TURKEY - IMF MISSION FOR THE 1999 ARTICLE IV CONSULTATION DISCUSSIONS AND REVIEW OF THE STAFF MONITORED PROGRAM CONCLUDING STATEMENT

A. Introduction

Over the past two decades, Turkey has suffered from chronically high inflation, which has prevented the economy from realizing its full growth potential. Last year, the Turkish authorities launched a program aimed at reducing inflation, described in the authorities' *Memorandum of Economic Policies* of June 26, 1998, whose implementation has been monitored by IMF staff under an 18-month staff monitored program (SMP).

While considerable progress has been made, a new and more comprehensive effort is now needed to uproot inflation. The authorities intend to implement a comprehensive program of macroeconomic and fiscal adjustment, with the goal of lowering inflation to 10 percent by end-2001.

The Turkish authorities have asked for IMF resources in support of their economic program to be implemented in the next three years. Major progress has been made in discussions between the authorities and the IMF staff during this visit, and a framework for an economic program that could be supported by the IMF has been agreed. The authorities have agreed with the staff on a number of specific steps to be implemented in the next few months, as well as on key macroeconomic targets and policies for 2000-2001. Once these steps have been implemented, and conditional on agreement on more detailed aspects of the 2000-2001 program, the staff will be ready to support the authorities request for a two-three year stand-by arrangement. The amount of this arrangement is now under consideration.

During the next few months, the SMP will serve, as a bridge towards the envisaged Fund-supported program. Quarterly quantitative targets for revenues, expenditures, and the primary surplus of the central government, as well as net domestic assets (NDA) of the Central Bank of Turkey(CBT) have been specified (Table 1), and will be monitored under the SMP.

B. Recent Economic Developments

Economic performance in Turkey since the conclusion of the 1998 Article IV consultation have been mixed. On the positive side, inflation has continued to decelerate, and by early 1999 had dropped to 48 percent (for the WPI) - its lowest level this decade. Skillful monetary management has succeeded in limiting the fallout of the economic crisis in Russia, as well as the general shift in international investors' sentiment vis-a-vis emerging markets. But these shocks, coupled with severe slippages in fiscal and incomes policy implementation and political uncertainty, have resulted in high real interest rates and a marked slowdown in economic activity.

While the primary balance of the central government improved from 0.1 percent of GNP in 1997 to 4.2 percent of GNP in 1998, only limited progress was made on the structural front. Moreover, starting in late 1998, fiscal policy was progressively relaxed and, in the absence of offsetting measures, the primary surplus would decline to 1 percent of GNP in 1999. Reflecting both the deceleration in economic growth and rising expenditure, the target for the primary balance under the SMP for the first quarter of 1999 was not observed, and it appears likely that the end-June targets will also have been missed. Without corrective measures, the high interest rates since mid-1998 will likely result in a widening of the overall deficit from 7.7 percent of GNP in 1998 to about 11 percent of GNP in 1999.

Against this fiscal weakening, the burden of adjustment has increasingly fallen on monetary policy, magnifying the effect of the external shocks on domestic interest rates. Promptly responding to the large capital outflows in the aftermath of the crisis in Russia, the CBT succeeded in protecting the external balance and in maintaining an adequate level of foreign exchange reserves. Quantitative benchmarks for net domestic assets (NDA) of the Central Bank of Turkey for end-March 1999 and end-June 1999 were met by comfortable margins.

Output started contracting in the second quarter of 1998, with GNP growth falling to 3.8 percent last year. In early 1999, the economy was operating well below potential, and the staff expects GNP growth for the year to be around 0.5 percent. The latest monthly activity and demand indicators, however, suggest that recessionary forces eased in the second quarter, with indicators of industrial production, exports and imports showing some rebound.

Inflation has shown some incipient increase since early 1999 reflecting primarily the increase in international oil prices. Taking into account the policy weakening before the elections, the disinflation process during the rest of this year is unlikely to proceed as rapidly as in 1998. However, guided by the macroeconomic policies envisaged below for the second half of this year, CPI inflation should continue to edge down, while WPI inflation could remain broadly unchanged at its current level.

