Billion)	13,847,101
Net NPL / Total Loans (%)	14.4
Gross NPL/ Total Loans (%)	31.7
December 2002	
Net NPL (TL Billion)	3,738,769
Gross NPL (TL Billion)	10,429,680
Net NPL / Total Loans (%)	7.1
Gross NPL/ Total Loans (%)	17.6

Source: BRSA.

For banks with CARs over 5 percent, SDIF was authorized to provide subordinated debt (convertible bonds with 7 year maturity and 2 years grace) to increase the CAR to 9 percent. Such capital injection were to be accompanied by restrictions on dividend distribution and withdrawals by third parties, and compliance with business plans including an SDIF representative on the bank's board. In the case of subordinated debt, any unpaid principal and interest would be converted to shares. In the event a bank's CAR fell below 5 percent, SDIF had the right to take over the bank. After the audits and recapitalization by owners, Vakif bank was in need of additional capital and SDIF provided subordinated debt to bring the capital adequacy ratio of the bank up to 9 percent, as consistent with the plan.

95. Since recapitalization efforts by the owners did not produce results, Pamukbank was transferred to the SDIF in June 2002. However, SDIF intervention in the bank was legally challenged, and the Administrative Appeals court stayed the execution of the takeover in November 2002, instructing SDIF to return the bank to the Cukurova group on the grounds that the owners were not given sufficient time to recapitalize. However, the owners did not want to take back the insolvent institution and an agreement between SDIF and the Cukurova group was finalized in January 2003. According to this agreement, legal proceedings are waived and SDIF will continue to exercise the ownership and management rights of Pamukbank. SDIF will also

exercise Pamukbank's shareholder rights (except dividend rights) in Yapi Kredi[3]. Since Cukurova is no longer a fit and proper owner, its shares in the latter bank will be sold within two years. In the meantime, the management board of Yapi Kredi will have members appointed conditional on approval by the SDIF. A debt restructuring agreement between Yapi Kredi and Cukurova group continues to be effective. Cukurova group debts to Pamukbank have been restructured according to a fifteen year payment plan and the bank will be available for sale after being restructured under the SDIF.

96. The Pamukbank agreement is less than ideal, but given the current economic circumstances in Turkey, it had the merit of preventing a drawn out legal battle that may have jeopardized even the legality of past bank takeovers. While the deal removed insolvent Pamukbank from the banking system, it was criticized because it constituted a departure from the rules of the recapitalization program. The Cukurova group did not have to put up any new capital. By allowing the group's loans to other institutions to be restructured under the Istanbul Approach, the authorities run the risk of not completely cleaning up the system.

97. The Turkish bank recapitalization program tried to incorporate many elements of international best practice (Box 3.1). Developing a long-term approach begins with good diagnostic work, as the Turkish Government did with the aforementioned audits. Second, empowerment of a single restructuring agency—in Turkey's case the SDIF—is an important step to avoid intra-governmental conflicts; and transparency with respect to that agency's actions has been important at every step to restore confidence. Third, the Turkish program has been comprehensive and credible, designed to resolve all troubled banks as promptly as possible. Fourth, the program relied on market forces to determine which banks should be recapitalized and those that failed the market test were taken over by the SDIF. International experience makes clear that the selection of banks to be capitalized should be made by markets, not governments and that bank owners should be given incentives to recapitalize and rehabilitate their banks as effectively and as quickly as they can.

98. There are still concerns that the banking system may not be adequately capitalized even after the recapitalization exercise. First, although shareholder equity increased by roughly US $1.5 billion during the fourth quarter of 2001, only 40 percent of this came from an increase in paid-in capital. Much of the rest came from increased asset valuation .[4] Second, prior to the recent adoption of the new regulation, loans extended to shareholders holding 10 percent or more of the capital and to entities with connected relationships with those shareholders were deducted from the capital base in determining capital adequacy.[5] This rule has been eliminated giving the

[3] Yapi Kredi is 41.8 percent publicly held with all remaining shares belonging to Cukurova which held 13.1 percent of the shares through Pamukbank.

[4] According to the Basle Committee on Banking Supervision, revaluations of real estate holdings (or equity holdings) can be included as Tier 2 supplementary capital, and since Tier 1 capital must comprise at least fifty percent of total capital, real estate revaluations may not exceed fifty percent of total capital. Also, the committee emphasizes that such reserves can be included within supplementary capital, "provided that the assets are considered by the authority to be prudently valued, fully reflecting the possibility of price fluctuations and forced sale." (Basle Committee, July 1988, p. 5).

[5] It was possible to circumvent this regulation by separating ownership by an industrial group into individual companies, each with less than the 10 percent ownership ceiling. Thus, loans to these entities did not have be deducted from capital. Credits made to operating companies of shareholders did not have be deducted either. Nevertheless, this law was conservative.

banks with a high level of related-party lending greater flexibility in complying with the capital adequacy requirements and artificially inflating their capital ratios relative to previous years.

Box 3.1: Bank Recapitalization: International Experience

Acting promptly, being comprehensive and credible is critical in bank restructuring. Piecemeal solutions almost never work. For example, Japan's attempts to resolve financial sector difficulties through a policy of low interest rates and hiding the real losses have clearly failed – after two rounds of recapitalizations in 1998 and 1999, market observers still consider the banks to be severely undercapitalized. Fixes such as increasing lending margins or an inflation tax to restore profitability never work and have distorting effects. In Korea, limits on deposit rates have helped develop a curb market, which later formalized into non-bank financial institutions, adding to financial instability. Again, forbearance on capital adequacy targets are often counter-productive. Throughout the 1980s, US regulators used forbearance techniques not to recognize the mounting losses in the S&L industry, which eventually led to a crisis and even greater losses. Clearly, not restructuring is not an option. In the past many countries, including Turkey, Thailand (1983-87), and Indonesia (1994) chose not to restructure, for which they eventually paid.

Delays or partial recapitalization efforts may backfire since undercapitalized banks in a context of broad government guarantees have incentives to increase risk taking behavior since gains accrue to the bank owners whereas losses end up with the taxpayers. One common trap in designing restructuring plans is to become pre-occupied with minimizing the up-front cash costs of recapitalization at the expense of higher longer-term fiscal costs and to neglect the incentives that are created for the restructured banks. Because it was partially done, Hungary, for example had to recapitalize its banks several times. Venezuela is a similar case with repeated recapitalizations. Even industrial countries have not been immune. France's Credit Lyonnais in the 1990s is such an example.

Once the decision to adopt a comprehensive bank restructuring has been taken, a single agency should be responsible for its implementation, and that agency's actions must be transparent. In many countries, adequate safeguards were not built in during the evaluation and decision making, and transparency was limited. For example, when stronger Korean banks acquired five weaker banks in 1998, the market reacted adversely since details on the government support for acquiring banks were initially limited.

The evidence also indicates that markets rather than governments should determine which banks merit recapitalization. One way of doing this is to maximize private contributions before injecting public capital, and then safeguarding the government funds by imposing strict measures on recipients. No support should be given to non-viable banks, which should be closed promptly. Hungary's recapitalization attached no conditionality to disbursement of funds and had to go through three rounds. Finally, it was sale to foreign investors of 60 percent of the banking system that resulted in adequately capitalized banks by late 1990s. Similarly, Japanese recapitalizations included only weak conditionality and did not lead to serious improvements. On the other hand Norway (87-93) and Poland (92-95) included strict conditionality (in the case of Norway, funds were injected only after shareholder capital was written down, and in Poland government bonds were accompanied by strict penalties for non compliance) and are considered to be successful cases, resulting in sustainable financial structures.

Not all market-based recapitalizations have been successful, however. Thailand's scheme encountered difficulties because banks were reluctant to take advantage of it due to requirements that diluted ownership and changed management. The program offered banks tier 1 capital support conditional on their adhering to stringent conditions and making management changes. While the approach ensured burden sharing between private and public sector, banks that needed fresh capital could delay their application and were allowed to recapitalize on a flow basis and comply with more stringent capital adequacy requirements at a later point in time. Thus, banks resisted using public funds and remain substantially undercapitalized with NPLs of over 25 percent at the end of 2001.

99. Since Turkish banks have significant equity participation in affiliates and associated companies, free capital is probably a more relevant concept in determining capital adequacy. Free capital is defined as shareholders' equity less investment in fixed assets, equity participations, affiliates and associated companies. The remaining equity represents the capital available to leverage a bank's ordinary banking business. To be even more stringent, one could deduct the unreserved amount of non-performing loans and/or accrued interest on loans. Given that over 30 percent of loan portfolio is non-performing, of which only 50 percent is reserved for, this is a significant issue. Free capital for private banks as of Sept. 2001 was substantially lower than the capital adequacy ratio, illustrating these issues (Table 3.5). Another issue is the assignment of zero risk weighing to Turkish Treasury bills and bonds. Given the large spread on Turkish Eurobonds (Table 3.1), it may be prudent to attach some risk-weight to these instruments. The fact that this is not international practice is because most BIS regulations are devised for countries with very high rated securities. Being more conservative in the Turkish case would obviously diminish the capital adequacy ratios of most institutions since they tend to hold a high percentage of government securities.[6] However, not doing so also has potential consequences as international rating agencies and investors may make their own adjustments to the reported ratios.

Table 3.5: Capital Structure in Private Commercial Banks

Total Private Banks (in millions of USD)	September 2001	December 2001	December 2002
Shareholders' equity	5,507	5,238	9,296
Less:			
Equity participations and affiliates	2,512	4,138	4,199
Premises and Equipment	1,560	2,987	3,365
Free Capital	1,435	-1,887	1,731
Less:			
Additional reserves to reach 100% coverage of NPL	519	3,828	960
Adjusted Free Capital	916	-5,715	772
Total Assets	56,394	68,027	73,093
Equity/Assets (%)	9.77	7.70	12.72
Free Capital/Assets (%)	2.54	-2.77	2.37
Adjusted Free Capital/Assets(%)	1.62	-8.40	1.06
Revaluation Reserves/Equity	22.00	11.13	1.45

Source: BRSA

100. The above issues underpin concerns that the banking system is still undercapitalized even after the recapitalization exercise. While regulatory capital is high, the low level of economic capital—the inadequacy of free capital to support traditional banking business—calls for an additional cash injection. International experience shows that partial recapitalization leaves banks fragile, distorts risk-taking incentives, wastes already injected resources and necessitates costlier repeat recapitalizations.

101. *Asset Management and Recovery.* Restructuring of the large non-performing loan portfolio of private banks and asset recovery of SDIF banks are important concerns. Currently, the SDIF is responsible for managing and collecting the bad loans of the intervened banks. Out of the US$ 10 billion NPL portfolio of these banks, only approximately US$ 1.7 billion had been

[6] Indeed, the proposed new accord states that risk weight on government securities will be determined at national discretion and recommends higher weights where needed, so that zero weight does not come as default anymore.

collected at the end of March 2003.[7] Having asset management as a part of SDIF has been counterproductive and lengthens the recovery process since public agents tend to be more restricted legally and are less flexible in making deals. Also, such public institutions lack incentives to finish the asset recovery quickly. To deal with the NPL portfolio of the remaining private banks, the Government has put in place a regulation on asset management companies to complement the Istanbul Approach. A private AMC with 20 percent ownership by the SDIF is being considered and the SDIF has initiated feasibility studies. In case a private AMC is established, it may be possible to transfer to it at least some of the NPL portfolio managed by the SDIF. The legal infrastructure for the establishment of an AMC has been completed.

102. It is also important to coordinate financial and corporate restructuring. Key issues are whether (i) to recapitalize banks before or after corporate restructuring, and (ii) to restructure non-performing loans through a centralized collection authority or through the banks themselves. Under an ex-ante recapitalization with appropriate burden sharing, as in the case of Turkey, the government recapitalizes banks based on an assessment of probable losses determined by outside reviews. Some loans may be transferred, at the time of the recapitalization or later, to asset management companies (centralized approach). For remaining loans to individual firms, the main function of the bank and other creditors is to drive operational restructuring, reduce debt to manageable levels, and if necessary provide working capital (decentralized approach). This mixed approach has been used in many developing countries, with success often depending on the degree to which they also enhanced other elements of the environment for private sector operations such as bankruptcy procedures (Box 3.2).

103. Since the Turkish recapitalization process is not linked directly to corporate restructuring, it may be necessary to provide additional incentives to encourage quick restructuring. These incentives can take the form of tax, accounting and other measures. Banks may be given more tax relief for provisioning or restructuring loans. Corporations may be given more favorable accounting relief for recognizing foreign exchange losses. Of course such measures may speed recovery but not necessarily contribute to fundamental reform—as in the case of Korea, Indonesia and Mexico—and should not be made available permanently. Finally, the recapitalization scheme also includes the requirement that 60 percent of SDIF assistance for tier 1 capital be lent out to non-group institutions by the end of June 2003. Such pressure on banks may be premature and dangerous in that it may add to the NPLs and erode the newly injected capital. This issue is addressed in the credit crunch section.

[7] At least half of the US$ 10 billion were loans to bank owners, which are considered less likely to be collected. Also US$ 308 million was generated by the sales of subsidiaries and real estate.

Box 3.2: Coordinating Financial and Corporate Restructuring: International Experience

Ex-ante recapitalization, such as the one Turkey has undertaken, can be implemented quick;y and signal to the market that problems are being resolved. Provided that it is carried out well, ex-ante recapitalization can be an investment which leads to lower costs. However, ex-ante recapitalization also carries big risks. If the recapitalization is not properly structured and bank operations and governance is not changed, the effort may be wasted. Banks will have better capacity to work out loans and take losses when capitalized, but they may still delay restructuring and roll over non-performing loans since they are able to attract new funds without difficulty. Similarly, firms may have little incentive to undertake operational restructuring if they have access to new funds. Banks in Japan, for example, did not have incentives to undertake corporate restructuring, as long as they could carry non-performing loans at low cost. These risks are especially high in developing countries where banks are not as strong as the big family-controlled conglomerates or large state-owned enterprises. Most banks also do not have the necessary skills and technical capacity, which takes time to build.

The alternative model requires tighter links between financial and corporate sector restructuring. Carried to the extreme, this is ex-post recapitalization, where banks receive public funds if and when they provide financial relief to corporations. This model maintains pressure on the banks and corporations to do realistic restructuring, but it introduces significant uncertainty in the meantime since depositors and creditors cannot be certain about the quality of their claims. This is why there are no examples of ex-post recapitization in practice. One compromise would be to provide some public funds immediately with further support conditional on progress in corporate debt restructuring.

Another important issue is whether to use a central entity such as an asset management company to resolve nonperforming loans. Indonesia, Korea, Malaysia, and Thailand, all eventually used AMCs, and out-of-court systems for corporate restructuring. All of them also enhanced to varying degrees the basic legal framework for the private sector including bankruptcy and corporate governance frameworks, liberalization of foreign entry in the financial and corporate sectors. Success with implementation of these measures has varied with Malaysia and Korea leading, Indonesia lagging behind, and Thailand in the middle (Claessens, Djankov and Klingebiel, 2001).

Empirical evidence on the centralized versus decentralized approach is limited but tends to favor the decentralized approach. A study of seven countries showed that most asset management companies did not achieve their stated objectives with only the Swedish AMC successfully managing its portfolio. Rapid asset disposition vehicles in Spain and US also achieved their objectives. However AMCs in developing countries (Ghana, Mexico, and Philippines) were not successful mostly due to weak legal frameworks, underdeveloped capital markets, lack of professional management, and political pressures (Klingebiel, 2001). Dado and Klingebiel (2002) analyze bank-led restructuring in seven countries and find that the success of this approach depends on the quality of the institutional framework, including accounting and legal rules, and on initial conditions including the capital positions of banks and ownership links. Norway and Chile were success cases. Poland and Hungary lagged behind Chile, although Poland improved its framework faster than Hungary. Thailand, Japan and Argentina made little progress.

3 STATE BANK RESTRUCTURING AND PRIVATIZATION

104. The international evidence indicates that state ownership of banks has negative consequences for financial development and economic growth (Box 3.3). Comprehensive restructuring and eventual privatization of state banks is an important pillar of the Turkish financial sector reform program. Until July 2001, nearly a third of banking system assets were accounted for by the four state banks, Ziraat, Halk, Emlak and Vakif (See Table 3.1). Ziraat traditionally focused on agricultural finance, Halk on lending to small business and artisans, and Emlak on public housing construction. Vakif is a retail and general corporate sector focused

bank.[8] Prior to the crisis, the state banks—principally Ziraat and Halk—suffered from large "duty losses," subsidized credits to agriculture and small businesses whose losses accumulated on the balance sheets of the banks. The duty losses were only occasionally paid down from the budget. In 2000, these losses ballooned to 12 percent of GNP. The continuous liquidity shortages of the state banks led to very high interest rates in the interbank market with damaging effects for the rest of the banking sector.

105. As part of the reform program, Ziraat and Halk were re-capitalized with government securities at market terms and all their duty losses were eliminated (Table 3.3). Emlak was liquidated. A new independent board was appointed to manage Ziraat and Halk in accordance with commercial principles, and to streamline and eventually privatize them. Vakif, because it was thought to have a much stronger client base and a diversified loan portfolio, was put up for privatization.

106. International experience suggests that pre-privatization injection of funds may decrease the probability of sale and can be easily squandered. Thus, while the 16 percent of GNP capital injection to the Turkish state banks recapitalized them, it is also important to make sure that this does not slow down the privatization efforts by removing fiscal incentives to sell the banks. As for the private banks, the issue of new bank lending is discussed in the credit crunch section below.

107. International experience also suggests that preparing the banks for privatization while improving the regulatory environment is very important. Turkish state banks are going through this process. Already, they have made significant progress in reducing personnel and the number of branches. Diagnostic studies by international consulting firms that have identified necessary improvements in banking operations—such as human resources, technology, and back office operations—which are being undertaken. The state banks will now be run according to commercial principles and there will be no mandated loss-making operations that are not directly paid out of the budget. These are significant steps. A recently completed pre-privatization study of Ziraat by international consultants has shown that the bank cannot prosper by financing agriculture alone. Ziraat is expected to become a broadly focused bank, including developing a presence in the SME market, as well as in consumer finance. This would be similar to the manner in which banks such as French Credit Agricole and Dutch Rabobank have developed. Traditionally, both had their roots in agriculture finance, but over time developed into broad based banks operating across all sectors of the economy, with their exposure to agriculture falling to less than 20% of their portfolios. This finding has implications for Halk which is likely to face competition from Ziraat in its new role. While a similar study is being undertaken to assess the future role of Halk, it is doubtful that there will be an independent role for Halk.

[8] Vakif has a different ownership structure than the other three state banks dating from Ottoman times. Most of its capital is in the form of shares historically belonging to foundations now represented by the government's General Directorate of Foundations.

Box 3.3: State Bank Restructuring and Privatization: International Experience

Empirical evidence using information from a large number of countries shows that greater state ownership of banks is associated with less financial sector development, lower growth and lower productivity and that these effects are magnified in countries with lower levels of income (La Porta, Lopez-de-Silanez, and Shleifer, 2000). Generally, rather than responding to principles of profit maximization, governments tend to be responsive to various interests, and especially to bolstering political support.

Bank privatization can yield real benefits, especially in developing countries where state ownership of banks is particularly damaging to growth. However, privatization is a complicated process and, if not well-designed, it can lead to crises. Chile (with bank privatization in 1975 and a crisis in 1982) and Mexico (1992 and 1994, respectively) are examples where privatization in a context of an underdeveloped regulatory and supervisory framework led to crisis. The emphasis was on the speed of sale. Although there were multiple causes, a weak regulatory environment was acknowledged to have led to fraud, looting and then crisis. Generally, it is important to have a deliberate and credible phasing out of state ownership over some period during which the environment is being improved as is being done in Turkey.

The Argentine bank privatization example supports this sequencing. On the eve of privatization, Argentina had a reasonably developed regulatory and infrastructure environment. Indeed, by 1997, Argentina had one of the strongest bank regulatory environments among emerging market economies (World Bank, 1998). Following privatization, the newly privatized banks' balance sheets and income statements began to resemble more those of other banks, with lower administrative costs and greater share of credit extended to the private sector (as opposed to state enterprises). Another important lesson from Argentina's privatization is the fact that weaker banks were more likely to be sold because of the pressure they exert on the budget. By removing this pressure, at least in part, recapitalization of state banks through injection of public funds can reduce the probability of privatization.

Countries that can attract foreign entry from reputable foreign names are in general in a stronger position in privatization operations. Even if the regulatory environment is not up to par, strong foreign banks can bring good skills, products, and even a capacity to train local bankers, and would presumably be motivated to protect their reputations to behave in line with the highest fiduciary standards. Indeed, the share of banking assets controlled by foreign banks has soared in several countries in recent years. For example, foreign banks have been very active in Eastern Europe—including Czech Republic, Poland and Hungary with more 50 percent foreign ownership—and Latin America—including Venezuela, Chile and Argentina, again with foreign ownership levels of 50 percent. Privatization of banks, especially in transition countries, and sales of failed banks have provided opportunities for banks from developed countries to acquire pre-existing branch networks and enter retail banking.

Until recently, foreign banks had committed very little capital to Turkey due to instability in the macroeconomic environment and fears of having their investment eroded by inflation. The prospect of a better macro-economic environment, the potential for growth in banking, improved transparency in the system, the need of Turkish banks for fresh capital and good partnership opportunities may be able to lure foreign banks to invest in Turkey. Two significant investments have been the takeover by HSBC of the failed Demirbank and the joint venture between Kocbank and Unicredito.

108. An important factor in allowing a faster pace of privatization of the state banks is to shrink their size. About 60 percent of the asset portfolio of these banks is made up of government assets (with loans making up only 17 percent), making them unattractive for privatization. Thus, privatization will require the government to reduce its reliance on these institutions to finance the budget. It may be possible to spin off this part of the banks' operation into a money market mutual fund invested in government paper managed by the banks. An alternative approach would be to create a narrow bank invested in government securities whose size would shrink as the government's financing needs are gradually reduced. An additional step in commercializing these institutions would be to limit their role in provision of subsidies. First,

it is important to ensure that all subsidies are transparently provided through the budget. Second, all commercial banks should be allowed to distribute these subsidies. In a transition period, some specific role in subsidy distribution could be reserved for the public banks since at present Ziraat and Halk have important information and expertise in these sectors. However, eventually all banks should be able to compete with each other in this area on a commercial basis. In this way, it would be much easier to privatize and attract foreign capital. Such concrete steps would prevent a very long and drawn-out privatization effort and minimize the chances that the restructuring/privatization of the state banks runs into political interference. These steps will also prevent the subsidy operations from reverting back to the "duty loss" system.[9]

109. Privatization of Vakif Bank has not materialized as expected. Privatization efforts made it clear that the bank could not be sold as is for the following reasons: (i) very high non-performing loans (about 35% of its loan portfolio), (ii) excessive non-banking assets on its balance sheet, such as real estate and tourism related assets, other non-financial subsidiaries, and (iii) lack of a clearly defined ownership and corporate structure. Vakif is a relatively large bank (about 7 percent of banking system assets) which has an important impact on the financial system. Although it was recapitalized as a result of the bank recapitalization program, the bank is still in need of urgent restructuring. Currently, there are plans for a buy-out by the employee pension fund, which already owns 25 percent of the bank. While this can be a transitional arrangement, care needs to be taken so that losses are not born by the employees. Another option would be to merge the bank with Ziraat Bank, which already has excess capital after the capital injection by the Government.

110. To summarize, Turkish state banks need to be privatized. While hasty privatizations without proper preparation of the banks and the regulatory environment can be destabilizing and costly, delaying bank privatization has higher economic costs. The Government has taken important steps in restructuring the state banks, merging and recapitalizing them, eliminating duty losses, establishing an independent board, reducing operating costs, and in general streamlining operations. The risk factors are the reduced fiscal incentives to privatize since the banks already received significant capital injections, potential revival of the "duty loss" practices given the high level of capitalization, and loss of political will for privatization. The requirement that the banks should make significant new loans may be difficult to meet in this economic environment. This requirement may increase the bad loan portfolio and squander newly injected capital. It is crucial to continue the privatization efforts of state banks. To do this, it is important to prepare specific privatization plans for the banks, to reduce government reliance on these institutions to finance the budget deficit, and to allow distribution of subsidies through all commercial banks.

4 CREDIT CRUNCH

111. After the crisis in Turkey, there has been a significant contraction of bank credit (see Figure 1 from Annex). Whether this is due to reduction in demand due to the sharp decline in economic activity and higher lending rates that accompanied the crisis or supply side factors is

[9] To take advantage of the improved financial position of the banks and to ease the pressure on the public debt burden, some of the interest and principle payments due to Ziraat and Halk were capitalized rather than paid in cash. It is important that such capitalization does not affect the liquidity requirements of the two banks.

not clear. A credit crunch can be defined as a reduction in lending by financial intermediaries to an amount that is less than the quantity that is desired by the borrowers, even if they are willing to pay for the cost of credit and are able to satisfy the non-price terms of credit required by the lenders. Defined in this way, a credit crunch represents a rationing of the supply of bank credit.

112. A reduction in the supply of bank loans may be caused by an erosion in the banks' capital position or deposit base, possibly accompanied by portfolio reallocation decisions by the banks. For example, tight monetary policy, by draining the banking system of its reserves, reduces the amount of funds available in the interbank market. Unless this reduction is offset by an increase in deposits or capital, it will lead to a reduction in loans. If borrowers are highly dependent on bank credit for financing their operations, then the cut back in lending will lead to reductions in real spending. The supply of credit may also shift (or bend back) because as borrower's net worth deteriorates following a crisis and collateral values decline, lenders are more inclined to charge a higher premium on loans to compensate for higher risk and higher cost of monitoring (financial accelerator view/credit rationing). Since ease of monitoring and quality of the borrower is an important factor here, small, unlisted and more specialized firms are more likely to bear the brunt of the crunch. Other factors that cause banks to cut back on credit may include an erosion of their capital base, greater regulatory scrutiny of bank portfolios and the imposition of tougher regulatory standards. The stock of credit may appear to be reduced when authorities require the banks to remove NPLs from their balance sheets as a result of restructuring operations. Bank lending could also be severely reduced when losses begin to erode the banks' capital to the point where they are unable to comply with regulatory capital adequacy ratios. In order to meet regulatory requirements, banks are forced to reduce their loan assets which require 100 percent risk weighing. This latter effect is generally characterized as a capital crunch.

113. International evidence on credit crunch arising from crisis is mixed as reviewed in the Technical Annex. The general message is that, while periods of credit crunch can occur following crises, particularly for smaller enterprises, these episodes are likely to be short. Once macroeconomic activity resumes, bank lending also increases. A disequilibrium framework was estimated to investigate the credit crunch effect in Turkey. The methodology and the estimation results are given in the Annex. The results indicate that in general there has been no credit crunch after the most recent crisis (although there was one after the 1994 crisis) because the demand was much more suppressed compared to supply. However, a downturn in credit supply due to capital regulations can be observed. With regard to credit to households—which includes credit card debt—there is some evidence of a credit crunch in the last six months of 1999. This can be thought of as a proxy for small and medium enterprise (SME) credit since most SMEs around the world use credit card debt to finance their operations.

114. To alleviate reductions in credit supply—particularly for smaller firms—most countries have eventually followed mildly expansionary fiscal and monetary policies. This is a luxury Turkey does not have. However, in trying to put an end to these perceived "credit crunches", the most important issue is to prevent bad firms from getting too much financing. Since the period of real credit crunch tends to be short, there is reason to do less rather than more. Simple, transitory rules operating on the firm side may be helpful. These can take different forms: a tax break for corporations; a scheme which gives a firms some government backed financing in the current year equal to a fraction of taxes paid during the previous one or two years (which is a crude test whether the firms were making profits, and may thus be viable firms if not for the

crisis, and were obeying the tax code); and/or some accounting relief, e.g., on foreign exchange losses. For the SMEs, an automatic roll-over for very small loans, lower capital adequacy weights on SME loans, or some trade finance scheme may be helpful. Indeed, some of these measures, particularly roll-overs and credit guarantees for SMEs, were successfully applied in Korea. Most SMEs around the around get the bulk of their external finance not from the banks, but from trade credit. This is also true in Turkey. However, receivables financing in Turkey is hampered because such claims are not protected in bankruptcy. Although it is possible to obtain credit against post-dated checks, it is not possible to do this using invoices or accounts receivables. A change in the legal framework to allow re-assignment of intangibles would go a long way in relaxing short-term financing constraints of SMEs.

115. Trying to promote credit expension by taking measures on the banking side may be counter-productive. Generally, resumption of bank credit is not a leading indicator. To the contrary, it follows output recovery. Requiring the banks to lend too much too soon may backfire and lead to additional non-performing loans. The private bank recapitalization program requires 60 percent of Tier 1 capital support provided by the SDIF to be extended as credits to non-group firms by the end of June 2003. Given the uncertain growth prospects, such requirements may end up eroding the capital soon after the recapitalization.

