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FROM: Vice President and Secretary

October 24, 1980

TURKEY - STRUCTURAL ADJUSTMENT LOAN

Attached for information is a note regarding the consultations under the Turkey Structural Adjustment Loan relating to the release of the final tranche.

Questions on this document may be referred to Mr. Berk (extension 72379).

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October 24, 1980

MEMORANDUM TO THE EXECUTIVE DIRECTORS

SUBJECT: Review of the Turkey Structural Adjustment Loan

As provided in Section 3.08 of the Loan Agreement for the Structural Adjustment Loan to Turkey (Loan 1818-TU), discussions were held in Washington from September 24 to October 3 on progress achieved in carrying out the economic program assisted by the loan.

General

After the military takeover on September 12, the new Government reaffirmed publicly its commitment to the January 1980 program and its intention to enact those parts of it previously held up by deadlock in Parliament, notably tax reform. The senior official largely responsible for the program holds the position of Deputy Prime Minister in charge of economic affairs in the new Government. The program continues to be implemented in a consistent way. Progress under the IMF standby arrangement remains satisfactory.

The review focused on recent performance and policies in the four areas agreed for monitoring of progress: export promotion, external debt management, domestic resource mobilization, and public investment.

Export Promotion

In the first eight months of 1980, exports increased only 6 percent in value over the corresponding period of the previous year against the Government's target of 10 percent in volume terms. While price movements have been uniformly favorable, and most commodities have shown volume increases, certain important agricultural and manufactured items have shown significant volume declines. The reasons include low initial agricultural stocks, lack of domestic finance for additional crop purchases, lower manufacturing production due to shortages of imported inputs and energy and labor disputes, and the need for time for the January 1980 and subsequent measures to have their full effect. Neither lack of adequate policy nor institutional weakness appears to have played a part. Now that a number of the problems have been overcome, the Government expects a large increase in exports during the remainder of the year.

There have been few changes recently in export policies and institutional arrangements. The Turkish Lira continues to be devalued in small steps approximately each two months. Export credits benefit from subsidized rates, especially since the interest rate liberalization in July. The Government has prepared a draft decree to establish an export credit insurance scheme. The establishment of specialized exporting companies has been facilitated.

Agreement has now been reached on all aspects of the study of the protection system. The first phase, to be completed by January 31, 1981, will be a short-term review of manufacturing industry to identify distortions, and define measures to increase export capability and capacity utilization, and remove bottlenecks. It is expected to lead to earlier action than originally anticipated, through changes in the 1981 import regime and other relevant policies. The second phase involves an in-depth study of export incentives, the import regime, and investment incentives; policy papers with recommendations for reform, and restructuring programs to assist affected industries, will also be prepared. The work will take until the end of 1982, about nine months after the originally agreed date; but reforms will be introduced as they are ready. The new system resulting from the liberalization program is expected to be fully in place by the end of 1984, which was the original expectation.

External Debt Management

External debt management policies have remained sound. Following the large rescheduling of debts to OECD member countries in July, Turkey is in contact with commercial banks regarding possible further assistance. Detailed agreement has been reached on the computerization of the large and complex volume of external debt data, currently assembled manually, with Bank technical assistance.

Domestic Resource Mobilization

Domestic resource mobilization efforts present a mixed picture. Large price increases in the state sector, both in the January 1980 program and repeatedly since then, are expected to permit a small operating profit for SEEs in 1980. However, budgetary transfers to them have increased beyond original expectations due to a consolidation of their tax payments and repayment of part of their large arrears to contractors. While Government revenues and expenditures have both declined in real terms over 1979 levels, revenues in particular are lagging, with substantial arrears in tax collection due to increased evasion prompted by failure to adjust income tax schedules for high inflation. The anticipated budget deficit for 1980 has increased significantly, borrowing from the Central Bank has stayed high, and Government arrears to contractors are still accumulating. Little can be done to correct these problems in the short run. The failure of Parliament to pass two tax bills since February 1980 has been a further major problem. The new Government has, however, stated publicly its intention to enact tax reforms shortly.

Interest rates on time deposits (and most loans) were liberalized on July 1, and have risen by 4 to 12 percentage points, depending on maturity. Bank deposits have responded immediately, with an increase in July only slightly less than total increases in the preceding six months.

Moreover, with greater competition emerging within the banking sector, it seems likely that interest rates will continue, at least in the short term, to be sufficiently attractive to financialize substantial private savings. The yield on private bonds has been raised somewhat, and that on Government bonds from 18 percent before July to 30 percent currently, both tax-free. Measures to increase the financialization of private savings thus go well beyond agreements under the loan.

Public Investment

The overall level of public investment continues to be tailored to available resources, and the current estimate implies a substantial real decline over the 1979 level. The criteria used for sector and project allocations remain appropriate to Turkey's present circumstances. Priority projects have retained a substantial increase in real allocations.

Conclusion

The progress made to date is consistent with the obligations in the Structural Adjustment Loan. Consequently, the Government of Turkey has been advised of the availability of the final tranche of $50 million.

Ernest Stern
Senior Vice President
Operations