

## I. ECONOMIC ENVIRONMENT

### (1) MAJOR FEATURES OF THE ECONOMY

1. Turkey has a landmass, excluding lakes, of 769,604 square kilometres (35% is arable); around 65% of its 68 million people live in urban areas. The most populated cities are Istanbul (about 10 million) and the capital Ankara (more than 4 million); its annual population growth rate was 1.6% in 2001 (down from 1.8% in 1997). Around 4 million Turkish people live abroad, more than half of which are in Europe. Turkey has a young population structure; about 30% are in the 0-14 age group. In 2002, Turkey ranked as the world's 17<sup>th</sup> most industrialized nation, and 85<sup>th</sup> out of 173 countries in terms of Human Development Indicators.<sup>1</sup>

2. Turkey is a middle-income country, with a GNP per capita of US\$2,584 in 2002; it is a major emerging market economy.<sup>2</sup> Its location between Europe and Asia, and along the Mediterranean, Aegean, and Black Sea constitutes a major advantage.<sup>3</sup> Services is the most important sector in terms of contribution to real GDP (about 65%). The sector is led by tourism (a major net foreign exchange earner), and financial services. Manufacturing contributes around one fifth to real GDP and about 80% to the total value of merchandise exports. Agriculture is an important sector of the Turkish economy despite the decline in its contribution to real GDP (to about 12%); it employs over 34% of the population. The mining, quarrying, and energy sector is being developed; Turkey is among the fastest growing energy markets in the world.

3. The exchange rate of the Turkish lira (TL) is market-determined; Turkey accepted the obligations of Article VIII of the Agreement of the IMF on 22 March 1990. On 22 February 2001, Turkey moved from a crawling peg to a floating exchange rate system; this immediately resulted in a depreciation of the lira.<sup>4</sup> Turkey's debt exposure has been a key source of external vulnerability. Moreover, its high inflation has imposed a heavy burden on the economy, worsened the inequality of incomes, and distorted the planning horizons of investors and savers.<sup>5</sup> Consequently, the economy has been under constant threat of instability, which has discouraged foreign and domestic investment. In addition, Turkey's economic growth has become increasingly volatile; there were severe recessions, in 1999 and 2001, when real GNP decreased by 6.1% and 9.5%, respectively (Table I.1).

4. Turkey is in the midst of implementing an ambitious economic reform programme supported by the 2002-04 Stand-By Arrangement (SBA) with the IMF<sup>6</sup>, and the World Bank's 2001-03 Country Assistance Strategy (CAS).<sup>7</sup> The programme is aimed, *inter alia*, at stabilizing the economy, particularly bringing inflation under control, and addressing some of the deep-rooted structural problems built over the previous decades: key industries, such as tobacco, sugar, transport, energy, and telecommunications remain dominated by public companies; insignificant foreign direct investment (FDI) inflows<sup>8</sup>; a fragile banking sector, where bank credit to private enterprises is very

<sup>1</sup> World Bank (2002).

<sup>2</sup> World Bank (2002).

<sup>3</sup> Turkey borders with Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Iran, Iraq, and Syria.

<sup>4</sup> Between 22 and 28 February 2001, the lira depreciated by 32.2% against the U.S. dollar.

<sup>5</sup> The costs associated with inflation are explained in WTO (1998).

<sup>6</sup> Total access under the IMF's SBA is SDR 12.8 billion, equivalent to about US\$16 billion. Turkey has so far drawn about SDR 10.8 billion. Turkey has signed 18 SBAs with the IMF since 1961. IMF (2003).

<sup>7</sup> The CAS envisages lending Turkey up to US\$6.2 billion during the financial years (FY) 2001-03. The World Bank has so far committed US\$4.5 billion, and in FY 2001/02, disbursements amounted to US\$2.5 billion. IMF (2003).

<sup>8</sup> FDI inflows, at 0.6% of GNP (the average over 1998-01), are insignificant compared with leading emerging market countries (IMF, 2002).

low <sup>9</sup>; and high public debt burden and current account deficits. The programme is also aimed at bringing Turkey closer to its goal of EU accession.