5 CHANGES IN THE INCENTIVE ENVIRONMENT AND FINANCIAL INTERMEDIATION IN THE LONG TERM

116. The Government has taken a number of urgent reform actions after the crisis to improve the incentive environment. Prudential regulations and the supervisory framework for banking have been strengthened. Prudential regulations on loan loss provisioning, large/connected lending practices, and foreign exchange exposures were brought in line with Basle/EU standards and the criteria associated with these regulations are being phased in. Tax advantages of repurchase (repo) transactions have been removed and these transactions are now required to be reported on balance sheets as collateralized finance transactions. Legal and tax measures are underway to encourage bank mergers. Bank supervision has been made independent and strengthened by the establishment of the BRSA. The deposit insurance agency (SDIF) has been transferred from the central bank to the BRSA, where it has responsibility for administering the deposit insurance scheme, resolving problem banks, and managing and recovering assets. As discussed above, a major restructuring effort has been started for the public banks with the end goal of privatization. Twenty insolvent private institutions have been taken over by the SDIF and efforts have been made to strengthen the capital position of the remaining private banks. The legal framework for creditor rights, bankruptcy and debt workouts is being strengthened. Further legal improvements to allow more effective insolvency procedures and better protected creditor rights are being prepared.

117. These are very impressive developments. Establishing stronger regulation and supervision, capitalizing the private banks and reducing government ownership of banks are important steps in establishing an effective, healthy banking system that would contribute to long term development of the Turkish economy. In banking, incentives are key to making sure the regulation and supervision is not circumvented and the newly injected capital is not wasted. Any

attempt to introduce additional capital without adequate attention to the underlying incentive structure cannot be sustained. Partial recapitalizations are also very dangerous because undercapitalized banks have distorted risk-taking incentives even under best circumstances.

118. Comparing Turkish banking indicators with those of selected countries around the world shows that there is still significant room for financial deepening. This includes higher ratios of money and bank assets to GNP, more credit to the private sector, higher efficiency reflected in lower interest margins, greater foreign bank share and lower state bank share in the long run (Table 3.6). In Turkey, there are still a number of factors that distort the incentive environment. In the past, the banking system's main role has been to finance the ever-growing needs of the public sector by mobilizing internal and external resources. The banks were given incentives such as very high yields on government paper, tax breaks, and deposit insurance to make this possible, and the shifts in their asset and liability portfolio reflected these incentives. Furthermore, state banks—which represent 30 percent of the banking sector—suffered from liquidity and solvency problems which undermined discipline and promoted excessive risk-taking by the whole industry. International experience shows that such a banking system cannot contribute significantly to economic development. A healthy financial system contributes to economic growth by mobilizing savings and allocating these to the best possible uses, monitoring management decisions and managing risk. If the government's demand for credit is excessive, there is not enough room for the banks to perform this resource allocation function. As discussed, empirical evidence shows that the greater the role of state banks play, the lower the level of financial development and economic growth, the more concentrated is credit allocation, and the higher the likelihood and cost of banking crises. Moreover, government reliance on the banking system for financing also impedes privatization of state banks.

Table 3.6: Turkey - Financial Development

	gdp/cap (95)	m3/gdp	bank credit to the private sector/gdp	Bank assets/ gdp	net interest margin	bank concentration	foreign bank share	state bank share
Argentina	8001	0.26	0.22	0.35	0.07	48.00	49.00	30.00
Chile	4992	0.43	0.59	0.61	0.04	59.40	32.00	11.70
Germany	30794	0.76	1.11	1.40	0.02	12.00	4.20	42.00
Greece	11901		0.38	1.03	0.03	70.00	5.00	13.00
Japan	42391	1.90	1.16	1.51	0.02	31.10	5.90	1.15
Korea	11475	0.84	0.65	0.78	0.02	47.50	0.00	29.70
Mexico	3393	0.30	0.18	0.31	0.05	80.00	19.90	25.00
Malaysia	4536	1.24	0.94	1.33	0.03	30.00	18.00	0.00
Turkey	3007	0.39	0.21	0.50	0.10	50.00	5.00	35.00
USA	29253	0.59	0.45	0.52	0.04	20.80	4.70	0.00

Source: Beck Demirguc-Kunt and Levine (2000).
Note: Values are 1995-99 averages.

119. If the move towards fiscal discipline and a low-inflation environment can be sustained, the banking system's role will take on much greater importance in Turkey. In the transition, there are also important risks. Banks will have to start behaving as commercial banks, expanding their credit portfolio and avoiding the potential risks that accompany such credit booms. At present, most of banks' interest income comes from securities. To offset the income

losses due to lower inflation and the move away from government securities, banks would have to improve their profitability. This requires the remaining regulatory and taxation burdens on the banking sector to be reduced. The latter is particularly important since such burdens can become more significant as inflationary income disappears (Eroglu, 2001). Liquidity and reserve requirements, and transaction taxes—on foreign exchange, stock market, and other individual transactions—need to be decreased. Some of these taxes also lead the banks to book their assets and liabilities abroad. Foreign banks are in a better position to do so and thereby gain an unfair advantage. Some of the larger foreign banks only keep approximately one fifth of their Turkish assets and liabilities in Turkey. There has been limited progress in this area. The Central Bank is now paying interest on reserve requirements and there are plans to phase out some of the costly transaction taxes and replace them with other revenue measures. Another area that would facilitate better evaluation of credit risk is the establishment of a credit bureau. Currently, the Central Bank collects information on only loan defaults which impedes credit analysis.

120. One of the important factors that distorts the incentive structure of the Turkish banking system is deposit insurance. Empirical evidence from the experience of a large number of countries around the world shows that poorly designed deposit insurance systems can do more harm than good by undermining market discipline and causing moral hazard, particularly in countries with weak supervision and regulation and undercapitalized banks (Demirguc-Kunt and Kane, 2002). In Turkey, deposit insurance scheme was established in 1983 and its coverage was made unlimited after the 1994 crisis. This allowed Turkish banks to increasingly engage in riskier operations—keeping large open foreign exchange positions for example—without much concern since their creditors and depositors were covered by the guarantee. This blanket coverage was extended to cover all creditors after the recent crisis.

121. In the long term, it is not feasible to retain a blanket guarantee since it would make the job of official regulators very difficult by undermining private market discipline. Indeed, there were plans to reform the deposit insurance scheme after the bank recapitalization was completed, but given the economic uncertainties these decisions have been delayed. One of the important decisions that will have to be made is the new coverage limit. Currently, there are plans to reduce coverage to 50 billion TL, which corresponds to the EU scheme. However, this coverage is over ten times the Turkish GNP per capita and is therefore too high. International evidence shows that best designed schemes have coverage levels of at most 2 times GNP per capita— like most European countries—which would be sufficient to protect the deposits of the majority of the depositors. Higher coverage levels would reduce market discipline, increase moral hazard and make banking crises more likely[10]. Currently, Turkey has a risk-based premium structure although the differentiation between premiums for high/low risk banks is not significant. It may be a good idea to retain the risked-based premium structure in the new limited deposit insurance scheme to replace the blanket guarantee.

122. In summary, the long-run institutional framework is key to make the banking reforms sustainable. Political commitment to the reform process is particularly important in continuing the reform efforts. Important steps have been taken to improve the incentive structure of the Turkish banking system since the crisis. Strengthening prudential regulation and supervision, efforts to recapitalize the private banking sector, the progress made so far in restructuring the

[10] Demirguc-Kunt and Huizinga, 2001 and Demirguc-Kunt and Detragiache, 2002

state banks, efforts to resolve the NPL problem and to ease the restructuring of the corporate sector are very important steps. However, in the long term, a healthy and effective banking system requires a stable macroeconomic environment, reduced public sector borrowing needs, lower state ownership, a lower regulatory and taxation burden, and a better designed deposit insurance scheme that does not undermine private incentives to monitor the banks. As the reform process moves forward it will be important to keep in mind that public supervision tends to be much more effective when it is free from political intervention and reinforced by private discipline, and partial bank recapitalizations without paying adequate attention to factors that undermine the effectiveness of regulatory/supervisory environments and impediments to bank profitability are doomed to be repeated.

CHAPTER 4: CORPORATE SECTOR

1 INTRODUCTION

123. The cumulative effects of the 2001 crisis were felt throughout the economy—starting in the financial sector and causing increasing distress in the real sector.[1] Net profitability of listed companies—on the decline between 1997 and 2000—turned into major losses in the first half of 2001 in every manufacturing sector except cement and glass. Losses totaled US$1 billion during the first semester of 2001, down from profits of US$1.6 billion in the same period in 2000. From the first quarter of 1999 through the first quarter of 2001, the share of listed companies at medium risk rose from 63 to 69 percent—while those at high risk jumped from 2 to 11 percent. Together, these companies accounted for 58 percent of listed companies' sales, 56 percent of employment, and 89 percent of bank liabilities. The corporate sector rebounded strongly in 2002, largely due to export-led growth and a modest recovery in domestic demand. Net profit in the corporate sector for the first nine months of 2002 reached US$2.3 billion, slightly higher than earnings for the entire year 2000. The main factor was a decline in financial charges, including foreign exchange losses.

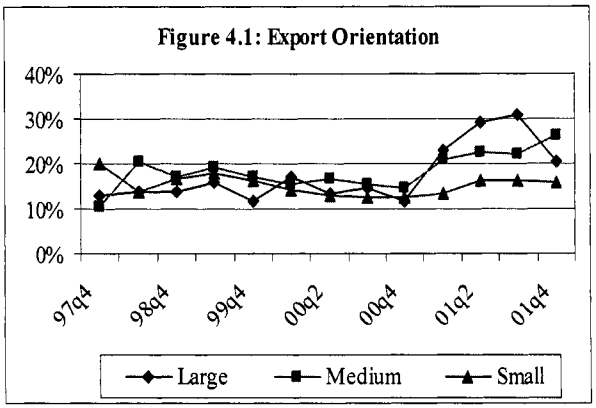
124. To assist in restoring growth, Turkey is in the process of implementing a comprehensive corporate restructuring program known as the Istanbul Approach (IA). Once firms enter the IA, there is a formal review process by a Creditors Committee. Once a workout is agreed to, the creditors and the debtor (the company) sign an agreement stipulating the terms and conditions of the workout, reporting requirements of the debtor and events which would trigger a review of the agreement. The creditors also sign an inter-creditor agreement specific to the specific workout case. The IA does not guarantee the survival of a company in distress. Regulatory authorities do not intervene and, because of its voluntary nature, the IA is only effective if it is mutually supported by the banking and corporate communities. Progress to date in implementing the IA has been reasonable. As of end-June 2003, 299 firms, 208 large firms in 32 groups and 91 small firms had entered the IA with US$4.8 billion in loans being restructured. These firms have approximately 46,335 employees, sales of about US$ 2.9 billion and exports of close to US$0.8 billion, and over US$ 7.5 billion in assets. Nevertheless, a number of issues have emerged which if left unresolved will impede progress. One issue is the lack of an adequate bankruptcy framework. Other issues involve technical concerns including the handling of so called category 2 loans in the balance sheets of banks and the participation of state banks. The Advisory Committee consisting of Treasury, the Central Bank, BRSA, the banks, TOBB and TUSIAD may be helpful in pushing the process forward.

125. Several medium-term reforms should complement the short-term corporate resolution process. These include measures to attract foreign direct investment and accelerate the privatization program. A careful review of the performance of state enterprises is required to assess their need for workouts and more fundamental restructuring. In addition, there is a need for accounting reform and improved corporate disclosure, as well as better corporate governance including strengthened independence for boards of directors.

[1] This review of the impact of the crisis is based upon a recent World Bank Study, "Turkey: Corporate Sector Impact Assessment Report", March 2003.

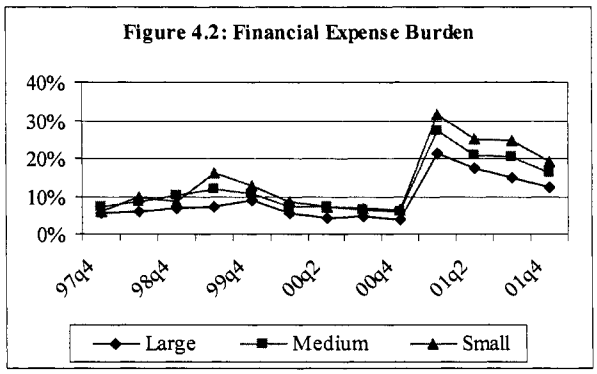
2 ANALYSIS OF CORPORATE DISTRESS

126. The 2001 crisis hurt all sectors—industry, construction, trade, and services. Industrial production fell 6.9 percent in the first half of 2001 and 9.9 percent for the year. Plant capacity use in the private sector fell to 62 percent in mid year, before recovery to 68 percent in the fourth quarter of 2001. Lower domestic demand was the most important factor undermining capacity utilization. Increased exports in a number of sectors—such as automobiles and textiles—helped mitigate corporate losses but even these sectors suffered significant losses in 2001 (Figure 4.1). The downturn forced most firms to reduce their workforces throughout 2001. Efforts have also been made to control wage costs, with shorter work weeks, strict control on overtime, accelerated vacation and maintenance schedules, and temporary furloughs. Although Turkish firms have been agile in responding to the crisis, worker distress has been considerable. Over the 2000-02, period, the unemployment rate increased from 6.6 percent to 10.6 percent.

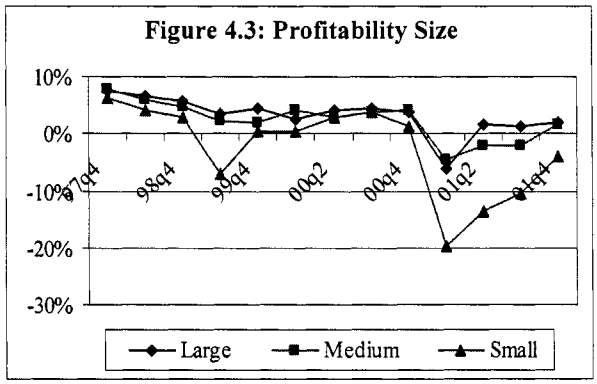


Source: CSIA Report 2003, World Bank

127. Data for non-financial companies (industry and services) listed on the Istanbul Stock Exchange (ISE)—a sample representative of Turkey's mid-cap and large companies—show worrisome trends. The series of crises over the past decade (1994, 1999, November 2000 and February 2001) have lowered company profits and increased financial fragility. Net profitability declined over the 1997-2000 period, then turned into major losses in the first half of 2001 in every manufacturing sector except cement and glass. Losses totaled US$1 billion at the end of second quarter of 2001, down from profits of US$1.6 billion in the same period in 2000. Interest rate coverage on an earnings before interest, taxes, depreciation and amortization (EBITDA) basis dropped below one beginning in the first quarter of 2001 and stayed that way until the fourth quarter. By contrast, the debt coverage ratio was consistently above one through 1999-2000 for most listed companies. In addition, financial expenses rose sharply as a percentage of revenue in the first quarter of 2001, hitting 27 percent (Figure 4.2). For 2001 as a whole, sales of listed companies were down



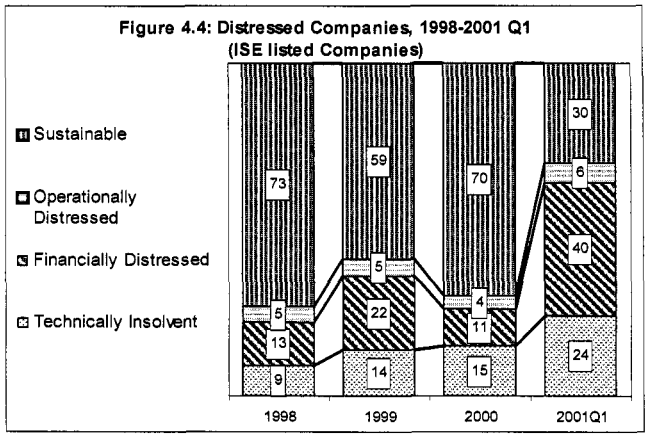
Source: CSIA Report 2003, World Bank



Source: CSIA Report 2003, World Bank

13 percent, earnings (EBITDA) were down 11 percent, and net earnings were down a staggering 80 percent.

128. The 2001 crisis put a larger share of listed companies at medium or high risk of default. Between the first quarters of 1999 and 2001 the share of listed companies at medium risk rose from 63 to 69 percent—while those at high risk jumped from 2 to 11 percent. Together these companies accounted for 58 percent of listed companies' sales, 56 percent of employment, and 89 percent of bank liabilities (Figures 4.3 and 4.4). Distressed companies have limited opportunities for a turnaround in the short term. Companies have cut production costs through import substitution and payroll reductions. They have also tried to improve management of working capital, but a general lengthening of receivables and inventories demonstrates the difficulty of doing so in a systemic crisis. Companies have also cut investments, with private investments down nearly a third in 2001. A few companies and banks have made rights offerings to increase equity capital, but the depressed stock market discourages equity financing.



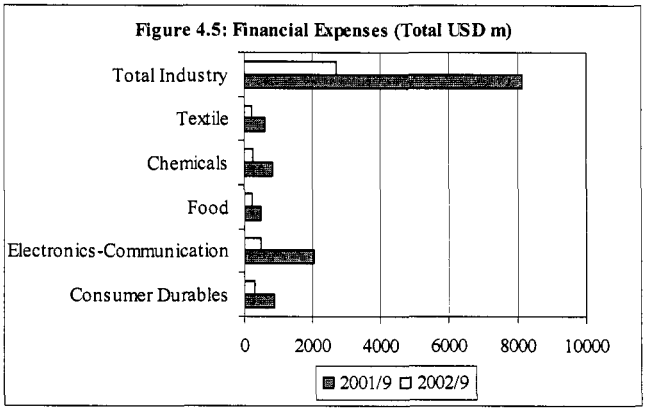
Source: CSIA Report 2003, World Bank

Table 4.1: Net Profitability by Sector, 2001-2002 (Millions of US Dollars)

	2001/12	2002/12
Consumer Durables	-35.9	168.9
Electronics-Communication	-530.7	139.6
Textile	-209.77	22.45
Transportation	48.6	100.3
ISE Total	**-1175.44**	**933**

Source: TSKB Research, Weekly Bulletin, April 21-25, 2003.

129. A major turn around in profitability occurred in the consumer durables sector in 2002, in particular the white goods sector, and that has continued in the first quarter of 2003. Other sectors with significant turn around in profitability in 2002 were electronics and communications, food processing and textiles (Table 4.1). The primary factor for the turnaround in profitability was a reduction of financial charges. Financial expenses include both interest payments and foreign exchange losses under the Turkish accounting principles (Figure 4.5).



Source: TSKB

3 SHORT-TERM RESOLUTION STRATEGIES

130. Implementing a comprehensive resolution strategy has been a continuing priority in dealing with the aftermath of the 2001 crisis and its effects on Turkish companies. Lessons from the recent crises in East Asia and Mexico indicate that the short-term resolution strategy should include: (i) segmenting problem companies by size so that companies of different sizes and needs can be treated appropriately; (ii) implementing a voluntary workout program; (iii) adopting a new bankruptcy framework, including the option for pre-packaged bankruptcies that would recognize the workouts in the courts; (iv) easing tax, legal, and regulatory impediments to crisis resolution; and (v) development of an asset management company or companies. Each of the major crisis countries in recent years—e.g., Mexico, Thailand, Korea, Malaysia and Indonesia—has implemented a voluntary workout program that was important in restoring the creditworthiness of the real sector. Getting the incentives right has proven difficult in other crisis countries including East Asia and Mexico[2]. Companies that have defaulted on loans could face seizure of their collateral if they abstain from the workout process. However, Turkey's weak bankruptcy framework may well serve as an obstacle to the workout program as debtors seek shelter from their creditor through the bankruptcy process. A resolution program is also vital to restore the soundness of viable banks and may include an asset management agency or company to remove the most distressed assets or special classes of assets such as real estate, cars and other saleable collateral, from the books of these banks.

Segmenting Problem Companies

131. Experience in other crisis countries suggest that thousands of small and medium-size enterprises, hundreds of mid-cap enterprises, and a few large groups may all be in trouble at the same time. Countries have dealt with these issues in various ways, but all have eventually recognized the need to segment problem companies. The types of segmentation discussed below are at the heart of the resolution strategy that has been developed and is known as the Istanbul Approach.

132. Companies can be broadly segmented into three groups. Small and medium-size enterprises—the first and most numerous casualties of such crises, with little power to effect outcomes—are usually too numerous to include in a corporate workout program. Solutions in support of small and medium-size enterprises need to be systemic, such as extended rollovers of credits including re-capitalization of past-due interest and extended grace periods for principal repayments. Mechanisms to improve liquidity in small and medium-size enterprises can help keep them afloat. The financial costs of stabilizing small and medium-size enterprises are small relative to the social and political costs of allowing thousands of them to sink, and should not take much time or effort to apply. At the other end of the spectrum are the large corporate groups that dominate the economy, with complex structures that may include a mix of industrial and financial companies. To the extent that these groups exhibit distress, they need to be monitored carefully and addressed on a case-by-case basis so that their problems do not provoke a secondary crisis and spill over into the banking sector, causing banks and non-bank financial institutions to collapse. The Daewoo collapse in Korea is perhaps the most prominent recent

[2] Kawai, Liberman and Mako (2000), "Financial Stabilization and Initial Restructuring of East Asian Corporations: Approaches, Results, and Lessons".

example of such a case. Finally, in the middle are mid-cap corporations. Depending on the economy, these firms have US$25-100 million in annual sales, normally require bank financing for working capital and investment, and may be the most adversely affected if a crisis causes a contraction in the stock of credit, as has happened in Turkey (and happened in East Asia and Mexico). Mid-cap companies—usually found using several banks and other financial intermediaries such as leasing companies, as well as supplier credits—normally form the core of a voluntary workout program. With adequate due diligence and a well structured workouts, many mid-sized companies can be restored to creditworthiness.

The Istanbul Approach

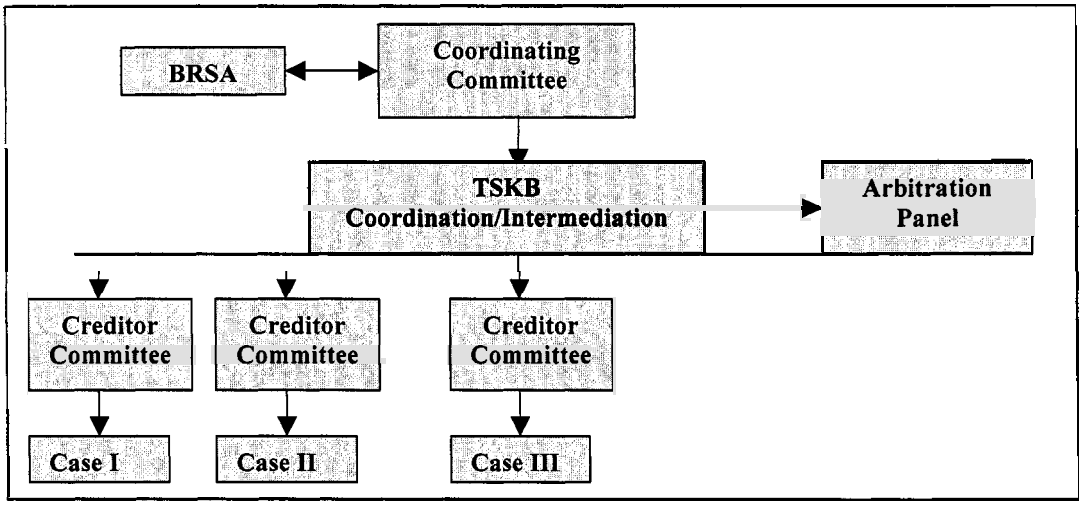
133. The Turkish Bankers Association, working with Government and industry representatives, has taken the lead in developing a voluntary, non-judicial workout program based on the London approach. The program, informally known as the Istanbul Approach (IA), has required the strong backing of the Treasury and the Ministry of Finance because of the policy and regulatory implications and the tax incentives normally required to make such a program operational. The IA is supported by amendments made by the law (No. 4743) dated January 31, 2002 to the articles of Banking Law (No. 4743) and by a circular of BRSA in April 2002. In addition, the BRSA has established clear provisioning rules in support of workouts and in coordinating workouts with intervened banks. At the heart of the IA is a Framework Agreement (inter-creditor agreement) signed in June 2002 by 34 commercial banks and non-bank financial intermediaries. Intervened and state banks have also signed the agreement. Finally, the agreement has been approved by the BRSA.

134. The IA incorporates key aspects derived from international experience with voluntary workouts. First, creditors must signal that they are willing to pursue a non-judicial resolution of a company's financial difficulties rather than resort to a formal process of seizing collateral or an insolvency procedure such as liquidation. Second, the out-of-court process under the IA is case-by-case, i.e., each company entering the process is addressed by a separate Creditors' Committee and that committee is directed by a lead bank holding the largest share of the credits or is appointed by the other creditors holding 75 percent of the credits by value. While the inter-creditor agreement has been signed by banks and non-bank financial institutions, other creditors such as trade creditors may join the workout process through the Creditors Committee. Third, the IA is time bound. That is, the Creditors Committee has a maximum of 90 days plus three 30 day extension periods (180 days) to reach a resolution and agree to a workout with the debtor. Fourth, the IA incorporates a due diligence process. The creditors commission an independent due diligence review of each distressed company's long-term viability, drawing on comprehensive information made available by and shared between all the likely parties to any workout.

135. A Coordination Secretariat, under the direction of TSKB, is responsible for oversight of the process and to ensure that its logistics and timing of the work (Box 4.1A). A lead bank is chosen to head the Creditors' Committee formed for each case. If there is no resolution, i.e., less than 55 percent of creditors by value agree to a proposed workout plan, then the case is dropped from consideration. A three-person Arbitration Committee, appointed by the board of the Turkish Bankers Association, makes decisions on workouts if they pass the 55 percent threshold, but do not reach approval of 75 percent of creditors. The arbitration panel can also decide on

any individual matter which the Creditors Committee brings to its attention. For the large groups or conglomerates, a group owned bank cannot take the lead for a group owned subsidiary, nor can the group bank vote in the creditors committee. A group bank is also not able to provide new financing to a group company.

Box 4.1A: Institutional Structure for Istanbul Approach

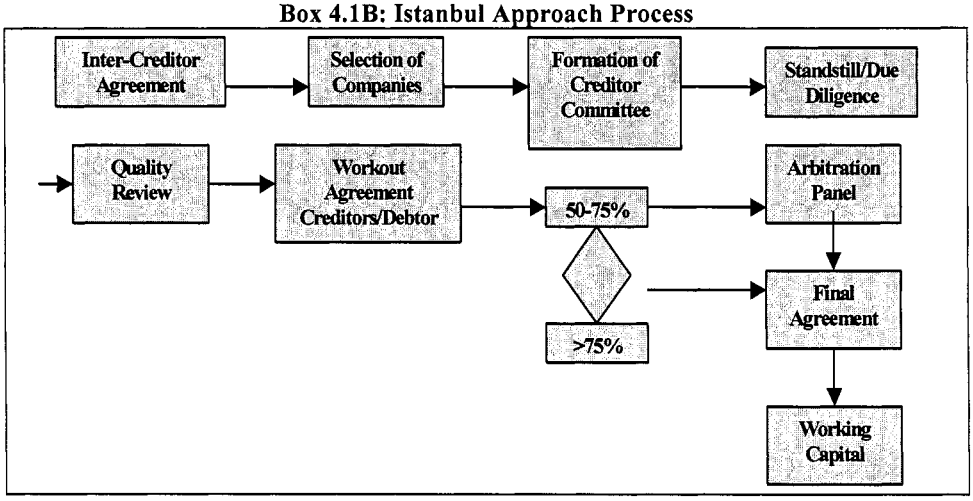


136. Because of its voluntary nature, the IA is only effective to the extent it is mutually supported by the banking and corporate communities. Regulatory authorities do not intervene and the IA does not guarantee the survival of a company in distress. During the period of the review and negotiation the creditors must agree to support a standstill. That is, each of the creditors agrees to maintain its credit facilities and not to move against its collateral to the disadvantage of the other creditors. This maintains the confidence of the workers, suppliers and the customers by allowing the company to continue operating. At the end of the due diligence period, the creditors have to form an opinion with respect to the company's viability and make a decision whether or not to go forward with the workout. Until the workout is agreed upon, creditors preserve their legal rights to pursue the debtor through the courts in the event a workout agreement is not reached.

137. Once a workout is agreed to, the creditors and the debtor sign an agreement stipulating the terms and conditions of the workout, reporting requirements of the debtor and events which would trigger a review of the agreement. The creditors also sign an inter-creditor agreement specific to the specific workout case. The IA allows companies to supplement their borrowing in case of a liquidity shortfall or pressing maintenance needs. New money can be provided on a pro rata basis by all existing lenders, by specific lenders with priority arrangements, or by the release of asset disposal proceeds subject to priority considerations. Banks can also benefit from the tax incentives that are a part of the Istanbul Approach. Banks are eligible for these incentives under the program for a period of three years with the option for extending the program. Other principles underlying this critical period of financial support include recognizing the seniority of existing claims and sharing losses on an equal basis between creditors in the same category. If creditors agree that a company is viable over the long term, they can consider a formal rescheduling—such as an interest holiday, re-capitalization of interest in arrears, extension of

loan maturities, lending of new money, or conversion of debt to equity. These longer-term financial changes need to be conditional on the implementation of an agreed business plan that may well require restructuring of the company over the term of the workout. Restructuring may include management changes, injections of fresh equity, sales of assets or divisions, mergers or even company takeovers by new owners. Box 4.1B diagrams the IA process.

