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WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

pretty slim pickings. ES 8/6/79

TO: Mr. Ernest Stern, Vice President, Operations DATE: August 3, 1979

FROM: A. David Knox, Acting Vice President, EMENA Region ADK

SUBJECT: TURKEY: Program Loan II

1. At the OECD-sponsored pledging session on May 30, Mr. Benjenk indicated the Management's willingness to recommend the Second Program Loan ($150 million) for an early consideration of our Board, subject to Turkey and the IMF reaching agreement on a new Standby. After agreement with the IMF was announced, and to enable us to advance matters accordingly, an appraisal mission visited Turkey in early July. It returned this week. Unlike the experience of the appraisal mission for the first loan, this one received excellent cooperation from all agencies and ministries, including the State Planning Organization and the Central Bank.

2. While an Issues Paper is being prepared with the idea of presenting the major issues to the Loan Committee, I thought that in the interim I should briefly inform you about this.

3. The performance under the First Program Loan has been creditable. While disbursements did not start as quickly as both Turkey and the Bank had anticipated, they totalled about $103 million, as of July 31. The loan should be fully disbursed by October/November. With the exchange rate adjustments made so far and the administrative measures taken to stimulate exports, including export rebates and the "imports for exports scheme", exports in 1978 were about 30 percent higher in value than in 1977; between January and June 1979, they were higher by 26 percent than in the same period in 1978. This performance is in line with the Government's August 22, 1978 letter to Mr. McNamara which formed the basis of the first loan.

4. In terms of overall economic performance, the results have been mixed, despite courageous actions, which were often taken only belatedly because of considerable domestic political difficulties. Nevertheless, the new Standby Arrangements approved by the IMF Board this month, are indicative of the Government's resolve to take the additional painful steps which are clearly necessary. The recent pledging of $1.45 billion of new aid, should help ease some of the political resistance to such steps. Among the measures that would have to be carried out would be further exchange rate adjustments to correct the difference between domestic and international inflation. Monetary ceilings and limits on budgetary and SEE deficits have also been negotiated. These steps, either implicit or explicit in the Standby Agreement, should help stablize the economy further in the short-term, and will be monitored by the IMF. The IMF is planning reviews in October 1979 and March 1980, prior to the release of the November 1979 and April 1980 tranches.

5. It therefore seems to me that the Bank's perspective regarding the economy, as a condition of making the Second Program Loan, should be more focussed on the medium-term. The Fourth Plan is now recognized by

the Government to be a document which sets the modified development strategy, but whose specific targets would be unachievable; and the Government's current Annual Program will have to be curtailed to more realistic levels in view of the commitments it has made under the new Standby. Our appraisal mission therefore focussed on determining the Government's policy objectives on six key points which we believe are important to a gradual restoration of health to the Turkish economy. The mission was successful in obtaining a Government statement on these objectives and policy actions in the attached letter addressed to Mr. McNamara. These are stated qualitatively, rather than quantitatively. However, since they relate to the medium-term and we would wish to avoid a duplication and possible conflict with the IMF, the qualitative statement retains the virtue of flexibility that we may need for our monitoring, especially if a new government comes into power a few months hence. In this connection, you should also know that the Government has tacitly agreed with the mission on the principle that the Bank would monitor the achievement of these objectives and actions, twice during the period of the proposed loan, and that disbursements would be tied to the outcome of these reviews.

6. For ease of appreciation, the mission has produced the attached tabular presentation of these major macro issues, the Government's contemplated policy measures regarding them, and the results they can be expected to bring.

Cleared with & cc: Messrs. Dubey (EMNVP), Thadani (IDF)

cc: Messrs. Benjenk o/r (EMNVP), Bart o/r, Asfour, Palmer/Baig (EM2)