**Table I.1**  
**Main economic indicators, 1998-02**

	1998	1999	2000	2001	2002
<b>Miscellaneous</b>					
GNP (US\$ billion)	206.6	185.3	200.0	145.7	179.9
GDP (US\$ billion)	201.6	183.2	198.4	147.3	181.6
GNP per capita (US\$)	3,255	2,879	2,965	2,123	2,584
Real GNP (annual percentage change)	3.9	-6.1	6.3	-9.5	7.8
Real GDP (annual percentage change)	3.1	-4.7	7.4	-7.5	7.8
Unemployment rate (per cent)	6.3	7.7	6.6	8.4	10.3
Consumer price index (end of period; percentage change)	69.7	68.8	39.0	68.5	29.7
Real effective exchange rate index (1995=100) <sup>a</sup>	120.9	127.3	147.6	116.3	125.4
Exchange rate (thousand TL per US\$; end of period)	314.5	541.4	673.4	1,450.1	1,643.7
Discount rate (per cent)	67.0	60.0	60.0	60.0	55.0
<b>Monetary sector</b>					
	(percentage change, end of year)				
Money supply (M2 broad money)	101.9	96.1	42.5	48.0	31.0
<b>Share of real GDP</b>					
	(per cent)				
Agriculture	16.9	14.6	13.6	11.4	11.7
Industry	21.4	21.9	22.5	24.2	24.1
- Manufacturing	18.0	17.9	18.5	19.3	19.1
Services	61.7	63.5	63.8	64.4	64.3
<b>Government finance</b>					
	(percentage of GNP)				
Primary balance	..	-0.2	2.7	5.5	3.9
<b>National accounts</b>					
	(percentage of GNP)				
Private consumption	67.5	67.4	69.7	68.3	66.4
Public consumption	12.4	14.2	13.7	13.5	14.0
Private fixed capital formation	18.0	15.1	16.0	11.9	11.0
Public fixed capital formation	6.0	5.4	5.8	5.3	5.7
Exports of goods and non-factor services	24.3	23.2	24.0	33.7	28.8
Imports of goods and non-factor services	27.9	26.9	31.5	31.3	30.5
<b>Memorandum</b>					
Current account balance (percentage of GNP)	1.0	-0.7	-4.9	2.4	-0.8
Gross external debt (percentage of GNP)	48.7	55.0	59.5	80.0	68.1
Gross official reserves (US\$ billion)	20.7	24.2	23.2	19.8	28.1
Gross official reserves (months of total imports)	5.4	7.1	5.1	5.8	6.6
Import cover (ratio of exports to imports)	58.7	65.4	51.0	75.7	69.8
Trade in goods and services (percentage of GNP)	55.3	51.8	57.3	66.9	60.4
Terms of trade (percentage change)	0.0	-1.3	-8.5	-2.3	-0.6

.. Not available.

a CPI based real effective exchange rate index uses the IMF weights for 19 countries: Germany, United States, Italy, France, United Kingdom, Japan, Netherlands, Belgium, Switzerland, Austria, Spain, Canada, Republic of Korea, Sweden, Chinese Taipei, Iran, Brazil, China, and Greece. Increases of the index indicate real appreciation of the Turkish lira.

Source: IMF, *International Financial Statistics*, various issues; and information provided by the Turkish authorities.

<sup>9</sup> Bank credit to private enterprises in Turkey is estimated at 25% of GNP, and represents one fourth of the average for EU countries. IMF (2002).

## (2) RECENT ECONOMIC DEVELOPMENTS

5. Since its last Trade Policy Review (TPR), Turkey has taken steps to stabilize its economy. At the time of the previous Review, the economy was recovering from the severe recession of 1994, registering annual GNP growth rates of 7% to 8% in the three following years. However, large fiscal imbalances and persistently high inflation had put into question the medium-term sustainability of such recovery.<sup>10</sup> Since then, Turkey has had four stabilization programmes. The first was a three-year disinflation programme, initiated in July 1998 to reduce wholesale price inflation from over 90% at end-1997 to 50% by end-1998, 20% by end-1999, and to single digits by end-2000.<sup>11</sup> The main policies of the 1998 programme were: (i) an increase in the primary surplus of the fiscal budget that would be sustained during the disinflation process; (ii) a shift in the management of key variables, such as public sector wages and agricultural support prices, so that they would be in line with targeted inflation; (iii) a supportive and closely coordinated monetary policy; (iv) structural reforms to ensure the progressive strengthening of public finances over time; and (v) stepped-up privatization to lower the domestic borrowing requirement and enhance economic efficiency.<sup>12</sup>

6. Despite some improvements in the inflation rate, Turkey could not implement some key structural reform measures envisaged in the 1998 programme: (i) approval of a regulatory framework for the telecommunications and energy subsectors to facilitate privatization; (ii) implementation of a social security reform designed to raise the minimum retirement ages and extending the minimum contribution period to be eligible for full benefits; (iii) privatization; and (iv) adoption of a banking sector reform bill to establish an independent regulatory body, and clarify remedial measures for banks. This slow progress on structural reforms worsened the economic situation and made the 1998 programme no longer viable. The Russian Federation default during the summer of 1998, deterioration in fiscal balances due to the general elections in April 1999, and the two devastating earthquakes of August and November 1999 worsened the situation.

7. In December 1999, Turkey launched another three-year stabilization programme, supported by a US\$4 billion credit facility from the IMF, relying on exchange-rate based disinflation and monetary control. The 1999 programme further entailed a series of measures on fiscal expenditures, and set performance criteria on the balance of non-interest primary budget. Among the structural reforms envisaged were: (i) addressing distortions built up in the agricultural sector, by phasing out existing indirect support policies over a two-to-three-year period and replacing them with a direct income-support programme; (ii) deepening social security reforms by undertaking further administrative measures to improve coverage, and the creation of a legal framework more suitable for the expansion of private pension funds; and (iii) privatization of operations in the key subsectors of telecommunications and energy.<sup>13</sup>

8. In 2000, the economy rebounded (real GNP grew by 6.3%), and domestic interest rates fell more sharply than expected; lower interest rates, coupled with increased confidence, induced a stock market boom. However, inflation turned out to be stickier than expected, and the lira appreciated by 15.7% in real terms, leading to a current account deficit of 4.9% of GNP. Furthermore, the foreign capital needed to finance the structural reform began to falter, raising concerns about the continuity of the programme and current account sustainability. This, in turn, reversed the declining trend in

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<sup>10</sup> WTO (1998).