Box 4.1B: Istanbul Approach Process



138. Eligibility and sequencing are key issues for the IA. Eligible firms are primarily large and mid-cap manufacturing firms. To qualify as a large firm, companies must meet at least two of the following criteria as of end-2001: having two or more banks as creditors, debt of more than US$10 million, more than 100 permanent employees, annual exports of US$15 million, total annual turnover of at least TL 25 trillion, and assets on an audited balance sheet of at least TL 15 trillion. There is also a need to address sequencing—that is, the criteria used to decide which firms enter the process initially. Although small and medium-size enterprises are covered by a modified form of the process handled primarily by the lead bank, the number of firms that can be restructured in the first phase may need to be limited to prevent the process from bogging down. In Thailand, the workout process bogged down with thousands of SMEs involved in restructuring. Thus a more systemic approach needs to be adopted for small firms[3]. Excluded from the process are marketing and trading firms (that is, non-producing firms) and firms with more than 50 percent state ownership.

Progress in Implementing the Istanbul Approach

139. As of end of June 2003, 299 firms (208 large firms in 32 groups and 91 small firms) were participating in the IA with some US$ 4.8 billion in loans being restructured. These firms have approximately 46 thousand employments, sales of US$2.9 billion and exports of about US$ 761 million, and about US$ 7.5 billion in assets. Many of the cases have completed the 90 days and are on to the first extension. Experience in most crisis countries is that a systemic workout process may well take several years to complete. Moreover, it is difficult to get the workout just

[3] Erzan and Filiztekin (2002), a background paper to this Report, analyzes growth, employment and productivity in Turkish manufacturing industry with respect to industry and size, and scrutinizes the vulnerability of firms with respect to the economic environment.

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 modifications of some workouts a couple of years into the process once economic conditions have stabilized. Although the IA was formally introduced in June 2002, implementation was realistically delayed until the effort to flush out NPLs and re-capitalize the banks was completed as outlined in chapter 3. At that point, newly capitalized banks had the proper incentive to have loans re-classified and to collect on provisioned loans. Following the recapitalization, improvements in loan classification and collection on provisioned loan are directly reflected in increased profits line and capital of the banks.

140. There are several impediments to the IA that prevent it from becoming a more robust restructuring process. The first, and most important, problem is with *category two loans*[4]. The banks are unwilling to bring companies with potentially viable, category two loans that need restructuring into the IA. Banks are also reluctant to provision for these loans, but recognize that they may well need restructuring and/or rescheduling and that the borrowing companies may require new working capital. There are three issues related to category two loans: (i) it is unclear under the legislation governing the IA whether these loans would automatically require provisioning if they are restructured under the IA; (ii) a number of category two loans are denominated in foreign exchange and with 12-18 months maturity which may have already become ineligible for the IA; (iii) the IA requires a 90 percent vote of creditors to approve workouts of performing loans—including category two loans—which is too restrictive.

141. The second problem involves *differences between state and SDIF banks and commercial banks.* Commercial banks claim that 3-4 large commercial banks are bearing most of the burden of the IA restructurings. That is, state and SDIF banks cannot participate in debt/equity swaps, cannot accept real estate collateral, and are reluctant to extend new financing. This is a material issue as the state and SDIF banks are major creditors in the workouts already underway. State banks claim they are ready to adhere to the IA rules as long as there is independent due diligence of IA cases by TSKB or external investment banks/accountants. Also, to provide new money, the state banks argue that they must be given first priority in accord with IA rules and this new money needs to be backed by new or shared collateral. The third problem is *that banks have focused their efforts on rescheduling and not fundamental restructuring of problem companies.* Most of the companies that have entered the IA process have large non-performing loans. A number of these companies had problems before the recent crisis. The banks are opting for long-term rescheduling (6-14 years) to lower the debt amortization burdens and to increase free cash flow in these companies. A number of the IA companies are being restructured through debt/equity swaps, debt/asset swaps and even change of management, but more pressure for real restructuring is needed. Most of the workouts will also require some fresh cash, but management of the banks are reluctant to increase their exposure to these companies. This was the experience initially in Korea where the banks focused on rescheduling. In the end, 50 percent of the Korean companies went through a second and third round of restructuring with a number of companies needing to be liquidated. This is likely to happen in Turkey as well. The banks will take larger write downs if they do not restructure the workout cases under the IA. Also, the corporate sector and the economy will be adversely affected.

[4] Loans that need to be extended but for which delays in repayment, if any, are less than 90 days and due to acceptable reasons – these loan do not need provisioning as NPLs in the balance sheet

142. Looking ahead, experience from East Asia points to some other issues that are likely to come up over the course of implementation of the Istanbul Approach. One will be the disposition of assets as loans are restructured. The SDIF is operating a public asset management company, but public agencies have often found it hard to operate such companies because of the commercial nature of the work. Companies that go through restructuring may well have a need for funds to manage assets that are difficult to dispose of during a crisis. Distressed companies and banks may also seek to divest land and other fixed assets from their portfolios. The lack of an adequate bankruptcy law limits the ability of the banks to press for restructuring. That is, they lack the "stick" in the system to require corporate restructuring. In countries that lacked an adequate bankruptcy system—e.g., Mexico, Thailand and Indonesia—it proved very difficult to follow through on voluntary workouts. In Korea, on the other hand, the bankruptcy system complemented the voluntary workout program. Some 13 large chaebols went into bankruptcy during the crisis and this served as a signal to other firms that they needed to restructure[5].

143. The voluntary nature of the Istanbul approach is critical to its success and it is important that Government not interfere in individual transactions. Nevertheless, there are several critical steps that Government can take to facilitate the process. Key recommendations are summarized in Box 4.2.

Box 4.2: Key Recommendations for Corporate Resolution

Recommendation	Timing of expected impact	
	Short term	Medium term
Policies to Support Corporate Restructuring		
• Implement a voluntary workout program based on the London approach	x	
• Commercialize asset resolution mechanisms		
– Sell distressed assets through an asset resolution agency—preferably one not created by the Government	x	
– Sell land and real estate through real estate investment trusts (REITs)		
• Strengthen the bankruptcy system and allow for pre-packaged bankruptcies to recognize workouts through the courts	x	x
• Ease tax, legal, and regulatory impediments to restructuring.	x	x

Asset Resolution

144. Corporate workouts will leave banks with many assets that they are poorly equipped to manage and that might be difficult to dispose of during the crisis. Moreover, these assets will not earn interest and will impair banks' reported financial performance. For example, a debt overhang will inevitably require debt-equity conversions or the swap of straight debt at high real interest rates for longer-term convertible debentures at lower interest rates. In Korea the interest rate on convertible debentures introduced in workouts was only 1 percent. In addition, many companies going through a workout will require additional long-term debt or equity injections to operate in the future.

145. Virtually all crisis countries have established asset management agencies or companies. However, most countries have found it difficult to operate publicly created agencies due to the commercial nature of asset disposal. Also, the lack of a secondary market for these assets in most countries significantly slows the process of asset disposal. As a result, the value of such

[5] Woo-Cumings (2001), "Miracle as Prologue: The State and the Reform of the Corporate Sector in Korea".

assets quickly plummets toward zero. Turkey in fact has already had a public asset management agency. Through the intervention of some twenty commercial banks, the SDIF is operating a public asset management agency. A BRSA circular issued in October 2002 established an enabling environment for the creation of private asset management companies. Diverse forms of asset management companies can be created by private entrepreneurs or major financial institutions. An alternative approach to the SDIF problem of asset disposal, is to consider profit participation deals. In East Asia and Eastern Europe, large financial groups have entered the market to purchase distressed assets—for example, in Korea they did so through a profit participation arrangement with the Korea Asset Management Company. International debt and equity funds could manage these assets for banks and potentially bring in institutional capital to provide some new money. Korea, for example, set up four funds with the participation of the Korean Development Bank, commercial banks, and internationally recognized fund management groups to help mid-cap companies seeking investors. The International Finance Corporation also made several direct investments in mid-cap companies in Korea. Such a role might be ideal for Turkey's private development bank, supported by commercial banks. A major impediment to the success of a commercially viable asset management company in Turkey will be the willingness of banks to dispose of distressed assets at a fraction of their value. If the banks need liquidity following the provisioning of NPLs, then they may be disposed to sell these loans. However, all indications are that the Turkish banks prefer to wait until the economy improves so that they can realize a better return on these impaired assets.

146. Land and real estate sales. Distressed companies and banks may seek to divest excess fixed assets or sell and lease back primary real estate. Banks will also need to divest land and buildings acquired as collateral during the crisis. During its crisis Korea established a land bank to allow companies to divest excess property, with an option to reacquire it in the future. It did so to prevent a precipitous fall in values as occurred in Japan. Although Korea's land bank was owned by the state, there is no reason Turkey could not attract institutional investors to establish such real estate investment trusts (REITs).

The Bankruptcy Framework

147. An important step is the establishment of adequate bankruptcy procedures. As noted above, it will be difficult to get firms to go through the needed restructuring (as opposed to a simple rescheduling of loans) without a functioning bankruptcy framework as a fall-back option. Corporate workouts and restructurings generally take place in the shadow of the law. Voluntary resolution requires reliable fallback options through established legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures. As the Mexican and East Asian experiences show, voluntary workout programs are often constrained by inadequate insolvency systems and by legal environments that discourage restructuring. In many crisis countries, weak bankruptcy systems have proven to be an impediment to the voluntary workout process. Turkey also has a weak bankruptcy system that can leave companies protected by the courts for years (Box 4.3). Currently, Turkish courts can take up to two years to resolve enforcement proceedings. During a crisis, the bankruptcy system is not by itself a viable alternative for restructuring problem companies. The number of distressed companies in Turkey would quickly overwhelm the court system were it to be the only alternative. However, the bankruptcy framework must be an effective alternative to voluntary workouts in order to provide

an important incentive (i.e., "stick") for companies to participate in the workout process (the "carrot").

Box 4.3: Legal Framework for Creditor Rights and Enforcement in Turkey

Turkey's legal framework for creditor rights and enforcement deals with procedures for enforcing the commercial rights of unsecured and secured creditors. For secured creditors it also covers laws and procedures for creating, registering, and enforcing collateral rights such as mortgages and pledges. Up to 90 percent of bank lending in Turkey is done on a secured basis, and most is guaranteed by a major shareholder. Types of collateral include real estate and movable assets; an unconditional mortgage on real estate is the most reliable form of security because it allows the creditor to bypass the courts and move directly to execution or foreclosure procedures.

In the event of a default, creditors can pursue execution or apply for an insolvency proceeding. Nearly all cases—almost 500,000 a year—are filed under the execution procedure. Procedures for debt recovery and foreclosure are generally effective, lasting an average of four to eight months over the past decade. Shorter proceedings tend to be uncontested, meaning they go directly to an executioner, which sends a collection order to the debtor. If creditors choose to go to court or a collection order is contested, it generally takes two to three years to reach a final judgment. In most cases, however, either the debtor does not contest the proceeding or a default judgment can be obtained. Courts are stretched to capacity and will likely become even more overburdened by efforts to collect on the non-performing loans of failed banks.

148. Enforcement of secured loans. Turkish banks typically secure their loans with real property worth far more than the loans. If a lender is unable to resolve a dispute with a borrower when a loan is not being properly serviced, the bank may initiate an enforcement action in the courts. While initiation of such lawsuits has traditionally been the trigger for banks to classify such loans as non-performing, new loan loss provision rules require classification based on performance and creditworthiness. The recent effort to push banks to flush out their NPLs could lead to a dramatic increase in the volume of enforcement actions. Given that the courts are already overloaded, the increased caseload will likely slow the completion of enforcement cases as well as all others. Because a contested enforcement proceeding can take more than two years to resolve, the prospect of further delays is worrisome. The banks are confident that court enforcement procedures are effective, if slow. The question is whether the system will work as well when caseloads increase further. Just as important is whether an enforcement system that works for lenders—because they typically hold considerable excess security—is effective in protecting borrowers. Except where lenders work together on an informal or ad hoc basis to work out a restructuring plan, the answer may well be negative.

149. The Savings Deposit Insurance Fund (SDIF) has intervened in some twenty private banks. To expedite recovery, the loan portfolios of these banks have been redefined as state receivables subject to collection under the Public Receivables Act (No. 6183). Because court judgments are not necessary for state receivables, this change could shorten average recovery periods to a little as six months. However, giving the loans of SDIF banks the status of state receivables raises several issues. First, accelerated collections enable the SDIF to recover in less time, thereby potentially giving it access to debtor assets more quickly than other creditors. Second, the Public Receivables Act applies to all assets of a debtor—not just assets that have been pledged—which may give the SDIF an effective priority and greater likelihood that it will be able to recover amounts owed to it relative to other creditors. Because the Act provides limited scope for rescheduling and almost no capacity to write off debt, it can be difficult to

develop a workout plan for a troubled debtor. Just as important, enforcement proceedings under the Public Receivables Act take place outside the commercial court system while other creditors must use the courts—making restructuring more cumbersome. The question of whether the SDIF acquires greater rights than the original holder of the debt simply by virtue of subrogation or assignment is certain to be challenged in the courts, resulting in delays. Indeed, this issue could have a widespread impact because other courts will likely take a wait-and-see approach. Depending on the final ruling, the result could potentially undermine the voluntary resolution process.

150. Legal framework for insolvency. Turkish insolvency procedures are usually not relied on as a means of recovering debt even in cases where borrowers are clearly insolvent. The average number of cases, about 1,500 a year—less than 0.5 percent of execution proceedings—reveals that insolvency has been marginalized. Unsecured creditors see the process as ineffective, fraught with extremely long delays, and yielding little or no benefit. Distributions to unsecured creditors reportedly do not exceed 3-5 percent, and no consideration is given to the time value of payments. As a general rule, secured creditors enjoy a privileged status under the Execution and Bankruptcy Act. The declaration of bankruptcy does not result in a stay on actions by secured creditors to foreclose on their collateral. Where foreclosure proceedings have not commenced, pledged assets can be entered as part of the bankruptcy proceeding, and the secured creditor has the option of disposing of the collateral on its own or allowing the administrator to do so. As a general rule it is difficult to salvage viable enterprises when secured creditors are exempt from the process and can collect on collateral that may be essential for the business. Weak insolvency procedures seriously impede the development of viable workout plans for illiquid debtors. The fact that secured creditors can execute against a debtor's core assets limits the scope for developing a plan to rehabilitate the debtor. However, given the inordinate delays and marginal use of the bankruptcy process, the current treatment of secured creditors offers a more reliable framework for risk assessment and management by lenders.

151. Pre-packaged bankruptcies. Experience in East Asia and Mexico highlights the impediments to corporate restructuring that can arise from valid legal checks and balances. These legal concerns—such as protections for public shareholders and controls on tax deductions for credit write-offs—often serve broader public policy interests and cannot be simply eliminated. Public shareholder rights to oppose diluting equity restructuring can be particularly difficult or impossible to override in an out-of-court workout, as seen in recent cases involving Daewoo affiliates in Korea. To deal with valid legal concerns, it may be necessary to rely more on court-supervised processes (such as "prepackaged" reorganizations) to effect equity restructurings of companies. In addition, the insolvency system can provide "front end" support to encourage debtors to cooperate with out-of-court workout efforts—as well as important "back end" support that makes it possible to override dissident creditors or shareholders in a corporate workout.

152. Turkey's insolvency law should be amended to restrain secured creditors from executing against their collateral as long as their property interests have not been affected. The insolvency law should provide a mechanism that preserves the value of the security for secured creditors, but that allows the excess security value to be used to help restructure the debtor. The amended law should also include provisions for pre-packaged bankruptcies. There is little point to these changes, however, unless it is accompanied by wholesale changes that allow the procedure to be

expedited. Time destroys the chances of successful restructuring—a process that takes years, instead of months, has little to offer. Expediting matters requires changes to judicial procedures, and ideally to the structure of the courts. In light of the comprehensive legal and institutional reforms needed, the Government undertook an overall assessment of its legal and institutional framework for creditor rights and insolvency, using the World Bank's *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001). This assessment has identified specific reforms required in Turkey's legal and institutional framework in core areas related to the enforcement of creditor rights (including creation, registration and enforcement of security), and formal and informal corporate insolvency. The Parliament passed a set of comprehensive amendments to the EBA on July 17, 2003 which address enforcement of creditor rights, formal/informal corporate insolvency and restructuring systems, credit risk management practices, and institutional and regulatory frameworks. In addition, The Government plans to enact a new section of EBA on pre-packaged bankruptcy by end-2003.

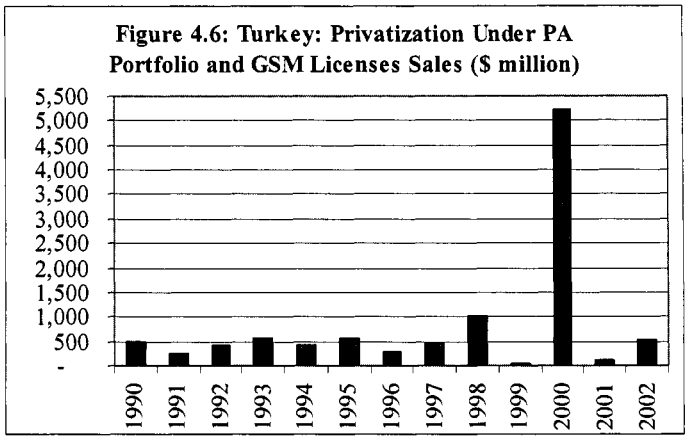
153. Easing tax, legal, and regulatory impediments to restructuring. The East Asian crisis highlighted numerous impediments to corporate restructuring, mergers and acquisitions, and the entry of foreign direct investment. Turkish firms face many of the same obstacles. Significant impediments encountered in one or more East Asian countries included: (i) treatment of debtor gains from debt restructuring as taxable gains; (ii) an inability of corporate creditors to deduct losses from corporate debt restructuring and voluntary workouts to reduce taxes; (iii) immediate taxation of non-cash corporate reorganizations such as mergers or spinoffs; (iv) little or no opportunity to transfer net operating tax loss carry-forwards to a corporate acquirer or new merged entity; (v) excessive fees and taxes on property transfers; (vi) constraints—such as the personal liability of staff—on the ability of state-owned financial institutions to incur losses through corporate debt restructuring; and (viii) constraints on the ability of banks to hold equity in debt-equity swaps or similar instruments such as convertible debentures. The Turkish Government has amended corporate tax laws and regulations to encourage mergers, acquisitions, asset spin-offs, and the sale of real estate and participation shares by banks augmenting their capital. It has also eliminated stamp, value added, and other duties on such transactions. These amendments address several of the obstacles to restructuring and workouts encountered in East Asia. However, more impediments may surface that could require Government action.

4 MEDIUM TERM STRUCTURAL REFORMS

154. In addition to the corporate resolution process, other measures are needed to foster the environment for a more dynamic corporate sector. Some of the most important of these measures are discussed in other chapters of this report. Macroeconomic stability including a stable and competitive exchange rate and lower real interest rates are very important for corporate sector recovery. These are discussed in chapter 1. Similarly, a healthy financial sector is critical to growth of the real sector and the relevant financial sector policies and reforms are discussed in chapter 2. Here, three other medium-term structural reforms are briefly considered: privatization, improved financial reporting and accounting standards, and corporate governance.

Accelerating Privatization.

155. Accelerating privatization is a key supply-side element in the effort to sustain growth. While Turkey began its privatization program in 1985—making it the first developing country to do so—it is now lagging far behind comparable economies in Latin America (Argentina, Chile, Mexico) and the main economies in Central and Eastern Europe (Czech Republic, Hungary, Poland). Privatization sales have consistently fallen short of expectations, regularly falling short of US$1 billion per year with the exception of 2000 when sale of a majority stake in POAS (petroleum distribution) and a third GSM license pushed sales above US$5 billion (Figure 4.6). The public sector still accounts for 15 percent of non-agricultural production. In most emerging market economies and many OECD countries, privatization has been major driver of foreign direct investment. Disappointing privatization performance in Turkey may have been a factor in its failure to attract significant levels of FDI.



Source: Privatization Administration and World Bank

156. Accelerated privatization could generate significant external resources, improve the efficiency of strategic sectors—such as telecommunications and energy—and send a strong signal to foreign investors and financial markets about Turkey's commitment to reform. But increased efficiency will not happen automatically: it will require implementing appropriate regulations, creating independent regulators, and allowing competition in these sectors. To achieve these tasks, the Government must make a long-term commitment to structural reform. In moving forward with privatization, the Government faces at least two important trade-offs. First, in the energy and telecommunications sectors, there is a clear need for revenues to be raised, but at the same time, establishing as much competition as possible is critical to securing Turkey's competitive position. Decisions favoring a more competitive structure could lower up-front revenues from privatization, but will maximize the long-run benefits. The second trade-off involves whether to prioritize sale of large companies, which can make a significant contribution to the fiscal program, or to focus on the sale of smaller firms which may not generate as much cash revenue but may be extremely important for stimulating the private sector, at least in the short run.

157. Despite the high competence and considerable experience of Privatization Administration (PA) managers in executing privatization transactions, the program has suffered from many flaws. The requirement that the Privatization High Council approves all sales, regardless of size, has forced even small divestitures to be recycled several times—significantly lowering their value and reducing transparency. A number of loss-making companies have been transferred to the PA, and they are absorbing its resources—both financial and human. The PA has effectively become a large state holding group—a function it is not equipped to handle. The bulk of the funds from privatization have been used to finance the unprofitable holdings rather than being

returned to the Treasury to retire debt. Privatization has been viewed as an important way of generating revenue to overcome fiscal problems, particularly during crises. The more fundamental objective of privatization—making Turkish industry more efficient and more competitive—has been subordinated.

158. Determined action to improve and de-politicize the privatization process will help strengthen the Government's reform credentials. 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. In parallel, the cross subsidization mechanism among companies in the PA's portfolio should be terminated to improve transparency and operational performance. The PA should be free to clear out its inventory of loss-making companies through mergers and liquidations. All privatization revenues and dividends from profitable companies in the PA's portfolio should be transferred to the Treasury and recorded in the budget. The costs of subsidizing loss-makers and of severance payments and other payments to workers laid-off or retired as a result of privatization should be provided transparently through the budget. Finally, future privatizations should not be carried out by line ministries but by the PA in order to take advantage of its experience and technical abilities. Despite significant tariff and non-tariff protection and price adjustments, some of the companies to be privatized experienced losses in recent years. The substantial accumulation of arrears needs to be cleared as part of the privatization process for these companies.

159. A new privatization program for 2003, which includes major companies of national importance, has been approved. The current privatization program targets several major holdings: those in PETKIM (petro-chemicals), TUPRAŞ (oil refining, partly divested in 2000), Turkish Airlines, ERDEMIR (steel), TEKEL (tobacco and spirits), and SEKER (sugar). The Privatization Administration should urgently adopt privatization plans for TEKEL and ŞEKER. The Privatization Administration should also continue to divest its smaller holdings. It should also amend the telecommunications law to authorize privatization of Turk Telekom subsidiaries and adopt new Turk Telekom privatization plan. In addition, state banks will be privatized over the next several years, and intervened banks will be divested or liquidated by the end of 2003. Moreover, the Government plans to sell other assets, such as some of its land holdings.

160. The 2003 privatization program has made reasonable progress. Based on sales contracts signed as of mid-May 2003, cumulative cash proceeds were in line to reach the end-June target of US$90 million. Highlights of the program are as follows:

- The PA has completed tenders for four TDI ports, Taksan (machinery), Gerkosan (iron and steel), TZDAŞ (agriculture machinery), and six SEKA facilities in the framework of the 2003 program. All of these tenders were approved by the Privatization High Council except for those which did not receive sufficient bids (Gerkosan, two of the SEKA facilities, and two TDI ports). Block sale tenders for 51 percent of the ETI group companies (ETI Copper, ETI Silver and ETI Electrometallurgy) have been announced. The PA has also finalized the merger of TURBAN, TZDAŞ and TUMOSAN under the Sümer Holding umbrella.

- A block sale tender for the entire 88.86 percent state stake in PETKIM (petrochemicals) was finalized on June and the winning bid was approved by the Privatization High Council in July.
- A block sale tender for the entire 65.76 percent state stake in TÜPRAS (refineries) was launched in early June and will close in September 2003.
- The PA, working with international consultants, has formulated a privatization plan for TEKEL (alcohol, tobacco and salt), including strategies for dealing with the key issues of over-employment, debt settlement, and excess inventory. The TEKEL privatization plan was approved by the Privatization High Council in March 2003. Tenders for 100 percent of TEKEL's alcohol and tobacco operations were launched in early June and will close in September 2003.
- A block sale/public offering for THY (national airlines) is scheduled for the third quarter of 2003.

Improving Financial Reporting and Accounting Standards[6]

161. Turkey's accounting standards do not fully comply with IAS or generally accepted accounting principles. This setup makes it impossible to assess accurately the real financial situation of companies because of obstacles such as high inflation, use of accelerated depreciation laws for taxation purposes, accounting treatment of foreign exchange losses and profits, treatment of finance charges as revenue in cases of deferred payment sales, and lack of consolidation requirements. In the absence of clear financial data, banks often make corporate credit decisions based on collateral. As a result companies that would not be eligible for credits based on business and cash-flow viability are able to borrow, while others may not be able to even though they have a viable business—but not the required collateral. The main problem is the lack of IAS in the reporting and disclosure required for listed companies by the Capital Markets Board, and for unlisted holding groups that have listed subsidiaries or affiliates or that own banks. Turkey's recovery from its crisis involves, among other things, an expectation of substantial foreign direct investment. While there are many reasons Turkey has not received as much foreign investment as expected, if it is to become more attractive to foreign investors in the future, Turkey must provide financial statements that meet international standards.

162. The solution is to apply IAS in order to determine the real profitability of companies which will benefit all stakeholders in the long run. It is important that accounting standards in Turkey be fully consistent with international standards. Maintaining separate Turkish standards will slow firms' access to international markets. While Turkish banks were required to adopt IAS for 2002, the Capital Markets Board should apply these standards to all listed companies, including unlisted subsidiaries and affiliates of major groups. A number of groups have on their own moved to IAS and to audits based on generally accepted accounting principles, primarily to raise funds in international capital markets. In addition, reporting should be required on a consolidated basis for all groups. Disclosure rules are needed for all contingent liabilities between a holding company and its subsidiaries as well as collateral (such as shares of the subsidiary) given to banks for loans or guarantees provided by the parent for subsidiaries or

[6] This discussion on accounting standards is based in part on a Deloitte and Touche report. The Bank's recent Study on Non-Bank Financial Institutions and Capital Markets in Turkey (April 2003) also discusses the accounting standards issue.

cross-guarantees from one subsidiary to another. During Korea's recent crisis, a web of guarantees left many chaebols in trouble. The chaebols were unable to detach good assets (subsidiaries and affiliates) from bad because of the cross-guarantees from subsidiaries and affiliates to other subsidiaries and affiliates. Implementing IAS 29 in Turkey will enable banks and capital markets to analyze the financial situation of holding companies and their subsidiaries. An Accounting and Auditing Standards Board should be established to provide the leadership and incentives needed to rapidly expand the use of these standards. IAS may not be suitable for all types of companies. For example, small and medium-size unlisted companies may not need financial statements prepared according to these standards. However, companies interested in raising capital from foreign sources must prepare financial statements based on IAS.

163. The Capital Markets Board has taken a major step with its new consolidation standards applicable starting from 2003. Previously, Turkish accounting standards did not require consolidation, except for a requirement that banks prepare, in addition to their main annual financial statements (which are unconsolidated), financial statements consolidating their financial sector participations. The lack of consolidation has been a serious weakness considering that large parts of Turkish industry are controlled by holding companies. The financial statements of these holding companies show only the dividend income from subsidiaries. Transactions among group companies often distort the reported profits and assets of individual companies. Consolidated reporting will correct for such transactions. International Accounting Standard 28 requires the equity method of accounting for associated companies (normally those with a shareholding of 20-50 percent). Under the equity method, the reporting company includes in its income statement its share of the profit or loss of its associated companies and adjusts the carrying value of its investment in each associated company to reflect changes in each company's net assets. Until the new Capital Markets Board standards came into effect, equity accounting was not required by any Turkish standard except in the financial statements of banks consolidating their financial sector participation.