AJDavar/bp

TURKEY: Key Points of the Economic Recovery Program

Main Issues	Recent Trends	Recent Measures	Policies and Measures for the Future	Expected Impact
A. Balance of Payments	Current a/c deficit was \$3.6 b. in '77 and \$1.8 b. in '78.	Administrative measures to prevent increase in deficit beyond '78 level.		
a. Exchange Rate Policy	Overvaluation and inadequate adjustments encouraged imports and capital intensive investments; discouraged exports.	Adoption in June '79 of a realistic exchange rate to help alleviate situation.	(i) Maintenance of Exchange Rate for Lira at competitive level. (ii) Review of "relevant arrangements" in Nov.'79 and March '80 to reach necessary understandings with the IMF.	Strengthen balance of payments; encourage exports and workers' remittances; stimulate less capital intensive investments.
b. Exports	Agricultural exports still dominate; export orientation is gradually increasing in the industrial sector. However, cumbersome export restrictions and licensing procedures and more lucrative domestic market discouraged exports.	Measures taken in '78/79 boosted exports by 30% in '78. Realestic exchange rate (since June '79) should help maintain growth trend. Permission to exporters to retain 50% of export earnings for import needs helps stimulate exports. Decree (May '79) has reduced procedural delays drastically.	Steps to further minimize export procedures; development of export credit, risk guarantee, and market development institutions, to be established by late '80. Incentives and priority for export oriented investments in private sector.	Continued export growth by at least 25% in '79, and similar growth in '80. Actions should contribute to upsurge of non-traditional exports; improve capacity utilization, and increase employment.
c. External Debt Management	Substantial accumulation of short-term indebtedness imposes an inordinately heavy burden, in the medium-term, on balance of payments; short-term debt went up in '78 by another \$2 b. because Turkey borrowed net short-term, and valuation adjustment of old debt, due to \$ slipping against Euro-currencies.	Guaranteed bilateral debts rescheduled up to June '79: IMF stand-by arrangement in July '79; commercial bank debts of \$429 m. rescheduled and further rescheduling of \$2.46 b. negotiated.	Further rescheduling on extended terms of guaranteed bilateral debt beyond June '79. Limiting new borrowing in '79/80 to US\$500 m. for maturities of less than 5 years plus \$500 m. for maturities 5-10 years.	Gradual restoration of creditworthiness, to maintain viable growth and economic stability.
B. Domestic Policies				
a. Inflation	Has encouraged consumption, discouraged savings and eroded potential benefits from Government's stabilization policies. Budget deficit of TL61 b. (4.7% GDP) and overall public sector deficit of TL115 b. (8.8% GDP) in '78. Net public sector borrowing from Central Bank TL63 b. in '78.	Effort to control public sector deficits and Central Bank borrowings in '78/79. Upward adjustment of interest rates in May '79.	With the objective of reducing the rate of growth of inflation in '79 and '80: limit total Central Bank credit to public sector to TL350 b. (net new borrowing of TL94 b. in FY79/80). Continue policy of limiting wage increases. Review interest rates periodically to minimize distortion of investment priorities and mobilize resources for investment program.	Gradual reduction in rate of growth of inflation in 1980. Slight decline in private consumption and some decline in private fixed investments.
b. Price Policies of SEEs	Underpricing of industrial goods produced or distributed by SEEs, has resulted in substantial losses, met through the budget and Central Bank borrowings. Has fueled inflation and contributed to the economic crisis. Total deficit of SEEs 4.1% GDP in '78.	Systematic increases in prices during '78/79, (petroleum products 100-150%, alcohol 90-100%, cigarettes, electricity, steel, cement, textiles etc.), should help alleviate the situation.	Continue policy of flexible pricing of SEE goods, encourage improved productivity and management by setting of production, profit and export targets. Total deficit declining by 0.8% GDP in '79.	Strengthen public sector finances. Improve resource allocation.
c. Public Sector Investment Program	An investment program, excessive in the light of available resources, and emphasis on large projects with long gestation period and marginal returns, has increased country's debt burden and fuelled inflation.	Priority to completion of ongoing projects and new investments mainly on priority projects for removing infrastructural bottlenecks or promoting exports.	Restraint on new investments in light of available resources with emphasis on completing ongoing projects near completion and projects contributing to exports, employment generation.	Sizable reduction in public fixed investments. Stimulate faster disbursements on priority project loans. Positive effect on containing inflation. Promotion of public sector exports.

T. C.
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20 Temmuz 1979

Mr. Robert S. McNAMARA
President, World Bank
Washington DC 20433
U.S.A.

Dear Mr. McNamara,

I wrote to you in August 1978 in connection with the Government of Turkey's request for a Program Loan, to explain the earnestness of our determination to increase export earnings and the types of measures which we intended to pursue. I am pleased to inform you that considerable progress has been achieved in the implementation of several important measures mentioned in that letter.

In this letter I wish to mention some important developments during this past year and to focus on the Government's principal objectives and targets in the medium term which need the World Bank's continued support.

In the context of our Fourth Development Plan, which some of your senior economic staff have had the opportunity to discuss with our State Planning Office staff earlier this year, and our experience of economic developments during 1978, the Government of Turkey has announced a series of important measures in the past six months which constitute now a substantial programme for the strengthening of the country's economy,

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increasing self-reliance and improving the pace of further economic development. The Government attaches prime importance to increasing the country's capacity for foreign exchange earnings and to ensuring the competitiveness of Turkish exports on a continuing basis, in order to maintain a satisfactory overall balance of payments position. The short term poblems associated with the country's external debt position are being managed to a position which will effectively limit the burden to a level that can be serviced appropriately over a number of years. The Government intends to maintain necessary measures to curb inflation, to increase domestic savings, to limit the burden of State Economic Enterprise deficits on the Budget, and to enforce more rigorous criteria for establishing priorities in the selection of public investments within the limits of available resources.