<sup>11</sup> Average annual inflation rate was 20% in the 1970s, 35-40% in the early 1980s, 60-65% in the late 1980s and early 1990s, and around 90% before the disinflation programme in December 1999 (OECD, 2002b).

<sup>12</sup> At the request of the Turkish authorities, a quarterly IMF review process backed up the programme, with the announcement of short-term targets for implementing a range of macroeconomic and structural policies (IMF, 2002).

<sup>13</sup> IMF (2003).

nominal interest rates provoking financial turmoil in November 2000. The three-year exchange-rate-based stabilization programme collapsed only 14 months after its launch, when the crawling peg for the lira was replaced by a floating exchange rate system on 22 February 2001. This created nominal interest and exchange rate shocks that affected all economic sectors.<sup>14</sup>

9. In May 2001, a "transition programme for strengthening the economy" was put into place with the same basic disinflation strategy. The 2001 programme also featured, *inter alia*: (i) a fundamental restructuring of the banking sector, including the financial and operational restructuring of state banks with the aim of privatization; (ii) a commitment to a floating exchange rate in an attempt to reduce vulnerability to currency shocks; (iii) a further fiscal adjustment to bring down inflation and interest rates, and ensure sustainability of public debt; and (iv) an enhanced role for the private sector. Just as the programme was beginning to show some positive results, the effects of the 11 September attack in the United States caused a big economic recession in Turkey. Turkey's GNP experienced its steepest decline since the 1940s (-9.5%), accompanied by rising inflation and unemployment rates.<sup>15</sup>

10. In response to the 2001 economic crisis, an economic reform programme was initiated for the period 2002-04. Its main elements are: (i) maintaining the floating exchange-rate regime; (ii) replacing the monetary targeting of the tight monetary policy with formal inflation targeting; (iii) further strengthening the banking sector; (iv) fiscal discipline to foster medium-term debt sustainability; (v) addressing redundancy problems in public sector employment; (vi) further liberalization of markets (including in energy and telecommunications) to promote private-sector-led growth; (vii) continuation of the agriculture sector reform; (viii) speeding up the privatization of public enterprises; and (ix) strengthening social assistance to help people adversely affected by the crisis.<sup>16</sup>

11. In 2002, the economy rebounded strongly and GNP growth reached 7.8%, more than double the 3% initial target, led largely by a surge in industrial production. The GNP growth target for 2003 is 5%.<sup>17</sup> The floating exchange rate system, still in place, gives greater flexibility to monetary policy to contain inflation: first through the use of base money targets<sup>18</sup>, and eventually with the introduction of formal inflation targeting once the uncertain ties in the domestic and external environment have dissipated.<sup>19</sup> The Central Bank of Turkey (CBT) has been making progress in the preparatory work towards a full-fledged inflation-targeting framework as early as possible. The institutional framework for monetary policy was strengthened by the approval of amendments to the Central Bank Law in April 2001, granting autonomy to the CBT to pursue its primary mandate of maintaining price stability.<sup>20</sup> Mainly as a result of the CBT's base money growth targets, inflation went down from

<sup>14</sup> OECD (2002).

<sup>15</sup> Overall unemployment, based on a households survey, jumped to 10.5% in the fourth quarter of 2001 (up from 5.5% in the third quarter of 2000) (IMF, 2003).

<sup>16</sup> OECD (2002).

<sup>17</sup> From the first half of 2002 to the first half of 2003, real GNP grew by 5.4%.

<sup>18</sup> The CBT announced a medium-term disinflation path consisting of consumer price index end-year inflation targets of 35% in 2002, 20% in 2003, and 12% in 2004. In this preparatory phase, in order to achieve this inflation path, base monetary growth eased in line with projected real output growth and inflation, with scope for revision if there is strong evidence of money demand shifts (IMF, 2002).

<sup>19</sup> Domestic uncertainties refer to the November 2002 election outcome, delays in the passage of the 2003 budget, and the consistency of the latter with debt sustainability. External uncertainties mainly centre on the military conflict in Iraq, whose effects had already been felt in 2002 in the form of higher oil prices. OECD, (2002b).

<sup>20</sup> In addition to institutional changes, technical preparations are proceeding for the introduction of inflation targeting; for example the CBT now issues Monetary Policy Reports, a forerunner to a quarterly Inflation Report. IMF (2002).

68.5% in 2001 to 29.7% in 2002, its lowest rate in two decades and well below the 35% official target (Table I.1). For 2003, Turkey's consumer price inflation target is 20%.<sup>21</sup>

12. Despite its recent economic crises, Turkey has achieved an important turnaround in its fiscal position since 1999, one of the main sources of its macroeconomic imbalances in the past. The public sector primary balance improved from a deficit of 0.2% of GNP in 1999 to a surplus of 5.5% in 2001, setting the stage for fiscal sustainability, a central plank of the economic programmes. Most of the fiscal improvement, about 4.5% of GNP, came from the broader public sector (outside the central government). In 2002, however, Turkey could not implement some important fiscal measures, such as reforming direct taxation, advancing privatization and reducing overstaffing in public companies in line with programme targets, and the public sector primary surplus reached 3.9% of GNP, missing the target of 6.5%. In addition, Turkey's public sector net debt burden remains high (79.4% of GNP in 2002).<sup>22</sup> For 2003, the public sector primary surplus target is again 6.5% of GNP.<sup>23</sup>