The external current account balance swung into surplus to the tune of about 1 percent of GNP in 1998. This strength reflects not only the drop in imports as the economy slowed down, but also the resiliency of Turkish exports to external shocks. While total exports declined, reflecting the sharp fall in both shuttle trade and recorded exports to Russia, exports excluding shuttle trade increased, despite low growth in the EU (Turkey’s main export market) reflecting continued strong competitiveness. In 1999, the external current account is projected to weaken somewhat, owing to the expected recovery of economic activity, and some weakening of tourism receipts due to political uncertainties, but should remain close to balance.

C. The Policy Agenda

Developments in 1998 and 1999 clearly indicate the need to reinvigorate the adjustment effort through a comprehensive program of fiscal and structural reform, with the goals of disinflating the economy, lowering real interest rates, and sustaining growth.

These goals are intertwined. In the last twelve months the problem of high real interest rates has been exacerbated by external shocks as well as political instability, particularly at end-1998. But interest rates have remained high throughout most of the 1990s, even in the absence of external shocks. Their level reflects two related factors. First, the long-standing weakness of fiscal and quasi-fiscal accounts. And, second, the uncertainty arising from high and volatile inflation and devaluation rates, which is in turn strictly related to the structural weakness of the public finances. Addressing this weakness is essential to disinflate the economy and bring real interest rates down to more desirable levels.

The mission clearly perceived growing consensus among all sides of the government coalition to undertake the difficult choices required to achieve strong fiscal adjustment and structural reform. The new government is determined to bolster the disinflation effort by reversing any policy slippages and by placing the adjustment on a stronger and more durable footing. Their disinflation targets is to lower CPI inflation to 25 percent by end-2000 (20 percent for WPI inflation), and to aim at a further drop in inflation to 10 percent by end-2001. These targets are realistic and commendable. The authorities' policy agenda is consistent with their achievement.

Fiscal Policy

The goal of fiscal policy in the immediate future should be to offset as soon as possible some of the implementation slippages that emerged in late 1998 and early 1999. But beyond the immediate future a more ambitious objective is needed: it is necessary to move the primary balance of the public sector (not merely the central government, but also the other components of the public sector) into surplus. This is necessary for both fiscal solvency and low inflation.

The authorities' agenda, clearly articulated in discussions with the mission, is fully consistent with these goals. The authorities intend to take immediate steps to achieve a primary surplus of the central government of over 2 percent of GNP (excluding privatization proceeds) in 1999. To this end, the government has identified measures aimed at yielding some 1 percent of GNP during the second half of 1999. These measures will be enacted over the next few weeks. Despite this adjustment the primary balance of the public sector (including the central budget, the extrabudgetary funds, the nonfinancial state economic enterprises, the local governments, as well as some quasi-fiscal primary expenditure) will remain in deficit (about 1.3 percent of GNP).

Turning this deficit into a surplus is the authorities' key fiscal goal for 2000. A significant fiscal correction will be implemented. This will entail improving the primary balance of the public sector by about 5 percentage points of GNP with respect to the expected outcome in 1999. The authorities are committed to raise the primary surplus of the public sector to 3 ¾ percent of GNP in 2000. Depending on the distribution of the adjustment across different components of the public sector, the primary surplus of the central government will range from 4¼ percent to 5½ percent of GNP.

This will be realized through both revenue and expenditure measures. More importantly, it will be realized mostly through long-lasting and structural measures. This is essential to ensure that the fiscal adjustment is not just temporary, as has often been the case in the past.

The authorities' commitment to these ambitious targets deserves full support and is an indicator of their decisiveness, backed up by a strong parliamentary majority. Fiscal adjustment is the best way to reassure financial markets, strengthen confidence, attract foreign capital, and bring down interest rates. Any potential effects on aggregate demand of the envisaged fiscal tightening should be offset by these favorable financial developments.

Structural reform

The authorities' structural reform agenda is far reaching and envisages a fast implementation schedule.

The government has already passed a new Banking Law, establishing an independent bank regulatory and supervision agency, which represents an important step in reforming and strengthening the financial sector. Further strengthening is needed, and is expected to take place in the period ahead. With a view to enhancing prudential standards, the ceiling on banks' net foreign exchange positions will be lowered to 20 percent of net worth by end-September 1999, and regulations will be rigorously enforced. The authorities have also indicated their intention to move swiftly to make the regulatory authority operational. It is essential that this authority operate with full independence and adequate operational resources.