164. The lack of inflation accounting has traditionally been a problem in Turkey which distorts the financial statements of businesses in fundamental ways. First, reported profitability may not be "real" for several reasons. If the real value of receivables erodes during the period up to collection, companies will charge higher prices to compensate for the delay in collection. High prices inflate reported gross margins, but losses from the erosion of receivables during the credit period do not appear in financial statements. The amount can be significant when credit periods are long. Payables erode in the same way, but receivables are often larger than payables. Reported profitability and gross margins are overstated because the goods sold were based on inputs purchased earlier, when prices were lower. Second, the real value of fixed assets—especially land—becomes much higher than the book value. Similarly, the current value of stocks is often higher than the purchase cost. Finally, if interest rates are very high but a large part of the interest compensates for an erosion of the principal, companies with borrowings may report profitability below real levels. Financial statements prepared in Turkey ignore all these problems except for the annual revaluation of tangible fixed assets and conversion of revaluation reserves to share capital. Compulsory standards for inflation accounting have been issued by the Capital Markets Board and they have become a requirement for the listed companies starting in 2003. Draft legislation on inflation accounting has also been prepared by GDR to address taxation related issues. At the same time, if disinflation progresses in line with the program targets, then the situation will improve automatically.

165. There are other obstacles to understanding the real position and financial performance of Turkish businesses. These include the lack of publicly available information, which can only be solved with changes in legislation, and a widespread belief that many transactions are not recorded in financial statements for tax evasion purposes. Although there is little research on the second problem, it is thought to affect mainly small and medium-size enterprises.

Enhancing Corporate Governance

166. Internationally, there is growing recognition that strong corporate governance standards are important in establishing an attractive environment for long-term institutional investors. The Commercial Code provides the legal framework for corporate governance in Turkey, focusing on the duties and obligations of directors and protection of minority shareholders. In addition, listed companies must comply with Capital Markets Board requirements on disclosure, independent audits, and stronger minority shareholder rights. Apart from these laws, there is no separate corporate governance code in Turkey. The Capital Markets Board should consider adopting a Corporate Governance Code that incorporates principles of transparency and disclosure and that requires timely, accurate information along with enhanced protection of minority shareholder rights. In addition, an institute should be established to train independent directors for seats on the boards of listed companies.

167. Corporate governance should follow a few basic principles. Boards should operate independently from management with a clear fiduciary mandate to oversee company performance and make policy decisions on such crucial issues as reorganization, sales of substantial assets, mergers with or acquisitions of other companies, efforts to borrow or raise capital, and adoption of corporate strategies. Increasingly, good practice principles of corporate governance require that a substantial portion of board members be independent—that is, not management. It is important to foster responsibility for performance and protect the decision-making power of top managers, as well as the fiduciary and oversight responsibilities of the board. To this end, the roles and decision making responsibilities for execution (management) and supervision/policymaking (the board) should be separated. In Turkish businesses, board and management positions are usually filled by the same individuals making for less effective overall governance. All shareholders, including foreign and minority shareholders, should have equal voting rights and transparent, enforceable rights in the case of significant corporate events such as dividends, mergers, acquisitions, liquidation, and bankruptcy. The Turkish Commercial Code does not provide sufficient voting equality and minority shareholder rights. Each share does not necessarily have only one vote; multiple voting powers are allowed. Minority shareholder rights are infringed on in three main areas: dividends policy, voting rights (that is, blocking rights) for key corporate events, and treatment in cases of bankruptcy or liquidation. Finally, as noted above, corporate activities and performance should be reported and disclosed in a clear, understandable, consistent way based on IAS. Transparency should also be required for entire holdings. Hence requirements for consolidating and disclosing financial results should be imposed on listed holding companies as well as private ones that have listed subsidiaries.

CHAPTER 5: SOCIAL POLICIES - THE IMPACT OF THE CRISIS AND LABOR MARKET MEASURES TOWARDS THE GROWTH[1]

1 INTRODUCTION

168. This chapter evaluates the evidence on the social costs of crisis in Turkey and then addresses labor policy measures to sustain economic recovery and growth—the principle theme of this CEM. The three year period between 1999 and 2001 was a tumultuous one for Turkey: There was a financial crisis, drought and the Marmara earthquake in 1999. Although the economy began to recover in 2000, a banking crisis hit towards the end of the year followed by the full-fledged economic crisis of 2001. The evidence suggests that the cumulative social impact of the crisis is likely to have been high. Unemployment has increased and real wages have fallen sharply. As might be expected, the impact on poverty rates has been marked. The urban poverty rate is estimated to have almost tripled between 1994 and 2001. Coping strategies by affected households have included migration, reduction of expenditures on food, education and health.

169. Turning the focus to labor market measures that might generate jobs, three issues that potentially affect the demand for labor are considered: labor laws; wages and productivity; and active labor market policies. The review of labor laws and a comparison with OECD countries finds that Turkey's labor laws are the strictest in the OECD in terms of employment protection. Of particular note are Turkey's severance pay requirements which are higher than any other country except Portugal, and the restrictions on use of temporary workers. These laws are meant to protect workers from exploitation and business cycle fluctuations. For most workers, the laws may have the paradoxical effect of increasing the insecurity faced by workers as employers avoid paying severance all together and hire short term workers illegally. Relatively low real wages in manufacturing has meant that Turkish labor is competitive with a selection of other countries, as wages are low enough to compensate for the higher productivity. The review of international experience with active labor market policies suggest that these can have limited impact on job creation but there are lessons for program design. The Unemployment Insurance Scheme introduced in August 1999 has had a promising start but now that it is established, the redundancy with the mandated severance pay is marked. An important 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.

[1] Assessments in this chapter are based on the former Labor Law (No.1475). To improve the flexibility of labor markets, Parliament enacted a new Labor Law (No. 4587)on May 22, 2003. The new law aims to increase job creation in the economy, and it allows for differentiation of labor contracts by introducing provisions for part-time and temporary employment. The new law also improves workers' rights, including through requiring employers to prove that the termination employment is based on a valid reason as set forth in the law. The new law will be fully analyzed as part of the on-going Labor Market Study.

The Social Impact of the Crisis

170. The crisis conditions have led to higher unemployment and lower real wages[2]. Between 1998 and 2001, real per capita GNP fell by 14 percent, with a particularly deep recession in 2001 before recovering in 2002. However, the unemployment rate actually increased in 2002 to 10.6 percent despite the growth in output. The pattern of employment has also changed. Between 1981 and 1987, employment in industry remained flat, while construction and services generated growth (World Bank (2000)). Between 1998 and 2002, in contrast, employment in industry including manufacturing actually rose, while employment in construction and services fell (Table 5.1). This is consistent with the argument in Uygur (2002) that Turkey experienced a real estate bubble, particularly a residential real estate bubble, starting in the late 1980s that began to deflate in the second half of the 1990s and burst after the financial crisis of 2000-2001. Also to be noted is the sharp fall in agricultural employment. Agricultural employment peaked in 1999, but then fell. Since a large part of employment in agriculture is on family-owned farms it is not typical for there to be lay-offs in the same manner as in urban employment. So the fall in agricultural employment is likely to have come from increased migration to urban areas. Since the urban sectors that typically first absorb rural labor, construction and services, were themselves in a downturn, recent migrants are not likely to have found work easily.

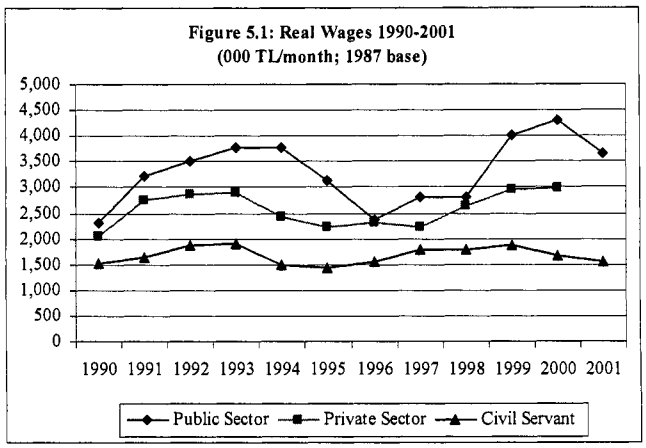
Table 5.1: Employment Indicators (1998-2001)

	1998	1999	2000	2001	2002
GNP per capita (constant 1987, TL)	1,831,010	1,690,131	1,767,187	1,572,820	1,668,421
Unemployment rate	6.4	7.1	6.6	8.5	10.6
Employment, total (in thousands)	20,872	21,414	20,579	20,367	20,287
Employment in agriculture	8,461	8,872	7,103	7,217	6,745
Employment in industry	3,338	3,440	3,738	3,734	3,888
Employment in manufacturing	3,088	3,386	3,570	3,548	3,675
Employment in construction	1,290	1,294	1,313	1,073	931
Employment in services	7,783	7,808	8,425	8,343	8,723
Public Employment (in thousands)	2,952	2,884	3,002	3,061	3,084
Inflation, consumer prices (annual %)	84.6	64.9	54.9	54.4	45.0

Source: SIS, Staff calculations

[2] This review of the impact of the crisis is based upon a recent World Bank Study, "Turkey: Poverty and Coping After the Crisis", 2003.

171. While the unemployment rate has increased, perhaps even more widely felt has been the fall in real wages. For public sector workers real wages fell by 14 percent in 2001, and for civil servants real wages fell by 9 percent. Figure 5.1 shows how for the last decade real wages in Turkey have tracked economic crises in 1994-95 and again in 2000-01. Real wages were increasing quite sharply till the financial crisis of 1994-95 when they fell precipitously. Real wages then started rising again as the economy began to recover, rising very sharply in 1998 and 1999. Following the financial crises of 2000-2001, real wages fell in 2001. Real wages for public sector workers are still close to the all time peaks of 1993 and 1994, although they are likely to fall again in 2002. Real wages for civil servants have tended to be less volatile. Also worth noting are the levels: on average, wages for public sector employees have tended to be higher than wages for private sector employees which in turn are higher than for civil servants.



Source: SIS

172. As might be expected, the impact of crisis on the poor has been quite severe. The impact on poverty rates is most directly observed through household survey data. Such data are available from a 1994 household income and expenditure survey carried out by the State Institute for Statistics and the 2001 household consumption and income survey conducted by Turkish researchers with World Bank support. The surveys are not easily comparable because of differences in methodology and coverage but do they provide an indication of the change in living standards between 1994 and 2001. In 1994, for the country as whole (that is, urban and rural), 7.3 percent of the population had expenditures below the poverty line, 8.5 percent in rural areas and 6.2 percent in urban areas. In 2001, the urban poverty rate had jumped to 17.2 percent. It is difficult to assess the impact on rural poverty in 2001 because of difficulties in comparing the data, and the estimate for urban areas should be treated as an upper limit. Nevertheless, it seems quite clear that there was a sharp increase in poverty. Many households were forced to reduce food consumption during the crisis. More than three-fifths of the urban households reported cutting down on food consumption according to the 2001 survey as did nearly three fourths of rural households. Thirty five percent of urban households and 44 percent of rural households reported spending less on health and education.

173. Poverty in Turkey is most closely linked to where one lives. The Southeast accounted for less than 7 percent of the urban population but 25 percent of the poverty. This region has been the major source of migration to urban areas, but much of this migration is to the Marmara region rather than to the urban areas within the Southeast. Households with children were also associated with urban poverty, particularly households having more than one child. Households with elderly dependents or a female head were not more likely to be poor than the general population. Low levels of education and not having a job were both associated with poverty but not by as much as living in the Southeast or having children in the household. Those with a university education are very unlikely to be poor. Urban households whose head had only a

primary education had a poverty of 25.9 percent compared to the average of 17.2 percent. The poverty rate for households whose heads reported themselves as unemployed was 30.6 percent, but only 7 percent of the urban population reported their heads as unemployed. While a comparison of the correlates of poverty in 1994 and 2001 was not possible for this study, it seems unlikely that these correlates have changed significantly. Traditionally, one of the most visible means that poor households in Turkey use to improve their livelihood is to migrate to urban areas. The major cities, Istanbul, Ankara and Izmir have grown dramatically, although there was some anecdotal evidence of reverse migration in 2001.

Labor Market Measures for Job Creation

174. Over the medium term, a private sector that generates well-paid jobs will be the key to improving livelihoods in Turkey. The rest of this chapter focuses on the other side of the equation – labor market measures to generate private sector jobs. Some very important measures for job creation that do involve the labor market are discussed elsewhere in this Memorandum, including restoration of macroeconomic stability, a sound financial system and a well functioning corporate sector. The focus in the remainder of this chapter is on possible measures in the labor market for job creation through labor laws, labor costs and active labor market policies.

175. **Labor market characteristics.** A striking 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 (Figure 5.2). In 2001, of the roughly 46 million adults, only 22 million were in the labor force and of these, 20 million were employed. Half the adult population, (conventionally defined as the population above 15) was not employed and not looking for work. This is largely because women are not in the labor force. What appears to be happening (World Bank (2000)), is that as Turkey urbanizes, women in rural areas are finding that there are not many wage earning opportunities, particularly for those with low education. They are thus choosing to stay at home. Other possible explanations for the falling labor force participation include discouraged workers dropping out of the labor force and undercounting of workers in a growing informal sector.

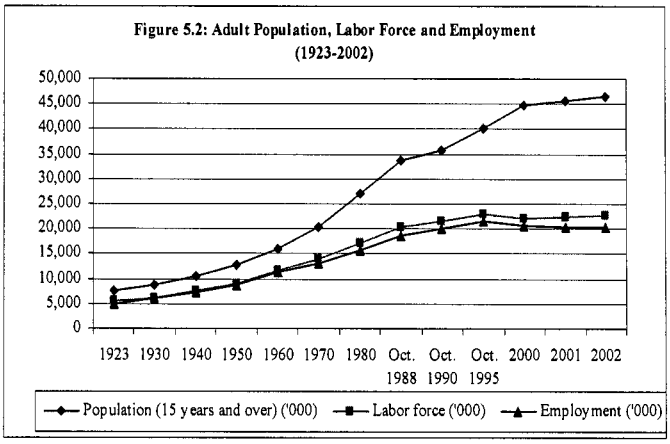


Figure 5.2: Adult Population, Labor Force and Employment (1923-2002)

Source: SIS

176. An earlier World Bank report, "Turkey: Economic Reforms, Living Standards and Social Welfare Study" completed in 2000 included a chapter on labor market issues in Turkey. The report drew on several background papers[3] and explored why the labor market seemed to under-perform in absorbing new entrants and generating employment. Two broad possibilities were investigated: (i) that the growth rate in the economy had been low and (ii) that the pattern of growth has not been labor absorbing. The finding was that both of these factors had contributed to the limited absorption of labor which suggested that policy should be aimed at the barriers to growth as well as the biases in the pattern of growth and constraints to labor demand. While not a study on the constraints to growth per se, the report pointed to the low investment rate in tradeable sectors and low rates of productivity growth as major constraints on growth. Value added per worker, a measure of productivity, was also low relative to Spain and Korea during their growth spurts. Productivity in agriculture was negative for 1975-1990 which held back overall growth and was a contributor to the growing inequality between regions.

177. On the question of why growth had not led to more labor absorption, the report noted that while services (and in particular construction) and industry had both experienced growth, the growth had led to productivity gains in industry and to employment growth in services. The report documented relative wage movements as a possible explanation. A series of wage hikes led to a sharp increase in wages in manufacturing starting from 1988 until the currency crisis in 1995, far outstripping value added per worker, and relative wages were increasing in tradeables (mining, manufacturing, energy and transport) relative to non-tradeables (including construction and trade). Econometric evidence from a panel of manufacturing industries found that the elasticity of employment with respect to wages is indeed negative so that increases in wages will lower employment, but that the elasticity was low. However, even with low elasticity, the magnitude of the increase in labor costs was suggested as a factor in the low labor absorption in industry.

178. **Labor law.** Work is such an important part of well-being that in every economy that the labor market is always more regulated than other markets. Regulation is often classified into two broad types[4]. The first is statutory regulation which refers to the laws and decrees that define the legal framework such as legislation governing the hiring and firing of workers, occupational health regulations, minimum wage or non-wage benefits, or the right to unionize. The second type of regulation, collective voice, results from negotiations between labor represented collectively and employers who are also sometimes represented collectively. All economies use both kinds of regulations although countries with an Anglo-Saxon heritage of common law tradition such as the UK and US tend to rely less on statutory law than countries with a civil law tradition such as France and Spain. Turkey tends towards the latter group (Sural (2001)). What actually happens in practice between employer and worker is context specific. Labor laws may not be followed in all instances. Union density may be low and/or bargaining agreements may extend to non-unionized labor (Betcherman et al (2001), Flanagan (1999)).

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[3] The background papers on labor markets were by Erol Taymaz (Trade Liberalization and Employment Generation: the experience of Turkey in the 1980s); Hakan Ercan (The Structure of Turkish Labor Markets: 1988-2025); Alpay Filiztekin (Convergence Across Turkish Provinces and Sectoral Dynamics) and Marnia Lazreg (Rural to Urban Migrant Women's Participation in the Labor Force)

[4] See Betcherman, Luinstra and Ogawa (2001) for a very useful review.

179. Labor law is customarily divided into individual and collective labor law. The first law on unions was enacted in 1947, collective bargaining is currently governed by the Unions Law passed in 1983. Individual labor law governs relations between employers and individual workers. In Turkey[5], this is provided by the Labor Act of 1971. It regulates the formation, form, types, content, and termination of labor contracts, and the reciprocal rights and duties of the worker and employer, and the settlement of individual labor disputes. Two aspects of labor market regulation might be considered especially important for labor market outcomes: employment protection and wage determination. Some of the critical features of Turkish labor law are presented below:

- Temporary employment is defined as employment that will be continue for at most thirty working days due to its nature, and is subject to the Code of Obligations rather than the Labor Act. Employment contracts necessitating employment for more than thirty days are regarded as permanent. The minimum age for employment is 15 years except for heavy and hazardous work in which case it is 18 years. The statutory working week is 45 hours and overtime is compensated at one and half times the normal hourly rate. Discrimination is prohibited based on the principle of equal pay for equal work for wage determination.

- Employment protection is provided through the provisions of the Labor Act that deal with termination of employment. An employer can dismiss a worker either by giving a term of notice or for a just cause. With the term of notice, no reason needs to be given and the length of the notice required depends on the length of employment. Just causes are classified under reasons of health; misconduct or improper behavior by the worker; or force majeure (if the worker simply does not report to work for a week).

- Unless the worker is dismissed for reasons of misconduct or improper behavior, severance compensation is due to the dismissed worker who have been employed for at least a year. Severance compensation is equal to thirty day's pay for each year's service although the thirty day period may be increased through labor contracts or collective bargaining. There is however a ceiling on severance compensation which is equal to the amount of the retirement bonus accruing to the highest ranking official subject to the Civil Servants Act. To protect against abusive or discriminative dismissal or for union activities, a worker who can prove that dismissal was for one of these categories is eligible for bad-faith compensation amounting to triple the notice compensation or for unionism compensation for which the minimum amount has been set at the basic annual wage.

180. The rules can be expected to have a significant impact on labor market outcomes. For example, employment protection rules are meant to enhance job security by making dismissal costly to the employer. One result should be to stabilize employment levels, all else being equal, reducing layoffs in downturns but also reducing hiring as the economy recovers. There may also be the unintended consequence of shifting labor demand to the informal sector or employment types. Betcherman et al (2001) suggest that over the last decade, OECD employment protection rules have remained rather stable, while these have been scaled back in Latin America. The US is regarded as having the least restrictive laws on employment protection.

[5] The description of Turkish labor law is based on Sural (2001).

181. Although it is intrinsically difficult to compare employment protection across countries, perhaps the most comprehensive effort has been made by OECD and presented in OECD (1999). The strictness of employment protection is measured along three dimensions: regular employment, temporary employment and collective dismissals. These are then combined into overall measures of the strictness of employment protection legislation (see Table 5.2). Version 1 of the overall measure does not incorporate the indicators on collective dismissal to allow comparability with data from the 1980s. Version 2 does include the indicators on collective dismissal and is thus the more comprehensive measure.

Table 5.2: Summary Indicators of the Strictness of Employment Protection Legislation

	Regular employment		Temporary employment		Collective dismissals	Overall EPL strictness [a] Version 1				Version 2	
	Late 1980s	Late 1990s	Late 1980s	Late 1990s	Late 1990s	Late 1980s		Late 1990s		Late	1990s
Central and Western Europe											
Austria	2.6	2.6	1.8	1.8	3.3	2.2	(8)	2.2	(15)	2.3	(15)
Belgium	1.5	1.5	4.6	2.8	4.1	3.1	(13)	2.1	(13)	2.5	(16)
France	2.3	2.3	3.1	3.6	2.1	2.7	(10)	3.0	(21)	2.8	(21)
Germany	2.7	2.8	3.8	2.3	3.1	3.2	(14)	2.5	(18)	2.6	(20)
Ireland	1.6	1.6	0.3	0.3	2.1	0.9	(4)	0.9	(4)	1.1	(5)
Netherlands	3.1	3.1	2.4	1.2	2.8	2.7	(11)	2.1	(14)	2.2	(13)
Switzerland	1.2	1.2	0.9	0.9	3.9	1.0	(6)	1.0	(6)	1.5	(7)
United Kingdom	0.8	0.8	0.3	0.3	2.9	0.5	(2)	0.5	(2)	0.9	(2)
Southern Europe											
Greece	2.5	2.4	4.8	4.8	3.3	3.6	(16)	3.6	(24)	3.5	(24)
Italy	2.8	2.8	5.4	3.8	4.1	4.1	(18)	3.3	(23)	3.4	(23)
Portugal	4.8	4.3	3.4	3.0	3.6	4.1	(19)	3.7	(25)	3.7	(26)
Spain	3.9	2.6	3.5	3.5	3.1	3.7	(17)	3.1	(22)	3.1	(22)
Turkey	..	2.6	..	4.9	2.4	..		3.8	(26)	3.5	(25)
Nordic countries											
Denmark	1.6	1.6	2.6	0.9	3.1	2.1	(7)	1.2	(8)	1.5	(8)
Finland	2.7	2.1	1.9	1.9	2.4	2.3	(9)	2.0	(12)	2.1	(11)
Norway	2.4	2.4	3.5	2.8	2.8	3.0	(12)	2.6	(19)	2.6	(19)
Sweden	2.8	2.8	4.1	1.6	4.5	3.5	(15)	2.2	(16)	2.6	(18)
Transition economies											
Czech Republic	..	2.8	..	0.5	4.3	..		1.7	(11)	2.1	(12)
Hungary	..	2.1	..	0.6	3.4	..		1.4	(9)	1.7	(9)
Poland	..	2.2	..	1.0	3.9	..		1.6	(10)	2.0	(10)
North America											
Canada	0.9	0.9	0.3	0.3	3.4	0.6	(3)	0.6	(3)	1.1	(4)
Mexico . .		2.3	..	..	3.8			..			
United States	0.2	0.2	0.3	0.3	2.9	0.2	(1)	0.2	(1)	0.7	(1)
Asia and Oceania											
Australia	1.0	1.0	0.9	0.9	2.6	0.9	(5)	0.9	(5)	1.2	(6)
Japan	2.7	2.7	..	2.1	1.5	..		2.4	(17)	2.3	(14)
Korea	..	3.2	..	2.1	1.9	..		2.6	(20)	2.5	(17)
New Zealand	..	1.7	..	0.4	0.4	.		1.0	(7)	0.9	(3)

..Data not available.
a) Figures in brackets show country rankings. All rankings increase with the strictness of employment protection.
Source: OECD (1999) Employment Outlook

182. Looking at the country rankings, Turkey is rated as having the strictest employment protection legislation of the 26 countries for which data are available under version 1 and second only to Portugal by version 2. The regional pattern is striking, the 5 countries listed in Southern Europe have the strictest employment protection legislation of all the countries listed by both measures. An extension of the OECD measures to Central and Eastern European countries (Riboud, Sanchez-Paramo and Silva-Jauregui (2002)) suggests that most of these countries fall in the middle of the OECD scale, implying that Turkey's legislation is stricter than in these countries as well. On examining the breakdown, Turkey's employment protection legislation is ranked 19th out of 27 (only 8 countries were stricter) on employment protection for regular employment. Turkey is rated as the strictest country of all on regulation of temporary

employment, and has relaxed regulation of collective dismissal (relative to individual dismissal) with only 5 countries have lighter regulation on collective dismissal.

183. What is driving these overall results? On regulation of permanent workers Turkey's regulations are about average on procedural inconvenience (12 out of 27) or difficulty of dismissal (12 out of 27). The Job Security Act passed in August 2002 is likely to change this ranking and make Turkey's regulation on these issues more strict within the OECD. In terms of notice and severance pay required for no-fault individual dismissals, only Portugal is rated stricter. Turkey's severance pay regulations described earlier imply that a typical worker with 20 years tenure is entitled to 26 months severance pay. In fact, for public sector workers this may significantly understate the benefits received on termination. The World Bank has carried out detailed calculations of the payments to be received by 40,000 workers in 23 state-owned enterprises (SOEs) in Treasury's portfolio and 22 SOEs in the Privatization Administration portfolio. These calculations which include job loss compensation and notification payments besides the other statutory payments indicate that average payment to worker is equal to 36 months of net salary for workers in the Treasury portfolio and 38 months for workers in the Privatization Administration portfolio. This makes costs of dismissing workers almost prohibitively high.

184. On regulation of temporary workers, Turkey's regulations are rated very strict because fixed-term contracts are allowed only for objective reasons such as the task itself being of temporary duration. It is used mainly for seasonal and agricultural work. This is a particularly strict rating as only Greece and Turkey of the countries rated have such restrictive criteria for the use of temporary workers. Temporary work agencies are not allowed at all in Turkey, again with the exception of agricultural work. Here too, Greece and Turkey have the strictest regulation against temporary work agencies. Indeed, fixed term contracts and temporary work agencies are the areas where OECD countries have by and large moved to lighten the regulations. In the past, countries in Europe in particular allowed fixed term contracts only for objective or material reasons but most of them have moved to lift this requirement. Similarly, the general trend has been to liberalize the use of temporary work agencies.

185. For collective dismissals relative to individual dismissals, the OECD measured strictness by the number of workers at which the dismissals are deemed collective, the additional notification requirements, additional days involved and other special costs to employers. On all these measures, Turkey's regulations are not among the strictest relative to the comparator countries.

186. Turning to the empirical results of the international evidence on the impact of labor market regulation, the evidence on whether stricter regulation hampers job creation is mixed. Influential studies in Latin America (Heckman and Pages (2000)) and the OECD (Lazear (1990)) indicate that job security provisions do increase unemployment, although Blank and Freeman (1994) and Freeeman (1999) argue otherwise. The survey by Betcherman et al (2001) of the empirical literature suggests that stricter employment protection for permanent employees leads to lower labor turnover (less firings but also less hiring); longer average unemployment durations, lower labor force participation rates and positive employment effects for skilled prime age males, but lower employment for women, young people and less-skilled workers.

187. In sum, it appears that to create a more dynamic labor market with more employment in the formal sector particularly for women and the young, Turkey should reexamine the regulations on temporary workers as well as the severance pay and notice required for dismissal of permanent workers. This will weaken job protection for permanent workers but on both these dimensions, Turkey has some of the strictest protection in the OECD. The Labor Security Law approved by Parliament in August 2002 is likely to have made Turkey's regulation of regular workers (where Turkey ranked in the middle) more strict. As consideration is given to labor market reforms, attention should be paid to the unintended consequences of the existing regulatory framework. Labor regulation is meant to protect workers from exploitation, and from undue business cycle fluctuations. The evidence suggests that for a substantial majority of workers it does neither. As will be seen in the next section, real wages in Turkey have shown considerable flexibility. For the roughly 10 percent of the people who are employed in the public sector, job security is high. For those employed in large firms who obey the law, job security may also be high because the very high severance payments makes it expensive to fire workers.

188. For the majority of the work force, labor laws are reportedly disregarded through measures such as unregistered workers, firings of workers after 11 months just before they are eligible for severance pay and then rehiring, and misreporting of wages. In these cases the labor laws may actually increase insecurity by giving firms incentives to disregard them. Indeed, a survey carried out by the Foreign Investment Advisory Service (FIAS) finds that employers do not find labor laws to be a major constraint precisely because they often do not follow them. However, these laws may well be a factor hindering the entrance of foreign investors who typically do not have this choice.

189. **Jobs, productivity and labor costs.** The impact of wages on job creation is a complex interaction with multiple feedback loops. Two channels are analyzed here: (i) the impact of wages on macroeconomic stability and (ii) the impact of wages on competitiveness of Turkish firms. There are a multitude of studies which demonstrate the importance of macroeconomic stability to sustained growth and hence job creation. Wages can affect macroeconomic stability in at least two ways. The first is the role of public wages in determining the government deficit. The second is the role of wages in inflation.