13. After deficits of 0.7% of GNP in 1999 and 4.9% in 2000, the current account registered a surplus of 2.4% of GNP in 2001, partly due to the real depreciation of the lira by 21.1%. In 2002, alongside Turkey's economic recovery, the current account registered a deficit of 0.8% of GNP, close to programme projections. For 2003, the current account deficit is expected to be equivalent to 3% of GNP (estimated to be US\$7.4 billion).<sup>24</sup>

14. External debt exposure, a key source of external vulnerability, has increased; gross total external debt jumped from 48.7% of GNP in 1998 to 68.1% in 2002, after having peaked at 80% in 2001, largely due to the substantial depreciation of the lira. Moreover, Turkey's payment obligations to the IMF are substantial over the medium term, particularly in 2005-06, when total debt service due is US\$18.5 billion.<sup>25</sup> In 2002, however, strengthened capital inflows to the private sector and increased non-resident deposits at the CBT contributed to a stronger than expected capital account balance, allowing the build-up of reserves of over US\$6.1 billion, twice as large as projected. With the conclusion of the fifth Review of the SBA in August 2003, Turkey will repay US\$4.3 billion in 2004, US\$ 7.8 billion in 2005, US\$10.7 billion in 2006, and US\$1.8 billion in 2007.

### **(3) TRADE PERFORMANCE AND INVESTMENT**

#### **(i) Trade in goods and services**

15. Turkey has continued to run a merchandise trade deficit since its last TPR, peaking at US\$22.4 billion in 2000, largely as a result of the 15.9% real appreciation of the lira (the year when the crawling peg system began). In 2001, the deficit decreased to US\$4.5 billion due to the severe contraction in economic activity and the 21.2% real depreciation of the lira. In 2002, the merchandise

<sup>21</sup> Over January-August 2003, the cumulative CPI inflation rate was 11.7%, while the August 2002-August 2003 rate was 24.9%.

<sup>22</sup> Pre-election spending initiatives in the run-up to the November 2002 elections, and weak revenue performance in anticipation that the new government would award a tax amnesty, partly explain why fiscal targets were missed in 2002. Turkey's gross redemptions of domestic debt have averaged US\$6 billion monthly during 2003 (IMF, 2003). According to the authorities, the net debt burden of the public sector is expected to fall below 70% of GNP at the end of 2003.

<sup>23</sup> Over January-May 2003, public sector primary surplus amounted to TL 9.5 quadrillion, slightly above the targeted level for that period.

<sup>24</sup> Turkey's Letter of Intent to the IMF, of 25 July 2003. During the first half of 2003, the current account registered a deficit of US\$4 billion.

<sup>25</sup> IMF (2003).

trade deficit was US\$8.3 billion after the Turkish economy had rebounded and the real exchange rate had appreciated by 7.8%.<sup>26</sup>

16. The ratio of Turkey's total trade to GDP rose from 52.2% in 1998 to 59.3% in 2002. In 2001, the country ranked 25<sup>th</sup> among world merchandise exporters (considering the EU countries together and excluding intra-EU trade)<sup>27</sup>, and 20<sup>th</sup> among importers, compared with 26<sup>th</sup> and 19<sup>th</sup>, respectively, in 1999.<sup>28</sup> For trade in services, Turkey ranked 24<sup>th</sup> as an exporter and 38<sup>th</sup> as an importer in 2001, a worsening of its ranking from 19<sup>th</sup> and 32<sup>nd</sup>, respectively, in 1999.

17. Turkey has a relatively diversified export base. In general, since 1998, the importance of manufactured goods has increased, while the share of primary products (mainly food, and to a lesser extent mining products) has declined. (Table AI.1). Machinery and transport equipment, clothing, textiles, food products, and iron and steel are the main exports (Chart I.1). The share of machinery and transport equipment in total exports rose from 15.1% in 1998 to 24% in 2002, and exports of iron and steel increased from 6.8% to 7.8%; clothing exports declined from 26.3% to 22.5% in the same period.

18. More than half of Turkey's exports go to the EU; Germany is still the major export market (16.3% of total merchandise exports in 2002, down from 20.3% in 1998). Turkey's goods exports to the United States increased from 8.3% of total merchandise exports in 1998 to 9.3% in 2002, whereas the share of Middle East countries in Turkish goods exports has been around 9% over the same period (Chart I.2 and Table AI.2).

19. Turkey's imports have fluctuated in parallel with the country's economic performance. Total merchandise imports decreased from a peak of US\$54.5 billion in 2000 to US\$41.4 billion in 2001 (among the lowest levels in a decade), due to the deep economic recession. In 2002, as a result of the significant recovery, total goods imports reached US\$51.2 billion. Manufactured goods represented 66.2% of total merchandise imports in 2002, down from 75.4% in 1998. The share of machinery and transport equipment in total merchandise imports decreased from 39.5% in 1998 to 30.4% in 2002; the share of chemicals increased from 14.3% to 15.4% over the same period, and the share of fuels jumped from 7.9% to 17.6%, partly as a consequence of the increase in oil prices (Chart I.1 and Table AI.3).

