CONCLUDING STATEMENT OF THE FEBRUARY 1999 IMF STAFF VISIT

A. INTRODUCTION

1. Last year the Turkish authorities launched a program aimed at achieving a lasting decline in inflation, which has distorted the economy for many years. The main features of the program included: (i) a large and sustained improvement in the primary budget balance, to narrow the large public sector deficits that lie at the heart of the inflation process; (ii) the adjustment of public sector wages and agricultural support prices in line with targeted inflation to minimize inflation inertia; (iii) structural reforms to ensure a lasting strengthening of the public finances; (iv) stepped up privatization to enhance economic efficiency and lower the domestic borrowing requirement; (v) measures to strengthen the banking sector; and (vi) limits on the expansion of the central bank's net domestic assets to ensure the consistency of overall policies. The program was described in the authorities' *Memorandum of Economic Policies* of June 26, 1998, and its implementation has been monitored by IMF staff under an 18-month staff-monitored program (SMP). The purpose of this visit was to review the implementation of the SMP through December 1998 and to discuss policies and targets for the first half of this year.

2. In many respects, the program has been very successful. Inflation slowed sharply as programmed, the primary fiscal balance was strengthened in line with program targets, and the central bank limited the expansion of its net domestic assets to within the program ceiling. Progress was made on structural reform, especially in the first half of the year, although the momentum of structural initiatives slowed thereafter.

3. Skillful management of economic policies adroitly steered the economy through a turbulent economic environment. Reserves were stabilized at a comfortable level and access to the international bond market was restored. These results, together with the strong external current account position, provide reassurance that the external position will remain viable in the period ahead.

4. But the external shock, the uncertain political environment, and inaction on key structural measures have left a legacy of high real interest rates that are putting pressure on the public finances and damaging the real economy. It is imperative to take early action. We look forward to working closely with the authorities on the design of a more ambitious and comprehensive disinflation strategy to be implemented after the forthcoming elections. Such a reform program would build on the progress achieved under the SMP and could be supported by Fund resources.

B. POLICY IMPLEMENTATION AND DEVELOPMENTS THROUGH DECEMBER 1998

The program succeeded in reducing inflation in line with the authorities' target. The SMP's quantitative targets for the budget and monetary policy were observed in 1998, but several important structural reforms were not implemented as planned.

Fiscal Policy

5. The primary fiscal surplus was in line with (and indeed slightly surpassed) the program target of 4.1 percent of GNP in 1998. Thanks to this large primary adjustment, the consolidated budget deficit stabilized (at about 72 percent of GNP), despite a shortening of maturities (from about 12 months in 1997 to 8 months in 1998), the unexpected rise in interest rates, and a related increase in interest outlays to 11.7 percent of GNP, from 7.8 percent in the previous year. However, the deficit of the broader public sector widened in 1998, largely because of mounting receivables owed by the Treasury to the state banks and the losses of other public entities, related in part to the larger-than-expected agricultural harvest and high costs of agricultural support.

Monetary Policy

6. Monetary policy faced difficult challenges in 1998. The central bank responded appropriately to the capital outflows experienced in the second half of the year, holding the growth of its net domestic assets to within the program ceiling of Tl 700 trillion, thus helping to stabilize reserves. At the same time, it sought to avoid a deterioration in competitiveness through its exchange rate policy.

Real Sector Developments

7. The external shock and associated high real interest rates have hurt the real economy. GNP growth slowed to 1.9 percent (year on year) in the third quarter of 1998 and an estimated 32 percent for 1998 as a whole, compared with over 8 percent in 1997. Recent indicators of industrial production point to a continuing slowdown in activity, as the economy continues to adjust. The balance of payments position improved in 1998, with reserves rising to about US$20 billion by end-year, as the external current account position (including shuttle trade) moved from a deficit of 1.4 percent of GNP in 1997 to a surplus of 0.4 percent. Progress in slowing inflation continued in January 1999, with the 12-month increase in consumer prices slowing to about 66 percent (from about 102 percent in January 1998) and wholesale price inflation slowing to 50 percent (from 92 percent), bringing the 12-month increase in wholesale prices to an eight-year low.