190. Stabilizing the economy with reasonable inflation and interest rates requires a sustainable public deficit which in turn requires sustainable public expenditures. An analysis of public expenditure patterns in the Public Expenditure and Institutional Review (World Bank (2001)) found that, relative to OECD countries, Turkey stood out on two categories: interest payments, and wages and salaries. Public sector wages and salaries in Turkey amounted to 24 percent of central government spending in 1999. In the OECD only Portugal and Greece have higher shares allocated to wages, while in the other countries the shares range from a low of 2.9 percent in Australia to a high of 16 percent in France. The data on public employment in Table 5.3 suggest that, unsurprisingly, total employment is less flexible than wages. During the crisis period from 1999-2001, public employment was actually increasing. As the PEIR points out reducing the public wage bill to sustainable level should be addressed in the context of a comprehensive public sector reform process that strengthens institutions to deliver services. Such an approach should involve a functional review of government and be grounded in a broader civil service reform strategy, in addition to privatization and specific policies to address over-employment in the state enterprises. Turkey's public sector reform program, as presented in Chapter 2, is consistent with this approach. As yet, however, the program has not set an explicit target for public sector salaries or for reductions in the public wage bill.

Table 5.3: Public and Private Employment (1999-2002)

	1998	1999	2000	2001	2002
Rural					
Private	9,830	10,170	8,844	8,634	8,386
Public	742	658	722	780	822
Total	10,572	10,827	9,566	9,414	9,208
Urban					
Private	8.090	8,360	8,733	8,672	8,817
Public	2,210	2,227	2,280	2,281	2,262
Total	10,300	10,587	11,013	10,953	11,079
Total					
Private	17,920	18,530	17,577	17,306	17,203
Public	2,952	2,884	3,002	3,061	3,084
Grand Total	20,872	21,414	20,579	20,367	20,287

Source: SIS

191. The evidence is mixed on whether wages a major source of inflationary pressures in the Turkish economy. As can be seen in Figure 5.3, real wages, particularly for public sector workers, rose sharply immediately before the crises of 1994-95 and in 2000-01, and then fell immediately afterwards. This pattern was partially the consequence of having backward indexation in an institutional setting where wage setting is staggered, i.e., determined once or twice a year (Taylor (1998) provides an overview of the large literature). When inflation declines rapidly, wages are slow to adjust since they are set once or twice a year, and real wages rise; conversely, as inflation rises real wages fall. In 2000, the macroeconomic stabilization program envisaged a shift to forward indexation to the inflation target (World Bank 2001) but true forward indexation in private sector has not materialized and incomes policy has remained relatively weak under the program. Nevertheless, empirical analysis by the IMF Research Department suggests that inflation inertia has significantly decreased in Turkey IMF (2002)).

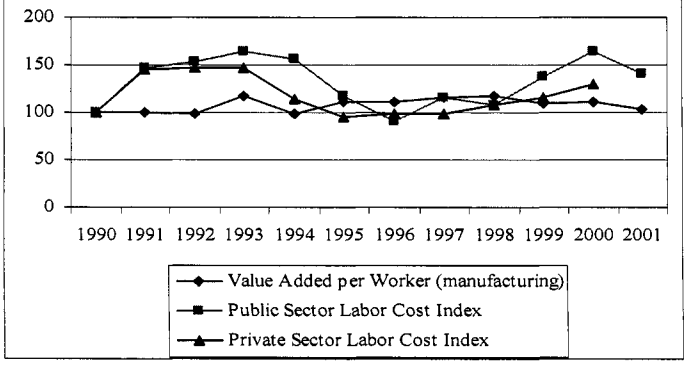
Table 5.4: Productivity and Wages in Selected Countries

	1980-85	1986-90	1991-1995	1996-2000	2001
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	3,290
Hungary		5,573	6,475	6,929	7,122
Korea	4,431	7,914	14,459	15,708	14,800
Mexico	3,069	2,354	4,340	4,104	5,414
Poland			4,114	5,948	7,005
Portugal	4,119	6,254	11,644	14,872	13,880
Spain	9,819	16,655	24,929	23,907	21,605
Value added/Labor cost					
Turkey	3.64	4.88	2.39	2.61	
Hungary			1.56	1.88	
Korea	2.14	2.03	2.24	2.72	
Poland			2.44	2.30	
Portugal			1.87	1.98	
Spain	2.34	2.49	2.40	2.39	
Employer's contribution to social security per worker ($)					
Turkey	384	735	2,227	1,754	
Hungary			1,731	1,857	
Korea	258	507	1,064	1,491	
Mexico		484	738	573	
Poland			1,166	1,598	
Portugal			3,148	3,379	
Spain	2,761	4,724	7,776	8,558	
Employer's contribution as percentage of labor cost					
Turkey	20	28	35	36	
Hungary			27	27	
Korea	6	6	7	9	
Mexico		21	17	14	
Poland			28	27	
Portugal			27	23	
Spain	28	28	31	36	

Source: OECD, team calculations

192. The impact of wages on competitiveness can be measured by looking at wages relative to productivity and also by comparing with other countries. Changes in labor costs should track changes in productivity over the long run. While long-run data on productivity are not readily available in Turkey, Figure 5.3 charts the evolution of labor costs and value added per worker in manufacturing, a proxy for productivity, between 1991 and 2001. Wages in both the private sector and public sector increased faster than value added prior to 1994, thereby reducing competitiveness and presumably labor demand—at least in manufacturing. Wages subsequently fell relative to value added between 1994 and 1996 and then rose again, particularly in the public sector. Despite falling in 2001, labor costs remained significantly above productivity levels from the 1990 base.

Figure 5.3: Indices of Value Added in Manufacturing and Real Labor Costs



Source: SIS

193. OECD data can be used to present international comparisons of labor costs (Table 5.4). These comparisons (in US Dollars) are indicative as the underlying data are collected by the national statistical agencies in slightly different manners and the data reflect exchange rate movements. Currently, labor productivity in Turkey is roughly comparable to Hungary and Poland, but well below the levels reached in Korea, Portugal or Spain. Labor costs are slightly below levels in Hungary, Poland and Mexico and well below Korea, Portugal and Spain. In terms of the ratio of value added to labor costs, the ratio in Turkey has declined from the very high levels seen in the 1980s, but labor is still competitive in Turkey compared to the other countries. These results are confirmed by the detailed background sectoral studies (textiles and clothing, and automotive sectors) carried out for this report.

194. **Active labor market policies.** Countries in the OECD have increasingly been implementing so called Active Labor Market Policies (ALMP) to assist job seekers to secure jobs. The genesis of these programs is traced back to the 1970s. Rising unemployment in Europe led to increasing concerns about the costs of the social safety net for the unemployed along with concerns that the safety net was creating incentives against job seeking and work. It was felt that a "trampoline" that assisted the unemployed to actually secure jobs was more appropriate than a safety net. Current terminology usually refers to safety net type programs as passive labor market policy and trampoline type programs as active labor market policy. Active labor market policies originated in Europe and most experience is still in the European countries. Typically active labor market programs are implemented side by side with existing safety net programs but ALMP are increasingly spreading through eastern Europe and Latin America where formal safety net programs are less prevalent. Active labor market programs[6] can include (i) job creation, (ii) training and (iii) employment programs programs to match workers and employers. These are described and design issues are briefly discussed below. Also described

[6] This review of active labor market polices draws heavily on Betcherman, Dar, Luinstra and Ogawa (2000)

is the now-significant empirical evidence on how the various programs have worked in practice. A large number of studies that evaluated labor market programs were reviewed by Dar and Tzannatos (1999) and summarized in Betcherman et al (2000).

195. *Job creation programs* fall into three broad categories. *Wage subsidies* are meant to encourage workers to hire new workers or to keep employees who might otherwise have been laid off. These subsidies are targeted to a particular category of worker or employer (examples include the long term unemployed, those coming from disadvantaged areas or youth) and can take the form of a direct wage subsidy or social security offset. The level and duration of the subsidy varies significantly between programs and countries. In the US, under the Targeted Job Tax Credit, firms are paid 50 percent of the individual's wages for a period of two years, while the UK job subsidy program provides up to 100 percent of wages for a period of six months. Monitoring employer behavior to prevent abuse is critical. A review of 22 evaluations of wage subsidy program in different countries found that these programs are susceptible to deadweight losses (program outcomes not being different that what would have happened without the program) and unintended effects such as subsidized workers replacing unsubsidized ones or employers hiring subsidized workers and laying them off once the subsidy period ends. While very few of the studies carried out a full cost benefit analysis, wage subsidies are unlikely to have positive economic returns.

196. The second category of job creation programs are *public works* where government either creates jobs directly or contracts with business or non-profits to provide jobs. Public works are typically targeted to the long term unemployed or the poor. They can lead to the creation of public infrastructure. The key design issue is the setting of the wage. The rule of thumb is that the wage should be equal to or less than the market wage for unskilled manual labor. This has the advantage of allowing self targeting. Only disadvantaged workers are likely to apply at these wages and restrictions on hiring can be avoided. Public works programs are among the most heavily funded in the OECD countries. Seventeen evaluations are available. These show that public works program can have desirable short term effects in raising employment, but they do not have a impact in terms of reducing long term unemployment. These are best used as a short-run anti-poverty intervention.

197. The third category of job creation is *micro enterprise development* which are seen as particularly useful in countries where banks are unable to conduct comprehensive risk assessments required to offer credit to unemployed workers who wish to start their own enterprises. Such programs are common in low income countries such as Bangladesh but have also been offered over the last twenty years in Massachusetts in the US, Denmark, Hungary and Poland. Experience suggests that good design characteristics include offering small amounts of initial credit with subsequent loans dependent on repayment record, use of market interest rates and use of groups lending rather than formal collateral. The 15 evaluations of micro enterprise development programs show high deadweight losses and failure rates for the assisted business: typically one-third to one-half of assisted businesses shut down in the first year of their operation. However, participants in the programs were more likely to be employed than control group participants. Little evidence is available on the cost-benefit of these programs.

198. *Labor market training programs* are usually aimed at retraining long term unemployed, retraining displaced workers especially when there are mass lay offs, and training young school

drop outs. Key design issues for these programs focus around finding the appropriate role for the government and linking these programs with employers. In Chile, for example, representatives of employers, employees and government sit on the governing board of vocational training institutes which has strengthened the ability of these institutes to respond to the needs of employers. Training programs typically account for a significant portion of expenditure on ALMP, typically between 40-60 percent, and it is not surprising that a large number of evaluations are available. 28 studies of training programs for the long term unemployed found that while these can have a positive impact, it is no more than the much cheaper job search assistance programs. They are more effective when the business cycle is expansionary. Tightly targeted on-the-job training for disadvantaged groups offered the best returns. Retraining programs for those laid off en masse (for example through large scale lay offs) show very small and statistically insignificant increases in employment possibilities, and often negative wage effects. Retraining for youth are rarely found to have an effect on employment probabilities or wages.

199. *Employment services' programs* seek to improve the functioning of the labor market by matching employers and employees. This assistance can include initial interviews at employment offices, in-depth counseling during the unemployment spell, job clubs etc. These kind of services are relatively inexpensive and can shorten unemployment spells. However, often the individuals who benefit most are the better-qualified, and thus are likely to have found jobs on their own. In many countries, private employment services have been established alongside public ones. These should be considered complementary rather than competitive. Private employment services charge fees and typically reach skilled segments of the work force while public services can target the most needy. Empirical evaluation of employment services programs found that these have often had positive effects, and is usually cost-effective relative to other ALMPs. Studies in Canada, Hungary, Netherlands and Poland suggest that these are more effective during economic expansions.

200. The particular mix of policies that is appropriate for each country is, of course, context specific. Policy makers have to consider the needs and priorities, institutional capacity and fiscal capacity in guiding their choices. In recent publications (OECD 2001, OECD 2002), OECD has been recommending that countries use a mix of all three kinds of programs, while noting that these are not panacea. Factors identified as important for success include availability of information on unemployed people and nationwide information on placements, effective management control mechanisms and supportive legislation. that are important for success. Turkey, after implementing the Unemployment Insurance Scheme described above, is now preparing to implement active labor market programs with the Ministry of Labor and the Turkish Employment Organization taking the lead.

Table 5.5: Overview of Active Labor Market Programs

Program	Appear to Help	Comments
1. Job-search assistance/ Emp. Services (19 evaluations)	Adult unemployed generally when economic conditions are improving; women may benefit more.	Relatively more cost-effective than other labor market interventions (e.g. training) – mainly due to the lower cost, youth do not benefit usually. Difficulty lies in deciding who needs help in order to minimize deadweight loss.
2. Training of long-term unemployed (28 evaluations)	Women and other disadvantaged groups generally when economy is improving.	No more effective than job-search assistance in increasing re-employment probabilities and post-intervention earnings and are 2-4 times more costly.
3. Retraining in the case of mass layoffs (12 evaluations)	Little positive impact - mainly when economy is doing better.	No more effective than job-search assistance and significantly more expensive. Rate of return on these programs usually negative. However, job search assistance may not be a direct substitute as it may cater to a different groups of the unemployed.
4. Training for youth (7 evaluations)	No positive impact.	Employment/earnings prospects not improved as a result of going through the training. Taking costs into account - the real rate of return of these programs is negative.
5. Employment/ Wage subsidies (22 evaluations)	Long-term unemployed in providing an entry into the labor force.	High deadweight and substitution effects. Impact analysis shows treatment group does not do well as compared to control. Sometimes used by firms as a permanent subsidy program.
6. Public Works Programs (17 evaluations)	Severely disadvantaged groups in providing temporary employment and a safety net.	Long-term employment prospects not helped: program participants are less likely to be employed in a normal job and earn less than do individuals in the control group. Not cost-effective if objective is to get people into gainful employment.
7. Micro-enterprise Development Programs (15 evaluations)	Relatively older groups, the more educated.	Very low take-up rate among unemployed. Significant failure rate of small businesses. High deadweight and displacement effects. High costs – cost-benefit analysis rarely conducted but sometime show costs to UI budget higher than for control group.

Source: Betcherman, Dar, Luinstra and Ogawa (2000)

201. An important leg of Turkey's passive labor market policy is the recently introduced Unemployment Insurance Scheme. The Unemployment Insurance Scheme was established in June 2000 and has enrolled approximately 4 million workers. Enrollment is compulsory for workers registered with SSK the social security system for private sector and state owned enterprises employees. 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 39,000 workers were receiving payments as of October 2002 because of the requirement that contributions have to be made for 600 days before workers can start receiving payments. The Turkish scheme is a type of compensation fund where the total unemployment benefit is a function of payments made by the worker [n.b this is to be confirmed]. These funds are becoming increasingly common in Latin America and have been introduced in Chile, Panama, Peru and Venezuela. Compensation funds are attractive because

they do not change the incentives for work which is a possibility with severance payments or traditional unemployment insurance schemes (Domelund and Gill (2002)). With the successful establishment of the Unemployment Insurance Scheme in Turkey there is now a redundancy with the mandated severance payments and the way is open to reduce or even phase out mandated severance payments. 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. The review should attempt to bring the fund into balance with an excess of contribution income over expenditure of not more than 15 percent.

CHAPTER 6: TURKEY'S EXTERNAL PROSPECTS IN A GLOBALIZING WORLD ECONOMY[1]

1 INTRODUCTION

202. Over the last twenty years, Turkey has become increasingly integrated into the world economy with imports and exports growing substantially as a share of GNP. There has been a diversification of the export mix towards manufactures exports and some change in the composition of export markets with the loss of Iraq as a significant trading partner after the Gulf war. This has been compensated by increased exports to the European Union, which remains Turkey's most significant market, and some gain in emerging Europe and Central Asia. The liberalization of trade policies that began in the 1980s, followed by the 1996 customs union with the EU and more recent free trade agreements with the central European countries, has been an important enabling factor in this good performance.

203. A forecasting exercise suggests that prospects for continued export growth are good under a scenario of economic reform. For the period through 2005, Turkey's export growth is expected to be around 9 percent on the average under the assumptions of Turkey's current strengths, recovery in the EU and more evenly balanced global growth. Goods exports are expected to be driven by growth in exports of automobiles and parts underpinned by increased FDI, a reorientation from existing plants to the export sector and aggressive capital expansion[2]. Electrical machinery and industrial equipment are also expected to grow strongly. Turkey's productivity advantage in textile apparel and clothing is above competitors, but the advantage is eroding. Competitive pressures are likely to restrain growth in the sector[3]. Tourism revenues are anticipated to grow at 12 percent per year. Finally, factor income receipts will be restrained by lower returns on holdings of overseas assets, but remittances should recovery strongly. The projected growth in exports is in line with performance in the second half of the 1990s.

204. An analysis of the sensitivity of the Turkish economy to external shocks emphasizes the importance of macroeconomic stabilization to sustained export-led recovery. While many countries have experienced volatility in income or the real exchange rate, Turkey has suffered exceptional volatility in both indicators. Volatility in GDP growth and the real exchange rate has been much higher than countries that went through crises such as Malaysia, Korea, Thailand and Mexico, only Indonesia and Russia saw comparable levels of volatility. The analysis suggests that the main sources of vulnerability are exchange rate shocks, interest rate shocks, slowdown in export markets and oil shocks. Interestingly, exposure to oil shocks has diminished over the 1990s with increased efficiency in energy use in Turkey and reduced importance of trade relations with Iraq. Slow recovery in the world economy—particularly delayed recovery in the EU, increased risk aversion of international investors, and the potential for post-war instability in Iraq are all significant external risk factors for the medium term. These risks highlight the importance of maintaining exchange rate competitiveness, containing import demand and attracting more foreign direct investment. A financial crisis usually improves competitiveness as

[1] This chapter draws from the background paper by Riordian, De Kleine, Suttle and Timmer (2002).
[2] Taskin (2002), a background paper for this Report, in "The Automotive Industry in Turkey: Overview of the Sector and Opportunities for Exports".
[3] Taymaz (2002), a background paper for this Report, in "Competitiveness of the Turkish Textile and Clothing Industries."

the nominal exchange rate collapses, but the tendency for the real rate to appreciate with the recovery should be watched closely. While a combination of fiscal and monetary tightness is required, the external analysis reinforces the importance of fiscal adjustment in order to lower domestic real interest rates and thereby ease pressure on the exchange rate.

205. Turkey must attract more foreign direct investment to promote competitiveness, ensure more stable capital inflows, and repay the large official debt coming due over the medium term. The experience of other countries such as Chile, Indonesia and Malaysia suggests that it is indeed possible attract FDI immediately after a financial crisis. Despite its large market size, skilled domestic labor, strategic location and competitive local firms as suppliers to multinationals Turkey has not been able to attract substantial FDI inflows. In addition to macroeconomic instability, factors inhibiting FDI have included political uncertainties, excessive bureaucracy, inadequate regulatory framework, and an opaque and unstable legal environment. Following significant analytical work with inputs from the private sector and the Foreign Investment Advisory Service (FIAS) of the World Bank, an FDI promotion strategy is being developed and implemented. A structured program to improve the investment environment was adopted by Government in December 2001. This program centers around a Coordination Committee (YOIKK) and technical committees to review and advise the Government on such areas as FDI regulation, company establishment, sectoral licenses, investment promotion and taxes and subsidies. 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.

2 BACKGROUND - ROBUST PERFORMANCE IN EXTERNAL BALANCE

Historical Developments

206. Turkey's integration in global trade and finance increased substantially over the past two decades with the establishment of a customs union with the European Union, diversification of the export product and market mix, and further opening of the capital account. External revenues are now generated from a highly diversified set of sources, notably with tourism, other emerging services exports and remittances accounting for almost one-half of earnings. Rapid growth in goods and services exports (11 percent over the decade and 12.5 percent during the latter half), has been a positive development for the country, as exports have come to contribute more-than 50 percent to GDP growth performance during the 1990s. Turkey's substantial gains in export market penetration in the industrial—as well as developing countries, finds the country well placed to benefit from increases in market over the next years. Turkey's current positioning within the international environment is the result of a long-term evolution of the country's integration into global trade and capital markets (Table 6.1). Several points stand out when viewing these developments.

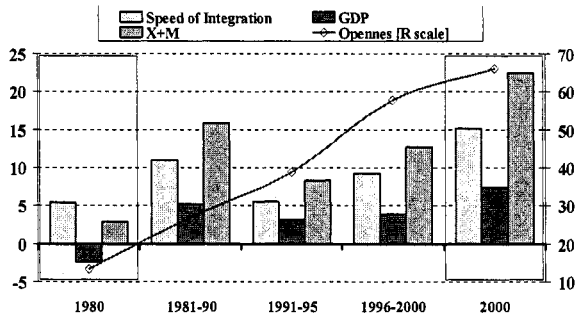
Table 6.1: Summary: Turkey's Links with the Global Economy, 1980-2000

Percentage points	1981-1990	1991-2000	1991-1995	1996-2000	2000
Trade in goods and services					
Openness ratio /a	**26.9**	**48.3**	**38.9**	**57.8**	**66.2**
Exports / GDP	12.7	21.9	17.5	26.2	29.5
Imports / GDP	14.3	26.4	21.4	31.5	36.6
Speed of integration /b	**11.0**	**7.3**	**5.5**	**9.2**	**15.2**
Export growth	19.7	10.8	9.0	12.5	19.2
Import growth	13.6	10.2	7.6	12.8	25.4
Manufactures share of exports	63.0	75.2	71.8	79.4	83.8
Intra-region trade (%) /c	**71.8**	**74.3**	**73.2**	**75.0**	**73.6**
EU-15	39.3	50.3	48.5	52.0	51.7
Europe & Central Asia	5.4	11.8	10.3	12.8	13.4
MENA region	27.0	12.2	14.3	10.2	8.5
Exports per capita /d	290	645	475	810	935
Terms of trade ch%	-0.3	-0.6	0.6	-2.0	-8.4
Finance and Debt					
Current balance /GDP (%)	-1.6	-1.1	-0.8	-1.5	-4.9
Private capital inflow /GDP (%)	2.3	3.6	2.2	5.3	8.2
FDI / Fixed investment (%)	0.12	0.19	0.20	0.18	0.22
EDT / GDP (%)	29.9	46.5	42.1	49.1	57.7
Variable interest share	32.0	42.3	34.0	45.7	46.8
Debt service / exports (%)	28.7	28.2	29.5	27.4	36.1

Source: World Bank.
Notes: /a Openness defined as the share in real GDP of exports and imports of goods and non-factor services.
/b Speed of integration measured as the growth of the sum of exports and imports (GNFS) less growth of GDP.
/c Share of Turkey's trade (X+M) with region 'i' / Total Turkish trade (X+M), in percent.
/d Exports (GNFS) per capita expressed in 1995 US dollars.

207. Openness—or the ratio of trade in goods and services to GDP—has risen impressively from 13 percent in 1980 to 66 percent by 2000, reflecting a pick-up in export share of 25 points and 27 point rise in import share of GDP (Figure 6.1). The evolution of Turkey's trade openness has been exceptionally favorable over the 1980s through 2000 (Figure 6.2). The *change* in share of trade to GDP since 1980 (about 53 points) finds close similarities with the performance of some of the stronger integrating countries, for example Mexico and Korea; has well outpaced that of the European Union as a group, as well as the aggregate of middle-income countries. Turkey's performance has narrowed the path to convergence in the *level* of openness with the European Union. Turkey's openness ratio (66 percent in 2000) contrasts with 74 percent for the EU, stands well above that of Latin American comparators as a group (42 percent), yet well below that of

Figure 6.1: Trade to GDP has risen by more than 50 percentage points

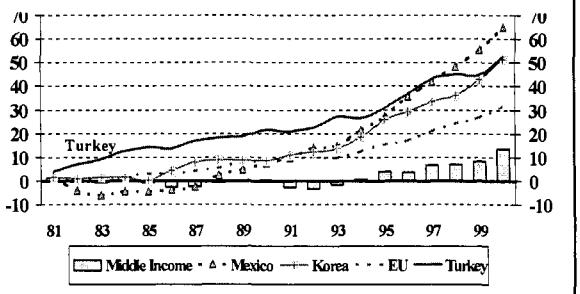


*Source: World Bank data, EPPG calculations. **Openness:** share in GDP of exports plus imports of goods and non-factor svcs. **Speed of Integration**: Trade growth less GDP growth.*

East Asian comparators (e.g. 95 percent for the region, Korea: 88 percent; Thailand 101 percent).

208. The pace at which the economy has opened to trade (or *speed of integration*) has varied over the last decades, with a large portion of the increase occurring during the 1980s, slower performance in the early 1990s, but a re-acceleration of trade with respect to output growth during the second half of the 1990s—and markedly during the global boom of 2000. Within the sample of comparators, Turkey's *speed of integration* during the second half of the 1990s (9.2 percentage points) ranks second only to Mexico's rapid rate of near 12 percent, spurred by NAFTA links (Figure 6.3). Among Latin American countries, Turkey's performance falls closer

Figure 6.2: Change in Turkey's openness* strong among comparators



*Source: World Bank data, EPPG calculations. * **Openness ratio**: share in GDP of exports plus imports of goods and non-factor svcs. **Change in pct points from 1980.***

Figure 6.3: "Speed of integration" bested only by Mexico over 1996-2000

*(*excess of trade growth over GDP growth)*

Source: National agencies; World Bank, Economic Policy and Prospects Group

to that of Chile in terms of degree of openness and to that of Mexico regarding the speed of integration over the 1990s. Among East Asian countries, Turkey is near par with Korea on both indices but still well below the extremely open economies of Malaysia and Thailand.

209. The *mix of export markets* has also shifted substantially over the 1980s to today. Turkey is well positioned geographically and culturally to trade intensively with three distinct markets—the European Union, Central Europe and the CIS (ECA), and the Middle East and North Africa (MENA) regions. Table 6.1 shows the persistence of western Europe as Turkey's principal export market, rising from 40 percent of Turkish trade during the 1980s to 50 percent during the 1990s. At the same time the importance of the MENA region has fallen sharply, in part due to U.N. sanctions upon Iraq, formerly Turkey's largest export market after Germany , and difficult economic conditions in the region tied to volatile oil markets and sporadic tensions. But a revitalization of trade with Central and Eastern Europe and the countries of the former Soviet Union is in evidence, reflecting stabilization and growth in this market following the initial years of transition. On balance, a measure of the strength of performance in Turkey's trade—*real exports per capita*—has risen three-fold from the average of the 1980s to 2000.

210. Services exports expanded rapidly at 12.7 percent per year during the early 1990s, but fell to half that pace of advance during the second half of the decade. Tourism revenues sustained healthy growth of 9 percent across the decade, while growth in arrivals fell somewhat during the second half (realizing an increase in tourism expenditure per visitor). However, volatility and decline has characterized several components of services revenues in recent years especially those related to construction. The earnings of Turkish engineering firms abroad declined by 11 percent per annum during the second half of the 1990s, due to reduced contract work in the CIS

and Middle East regions. This served to slow the advance of "other services" from a robust 15 percent pace in 1991-95 to 4.2 percent over 1996-2000. The growth of factor income receipts and transfers ratcheted higher during the latter 1990s, partly offsetting the slackening growth in other foreign revenue sources. Strong earnings growth associated with Turkish investment assets abroad—tied to the global boom in equity and fixed income markets of the mid-to-late 1990s—produced an income stream that amounted to some U$2.2 billion per year, double the US$1 billion level during the decade's first half. Worker remittances advanced by a strong 6.5

Table 6.2 Turkey: Current Account Balance
(US$ billion, 1990-2000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Trade Balance	-9.6	-7.3	-8.2	-14.2	-4.2	-13.2	-10.6	-15.4	-14.2	-10.4	-22.4
Merchandise exports, FOB	13.0	13.7	14.9	15.6	18.4	22.0	32.4	32.6	31.2	29.3	31.7
Merchandise imports, FOB	-22.6	-21.0	-23.1	-29.8	-22.6	-35.2	-43.0	-48.0	-45.4	-39.8	-54.0
Services Balance	2.4	2.5	3.2	4.0	3.8	6.4	3.7	7.9	10.5	3.9	7.3
Services, Credit	8.9	9.3	10.4	11.8	11.7	16.1	14.6	21.3	25.8	18.7	22.3
o/w Tourism	3.2	2.7	3.6	4.0	4.3	5.0	5.7	7.0	7.2	5.2	7.6
Services, Debit	-6.5	-6.8	-7.3	-7.8	-7.9	-9.7	-10.9	-13.4	-15.3	-14.8	-15.0
o/w Interest	-3.3	-3.4	-3.4	-3.6	-3.9	-4.3	-4.2	-4.6	-4.8	-5.5	-6.3
Transfer Balance	4.5	5.1	4.1	3.8	3.1	4.5	4.4	4.9	5.7	5.2	5.2
o/w Workers' remittances	3.2	2.8	3.0	2.9	2.6	3.3	3.5	4.2	5.4	4.5	4.6
Current Account Balance	-2.6	0.3	-1.0	-6.4	2.6	-2.3	-2.4	-2.6	2.0	-1.4	-9.8
Current Account Balance (% of GNP)	-1.1	0.2	-0.6	-3.6	2.0	-1.4	-1.3	-1.4	1.0	-0.7	-4.9

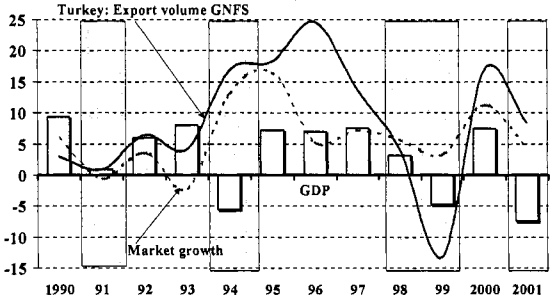
Source: Central Bank.

percent annually, reflecting fairly favorable conditions in the EU and high returns in Turkish financial markets. The average flow of remittances increased by US$1.5 billion between the first and second halves of the 1990s—from US$3 billion to US$4.5 billion. In contrast, flows of official current transfers dropped sharply over the course of the decade (Table 6.2)

211. Overall, Turkey's current account balance for the 1990s contrasts favorably with comparators. The average annual deficit of 1.1% of GDP) matches the outturn for middle-income countries. It represents a much less severe deficit than for Latin comparators, and is only moderately greater than that for the East Asian countries. Prior to the 2001 crisis, Turkey's external debt profile was fairly well positioned among comparators, although debt/GDP and debt servicing ratios well exceeded the average for the middle income group.