20. Turkey's goods imports largely originate in the EU, which accounted for 45.3% of total merchandise imports in 2002 (down from 52.4% in 1998). Germany is still the leading source of Turkey's imports, supplying 13.7% of total merchandise imports in 2002 (down from 15.9% in 1998). Goods imports from the Russian Federation rose from 4.7% in 1998 to about 7.5% in 2002; Middle East countries also increased their share from 4.3% to 5.8% during the period (Chart I.2 and Table AI.4).

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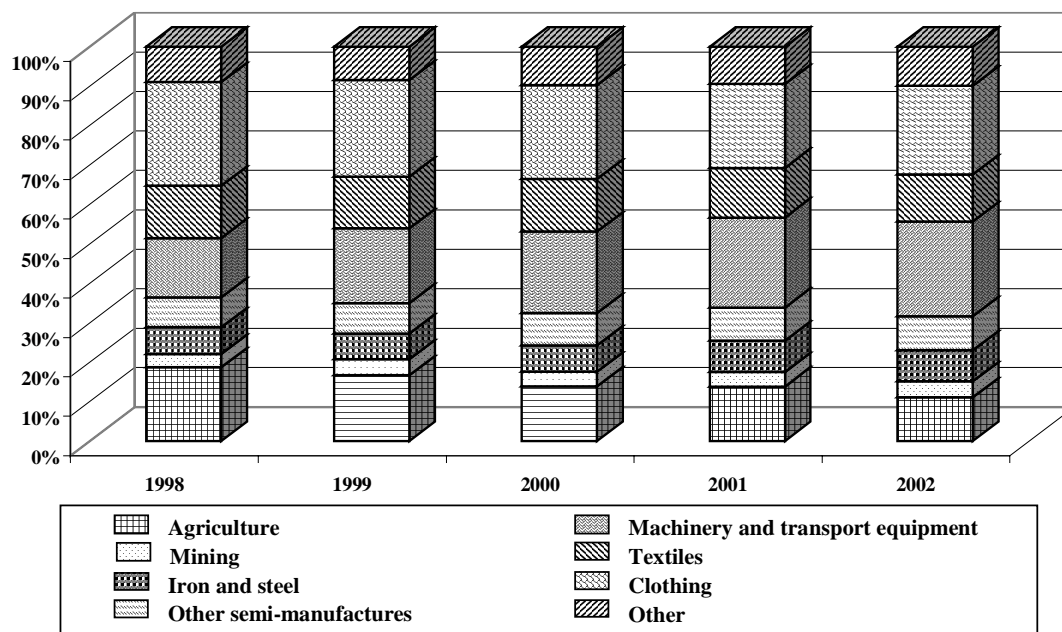
<sup>26</sup> During the first half of 2003, the merchandise trade deficit amounted to US\$5.5 billion.

<sup>27</sup> WTO (2002).

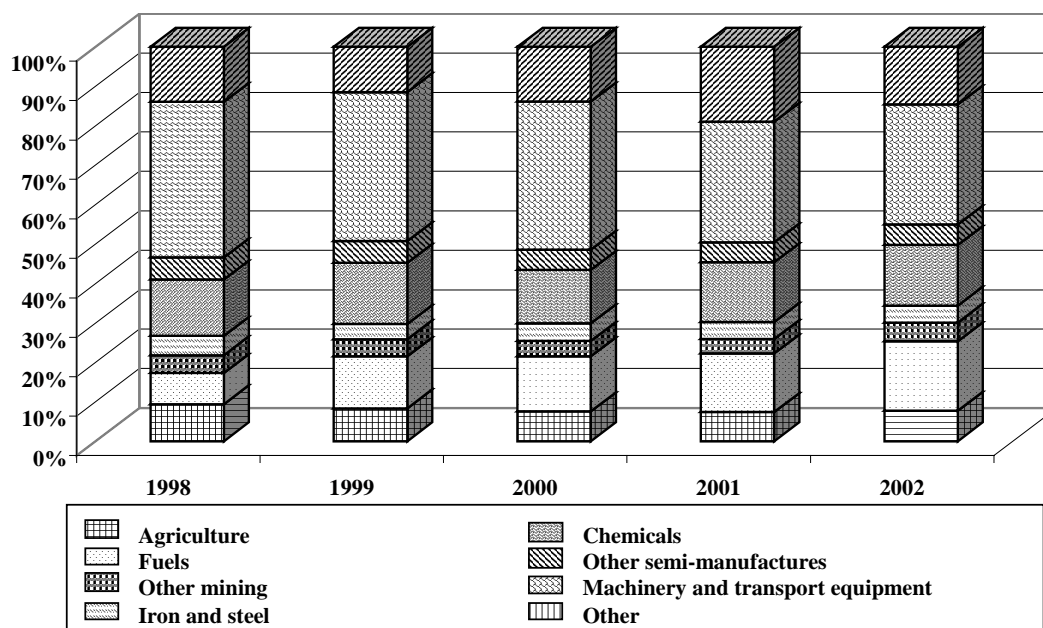
<sup>28</sup> WTO (2000).

