Statement by Terrie O'Leary
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Turkey: Country Assistance Strategy

We endorse the Country Assistance Strategy (CAS) for FY01-03, which is to provide support to Turkey's modernization and restructuring and to reduce the economy's vulnerability to shocks, including contagion from financial crises elsewhere. We also support the two proposed adjustment loans.

Country Assistance Strategy

The Bank has designed the FY01-03 CAS following an analysis of social and economic conditions. While absolute poverty is low, the bottom third of the population is unable to afford many basic needs. Unemployment and lack of education are critical factors underlying poverty in Turkey. The Bank's programme will be focused on supporting the government's priorities of achieving stable growth, generating productive investment and improving education access. The CAS continues to assume a high case commitment and disbursement scenario, with total IBRD lending over the three year period projected at US$5 billion. Roughly half of this amount will be provided in the form of adjustment lending. In particular, Bank Group activities will be focused in five broad areas:

a) implementing reforms for growth and employment generation;
b) improving public management and accountability;
c) expanding social services and social protection;
d) strengthening environmental management and disaster mitigation; and
e) accelerating connectivity and technological capabilities.

These priorities are also in line with the government's goal of moving towards EU accession. The economy, however, was dealt a severe blow by two large earthquakes in 1999.

The CAS's emphasis on support for the social sector is appropriate. In view of the current banking crisis and a very mixed economic policy track record, however, it would seem that the CAS might be more cautious in its assessment of economic developments over the short and medium term. The continued resolve of the government to pursue reform and restructuring is key to overcoming the crisis. Recent political developments in the country, however, highlight the fragility of the government. The potential for a weakening of the government's resolve to pursue an economic stabilization programme remains high. In this context, is staff's assumption of a high

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case operating scenario valid?

Although inflation has declined in Turkey, it has not fallen as rapidly as targeted under the IMF program. CPI inflation is running about 35% year/year, compared to a year-end target of 25%. As a result, there has been an unwanted real appreciation in the exchange rate over the past year. In addition, growth in domestic demand has been extremely rapid following the August 1999 earthquake, stoked in part by falling nominal interest rates under Turkey’s anti-inflation program. These factors have led to a substantial widening in the current account deficit – to an estimated 5.2% of GDP this year, compared to 0.8% in 1999.

To help combat the rising current account imbalance, the Turkish authorities have indicated they will tighten fiscal policy in the next year. While a larger primary surplus is being targeted in 2001 (5.7% of GNP vs. 4.9% in 2000), it is not clear that this target will be sufficient. There is concern that the measurement of the primary balance does not capture a number of off-budget expenditures. This suggests that the size of the surplus is over-estimated while the size of the central government deficit is under-estimated. According to the IMF, the deficit is not projected to narrow significantly this year (11.3% of GNP in 2000 vs. 11.6% in 1999). This will likely maintain pressure on social spending. More transparency is needed with respect to budgetary reporting, as well as better conformity with conventional national accounting standards.

We would have appreciated a fuller discussion in the CAS of the role of the IFC and MIGA in supporting the government’s privatization agenda. Until now Turkey has been slow in moving ahead with its privatization agenda. The recent announcement by the government that it will increase the bidding rights to Turk Telekom from 20% to 33.5% and guarantee management rights should help stimulate investor interest. However, there is some dispute over the market valuation of Turk Telekom and, in addition, some analysts have warned that the high fees for UMTS licences could dampen investor demand, although the government has indicated that the new company will be granted rights to Turkey’s fourth GSM licence at competitive rates.

The government’s decision to sell a 51% stake in Turkish Airlines, accelerated due to the recent financial crisis, is a welcome measure. While this has the potential to provide encouragement for investors, the privatization process could still run into some delays. The state-run company has been running large losses in the last two years, in part because it has not been able to raise fares on unprofitable domestic routes. As foreign investment will be restricted to 24%, the number of possible bids for this loss-making enterprise appears limited. Unless there are credible tenders for the company, privatization in the transportation sector could remain difficult and protracted.

In the energy sector, more efficient infrastructure is needed to help eliminate bottlenecks that have constrained economic growth. However, the creation of an efficient energy industry requires the privatization of state-owned enterprises, along with clear and stable market rules (the government has generally maintained energy prices below market levels). As the energy supply-demand gap is projected to widen sharply over the coming decades, Turkey clearly needs to liberalize this sector by eliminating barriers to entry and reforming the legal and regulatory frameworks.

As we have stated in the past, there is no doubt or debate as to the economic benefits and
enhanced structural reforms that privatization can bring to a country, especially in the case of Turkey. However, pace, timing and sequencing are crucial. Privatizations cannot be timed to order, if they are to be successful. Privatizations of public sector entities are difficult when government capacity is strong, market conditions are favourable and there is full public support. We need to help the government seek quality reform, on a limited scale, with transparent, measurable and equitable processes that are fully consistent with and actually reinforce, the principle of good governance. The privatization agenda in Turkey is a crucial element of the macroeconomic and structural reform strategy in the country. It is imperative that we help establish a conducive framework for success that really emphasizes quality over quantity in the process going forward.

Turkey’s gross financing needs for 2001 have been estimated by the IMF to be around US$56 billion. After other sources of financing have been taken into account, private creditors will need to contribute more than $40 billion to the external financing of Turkey in the next year, in large part through commercial bank rollovers of maturing debt. Without private sector involvement, Turkey will not be able to recover from the present financial crisis. Negotiations are underway with foreign bank creditors.

While we support the two proposed sectoral adjustment loans, we would be very reluctant to see the World Bank assuming the role of provider of balance of payments assistance should the country’s financial crisis persist.

Financial Sector Adjustment Loan (FSAL)

The current financial crisis has renewed the sense of urgency for the government to move of banking sector restructuring. The resolution of the bad debts of 10 commercial banks now under state receivership has taken longer than anticipated. While the assets of these banks are estimated to represent only 5% of total banking sector assets, the delays have only added to the final cost of restructuring. Since the failed banks have continued to take on high-interest-bearing deposits in the interim and as the government has recently issued a guarantee to all bank depositors and creditors, the government’s contingent liabilities have correspondingly increased. The recent take-over of an 11th bank (also one of Turkey’s largest banks) by the Turkish Banking Supervisory Board will also add to the contingent liabilities. It should be pointed out that the process by which the failed banks have taken on new deposits since their take-over by the supervisory board has been less than fully transparent, as the carrying costs have not been made public. A further strengthening of accounting standards in the banking sector would therefore appear to be warranted and has been reflected in the conditions of the FSAL as a requirement to upgrade to Basle/EU standards.

Legislation has recently been passed by Parliament to privatize 4 of 7 state banks – a key step to restructuring the banking sector, as these 4 banks account for about 40% of total banking sector assets and deposits. The problem with these banks has been longstanding, as they have frequently provided subsidized credits for housing, agriculture and small business, thus distorting the market structure of the banking sector. Rationalization of these banks will require appropriate plans for operational, financial and capital restructuring in preparation for their eventual privatization. We
are satisfied that the proposed FSAL has taken these needs into consideration.

It is critical that the Turkish authorities spell out clearly the pace and nature of reforms in the banking sector – and, just as importantly, adhere to them. Since the banking sector has been at the source of the current crisis, a failure to be transparent about reforms in this area would only diminish the credibility of the government’s overall commitment to reform and could jeopardize the success of the World Bank’s programs of assistance, as well as the IMF’s supporting arrangements.

In closing, we wish to commend the Turkish authorities on their efforts to date and wish them all the best well in the challenging times ahead.