212. Trade policy has played an important role in boosting Turkey's trade integration and export performance. Important policies have included removal of quantitative restrictions on imports adopted during the 1980s; the 1996 customs union with the EU, and more recently FTAs accorded with Central European countries and a process of greater opening to countries of the Mediterranean region (EU-MED Initiative). Diversification of the *export mix* has also served Turkish integration well. Rapid market penetration in key products has brought about a dramatic shift toward manufactures exports, from 63 percent of total shipments during the 1980s to 84 percent by

Figure 6.4: Growth of Turkey's exports exceed the growth of the export market



Source: World Bank data and calculations.

2000, helping to boost overall export growth. Turkey's exceptional performance in trade integration has played a part in the longer term development of the country's key sources of foreign exchange revenue. Despite difficulties, the evolution has been a positive one, characterized by shifts in products and markets in goods trade; by diversification into services exports, and supported by continuing flows of private transfers from abroad. Turkey's revenues on current account now stem from a broad and fairly balanced set of sources Exports have become a key driver of economic growth as Turkey has opened its economy and increased market penetration (Figure 6.4).

Crisis and Recovery Since 2001

213. During 2001, the large devaluation assisted in propelling dollar-based goods exports to an advance of 11.3 percent (15.2 percent in volume) from growth of 8 percent in 2000. This performance occurred against a background of decline in global economic activity, a dramatic contraction of world trade growth and a 7 percentage point drop in the growth of Turkey's export (in volume terms). In effect, Turkey's export market penetration increased by some 11 percentage points, progress which will assist in underpinning export growth further as market activity recovers. Overall, Turkey recorded a current account surplus of 2.4% percent of GDP in 2001, compared to the deficit of 4.9% percent of GDP in 2000 which played a key role in undermining confidence in the exchange rate based disinflation program. For investors, the rapid correction in the current surplus has been an encouraging factor, although for the Turkish authorities and populace the associated recession and decline in import purchasing power was extremely painful. Strong export performance, buoyant tourism and renewed capital inflows—together with large IMF disbursements 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. Export growth has continued into the first half of 2003, its growth rate was 30 percent in dollar terms in the January-May 2003 period despite the impact of the Iraq war. However, the real exchange rate has rebounded strongly from its post-crisis lows, appreciating by some 25.5 percent from mid-2001 through June 2003. The strengthening Lira has not yet hurt export performance as it has been counterbalanced by a very sharp drop in real wages. Nevertheless, the widening current account deficit (now projected to reach 3.2 percent of GNP in 2003) is an emerging cause for concern, particularly as it is being accompanied by a return of short-term capital inflows.

3 GLOBAL OUTLOOK

214. Turkey's nascent recovery from the 2001 crisis takes place against a background of an uncertain firming of *global* growth. The year 2001 was characterized by sharp deceleration in economic activity and trade, affecting industrial and developing countries alike. World GDP growth fell from 3.9 percent in 2000 to 1.2 percent during 2001, while world trade collapsed from double-digit gains to a mere 0.4 percent growth. The recovery among the industrial countries, which commenced in late-2001 in the United States, followed by the Euro Area in early-2002, faltered in mid-2002, and quarterly real GDP growth in the major economies slowed from 2 percent in the first half of 2002 to 1 percent in the fourth quarter. The recovery in global

growth was tempered, among other factors, by corporate-sector adjustment, volatility in equity prices and both business and consumer uncertainty tied to concerns about the coming war in Iraq.

Early indicators suggest continued sluggishness continued into the first quarter of 2003, due to the impact of the war in Iraq and the SARS virus outbreak. As a consequence, the anticipated recovery in world trade volumes is expected to be delayed until the summer. The outlook for the year 2003 as a whole is for growth to be spurred by firming real fixed investment spending and improving confidence, as the more immediate uncertainties, such as Iraq and SARS are resolved. A high-tech led turnaround in manufacturing sectors in East Asia and the United States is anticipated to spread to Europe through trade links. Low interest rates should spur a revival of consumer durable demand and investment over the coming months and quarters leading to a stronger profile for global growth in 2003-05. World GDP is anticipated to expand at 2.3 percent during 2003 over 2002, coming to stabilize near longer-term rates above 3 percent during 2004-05 (Table 6.3).

Table 6.3: Global Conditions Affecting Growth in Developing Countries, 2001-2005
(percentage change, multi-year periods compound average, except LIBOR)

	Current Estimates		Current Forecasts		
	2001	2002	2003	2004	2005
World trade (volume)	**0.4**	**3.0**	**6.2**	**8.1**	**8.1**
Inflation (consumer prices)					
G-7 OECD countries[a/ b/]	1.5	1.0	1.4	1.3	1.3
United States	2.8	1.6	2.5	2.3	2.1
World GDP (growth)	**1.2**	**1.7**	**2.3**	**3.2**	**3.1**
Industrial countries	**0.8**	**1.4**	**1.9**	**2.9**	**2.6**
United States	0.3	2.4	2.5	3.5	3.0
Japan	0.3	-0.3	0.6	1.6	1.4
Euro Area	1.5	0.8	1.4	2.6	2.6
Developing countries	**2.8**	**3.1**	**4.0**	**4.7**	**4.8**
Turkey's export market growth**	**2.4**	**2.0**	**4.7**	**6.7**	**7.1**
EU-15 (52% of market)	1.1	-0.6	2.9	6.3	7.3
CEECs (6%)	1.6	5.4	8.3	8.0	7.7
CIS (9%)	7.5	7.6	8.0	8.3	7.4
MENA (14%)	9.6	4.8	4.9	4.8	5.0
United States (9%)	-3.6	4.0	6.9	7.8	7.0

Source: World Bank, Economic Policy and Prospects Group, baseline, *Global Development Finance-2003 with updates.*

Notes: a/ Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b/ In local currency, aggregated using 1995 GDP weights.
c/ Unit value index of manufactures exports from G-5 to developing countries, expressed in U.S. dollars.
** total export market growth is weighted sum of real import demand in Turkey's export markets.

215. Growth in the Euro Area, which represents the largest share of Turkey's export markets, is expected to recover slowly. Early indicators for the Euro Area during the first quarter of 2003 show industrial activity losing momentum. Economic confidence indicators (industrial, retail and consumer confidence) reached a six year low in March 2003. Euro Area growth is projected to be 1.4 percent gain in 2003, and is forecast to stabilize at 2.6 percent during 2004-05. After spiking to just over US$33 per barrel in early March, 2003, crude oil prices fell to below US$25 per barrel in April 2003, after it became clear that there would be limited disruption to oil supplies outside of Iraq as a result of the war. Oil prices are forecast to rise slightly in 2003 to an

average of US$26 per barrel for the year from just under US$25 per barrel in 2002, and then to decline sharply in 2004 to US$21 per barrel and further to US$20 per barrel in 2005 (World Bank average crude oil price in nominal terms). Declining oil prices will reduce the import bill for Turkey and help reduce inflationary pressures from pass-through effects. Capital flows to emerging markets declined in early 2003, reflecting the concern of foreign investors due to uncertainty in the lead-up to and during the Iraq war. Sentiment should improve now that major hostilities Iraqi have wound down and assuming related uncertainties are resolved. Given low industrial country yields, underpinned by increasing liquidity and lower risk aversion, the environment for capital flows to emerging markets appears conducive. Total world equity flows to emerging markets are forecast to firm moderately from an estimated US$152 billion in 2002 to US$158 billion in 2003.[4]

216. The crisis in neighboring Iraq and associated uncertainties created additional hurdles for Turkey's recovery. The buildup to war depressed domestic demand and tourism, in addition to dampening investor confidence worldwide. Although Turkey did not come to terms with the United States on a multiyear support package prior to the outbreak of hostilities, the resulting downward pressure on the Lira was limited and subsided fairly quickly, in part due to the fact that the Lira is considered to be close to purchasing power parity. Subsequently, the apparent resolution of the war, and the stability in northern Iraq, has mitigated some of the concerns of foreign investors. There is also the likelihood that Turkish exporters will benefit from the reconstruction effort in Iraq. Further improving investor confidence, the IMF's fourth review was completed in April, 2003. Nevertheless, foreign investors will continue to watch for deviations from the IMF supported policies in the coming reviews. The US Congress approved a US$75 billion war financing package, which includes a US$1 billion grant to Turkey (exchangeable for up to US$8.5 billion in loan guarantees). If disbursed, the grant will provide an additional boost to investor confidence.

217. The global recovery is coinciding with improved domestic conditions in Turkey in the wake of implementation of the crisis recovery program. Strengthening global production should support continuation of Turkey's recovery through its effects on export growth and the follow-through to favorable developments in industrial production, employment gains, and eventually to a firming of domestic and foreign investment. Challenges remain as the volatility and uncertainty that have characterized Turkey's economy may work against a full realization of opportunities in export markets. International financial markets continue to be highly risk averse, particularly in the wake of major sovereign default and corporate financial difficulties in the industrial countries, and, albeit apparently easing, political uncertainty in the neighboring Middle East. Overall balance of payments developments will require careful monitoring.

4 PROSPECTS FOR TURKEY'S EXTERNAL REVENUES, 2001-2005

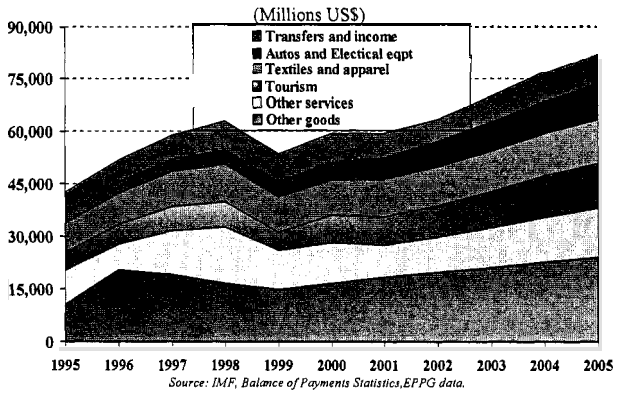
218. Prospects for Turkey's foreign exchange revenues, encompassing goods, services, transfers and income are encouraging for the period through 2005. Turkey's potential is much

[4] *Global Development Finance 2003: Striving for Stability in Development Finance*, The World Bank, 2003. http://www.worldbank.org/prospects/gdf2003/

greater than has been realized to date, given its positive endowments of labor, resources and physical location. Turkey has an opportunity to capitalize upon external strengths potentially leading to a strong rebound and sustainable economic expansion thereafter in which exports can play an important role. An indicative review and forecasting exercise for each of these revenue sources reveals both driving and restraining forces to growth. Turkey's traditional and emerging strengths in trade, combined with emergence of a more supportive external environment, should yield strong advances in export earnings over the forecast period (Table 6.4) under a scenario of continued reform[5].

219. Based on improvements in Turkey's export market and continued competitiveness of its exports, the growth of goods exports could reach 9 percent per annum over the 2001-05 period. Penetration of western European markets has been noteworthy, but demand for Turkish export products is growing more rapidly among the CEE/CIS group of countries (by four-fold over 1996-2000). Efforts to target that market effectively would help sustain rapid growth of exports. As for many countries, Turkey's exports can be segmented into emerging and diminishing sectors[6]. Among principal export products, the outlook for automotive and parts is most encouraging (Figure 6.5). The sector is anticipated to pace export growth over the medium term, driven by the current overcapacity and reorientation of output from existing plants to exports, together with expectations of aggressive capital expansion fueled by increased FDI and export plans of major multinational firms. Electrical machinery and related goods, largely household (TVs, white goods) and industrial equipment (distribution and circuits) are projected to continue their dynamic export potential, having advanced by 18 percent per year over the 1990s and continuing double-digit gains during 2000-01. Reorientation of agricultural, especially fruits (citrus) and fruit preparations shipments toward markets with increasing demand (CIS and MENA regions) could help to underpin growth in these products.

Figure 6.5: Turkey's revenues: expansion strongest in tourism and autos



[5] This indicative projection exercise is designed to give an idea of Turkey's medium-term foreign exchange earnings potential; it is not a forecast. The figures presented in Table 6.4 are broadly in line with, but not necessarily equal to, the underlying projections under sustained reform scenario presented elsewhere in the CEM.

[6] Among emerging sectors can be included: (i) automobiles and parts, domestic appliances and televisions; (ii) niche markets in textiles and apparel; (iii) potential growth in non-ferrous metal mining and export activity; (iv) niche markets in fruit and preserves; (v) construction and transport receipts tied to the Baku-Ceyhan pipeline; (vi) tourism—including alternatives to "sun and sand" package tours; and (vii) passenger transport services and professional and technical services. Among diminishing sectors can be included: (i) domestic production of cotton textile fabrics; (ii) simple apparel exports; and (iii) ferrous metal ores and fabricated products; selected iron and steel products.

Table 6.4: Turkey: Indicative Projections of Foreign Exchange Revenues, 2001-2005
Measured in U.S. dollars, shares and growth rates in percent /a

Millions U.S. dollars *Period averages*	2000	2001E	2002F	2003	2005	Growth 2000-01	Growth 2001-05
Merchandise Exports	**31,665**	**35,255**	**37,930**	**40,970**	**46,690**	**11.3**	**7.3**
Food and beverages	3,400	3,970	4,265	4,710	**5,570**	16.8	8.8
Agricultural Products	1,805	2,130	2,315	2,580	**3,110**	18.0	10.0
Manufactures	23,025	25,950	28,060	30,375	**34,630**	12.7	7.5
Textiles, apparel & clothing	10,205	10,615	11,068	11,600	**12,515**	4.0	4.2
Metals, minerals, mtl mfgrs	3,400	3,910	4,145	4,475	**5,120**	15.0	7.0
Automotive products	1,505	2,185	2,830	3,345	**4,170**	45.0	17.5
Electrical machinery/related	3,495	3,990	4,425	5,000	**6,075**	14.2	11.0
Other manufactures	4,420	5,250	5,590	5,950	**6,750**	18.7	6.5
Other goods	5,245	5,340	5,600	5,885	**6,490**	1.8	5.0
Services Exports	**19,485**	**17,210**	**19,200**	**21,785**	**26,920**	**-11.7**	**11.8**
Tourism [Travel]	7,636	8,090	9,060	10,350	**12,700**	6.0	12.0
Tourism arrivals 'ooo /b	9,586	10,775	11,745	12,870	**14,680**	12.4	8.0
Transport services	2,955	2,505	2,710	2,985	**3,530**	-15.2	9.0
Other services	8,895	6,610	7,430	8.450	**10,680**	-25.6	12.7
Construction services	1,032	1,150	1,195	1,260	**1,455**	11.6	6.0
Other Business	4,580	2,090	2,300	2,730	**3,560**	-54.3	14.2
Personal, Cultural	2,590	2,420	2,920	3,340	**4,375**	-6.6	16.0
Income and Transfers	**8,200**	**6,820**	**6,215**	**7,230**	**8,425**	**-16.8**	**8.3**
Factor income receipts	2,880	2,770	1,810	2,385	**2,860**	-3.8	0.8
Worker remittances	4,560	2,785	2,965	3,320	**3,925**	-39.0	9.0
Official transfers	305	275	420	440	**450**	-10.8	13.5
Current Acct Revenues	**59,345**	**59,280**	**63,350**	**69,985**	**82,035**	**-0.1**	**8.5**
Share of GDP	*29.8*	*38.4*	...	...	**...**	...	...
Memo items:							
Merchandise export volume ($bn)	35.5	40.6	47.0	51.2	**57.2**	14.2	9.0
Exports of GNFS (1995$ bn)	54.9	57.7	67.6	75.0	**86.2**	5.2	10.6
Real revenues (adj XGS price) $bn	63.7	65.2	75.0	83.6	**96.1**	2.5	10.2
Import PP of revenues /c	57.5	57.6	67.3	72.3	**80.3**	0.2	8.6
Population (mn)	65.3	66.2	67.1	68.0	**69.7**	1.4	1.3
Per-capita revenues ($)	910	895	945	1,030	**1,180**	-1.5	7.0
per-capita import PP	880	870	1,000	1,065	**1,150**	-1.2	7.3
Import deflator (GS, 95=100)	103.2	102.9	94.2	96.8	**102.2**	-0.3	-0.2
Export deflator (GS, 95=100)	93.2	90.9	84.5	83.7	**85.3**	-2.5	-1.6
Terms of trade (1995)	90.3	88.3	89.7	86.4	**83.5**	-2.2	-1.4

Source: IMF BoP statistics, UN COMTRADE database, Bank of Turkey/SIS, World Bank, World Tourism Organization and EPPG estimates.

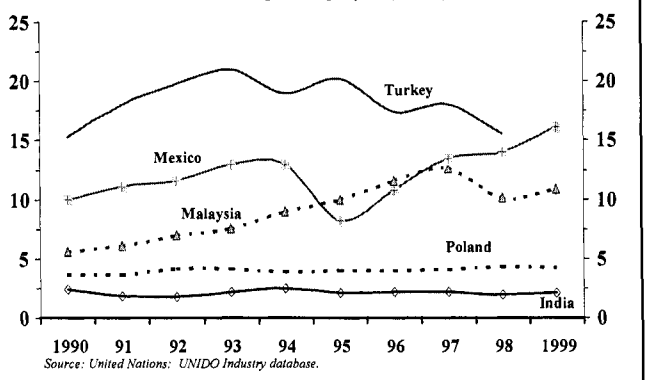
Notes: /a current U.S. dollars, compound average growth rates;
/b estimate of total tourism arrivals from World Tourism Organization;
/c total current account revenues deflated by the GNFS import deflator—a measure of capacity to import.
World Bank Projections.

220. Tourism carries strong multiplier links across broad sectors of the domestic economy, and serves as a driving force for transport services and other streams of revenues, trade-related and administrative. Increased marketing efforts are required in tourism—both to sustain "sun and sand" tourism against competitive pressures, and to diversify attractions by capitalizing further on Turkey's substantial historic, cultural and environmental endowments. This could help sustain a "year-long" tourism industry vis-à-vis the current five month period of activity concentrated in coastal provinces. Prospects for professional and technical services exports are

bright as these sectors increase in sophistication and demand resumes in the industrial countries for such services as communications, informatics and related services. Finally, factor income receipts will be restrained by lower returns on holdings of overseas assets, while remittances should re-establish stronger rates of advance over the medium term.

221. Turkey's level of productivity in textile apparel and clothing (TAC)—a key export sector—stands well above comparators, but that level is eroding. Growth in output per employee (in USD terms) has faltered since the mid-1990s, while it has risen rapidly in such countries as Mexico and Malaysia (Figure 6.6). Productivity in the TAC sector should be increased through restructuring and modernization in order to meet stiff competitive pressures. TAC exports to the EU market will continue to face an environment of intense and growing competition, increasingly from the Central and Eastern European countries, as well as the countries of the CIS and Asia, especially China. Central Europe has emerged as an alternative for EU production and, since July 2001, Mexico enjoys the same customs-free, quota free access to the EU market as Turkey. China, the world's largest TAC exporter (US$50 billion in 2000) has joined the World Trade Organization and will be seeking concessions in this area. Under the Uruguay Round and multi-fibre Agreement (MFA), all textile quotas are to be lifted by 2005, benefiting to the largest extent the low-cost producers of Asia (China, India, Pakistan and several ASEAN producers)[7].

Figure 6.6: Turkish advantage in productivity *levels* in TAC is fading



Source: United Nations: UNIDO Industry database.

222. In summary, the "base case" outlook for Turkish exports over the 2003-05 period is quite favorable. This assessment is grounded in assumptions regarding the global outlook and continuation of Turkey's economic reform program. Risks in export markets remain elevated in the near-term (especially the chance that recovery in the EU is somewhat delayed and lackluster); but a return to more evenly balanced global growth appears to be the most likely scenario. Following the extraordinary 12.8 growth of USD exports in 2001—on the strength of sharp currency devaluation—export growth accelerated further in 2002 to 14.1 percent. Projected export revenue growth over the 2001-05 period has the potential to parallel the performance of the second half of the 1990s (7.3 percent annual growth).

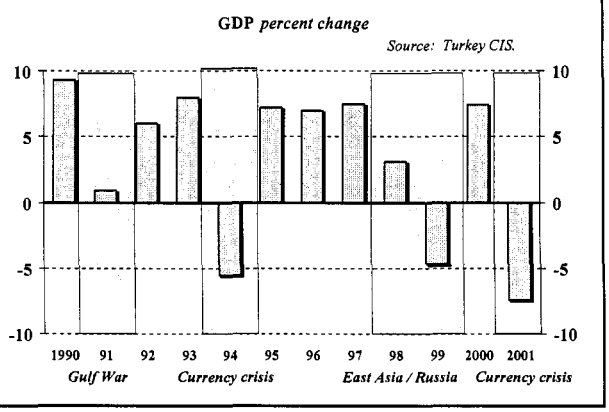
[7] Taymaz (2002).

5 EXTERNAL VULNERABILITY AND RISKS

External Vulnerability

223. Recent developments have underlined Turkey's exposure to shocks from the external environment. As highlighted in Figure 6.7, external shocks have often accompanied Turkey's domestic crises over the past decade. Among these figure the Iraqi invasion of Kuwait in 1990-91 and the East Asian and particularly Russian crises of the late 1990s. Even the 1994 crisis had a fundamental balance of payments dimension. Among factors leading to increased external vulnerability have been: (i) a concentration of merchandise exports in the cotton/textiles/yarn sectors, (ii) high import demand including reliance on imported intermediate and capital goods to support export growth across many sectors, (iii) dependence on imported energy, and (iv) reliance on short-term capital inflows giving rise to increased susceptibility to changes in international financial conditions. Turkey also faces important geopolitical risks as highlighted by the external shock in the aftermath of the terrorist attacks in the United States on September 11, 2001 and the Iraq war. underlined that. In addition to Iraq, other geopolitical concerns very relevant to Turkey are developments in Cyprus and the process of accession to the European Union. The geopolitical factors, while important to note, are not discussed further in this section.

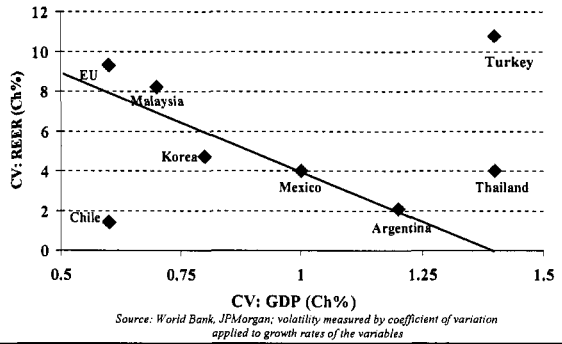
Figure 6.7: A sequence of crises during the 1990s



Source: World Bank

224. Turkey's high degree of external vulnerability has exacerbated domestic imbalances and contributed to elevate the *volatility* of Turkish output growth to levels twice as high as that for middle-income countries as a group. In turn, the instability of growth and of the exchange rate, inflation and interest rates over the decade has made the macro climate for investment difficult, hampering domestic capital spending and constraining foreign investment flows to meager levels. Over the 1990-2000 period, real exchange rate volatility[8] for Turkey (cv 10.8) stood some 4-6 points above that of the East Asians (Indonesia an exception); and volatility in GDP growth well exceeded that for Korea and Malaysia. Figure 6.8 highlights Turkey's "outlying" position when

Figure 6.8: 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

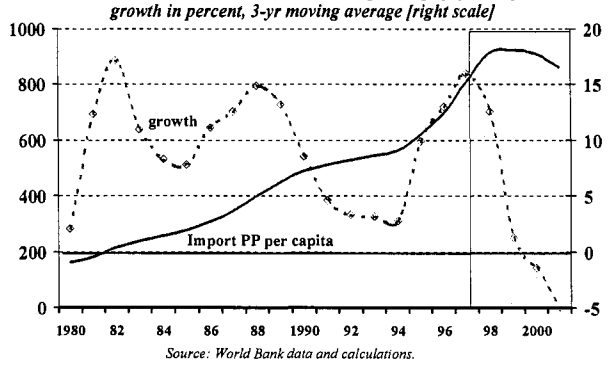
[8] Measured as the coefficient of variation (sigma/mean) of the *growth rate* of the REER across countries.

comparing the volatility of output growth with that of the real effective exchange rate over the 1990s[9]. Other countries having experienced crises, rapid in-and-outflows of capital and volatile exchange rate paths, including Mexico, Korea and Malaysia, have managed though policy and other methods to restrain volatility of both GDP growth and the real exchange rate to more moderate levels. It may be argued that in these cases, fiscal and monetary policies were more effective in stabilizing the economy. For Turkey, it is likely that *sequential crises and recoveries* ("boom and bust" phenomenon) tied to pro-cyclical fiscal policy and destabilizing short-term financial flows left the economy without a substantial "grace" period under which stabilizing macro conditions could take root and from which more sustainable growth could be generated.

225. An important factor in Turkey's external vulnerability is structurally high import demand. The volume of imports of goods and services covered by Turkey's foreign exchange earnings has declined by 1.8 percent per year over the period. Figure 6.9 shows that a secular up-trend in per-capita import purchasing power has been punctuated by cyclical and other short-medium term disturbances over the period since 1980. However, import purchasing power appears to have reached a plateau in 1998 and decelerated since under the crisis.

Figure 6.9: Slackening pace of growth in per-capita import purchasing power

levels in 1995 US dollars, 3-yr moving average [left scale]
growth in percent, 3-yr moving average [right scale]

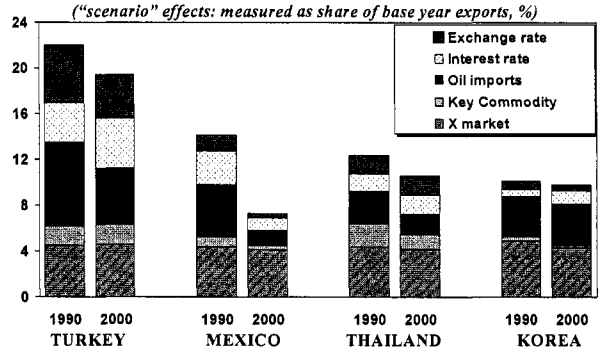


Source: World Bank data and calculations.

226. One way of quantifying the vulnerability of the Turkish economy to more conventional external economic shocks, and how that vulnerability has changed over the past decade, is presented in Figure 6.10. In this exercise, the economy is subjected to five "shocks": (i) a 5 percentage point drop in export markets; (ii) a 20 percent fall in the selling price of the key commodity export (cotton for Turkey); (iii) a 20 percent rise in the oil price; (iv) a 20 percent drop in the dollar (which raises the burden of non-dollar debt); and (v) a 200 bp rise in LIBOR. The impact of these shocks is quantified for both 1990 and 2000 and expressed in terms of 1990 exports (left bar) and 2000 exports (right bar). A similar exercise was also undertaken for three of Turkey's peers - Mexico, Thailand and Korea.

Figure 6.10: Turkey's exposure to international risks: well above comparators

("scenario" effects: measured as share of base year exports, %)



Source: World Bank, Economic Policy and Prospects Group.

[9] It should be pointed out that for efficiency of presentation, the figure excludes several comparator countries where volatility in exchange rates and/or output growth has been higher than in Turkey; specifically Indonesia and Russia.

227. Four points are worthy of note from this exercise. First, Turkey's overall external vulnerability has declined since 1990. Should all five shocks occur at once, then the hit to the economy would be equivalent to about 18 percent of exports, down from 22 percent in 1990. Second, Turkey's external vulnerability remains relatively high by international standards. Mexico, for example, has been able to engineer a far greater improvement. Third, Turkey remains quite sensitive to commodity price shocks. The country's exposure to oil shocks has diminished somewhat over the decade given increased efficiency in energy use and the decoupling of trade and transport arrangements with Iraq (crude and refined product imports have declined from 20 percent to 13 percent of total imports over the decade), but it remains relatively high. Moreover, the rising prominence of textiles in the export product mix means that the impact of a decline in the key export price has actually risen over the past 10 years (unlike the other three countries). Finally, the country's financial risks remain relatively high. Notably, exposure to interest rate changes has risen, with interest-sensitive debt increasing as a proportion of total international debt from 47 percent in 1990 to 58 percent in 2000. Of course, this is not all bad in a falling global interest rate environment. However, relatively high exposure to interest-sensitive debt underlines Turkey's exposure to volatile international private debt flows which became particularly evident in the early months of 2001.