**Chart I.1**  
**Structure of merchandise exports and imports, 1998-02**

**(a) Exports**



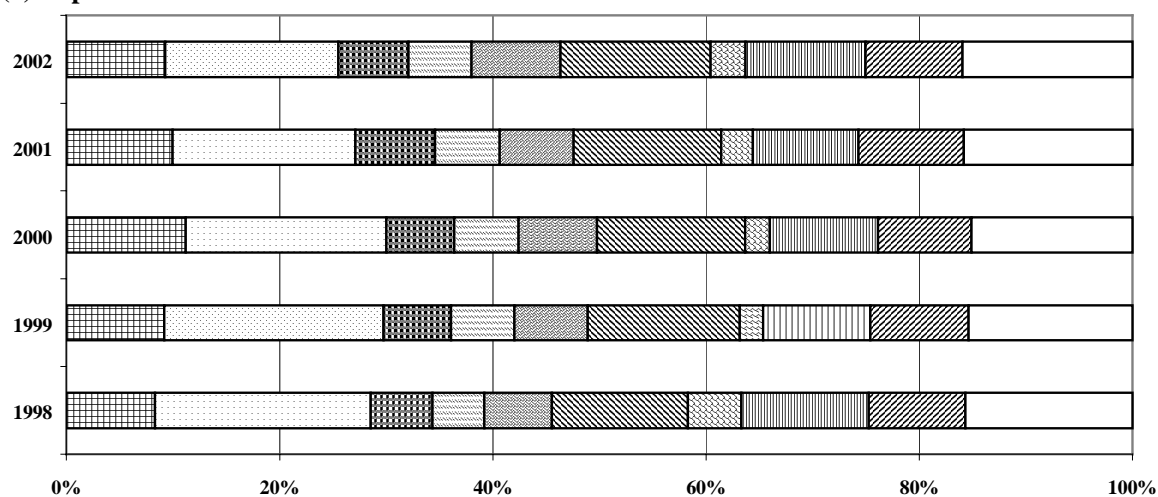
**(b) Imports**



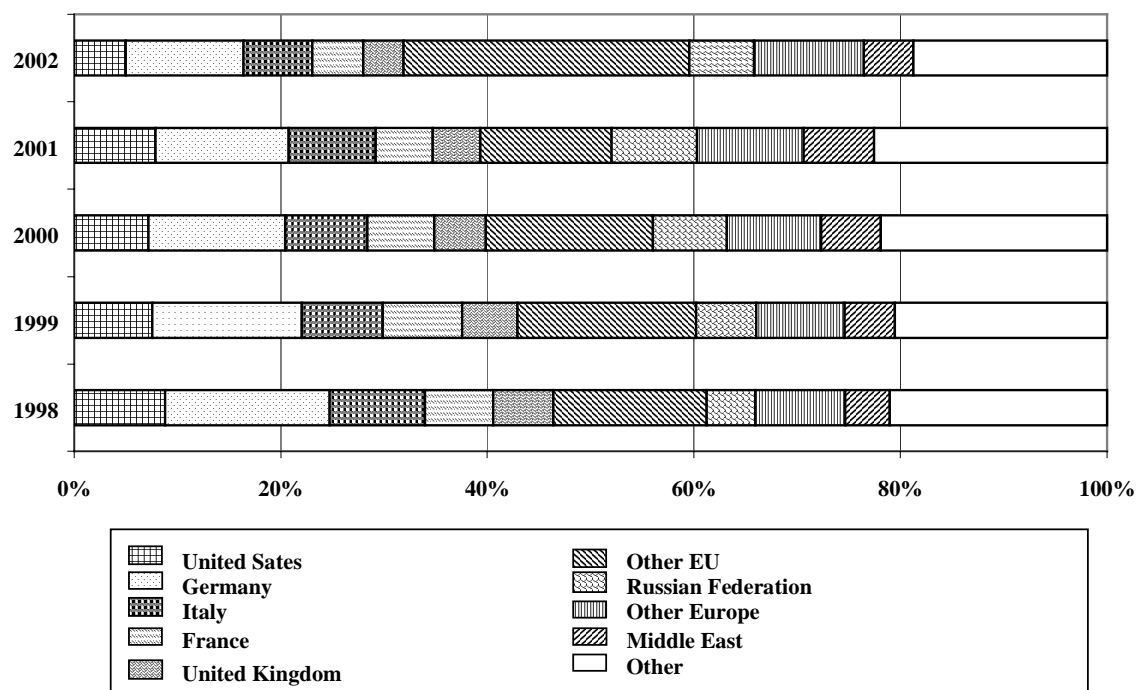
Source: WTO Secretariat calculations, based on UNSD, Comtrade database.

**Chart I.2**  
**Direction of merchandise trade, 1998-02**

**(a) Exports**



**(b) Imports**



Source: WTO Secretariat calculations, based on UNSD, Comtrade database.



21. Balance-of-payments data indicate that Turkey continues to be a net exporter of services, albeit with a decreasing surplus (Table I.2). Total exports of services decreased from US\$23.7 billion (equivalent to 11.5% of GNP) in 1998 to US\$14.8 billion (8.3% of GNP) in 2002; tourism accounted for US\$8.5 billion (57.4% of total services receipts) in 2002, up from US\$7.2 billion (30.4% of total services exports) in 1998.<sup>29</sup> Total imports of services decreased from US\$10.2 billion in 1998 to US\$6.9 billion in 2002. The major items on the debit account are transportation and travel services.