Reform of the social security system is one of the top priorities of the government's agenda. The deficit of the social security system will reach 3 percent of GNP in 1999, almost

TL 2 ½ quadrillion. This deficit is an anomaly, particularly in a country with a very young population. Without reform, demographic forces will rapidly increase this deficit over time, increasingly shifting the burden of the adjustment on future generations. The high number of relatively young retirees is a particularly serious problem: the pension system is not working as a tool for the social protection of the elderly, but as a way of distributing income to people still in their prime working life. To solve these problems, the government is proposing far-reaching reforms affecting all the key parameters of the pension system (retirement age, length of the contributing period, length of the reference period for calculating the pension base, indexation system) with the overall goal of ensuring the financial viability in the accounts of the social security system over the medium term. Approval of a strong reform along the lines currently envisaged by the government is essential. It will be a key test to the markets of the authorities' resolve.

Attracting foreign productive capital, promoting economic efficiency, and raising revenues to contain public debt, are the key goals of the authorities privatization program. Following the hiatus in late 1998 and the first half of 1999, the government now is determined to resume its privatization program. In particular, the authorities intend to undertake such legal and regulatory measures, as may be necessary, including those to allow for international arbitration, to permit an acceleration of the privatization in the energy and telecommunication sector. These steps are long overdue and should be implemented as soon as possible.

The government has also signaled important shifts in agricultural support policies, with a view to reforming the agricultural support system to avoid waste, reduce the fiscal burden, and make the system more equitable. In particular, they have indicated their commitment to replace over time the existing agricultural subsidies with direct income support, with the goals of reducing the accumulated stocks of agricultural products and achieving net savings for the public finances. This is an important initiative, in line with past recommendations from both the IMF and the World Bank.

Monetary and exchange rate policy

The independence with which monetary policy has been managed during the last few years has contributed significantly in alleviating the cost for the Turkish economy of adverse shocks. In the period ahead, the CBT will continue to manage monetary and exchange rate policies flexibly with a view to containing inflationary pressures while protecting the Central Bank's foreign exchange reserves.

Faced with negative development on the fiscal front, monetary policy has had to remain tight over the last few months. The authorities' renewed commitment to fiscal consolidation, backed up by concrete fiscal and structural measures, should however allow in the period ahead a more balanced mix between monetary and fiscal policy, and result in declining nominal and real interest rates, which should stimulate growth. Consistent with these goals, quantitative benchmarks on NDA of the CBT have been established under the SMP (Table 1).

Incomes policy

Incomes policy will be essential to contain inflation in the immediate future, and to anchor inflation expectations in 2000 and 2001. In Turkey, as in most countries, wage growth in the public sector provides a clear signal of the authorities' commitment, thus affecting critically wage developments in the private sector. Forward looking indexation focussed on targeted inflation is needed to bring inflation down rapidly. The private sector should take the opportunity over the coming months to set up appropriate arrangements that would allow a rapid deceleration of wage growth in 2000 and 2001.

D. Concluding Remarks

Winning the battle against inflation requires a coordinated effort of monetary, fiscal and structural polices. Too often during the 1990s, disinflation has been attempted in a piecemeal fashion, with progress in some areas being offset by slippages in others. The IMF mission has been much impressed by the cohesion of the coalition partners and the resolve of the authorities to address these issues in the context of a coherent and far reaching program. The staff believe that the authorities' program, if fully implemented, will result in a sharp decline of nominal and real interest rates, a rapid pick-up of economic activity, and a deceleration of inflation to 25 percent during 2000, and 10 percent by end-2001.

The authorities' clear goal is to free Turkey of the burden of inflation that has hampered growth, exacerbated income inequality, and left the economy under a cloud of vulnerability. Achieving these results will require cooperation from all segments of the Turkish economy and society, government, workers, entrepreneurs: a national effort is needed. We are confident that thus effort will be made and that Turkey will attain this goal.

Quantitative Indicators for the Staff Monitored Program for 1999