228. The vulnerability effects outlined above reflect only direct impacts which would be partially offset (or accentuated) by other economic factors, and by policy decisions geared toward addressing adverse consequences. For example, the effects of rising interest rates would be mitigated somewhat by increased returns to holdings of foreign reserves. The rise of the euro (or yen) would provide stimulus for home country exports to Europe (Japan) and to third country markets. In Turkey's case, an increase in oil price would be partially offset by improving market conditions among the oil exporting countries (including Russia), increased exports to those markets and potentially higher remittance inflows from workers finding employment in the Gulf states and other hydrocarbon exporters. As trade and financial integration accelerate over the coming decade, decision-makers will need to become increasingly aware of the accompanying risks and alternate approaches for managing these risks in order that they may be better reflected in the design and implementation of policy.

External Financing Risks

229. Aside from pure interest rates and exchange rate risks, the main external financial risks facing Turkey are the volatility of capital flows evident across all emerging markets in recent years and the availability of adequate private finance to cover medium-term external financing needs. Capital flows to emerging markets declined again in 2002 from already very subdued levels in 2001. Flows to Turkey edged up slightly in 2002, to US$7.3 billion, having collapsed from US$22.1 billion in 2000 to US$6.9 billion in 2001. Globally, bank lending to emerging economies has dropped precipitously, reflecting increased risk aversion in the aftermath of the Argentine default as well retrenchment after losses stemming from Enron, Worldcom and other corporations in financial distress. Interest rate spreads rose through much of 2002, peaking at very high levels in September. They have since declined sharply in most countries although they have remained high and volatile for Turkey, partly reflecting uncertainties surrounding the November 2002 election, then the build up to the Iraq war and, most recently, the status of the IMF program. In the aftermath of Turkey's financial crisis there are a number of uncertainties

and vulnerabilities regarding private capital market flows that require analysis and pro-active monitoring and evaluation on the part of the monetary authorities.

230. The Turkish external capital flow cycle of recent years is similar to many others. Developments in Turkey echo developments in Mexico through the mid-1990s and the experience of Mexico (and other countries that suffered severe boom-bust cycles in the 1990s) helps serve as a base for comparison. As countries struggle to adjust to the post-crisis world, there are three stylized facts that are relevant. First, countries have had to adjust to a lower volume of external financing and with corresponding adjustments to the current account. In macro terms, this requires that import demand growth be restrained and that exchange rate competitiveness (which generally improves sharply through exchange rate adjustments during the crisis) be retained. The appropriate blend of policies that helps achieve the required shift of resources into the tradeable sector is a tight overall monetary and fiscal stance, but with more fiscal than monetary tightness over time (which helps keep real interest rates lower and therefore the real exchange rate more competitive). Second, countries have had to adjust to a different blend of financing. The collapse in portfolio and bank flows tends to persist beyond the crisis period in part because the country is viewed as a higher risk by this category of investor. This also reflects a conscious decision by domestic borrowers (the government included) to shy away from forms of borrowing that have proved to be unstable. The key financing adjustment made by countries that have completed a successful turnaround from crisis is a shift towards FDI. Third, exceptional official funding typically disbursed during a crisis must be repaid fairly quickly. Brazil, Mexico and Korea all repaid emergency IMF financing within 2-4 years. They could do this as other sources of finance were sufficiently strong.

Table 6.5 Turkey: External Financing Requirements and Sources, 2000-2006
(in billions of US dollars)

	Actual		Estimate Program		Projection		
	2000	2001	2002	2003	2004	2005	2006
Gross financing requirements	**25.9**	**10.5**	**24.5**	**29.6**	**25.5**	**18.3**	**18.2**
Current account deficit (excl. official transfers)	10.0	-3.2	2.3	7.4	6.2	6.6	5.9
Amortization on debt securities, o/w:	1.7	2.1	2.7	4.4	3.1	3.4	3.4
Medium and long-term debt amortization, o/w:	13.8	14.3	13.4	16.4	14.1	14.5	14.7
Accumulation of gross reserves	0.4	-2.7	6.2	1.4	2.2	-6.2	-5.9
Available financing	**25.9**	**10.5**	**24.5**	**29.6**	**25.5**	**18.3**	**18.2**
Foreign direct investment (net)	0.1	2.8	0.9	1.3	0.9	1.1	1.4
Portfolio flows	3.4	-1.7	4.2	5.5	6.6	7.1	7.2
Medium and long-term debt financing, o/w:	18.1	13.2	15.6	16.3	18.6	19.1	20.3
Public sector 1/	3.4	3.2	2.9	2.6	3.6	3.0	3.1
Private sector	12.8	9.2	11.4	13.1	13.4	14.3	15.2
Deposit money banks	1.9	0.9	1.3	0.6	1.6	1.8	2.0
Short-term debt financing (net)	3.6	-12.1	-2.5	4.6	-1.2	-1.1	-1.4
Official transfers	0.2	0.2	0.5	0.5	0.5	0.5	0.6
Other 2/	-2.8	-2.1	-0.6	-0.1	0.0	0.0	0.0
IMF (net)	3.4	10.2	6.4	1.5	0.1	-8.4	-9.8
Purchases	3.4	11.3	12.5	2.1	1.9	0.0	0.0
Repurchases	-0.1	-1.1	-6.1	-0.6	-1.8	-8.4	-9.8

Source: Central Bank, IMF and WB estimates.

1/ General government and Central Bank of Turkey.

2/ Errors and omissions.

3/ IMF 4th review figures adjusted by the World Bank.

231. Turkey faces a serious external financing challenge over the medium term. The challenge is how to generate enough capital inflows to: (a) underpin the floating exchange rate regime, (b) finance a moderate current account deficit linked to sustained recovery, (c) service sizeable repayments of IMF loans, and (d) avoid a renewed over-dependence on volatile short-term debt inflows. Increased FDI is key to successfully meeting this challenge in order to provide adequate capital for private investment and export growth without adding to the already considerable external debt burden. Table 6.5 summarizes the projected medium-term external financing plan under the program which underscores several key points. Regarding the current account balance, the projections assume that the return to deficits seen in 2002-03 will continue, but that the deficits will be modest in line with financing constraints. The financing plan highlights the importance of FDI as a medium-term source of funding. An even larger surge in FDI would be desirable to head off the renewed buildup of short-term debt foreseen under the program.

232. The financing picture for Mexico before and after the "Tequilla crisis" of 1994-95 crisis that may serve as an example of the change in composition of external finance that can assist in rapidly and sustainably exiting a crisis. Similarities to Turkey can be found in Mexico's tight trade and other linkages with the United States through NAFTA and earlier the *maquilladora* system, which echoes Turkey's customs union, links through trade, tourism, remittances and official funding to the EU. The external environment for Mexico during the mid-1990s was supportive with the U.S. growing at a 3.5-4 percent pace and import demand advancing at double-digit rates; while the period following Turkey's crisis of 2001 should see an improved external environment as outlined earlier. Table 6.6 highlights financing flows during Mexico's Tequilla crisis for both the "collapse" (1994-95) and "recovery" (1996-97) phases. The collapse phase opened with the boom conditions of 1994 which saw the current account deficit reach 7 percent of GDP, massive inflows of equity investments and increased short term debt. At the same time, the beginnings of capital outflow and use of official reserves to stem pressures on the currency (almost fully depleted) can be discerned. During 1995, the current account adjustment was indeed rapid and severe, in part tied to the massive withdrawal of private short-term debt and continued capital outflow. Exceptional official lending helped to stave off what appeared to be imminent default. In the recovery phase during 1996-97, the Government was compelled to reduce the fiscal and external deficits to modest levels under the auspices of the IMF—and these objectives were achieved. On the financing front, short term debt resumed at modest levels in 1997, but equity investments (a large portion of which FDI) ramped-up towards 3 percent of GDP, helping to finance repayment of IFI emergency loans coming due; capital flight money returned, assisting in this process, and reserves were once again accumulating.

Table 6.6: Mexico - External Financing

($ billion)	**1994**	**1995**	**1996**	**1997**
Current account balance	-29.7	-1.6	-2.3	-7.4
% GDP	-7.0	-0.6	-0.7	-1.9
Equity investments	15.1	10.0	12.0	16.0
Private debt, net	9.1	-14.8	1.6	2.8
Short-term, net	2.3	-16.2	-10.5	1.0
Official debt, net	0.8	24.6	-10.6	-6.8
Other items, net	-14.2	-7.7	1.9	4.7
Change in reserves	18.8	-10.6	-2.6	-9.4

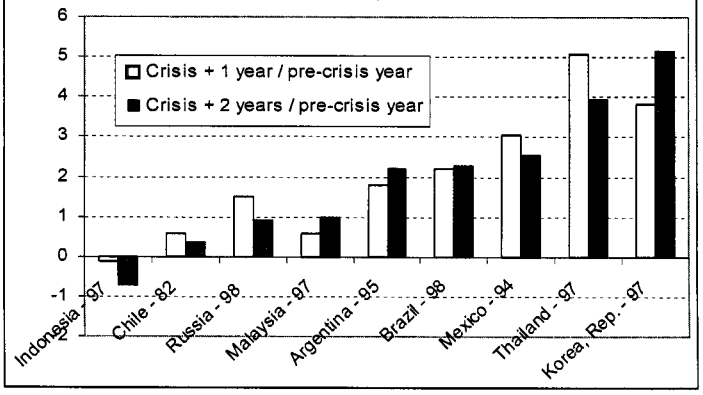
Source: World Bank

6 THE ROLE OF FOREIGN DIRECT INVESTMENT

233. Foreign direct investment can be a vital resource to help a country recover from a financial crisis. A review of experience in countries that went through crisis found that with the exceptions of Chile, Indonesia and Malaysia, net FDI flows remained positive through crisis and subsequent years, unlike short-term capital flows, such as portfolio investment. In addition, net FDI flows in the year subsequent to the onset of crisis were higher relative to GDP than in the year immediately preceding it. Countries that introduced economic reforms in general, and in particular toward FDI inflows—such as Argentina, Brazil, Mexico, Korea and Thailand—witnessed sustained increases in FDI inflows in the post-crisis period (Figure 6.11).

Figure 6.11: Ratio of FDI Inflows: 1 and 2 years after crisis relative to 1 year prior to crisis

ratios of FDI shares to GDP, ratio over 1 indicates post-crisis FDI inflows were above pre-crisis inflows

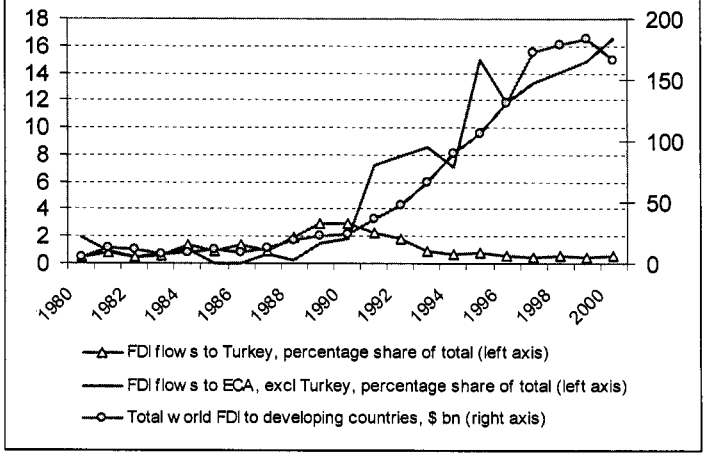


Source: World Bank

234. Recent research suggests that FDI can increase productivity in host countries and act as a catalyst for domestic investment and technological progress (de Mello, 1999). These effects can help countries sustain higher levels of growth. Borensztein et al (1995) show—in a cross-country regression framework with 69 developing countries—that FDI contributes more to domestic growth than domestic investment. FDI can spur productivity increases in domestic firms by stimulating them to invest to meet the increased competition associated with the new foreign entry. Borensztein et al (1995) also find that FDI is more productive than domestic investment when the host country has a minimum threshold stock of human capital. This second qualifying point indicates, that sufficient absorptive capacity (e.g., educational attainment, R&D, infrastructure) is required for FDI to lead to spillovers, such as technology transfers. On average, FDI inflows represent about 2 percent of GDP in developing countries as a group. And as a share of fixed investment, FDI represents 2.5 percent during the 1990s, up from 1.5 percent during the 1980s (Figure 6.12).

Figure 6.12: Total World FDI flows to Developing

Percentage shares to Turkey and to ECA

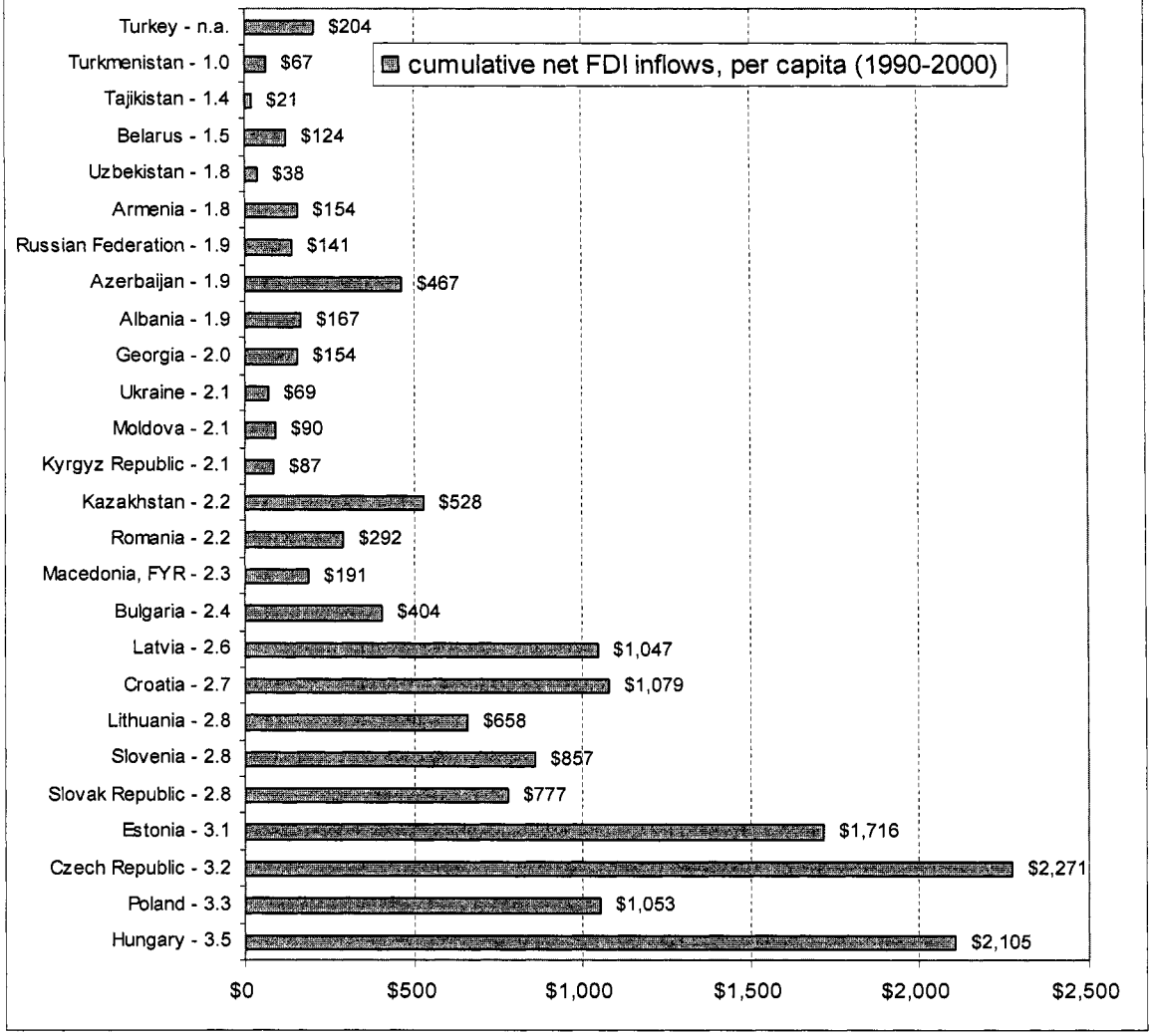


Source: Treasury and World Bank databases

235. Survey data from the EBRD across the transition countries indicates that the depth of reform appears to be strongly correlated with a country's ability to attract FDI. FDI is especially

sensitive to uncertainty as investors have the option to place their resources in other countries. The greater the degree of uncertainty, the lower the risk is for an investor to delay gaining market share in the country. As uncertainty is often driven by government policies, if reforms are pursued systematically and commitment is strong, this has a positive influence on the investment environment. Countries with high institutional performance ratings captured the highest cumulative net FDI inflows (dollars per capita). For example the top four rated countries (Czech Republic, Estonia, Hungary, and Poland) received an average of close to US$1,800 in FDI inflows per capita during 1990-2000 compared to the US$150 per capita average of countries

Figure 6.13: FDI inflows ranked by EBRD Institutional Performance Indicator
from lowest to highest rating, rating with country name

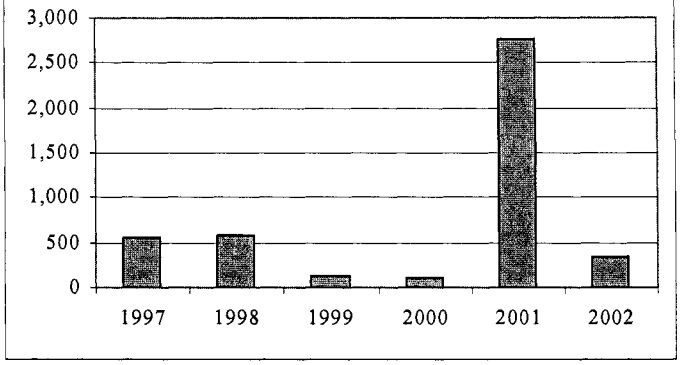


Source: World Bank databases and EBRD Transition Report, 2000

which ranked as having initiated the least reforms over the decade (Figure 6.13).

236. FDI represents a critical, but largely untapped, source of finance for Turkey. Turkey should be a magnet for FDI given its large market size, skilled domestic labor, strategic location and competitive local firms as suppliers to multinationals. However Turkey has never been able to attract the substantial FDI inflows commensurate with these advantages. Turkish FDI levels have stagnated during the last 15 years while total FDI worldwide increased by a factor of 12. FDI inflows averaged US$240 million per year during the 1980s, with a rapid increase at the end of the decade to over US$800 million, following the introduction of a number of reforms aimed at trade liberalization, moving away from protectionism and import substitution. FDI inflows increased to just over US$1 billion in 1990 and plateaued close to that level throughout most of the decade, despite the global expansion of FDI to emerging markets. In 2000, following the introduction of new economic program and the European Union's decision at Helsinki to include Turkey among the formal applicants for accession, FDI inflows increased to over US$1.7 billion. In 2001, FDI inflows peaked at US$3 billion, boosted by substantially lower asset prices and a mobile telecommunication investment transaction (Telecom Italia), before falling sharply again in 2002 (Figure 6.14). These figures are quite low especially compared with FDI inflows in the realm of 4 percent of GDP for advanced transition countries such as Hungary and the Czech Republic.

Figure 6.14: Annual FDI Inflows to Turkey



Source: Treasury and World Bank

237. On paper, Turkey has an attractive foreign investment policy. It has one of the most liberal investment regimes in the OECD as almost all areas open to the Turkish private sector are also open to foreign participation. Turkey also has a very generous incentives regime and free zones.[10] Additionally, Turkey has very positive locational factors given its proximity to the EU, Central and Eastern Europe, the former Soviet Union, the Middle East and North Africa and given its sizeable domestic market of over 67 million people. Turkey is also an attractive host country for FDI because of its skilled workforce and relatively modest labor costs. The Customs Union with the EU and the prospect of eventual membership are important factors as well. Overall, the trade regime is quite open and the infrastructure system is relatively well developed. Due to expectations of high growth, and given a large population base, the U.S. Department of Commerce has designated Turkey as one of the ten 'big emerging markets' (BEM) along with China, India, and Brazil. This group of BEM countries is expected to offer the greatest commercial opportunities due to high economic growth, the size of the economy and rapidly growing population.[11]

[10] The incentives regime includes grants of up to 70 percent of total fixed investment, exemptions for customs duties, VAT refunds and subsidized credits. (www.treasury.gov.tr)

[11] The 10 big emerging market countries are Argentina, Brazil, the Chinese Economic Area, India, Indonesia, Mexico, Poland, South Africa, South Korea, and Turkey. Together these countries are expected to account for over 40 percent of total global imports over the next 20 years according to the US International Trade Agency of the Department of Commerce. (Source: www.ita.doc.gov.)

238. Notwithstanding many positive features, a number of factors have discouraged foreign investors from moving into Turkey. These factors include macroeconomic instability, political uncertainties, excessive bureaucracy, inadequate regulatory framework, the lack of a level playing field exacerbated by uneven enforcement of tax collection and other rules and regulations, and an opaque and unsettled legal environment. The enabling environment for privatization, an important potential source for FDI, has been bogged down by delays, legal wrangling and pressure from vested interests. A signature example has been the disappointing results of long-standing efforts to attract large-scale foreign investment in Turkey's energy sector.

239. Turkey has begun to assess the problem and develop a more comprehensive FDI strategy. Assessments of the FDI environment have been carried out in collaboration with FIAS including: Diagnostic Review of the FDI Environment (2000), Administrative Barriers to Investment (2001), Legal Framework for FDI (2002), and Institutional Strategy for FDI Promotion (2002). These assessments were supported by the private sector—most importantly the chamber of commerce (TOBB), the foreign investors' association (YASED), the Turkish business assocation (TUSIAD) and the Istanbul Stock Exchange (ISE). A structured agenda to improve the investment environment was adopted by the Government in December 2001. This program centers around a Coordination Committee (YOIKK) and nine technical committees to review and advise the Government on such areas as FDI regulation, company establishment, sectoral licenses, investment promotion and taxes and subsidies. Chaired by a cabinet minister, YOIKK is responsible to implement and supervise the reform initiatives developed by the specialized technical committees consisting of representatives from relevant government agencies and the private sector. A new FDI law was enacted in June 2003 which incorporates input from FIAS and YOIKK. The law importantly removes all prior approvals and minimum capital requirements for foreign investments and guarantees free capital flows. A number of other legislation were amended to improve FDI regime and investment climate. Enacted laws as a direct result of the YOIKK process until June 2003 include: (i) law on employment of foreign personnel; (ii) law on the investment incentives which enables a shift to an automatic state aid system in tine with the EU requirements; and (iii) law on the company registration that simplifies and streamlines the company registration process. Legislation to establish an independent investment promotion agency (IPA) has also been prepared.

240. However, further action is needed to improve the environment for FDI in Turkey. Key priorities include progress on macroeconomic stabilization, privatization and regulatory reform. These broad initiatives should be complemented by progress on the specific FDI agenda including:

- Moving ahead with establishment of an IPA on the basis of the following guidelines:
  - mandate: solely investment promotion (no regulatory function).
  - financing: public sector as the main financing source with strong supplementary financing from business associations and private firms.
  - governance: Board of directors with majority private sector representation.
  - authority: The Board of directors to govern the IPA with its president answering to the Board only. The IPA to provide regular financial reports to the Government and be subject to public audit of its accounts.

- Activating the Investor Council consisting of high-level representatives of the international business community.
- Initiating a full-scale review of commercial law in Turkey to identify and address important obstacles to FDI in the legal framework.
- Continuing implementation of: (i) the medium-term tax strategy including improved fairness and transparency in tax collection and (ii) the national anti-corruption strategy.
- Developing a strategy to promote "green-field" foreign investment in the SME sector.

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TECHNICAL ANNEX - BANKING CHAPTER 3

Credit Crunch in Turkey?

1. Banking and currency crises often coincide with steep reductions in credit to the private sector, and Turkey's recent experience is no exception (see Figure 1). It is often unclear whether declines in credit are due to a reduction in demand, brought about by the sharp decline in economic activity and higher lending rates that typically accompany crisis, or to supply side factors. In this paper, we employ switching regression to explain the level of real credit to the private sector in Turkey from 1991 to 2001. The underlying intuition is that in any given period the interest rate might not clear the market, and thus the observed credit level is determined by the minimum of the quantity supplied or the quantity demanded. By enabling the researcher to estimate separate equations for demand and for supply, switching regression helps to identify which of the two regimes is responsible for generating individual observations. When estimated supply and observed credit are similar, but both lie below estimated demand, we interpret this as evidence of credit crunch. Switching regression enables us not only to identify episodes of credit crunch, but also to assess which of the determinants of the supply equation are the cause. Similarly, when depressed demand is responsible for low observed credit, the determinants of the demand equation can point to the cause of the problem.

1. INTRODUCTION

2. A credit crunch can be defined as a reduction in lending by financial intermediaries to an amount that is less than the quantity that is desired by borrowers, even if they are willing to pay for the cost of credit and are able to satisfy the non-price terms of credit required by the lenders. Defined in this way, a credit crunch represents a shift in the supply of bank credit. This reduction in supply of bank loans may be caused by the erosion in the intermediaries' capital position or deposit base, which we will refer to as a reduction in lending capacity. For example, tight monetary policy, by draining the banking system of its reserves, reduces the amount of funds available in the interbank market. Unless this reduction is offset by an increase in deposits or capital, it will lead to a reduction in loans.

3. Banks might also cut back on credit due to greater regulatory scrutiny of their portfolios and the imposition of tougher regulatory standards. For example, credit may appear to be reduced when authorities remove the NPLs from banks' balance sheets as a result of restructuring operations. Bank lending could also be severely reduced when losses begin to erode the banks' capital to the point where they are unable to comply with regulatory capital adequacy ratios. In order to meet the regulatory requirements banks are forced to reduce their loan assets – which require 100 percent risk weighing. It is this form of reduction that is generally characterized as a capital crunch.

4. Informational asymmetries that accompany crisis can also induce credit rationing (Stiglitz and Weiss, 1981). Supply of credit may shift (or bend back) because as borrower's net worth deteriorates following a crisis and collateral values decline, lenders are more inclined to charge a higher premium on loans to compensate for higher risk and

higher cost of monitoring (financial accelerator view/credit rationing). Since ease of monitoring and quality of the borrower is an important factor here, small, unlisted and more specialized firms are more likely to bear the brunt of the crunch.

5. International evidence on credit crunch is mixed. Although there is some evidence that the tighter rules for financial institutions affected the supply of loanable funds in Indonesia, Korea, Malaysia, the Philippines, and Thailand (Ding, Domac and Ferri, 1998), there is also evidence that a large part of the reduction in credit was due to demand factors. For example, Ghosh and Ghosh (1999) find that in Korea and Thailand it was the rising real interest rates and weakening economic activity that lowered credit demand, although in Indonesia the supply of credit was the binding factor briefly in 1997. Beng and Ying (2001) also show that in Malaysia, it was the decline in demand for credit that led to the decline in loans after the crisis. Survey results confirm the importance of access to credit although again it is not clear to what extent the lack of access to credit reflected the poor prospects of firms and the state of the financial sector (Dollar and Hallward-Driemeier, 2000).

6. Although all corporations are generally affected by a crisis, those with riskier financing patterns are more likely to be denied credit. Dollar and Hallward-Driemeier provide some support for this argument, showing that firms that did not rely on foreign exchange financing as much faced a less severe credit crunch. The degree of informational asymmetries – as reflected in the type of financing – is likely to be important. For example Domac and Ferri (1999) also show that in Korea, small businesses were particularly vulnerable to shocks that affected smaller regional banks, which normally provided them with most of their funding. Finally, investigating the aftermath of banking crises in 36 countries over the 1980-95 period, Demirguc-Kunt, Detragiache and Gupta (2000) show that output recovery generally begins in the second year after the crisis and is not led by a resumption in bank credit growth. Banks, including the stronger, well-capitalized ones, reallocate their portfolio away from loans following a crisis. Thus, the evidence casts doubt on the hypothesis that resumption of lending is a necessary condition for output recovery. What generally happens is that once the macroeconomic outlook improves, firms are able to substitute other sources of financing such as suppliers' credit, internal financing, foreign credit lines, equity or bonds. This behavior was observed in Mexico following the 1995 crisis (Krueger and Tornell, 1999). To sum up, while periods of credit crunch can occur following crises, particularly for smaller enterprises, this episode is likely to be short. Once the macroeconomic activity resumes, bank lending also increases.

A Disequilibrium Model of Credit Crunch

7. Absent a credit crunch, or similar credit market imperfections, the interest rate adjusts so that the supply of credit equals its demand. If interest rates do not adjust, or do not adjust sufficiently, the demand for credit Q^d will not equal the supply Q^s, and the actual level of credit will be:

$$Q_t = \min(Q_t^d, Q_t^s)$$

8. Financial crises tend to coincide with steep reductions in the levels and/or growth rates of real credit. These reductions could be caused by either demand side factors or supply side factors, or both, which creates an identification problem for the researcher. We follow Pazarbasioglu (1997) and Ghosh and Ghosh (1999) ("GG") who use a switching regression framework which imposes a priori exclusion restrictions to identify separately a supply and a demand equation. For example, GG (1999) calculate a proxy for banks' lending capacity, and use it to identify the supply equation under the assumption that capacity affects supply of credit but not demand. We employ a similar technique below.