**Table I.2**  
**Balance-of-payments, 1998-02**  
(US\$ billion)

	1998	1999	2000	2001	2002
<b>General balance</b>	<b>0.4</b>	<b>5.2</b>	<b>-3.0</b>	<b>-12.9</b>	<b>-0.2</b>
<b>Current account</b>	<b>2.0</b>	<b>-1.3</b>	<b>-9.8</b>	<b>3.4</b>	<b>-1.5</b>
<b>Trade balance</b>	<b>-14.2</b>	<b>-10.4</b>	<b>-22.4</b>	<b>-4.5</b>	<b>-8.3</b>
Exports	30.7	28.9	30.7	34.4	39.9
Imports	-44.9	-39.3	-53.1	-38.9	-48.2
<b>Services (net)</b>	<b>13.5</b>	<b>7.5</b>	<b>11.4</b>	<b>9.1</b>	<b>7.9</b>
Service (credit)	23.7	16.8	20.4	16.0	14.8
Tourism receipts	7.2	5.2	7.6	8.1	8.5
Service (debit)	-10.2	-9.3	-9.0	-6.9	-6.9
<b>Income (net)</b>	<b>-3.0</b>	<b>-3.6</b>	<b>-4.0</b>	<b>-5.0</b>	<b>-4.5</b>
Credit	2.5	2.3	2.8	2.8	2.5
Interest	1.0	1.0	1.2	1.1	0.8
Debit	-5.5	-5.9	-6.8	-7.8	-7.0
Interest	-3.9	-4.5	-4.8	-5.5	-4.4
<b>Current transfers</b>	<b>5.7</b>	<b>5.2</b>	<b>5.2</b>	<b>3.8</b>	<b>3.4</b>
Workers remittances	5.4	4.5	4.6	2.8	1.9
Imports with waiver	0.2	0.3	0.4	0.8	1.0
Official transfers (net)	0.1	0.4	0.2	0.2	0.5
<b>Capital account</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Financial account</b>	<b>-1.3</b>	<b>-0.4</b>	<b>12.6</b>	<b>-1.7</b>	<b>1.6</b>
Direct investment (net)	0.6	0.1	0.1	2.8	0.8
Portfolio investment	-6.7	3.4	1.0	-4.5	-0.6
Assets	-1.6	-0.8	-0.6	-0.8	-2.1
Liabilities	-5.1	4.2	1.6	-3.7	1.5
Debt securities	-4.6	3.8	1.1	-3.7	1.5
General Government	-4.2	3.7	1.0	-3.6	2.0
Bond issued abroad (net)	-0.3	3.1	6.1	0.1	1.0
Other investment	5.0	1.8	11.8	-2.7	7.5
Assets	-1.5	-2.3	-1.9	-0.6	-0.7
Liabilities	6.5	4.0	13.7	-2.1	8.2
Loans	3.5	3.0	12.9	0.6	5.3
Monetary Authority	-0.2	0.5	3.3	10.2	-6.1
General Government	-1.7	-1.9	0.1	-2.0	11.8
Banks	0.9	2.1	4.4	-8.1	-1.0
Other sectors	4.5	2.3	5.0	0.4	0.6
Currency and deposits	2.9	0.2	-0.02	-0.8	0.4
Monetary Authority (FX accounts held within CBRT)	0.6	-0.2	0.6	0.7	1.3
<b>Reserve assets</b>	<b>-0.2</b>	<b>-5.7</b>	<b>-0.3</b>	<b>2.7</b>	<b>-6.1</b>
<b>Net errors and omissions</b>	<b>-0.7</b>	<b>1.7</b>	<b>-2.8</b>	<b>-1.7</b>	<b>-0.1</b>

Source: Information provided by the Turkish authorities.

<sup>29</sup> During the first half of 2003, total services exports amounted to US\$6.1 billion (tourism contributed US\$2.7 billion); and total imports reached US\$3.5 billion.

**(ii) Investment**

22. Turkey's vast potential for attracting foreign investors and fostering domestic investment remains largely untapped. Inflows of foreign direct investment (FDI) remain low in absolute terms but also by East European or Latin American standards.<sup>30</sup> FDI inflows peaked at 2.3% of GDP in 2001 (US\$3.3 billion, up from US\$1.7 billion in 2000), but this was largely accounted for by one-off sales of telecommunication licences (Chapter IV(5)(iii)). In 2002, foreign investment inflows, in the form of equity capital, dropped to US\$590 million, the lowest level since 1988, mainly due to political instability and continuing uncertainty after the crises in late 2000 and early 2001. Over the period 1980-2002, foreign investment inflows in Turkey amounted to about US\$14.7 billion, less than the amounts invested by foreign companies in some emerging countries in a single year.<sup>31</sup>

23. In general, FDI in Turkey has been inhibited by several factors, notably economic instability, and the slow progress in the implementation of its privatization programme (Chapter III(4)(ii)). In addition, according to a 2001 study undertaken by the Turkish Treasury and the World Bank, foreign investors consider the Turkish legislative framework complicated and not transparent. Some of the specific problems facing investors in Turkey include: (i) frequently changing tax and accounting rules and procedures; (ii) excessive documentation requirements; and (iii) cumbersome customs procedures, municipal regulations and inspections, and industrial standards and certification.