Structural Policies

8. In the first half of 1998, the privatization program gained momentum, international pricing was adopted for petroleum products, agricultural support

prices were raised broadly in line with targeted inflation, tax reform legislation was adopted to reduce tax collection lags and widen the tax base (although the envisaged reform on streamlining the VAT system through imposing a consumption tax on luxury goods was not implemented), and the authorities initiated a phased reduction in the ceiling on banks' net open foreign exchange position from 50 percent of net worth to 30 percent by end-1998. But this momentum was not sustained and key structural reform measures envisaged in the SMP were not implemented, including: (i) approval of a regulatory framework for the telecommunications and energy sectors to facilitate privatization; (ii) a long-postponed social security reform designed to raise the minimum retirement ages and extending the minimum contribution period to be eligible for full benefits; (iii) a quantum jump in privatization; and (iv) the adoption of a banking sector reform bill to establish an independent regulatory body, depoliticize supervision practices, and clarify remedial measures for banks.

C. POLICIES AND TARGETS FOR THE FIRST AND SECOND QUARTERS OF 1999

Slow progress on structural measures and political uncertainty have contributed to the high real interest rates that are now placing a heavy burden on the economy and the budget. This underscores the importance of achieving a decisive change in expectations through the adoption and steadfast implementation of far-reaching reforms. It is understandable that such measures cannot be initiated in the months preceding the election. Therefore, for the next few months macroeconomic policies under the SMP are geared towards safeguarding the external position and ensuring that the gains made to date are maintained. To this end, targets for the monitoring of the SMP have been set through end-June 1999, with the expectation that a more comprehensive and ambitious reform program, that could be supported by Fund resources, will be adopted after the elections.

Fiscal Policy

9. The fiscal program envisages continued improvements in revenue collections that are targeted to yield Tl 3,005 trillion by end-March 1999 and Tl 7,280 trillion by end-June (Table). Cumulative non-interest expenditure is to be limited to Tl 3,140 trillion by end-March 1999 and Tl 6,700 trillion by end-June. For the year as a whole under current policies, the authorities are committed to achieving a primary fiscal surplus of at least 3 percent of GNP. They fully recognize the importance for the public finances and the disinflation effort to contain increases in wages and agricultural support prices, an effort for which a social consensus must be forged.

Monetary Policy

10. The monetary program aims at safeguarding the reserves of the central bank and the gains made to date in reducing inflation. Accordingly, the expansion of the central bank's net domestic assets will be limited to Tl 800-

900 trillion at the end of the first quarter of 1999, and Tl 1,000 trillion by end-June 1999. Exchange rate policy will continue to be geared to avoiding a real appreciation of the lira.

Structural Reform

11. It is important to pass without delay the draft banking legislation now before Parliament. In addition, the authorities have reiterated their commitment to further lowering the ceiling on banks' net foreign exchange positions to 20 percent of net worth by end-September 1999 and to strengthening the enforcement of prudential regulations.

D. CONCLUDING REMARKS

Under the SMP Turkey has successfully weathered major external shocks and made impressive progress in reducing inflation. The policies outlined under the SMP for the first half of 1999 will consolidate these gains. But much remains to be done to tackle the fiscal and structural roots of Turkey's chronic inflation, and the cost of inaction is high. A reinvigoration of the macroeconomic and structural reform effort after the elections is needed without any delay. As soon as Turkey is able to move forward in a decisive way on these much-needed and long-delayed reforms in the framework of a comprehensive disinflation program, the Fund will be able to provide strong and concrete support. In the meantime, we will cooperate closely with the Turkish authorities to develop a program for the post-election period that can be supported with Fund resources. This work will be pursued in the course of planned visits in the coming months to Washington by the Turkish authorities and in the context of our regular reviews of the SMP.

Table 1. Turkey: Quantitative Indicators for the Staff Monitored Program for 1998-99