9. In the supply equation, we follow GG and use separate proxies to control for the lending capacity of the banking system versus its willingness to lend (at a given capacity). We assume that the real supply of credit to the private sector depends, therefore, on the spread between lending and deposit interest rates, on sector lending capacity (L), and on an index of current industrial production (ip):

$$Q_t^s = \alpha_0^s + \beta_1^s spread_t + \beta_2^s L_t + \beta_3^s ip_t + \varepsilon_t^s$$

10. The index of current industrial production is a proxy for borrowers' ability to repay their loans which, in turn, serves as our proxy for bankers' willingness to lend. In some specifications, we replace the index of industrial productivity with an index of stock market prices (S). We use GG's definition of lending capacity: total banking sector liabilities plus net worth *minus* cash in vault *minus* capital *minus* required reserves.[1] More detailed descriptions of the construction and data sources for each of the variables are in Table TA **5**.

11. Demand for credit should decline when the real interest rate (r) and inflation (inf) rise. We use inflation as a proxy for general macroeconomic instability. Following GG, the demand equation also incorporates a number of proxies for firms' needs to finance current and future output. The index of industrial production enters the demand equation to control for working capital requirements and as an indicator of future output. The index of stock market prices enters as another proxy for future output. Finally, the output gap, measured as the deviation of current industrial production from its (Hodrick-Prescott filtered) long-run trend, controls for the short-term credit needs of firms suffering an adverse shock that need help while waiting for economic conditions to improve. Our basic credit demand equation is:

$$Q_t^d = \alpha_0^d + \beta_1^d r_t + \beta_2^d \inf_t + \beta_3^d ip_t + \beta_4^d S + \beta_5^d gap + \varepsilon_t^d$$

12. We estimate the probability that a given observation comes from the supply (or demand) regime and the associated coefficients for each equation via maximum likelihood. The likelihood function is derived in the appendix.

[1] When it falls below our definition, GG use the "maximal banking sector assets implied by the prevailing capital adequacy requirement" as their definition of lending capacity.

Results

13. Maddala (1989) points out that the likelihood function can become unbounded which makes convergence to a maximum impossible. In our case, collinearity between regressors affects convergence in some specifications. There are strong associations between our proxies for borrowers' current credit needs and their current and future ability to repay their loans. For example, there is a significant negative correlation (-.41) between the output gap (our proxy for current credit needs) and the index of industrial production. In addition, there is a strong positive association between industrial production and the stock market index (.71), our proxies for borrowers' ability to repay current and future loans.

14. Our model follows closely those in GG (1999), except that to enable it to converge, we had to replace the index of industrial production with the stock market index in the supply equation. In model 1 (Table TA 1) the overall fits of the demand equation (σ_d=.115, t=7.26) and the supply equation (σ_s=.126, t=12.27) are good. The coefficients on the interest rate variables are of the hypothesized signs, and the negative coefficient for the real lending rate is significant in the demand equation. As hypothesized, inflation is negative and significant in the demand equation, while the output gap and the index of industrial production are both positive and significant. In the supply equation, both lending capacity and the interest rate spread are positive, as hypothesized. Only lending capacity is significant. The stock market index is not significant in either equation.[2]

15. It is somewhat troubling that the spread variable, which theory suggests should be a key determinant of credit supply, performs poorly in model 1. This appears to be attributable to the deposit interest rate. Although the interest rate spread used in Table TA 1 is based on deposit rates from *IFS*, we have also tried deposit rates from the Turkish Bankers' Association that yield similar results. In many cases, the adjustments to the deposit and lending interest rate series are asynchronous, resulting in multiple periods with negative spreads that are quite large in magnitude.

16. We replace the spread variable in the supply equation with the real lending rate in model 2.[3] Once the noise associated with the deposit rates produces is purged, coefficients for all variables except the stock market index are significant and of the hypothesized sign. In particular, the interest rate variable is negative in the demand equation and positive in the supply equation, which should inspire greater confidence in the model. In addition, the fit of both the supply and the demand equations is good – σ_d=.106, (t=8.40) and σ_s=.126, (t=9.77).

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[2] When the index of industrial production replaces the stock market index in the supply equation (as in GG 1999), we obtain similar qualitative results except that the demand curve has poor fit and the coefficient on the spread variable is negative. Moreover, to enable those models to converge, we must replace the real interest rate variable with the nominal interest rate in the demand equation. This substitution renders the inflation variable insignificant.

[3] GG (1999) also appears to use lending rates rather than spreads in their supply equations.

17. These results are illustrated in Figure TA 2 The overall fit of the switching regression may be judged by the extent to which the actual real credit level matches the minimum of estimated demand and estimated supply in each period. For model 2, there are many periods for which actual and predicted credit levels are very similar. There is evidence of credit crunch (i.e., estimated supply and actual credit lie near one another and below estimated demand) after the 1994 financial crisis, from late 1994 to mid-1998. However, from early 1999 onwards, slack demand appears to be constraining credit. That is, demand better explains observed credit levels, and both lie below estimated supply.

18. Across all models, the most important variable in the supply equation is lending capacity, over which the government does have some control. Estimated credit supply dips in late 2001, which could be attributable to more stringent capital requirements. Figure TA 3 indicates that the ratios of both capital and required reserves to banking liabilities increased at this time.[4] For capital, the jump was especially pronounced. However, the models here suggest that any bank supervisory-induced reductions in lending capacity were not the cause of credit decline in 2001. In that sense, efforts to increase lending capacity by easing capital requirements appear to be unnecessary and could be counter-productive. The current focus should be on improving the investment climate and thus restoring credit demand. Macroeconomic stability and the lower interest rates that accompany it should help increase demand for credit, which currently appears to be the more serious constraint.

Credit to Households and Government

19. Although the foregoing models indicate no current supply-side constraints on aggregate credit from deposit money banks to the private sector, it is highly probable that some parts of the Turkish economy are more affected by slow credit growth than others. For example, credit rationing *a la* Stiglitz and Weiss is most likely for prospective borrowers with little net worth such as small businesses and individuals. To assess whether this concern has validity for Turkey, we re-run the switching regression with credit to households (including both consumer credit and credit cards) as our dependent variable. Although this measure does not include direct lending to small businesses, it is likely that many small business owners finance a high share of their operations through personal loans and credit cards. In that sense, household credit should reflect some of the difficulties that small businesses have had in weathering recent financial crises.

20. The household credit model appears in Table TA 4 and the estimated demand and supply are in Figure TA 4. The demand equation is very similar to that for aggregate private credit: inflation and the real lending rate enter negatively and significantly while the coefficients for the output gap, industrial production, and the stock market index are all positive and significant. In the supply equation lending capacity is the only significant variable, which is also true for some of the aggregate credit supply equations. Given the similarities between the household and aggregate credit models, it is not surprising that the two types of models offer similar qualitative results regarding credit crunch. In

[4] Not only the ratios but also real capital and real required reserves increased.

particular, there is evidence in support of a household credit crunch from 1994 to 1998. In the last six months of 1999, there is also some evidence of a credit crunch, as the estimated demand lies above the estimated supply equation. However, at the very end of the period (late 2001), observed credit levels are similar to estimated demand and lie well below estimated supply. Supply does not appear to be constraining current credit to the household sector.

21. It is interesting to note that in percentage terms the mid-90s household credit crunch is much larger than that for aggregate credit. For example, in models 1 and 2, observed aggregate credit is 65-95% of the estimated credit demand for almost all periods from 1994 to 1998. Over the same period, observed household credit is only 45-70% of estimated demand, which provides one indication that households and small businesses are more adversely affected by credit crunches than other private sector borrowers. This might provide a rationale for offering incentives to banks to lend to small businesses during credit crunch.

22. As a final empirical exercise, we run a switching regression with real credit to the government as the dependent variable (Table TA 4) to summarize state intervention in credit markets. As in the private credit regressions, inflation and high real interest rates are negatively associated with government demand for credit. However, as might be expected, the proxies for private sector credit needs (output gap, industrial production, and the stock market index) are not positively correlated with government credit demand. Coefficients for all of those variables are negative, and the one for the stock market index is significant. Perhaps the most striking feature of the government credit model is the poor fit of the supply equation (Figure TA 5). While real credit to the government remained relatively constant during this period and thus does not appear to have crowded out private borrowing, it is interesting that government borrowing has no relation to the banking sector's lending capacity.

Conclusions

23. The analysis presented here indicates that, although supply side constraints appear to have been responsible for a mid-1990s credit crunch, the recent credit decline in Turkey is attributable to demand side factors. This leads to (at least) two conclusions. First, since in general we do not see a credit crunch and if there is one it is more likely to be there for the smallest firms, there is reason to do less rather than more, and simple transitory rules working on the firm side may be the most helpful approach. These can take different forms: a tax break for corporations; a scheme which gives a firm some government backed financing this year equal to a fraction of taxes paid last year or two years ago (which is a crude test of whether the firms were making profits, and may thus be reasonable firms this year if it were not for the crisis, and were obeying the tax code); some accounting relief, e.g., on foreign exchange losses; and for the SMEs, an automatic roll-over for very small loans, lower capital adequacy weights on SME loans, or some trade finance scheme may be helpful. Indeed, some of these measures, particularly roll-overs and credit guarantees for SMEs were successfully applied in Korea.

24. Legal changes could also improve the financial contracting environment for firms and thus facilitate better access to credit. Most SMEs get the bulk of their external finance not from the banks, but from trade credit. This is also true in Turkey. However, receivables financing is not legally allowed in Turkey. Although it is possible to get credit against post dated checks, it is not possible to do this using invoices or accounts receivable. Such a change in the law to allow re-assignment of intangibles would go a long way in relaxing short term financing constraints of SMEs.

25. Second, since demand side factors appear to be primarily responsible for the recent low level of private credit, taking measures on the banking side may be counter-productive. In particular, current proposals to effectively relax capital adequacy requirements by permitting substantial upwards revaluation of bank's real estate and other equity holdings is unwarranted. Although the models presented here indicate that stricter capital requirements did coincide with reductions in the estimated supply of credit in 2001, supply was not the binding constraint on observed credit levels. Therefore, relaxing capital requirements to improve credit supply is both unnecessary and unwise, as it will lead to a more fragile banking sector over time. Moreover, resumption of bank credit is generally not a lead indicator; to the contrary, it follows output recovery. Requiring the banks to lend too much too soon may backfire and lead to non-performing loans.

Table TA 1: Switching Regression Results

	Model 1		Model 2	
	Coeff.	t-statistic	Coeff.	t-statistic
Credit Demand				
Constant	15.091	8.40	19.447	22.08
Real Lending Rate	-.480	3.35	-.340	2.77
Inflation	-5.939	3.03	-2.840	1.70
Output Gap	.126	2.96	.067	2.05
Industrial Production	3.488	6.37	2.222	9.23
Stock Market Index	-.114	1.17	.045	0.91
σ_D	.115	7.26	.106	8.40
Credit Supply				
Constant	6.122	2.59	-3.842	0.80
Lending Capacity	.754	7.84	1.109	6.27
Stock Market Index	.095	1.24	.002	0.02
Spread	.065	0.52		
Real Lending Rate			.154	2.13
σ_s	.126	12.27	.126	9.77
Log Likelihood		88.57		91.94
Observations		114		114

Table TA 2: Summary Statistics

Variable	Mean	Median	High	Low
Real Credit (Trillions of 1995 Lira)	13.1	13.2	20.8	6.9
Real Lending Rate	3.8%	6.1%	53.6%	-200.2%
Nominal Lending Rate	59.1%	61.5%	76.1%	37.2%
Interest Rate Spread	-14.6%	-14.5%	23.6%	-80.3%
Deposit Rate	73.7%	76.6%	131.8%	33.8%
Inflation (monthly)	4.6%	4.4%	22.1%	0.5%
Output Gap	-0.03	-0.31	19.78	-20.63
Index of Industrial Production	106.2	105.9	130.6	82.3
Stock Market Index (Deflated by WPI)	19686	15129	60207	4250
Lending Capacity (trillions of Lira)	18,600	4,870	101,000	187
Banking Sector Assets (trillions of Lira)	23,600	6,320	118,000	248
Banking Sector Liabilities (trillions of Lira)	19,300	4,870	106,000	226
Banking Sector Capital (trillions of Lira)	3,550	928	26,200	36
Banking Sector Required Reserves (trillions of Lira)	1,280	452	6,420	20
Banking Sector Cash in Vault (trillions of Lira)	180	68	758	4

Table TA 3: Correlations

	real credit	output gap	real lending rate	nominal lending rate	spread	inflation	industr produc-tion	stock market index	lending capacity
real credit	1.00								
output gap	-.17*	1.00							
real lending rate	.18*	.11	1.00						
nominal lending rate	-.05	.25***	.17*	1.00					
spread	.08	-.10	.45***	.25***	1.00				
inflation	-.19**	-.02	-.94***	18*	-.36***	1.00			
industrial production	.84***	-.41***	.10	.09	18*	-.07	1.00		
stock market index	.79***	-.11	.17*	-.04	.24***	-.18*	.71***	1.00	
lending capacity	.89***	-.11	.11	-.17*	.02	-.17*	.68***	.83***	1.00

Table TA 4: Credit to Households and Government

	Households		Government	
	Coeff.	t-statistic	Coeff.	t-statistic
Credit Demand				
Constant	-7.723	3.99	13.055	5.93
Real Lending Rate	-1.861	9.19	-.018	3.80
Inflation	-19.811	6.89	-23.173	3.98
Output Gap	.077	1.90	-.054	0.66
Industrial Production	2.838	6.02	-.728	1.27
Stock Market Index	.292	2.48	-.220	1.99
σ_D	.115	4.14	.330	8.49
Credit Supply				
Constant	-47.335	7.69	-6.956	6.10
Lending Capacity	1.818	7.42	.786	13.51
Stock Market Index	-.146	0.93	-1.017	16.59
Real Lending Rate	.013	0.09	-.022	11.98
σ_s	.239	8.50	.016	0.08
Log Likelihood		26.4		-9.5
Observations		114		114

Table TA 5: Variable Construction and Data Sources

Symbol	*Definition*	*Source*
Q_t	Real Credit to the Private Sector. Nominal Credit deflated by WPI; logarithm	*International Financial Statistics*, line 22
r_t	Real lending rate; nominal medium lending rate, adjusted for annual inflation	Turkish Bankers' Association
i_t	Nominal Lending Rate; medium term lending rate	Turkish Bankers' Association
inf_t	Consumer price inflation; Δln(CPI)	*International Financial Statistics*, line 64
gap_t	Output gap; deviation of current index of industrial production from its Hodrick-Prescott filtered long-run trend; logarithm	Index of industrial production, *International Financial Statistics*, line 66
ip_t	Index of industrial production; logarithm of three-month backward moving average	*International Financial Statistics*, line 66
S_t	Stock market price index; deflated by WPI; logarithm	Ismail Arslan, World Bank Office, Ankara
L_t	Real lending capacity; total commercial bank liabilities + net worth – cash in vault – capital – central bank reserves; deflated by WPI; logarithm	Liabilities: *IFS* lines 24-26, 45-47 Assets : *IFS* lines 20-22, 40-42 Cash in Vault and Reserves: Central Bank of Turkey Capital: *IMF* Country Desk for Turkey
$spread_t$	Nominal medium term lending rate minus nominal deposit interest rate	Lending rate: Turkish Bankers' Association; Deposit Rate: IFS ln 60L

Data are monthly from December, 1991 to December, 2001.

Figure TA 1: Real Credit to the Private Sector

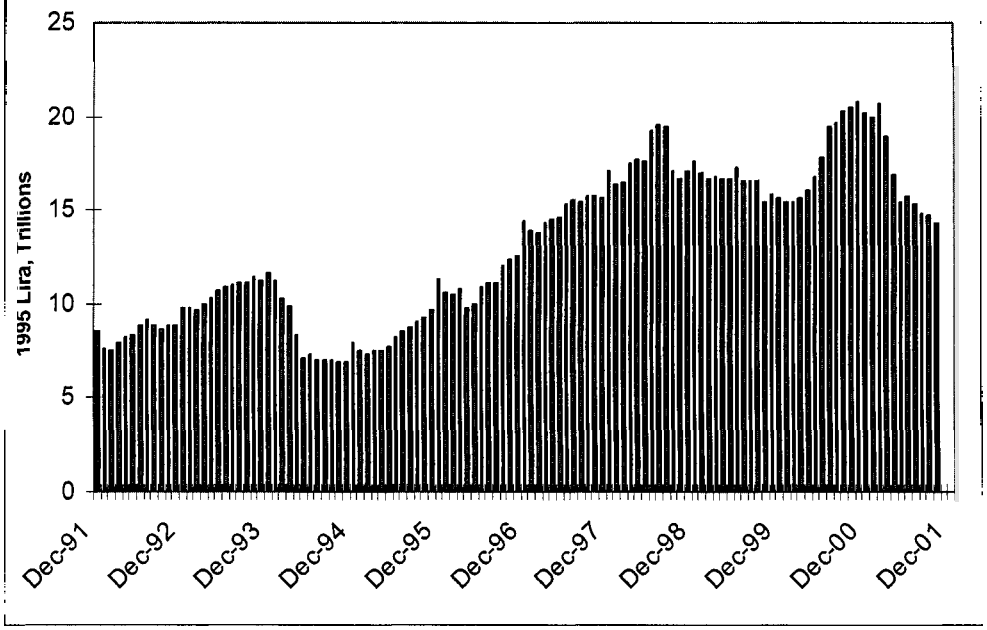
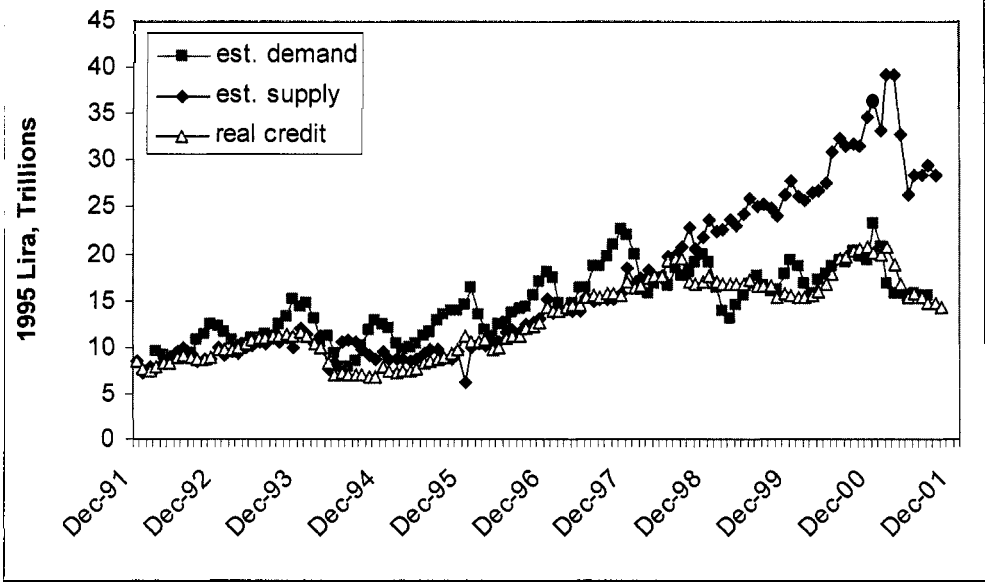


Figure TA 2: Credit Demand and Supply (Model 2)



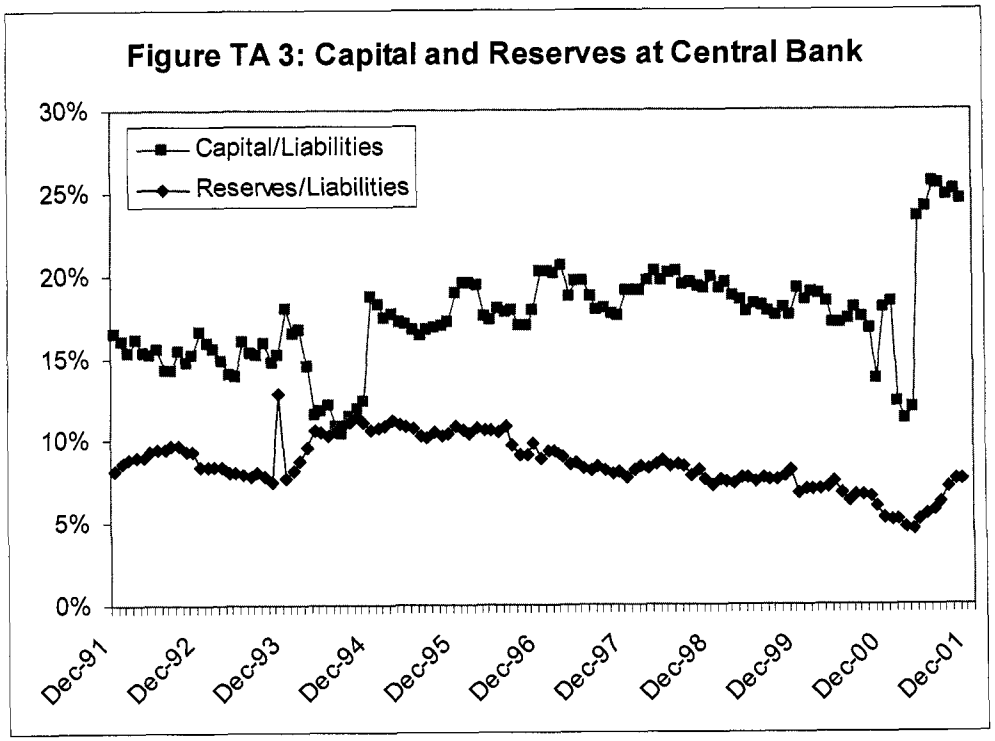


Figure TA 3: Capital and Reserves at Central Bank
30%
25%
20%
15%
10%
5%
0%
Capital/Liabilities
Reserves/Liabilities
Dec-91
Dec-92
Dec-93
Dec-94
Dec-95
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Dec-01

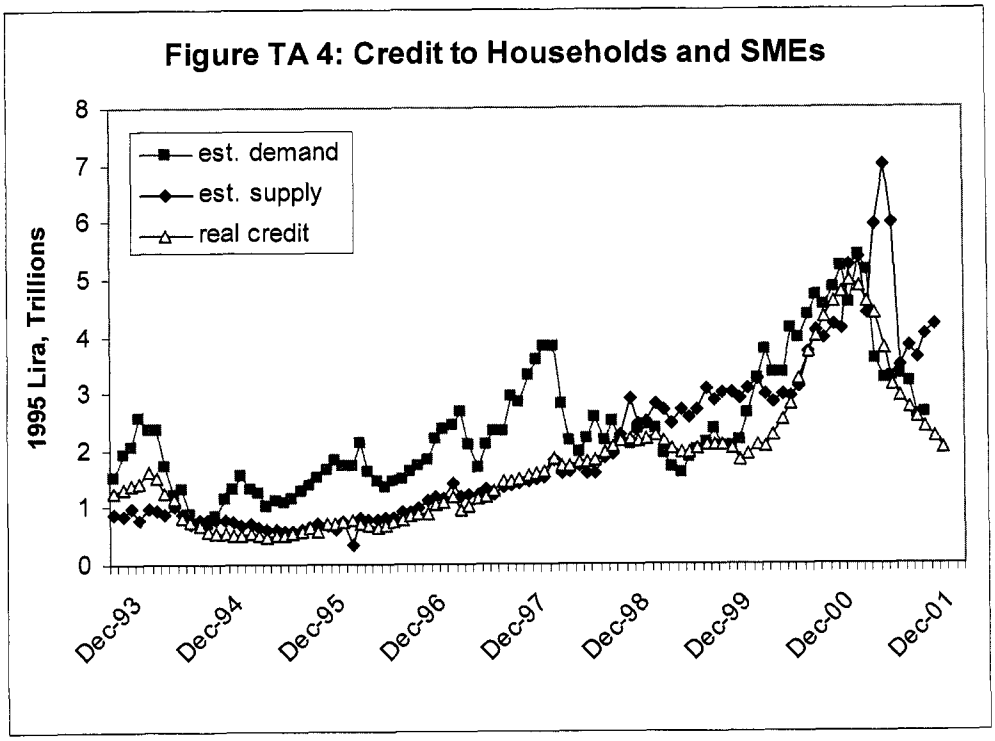


Figure TA 4: Credit to Households and SMEs
1995 Lira, Trillions
8
7
6
5
4
3
2
1
0
est. demand
est. supply
real credit
Dec-93
Dec-94
Dec-95
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Dec-01

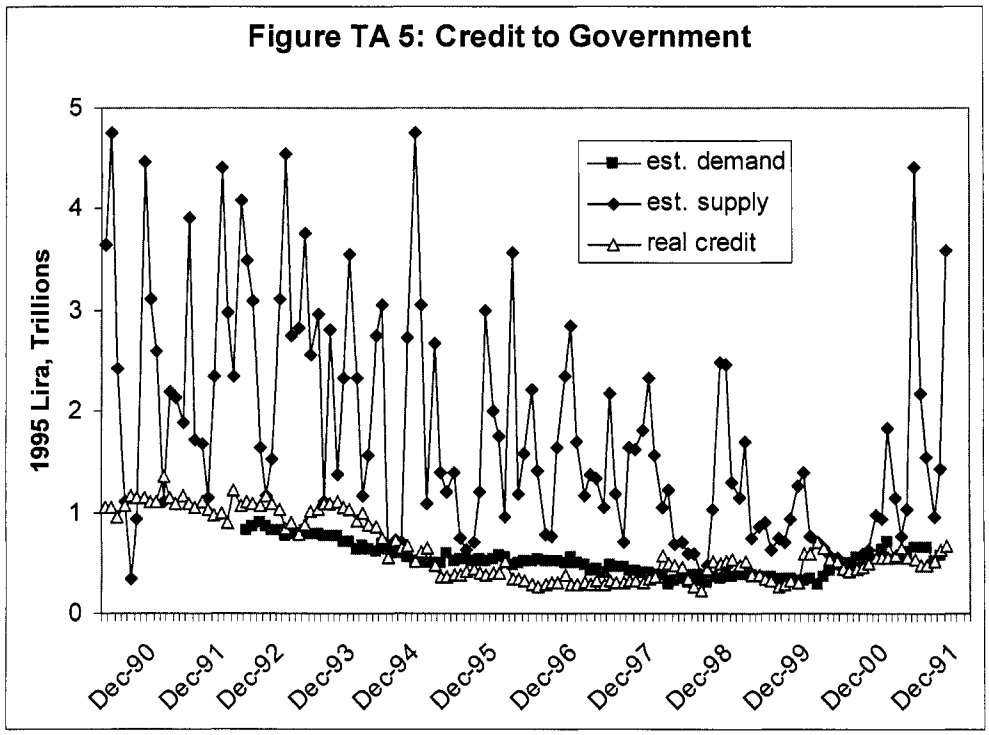


Figure TA 5: Credit to Government
1995 Lira, Trillions
5
4
3
2
1
0
est. demand
est. supply
real credit
Dec-90
Dec-91
Dec-92
Dec-93
Dec-94
Dec-95
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Dec-91

Appendix. Likelihood Function

The probability that the observed quantity of credit at time t is determined by the supply equation is:

$$\theta_t = P(Q_t^d > Q_t^s) = \Phi((Q_t^d - Q_t^s)/(\sigma^{s2} + \sigma^{d2}))$$

σ^s and σ^d are the estimated standard errors of the credit supply and credit demand functions and $\Phi(\cdot)$ is the cumulative normal distribution.

If observation t comes from the demand function, then $Q_t = Q_t^d < Q_t^s$ and the density of $Q_t, h(Q_t)$, is given by:

$$h(Q_t \mid Q_t = Q_t^d) = \int_{Q_t}^{\infty} \phi(Q_t, Q_t^s)/\theta_t dQ_t^s$$

where $\phi(\cdot)$ is the joint density function of Q_t^d and Q_t^s. Similarly, if the observed credit level is determined by the supply equation, then $Q_t = Q_t^s < Q_t^d$ and:

$$h(Q_t \mid Q_t = Q_t^s) = \int_{Q_t}^{\infty} \phi(Q_t^d, Q_t)/(1-\theta_t) dQ_t^d$$

Density function $h(Q_t)$, therefore, is given by:

$$\begin{aligned} h(Q_t) &= \theta_t h(Q_t \mid Q_t = Q_t^d) + (1-\theta_t) h(Q_t \mid Q_t = Q_t^s) \\ &= \int_{Q_t}^{\infty} \phi(Q_t, Q_t^s) dQ_t^s + \int_{Q_t}^{\infty} \phi(Q_t^d, Q_t) dQ_t^d \end{aligned}$$

The associated log likelihood is $\sum_{i=0}^{T} \log h(Q_i)$.