24. The Turkish authorities have recently been implementing measures to improve the investment climate in the country. In particular, in June 2003, a new Law on foreign investment was enacted to pave the way for a surge in foreign investment inflows (Chapter II(5)). Parliament has also recently enacted a Bill that simplifies the company establishment process both for foreigners and locals. Previously, it took 53 days for a standard company to legally start operations in Turkey, and required permission from 19 different authorities. This is now achievable at Trade Registry Offices within 24 hours, after passing through three authorities. In addition to the investment incentives already in place (Chapters II(5), and III(4)(i)), the tax burden on corporations is to be reduced from 44% to 37%; and 40% of investment funds are to benefit from investment allowance.

25. Since 1998, manufacturing and services have attracted almost all FDI inflows into Turkey; FDI in agriculture and mining has been very low and in some years even zero (Table I.3).<sup>32</sup> The share of the manufacturing sector in total FDI decreased from 58% (US\$553 million) in 1998 to 29% (US\$171 million) in 2002, whereas the share of services jumped from 38% (US\$362 million) to 71% (US\$419 million) over the same period. The EU continues to be by far the largest investor in Turkey, accounting for 83% of total FDI inflows in 2002 (up from 58% in 1998). Some other OECD countries, particularly the United States, as well as Middle East countries, complete the list of investors into Turkey.

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<sup>30</sup> Turkey's FDI inflows represented only 0.6% of GDP over the period 1998-01. The equivalent figure for countries such as Hungary, Czech Republic, and Brazil were: 3.4%, 8.7%, and 4.7%, respectively (OECD, 2002).

<sup>31</sup> *Financial Times*, 2 July 2003. During the first half of 2003, FDI inflows into Turkey reached US\$242 million.

<sup>32</sup> During 1998-02, total FDI in agriculture and mining amounted to US\$9 million and US\$56 million, respectively.

**Table I.3**  
**Foreign direct investment in Turkey<sup>a</sup>, 1998-02**  
 (US\$ million)

	1998	1999	2000	2001	2002
<b>Total</b>	<b>953</b>	<b>813</b>	<b>1,707</b>	<b>3,288</b>	<b>590</b>
<i>Sectoral breakdown</i>					
Agriculture	0	0	9	0	0
Mining	38	13	2	3	0
Manufacturing	553	353	953	672	171
Services	362	447	743	2,613	419
<i>Country breakdown</i>					
EU	553	377	1,093	2,732	490
Other OECD	391	276	426	555	93
Middle East	3	155	171	0	0
Other	6	5	17	1	7

a Direct investment inflows of non-residents.

Source: Information provided by the Turkish authorities.

26. The total number of issued incentive certificates decreased from 4,291 in 1998 (with a total projected eligible investment cost of TL 4,495 trillion), to 3,002 in 2002 (with a total projected eligible investment cost of TL 15,230 trillion); total foreseen employment for the related investments dropped from 285,790 persons to 142,806 persons over the same period.<sup>33</sup> Total investment (realized) with incentive certificates increased from TL 861 trillion in 1998 to TL 1,928 trillion in 2002, and total employment dropped from 69,224 persons to 26,524 over the same period. The poorest ("priority") regions (mainly located in East Anatolia, Central Anatolia, and South-East Anatolia) have received, in value terms, TL 1,152 billion (7.3% of the certificates during 1998-02).

#### (4) OUTLOOK

27. Turkey's ambitious economic reform programme reflects the extent of its challenges. The current programme, with the support of the IMF, is due to expire by end-2004. Until then, the public sector primary surplus target is around 6.5% of GNP to smooth out the high public debt. Reduction of inflation to single digits over the medium term, and the introduction of formal inflation targeting are also expected. The structural reforms are mainly aimed at scaling down the public sector, further strengthening the financial sector, and enhancing the role of the private sector. In 2004, state banks, the sugar company, Turk Telekom, the state monopoly on alcoholic beverages, key assets in the energy sector, and state-owned petroleum refineries are to be privatized. It is hoped that the privatization, together with the new law on foreign investment, will pave the way for an increase in FDI inflows commensurate with the country's potential.

28. Turkey's long-term strategy for the period 2001-23, envisages promoting an export-oriented, technology-intensive production structure, with emphasis on high-value-added manufactured products and services. The contributions of manufacturing and services to the economy are to increase gradually to 30% and to 65%, respectively by 2023. This is to be achieved at the expense of agriculture, whose share in GNP is projected to fall to 5% by 2023.<sup>34</sup>

29. In the long term, it is also expected that the ratio of total investment expenditures to GNP will increase from about 22% in 2000 to approximately 27% in 2023, with the share of the public sector in

<sup>33</sup> The costs reflect the total amount of fixed investments foreseen throughout the whole investment.

<sup>34</sup> Undersecretariat of State Planning Organization (2001).

total investments decreasing from 30% to 10% by the end of the period. Public investment is set to be intensified in education, health, and R&D during 2001-23, while those on energy, transport, and communications are to be maintained at their current levels until 2010, and be gradually reduced afterwards.

30. The long-term strategy is reflected in the eighth five-year development plan, for the period 2001-05, under which the share of agriculture in Turkey's GNP is expected to continue to fall, and the contributions of manufacturing and services are projected to increase. Total investment expenditure is also expected to increase by 6.7% per year on average during 2001-05.