The Government has recently concluded a new stand-by arrangement with the International Monetary Fund which defines specific performance targets for 1979-80, which should establish a base for our medium term development program. I assume that its detailed provisions have already been communicated to you by staff and will not therefore repeat them here.

Export earnings, which have shown considerable buoyancy during 1978 and the first six months of this year, are expected to improve further as a result of the recently announced change in the parity value of the Turkish Lira. The Government realizing the foremost importance of export growth, will continue to ensure that exports remain competitive in world markets and profitable for exporters. The Government intends also to accelerate the pace of implementation of institutional improvements which have been under consideration. A few selected measures which I had mentioned in my letter to you last year are discussed below:

(a) While maintaining emphasis on the use of modern techniques and appropriate inputs for increasing the output of major export crops, the Government will continue to take necessary steps to relieve prevailing storage and transportation bottlenecks, provide additional resources for market research to identify promising non-traditional export crops and products, and channel further financial support to export-oriented production and marketing projects in the agricultural sector.

(b) In response to our request the International Trade Centre at Geneva has now sent to us a detailed proposal for the development of appropriate institutional and technical service arrangements. This is being examined in the concerned Ministries and after consultation with the ITC on the content and procedures for implementation of the project we will take necessary measures at an early date.

(c) Arrangements for export credit risk insurance which have been under study for some time in concerned Ministries will be completed for early implementation.

(d) In recent months export targets have been set for a number of State Economic Enterprises, and the Government intends to extend the targeting system to other SEE's which have potential for export trade development also.

(e) Priority in access to foreign exchange, term credit and working capital will be allowed to firms in both the private and public sectors which can achieve greater export earnings.

(f) A draft Decree for improvement of the procedures for encouragement of domestic and foreign investments, is presently under active consideration by Government and we expect that it will be finalized at an early date. The changes would provide encouragement as well as speedy approval for the deployment of foreign resources and technology in support of export expansion.

The debt re-scheduling process did not progress as rapidly as we would have wished in the first half of the year, but we have recently concluded agreements for the refinancing of Bankers Credits amounting to $. 429 million and for new money from commercial banks to the extent of $407 million both on seven-year terms which include a three-year grace period. Agreements for rescheduling of Convertible Turkish Lira Deposit Accounts worth $ 2.400 million for a similar term have also been negotiated; these will be formally concluded after technical verification of the amounts in individual accounts within the next few weeks. We expect further favourable developments as a consequence of the announcement of measures in June last to strengthen our foreign exchange earning capabilities, and we will continue our policy for suitable re-scheduling of debt on extended terms in order to reduce excessive bunching in the next two three years, and to gradually restore creditworthiness to the healthy level needed to maintain viable growth and economic stability.

In regard to domestic policies, the Government is committed to the reduction of inflationary pressures. It will continue its policy of curbing the excessive growth of nominal incomes, and press forward vigorously for improved productivity and capacity utilization. Taking into consideration the evolution of prices and their implication for public finances, credit policies will focus on measures to generate adequate resources for the approved Investment Programme for each year and the maintenance of an adequate return on all types of investments so as to minimize distortion of priorities, particularly in the private sector.

In the public sector, State Economic enterprises will be encouraged to maintain flexible pricing policies and to gradually eliminate operating deficits. Further improvements in management and productivity, and progressively more ambitious targets for the growth of output, profits and exports should help generate resources for more rapid development as well as improve resource allocation mechanisms. Improved allocation of scarce resources is particularly important in the context of the severe restraints within which the medium term development programme has to be implemented. The Government intends to give very high priority to the completion of those ongoing projects which, with modest increases in the allotment of funds, will yield speedy and substantial returns; other priorities would include projects through which quick impact can be achieved on exports and employment. I need hardly add that the Government attaches great importance to the speedy and economical achievement of high levels output in existing and new enterprises, in support of the export drive as well as to contain inflationary pressures.

As a large number of Ministries and agencies of Government are involved in the implementation of critically important elements of the Government's medium-term development program, we have appropriate procedures for internal review of progress achieved, identification of significant shortfalls, and appropriate corrective policy measures. The Ministry of Finance will prepare a periodic summary record of progress in relation to important targets and the decisions made by Government on new policy measures relevant to these. This record could serve as an effective basis for periodic exchange of views between the Government and the World Bank regarding progress in implementation of our medium term development program.

It must be noted that the investment levels contemplated for inclusion in our 1980 Investment Programme would depend in part upon financing that we expect to obtain through a second Program Loan. This has been assumed also in our stand-by arrangement with the International Monetary Fund to which I have referred earlier in this letter.

Taking into consideration all the facts set forth above, The Government of Turkey would like to request very early approval of a second Program Loan for US $. 150 million.

With personal regards.

Yours Sincerely,

Ziya MÜEZZİNOĞLU
Minister of Finance