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Memorandum for:

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The attached memorandum was prepared by [redacted] Iberian-Aegean Branch, Western Europe Division, at the request of Ann Corro, Turkish Desk Officer, for Frank Vargo, Deputy Assistant Secretary for Europe in IEP/ITA.

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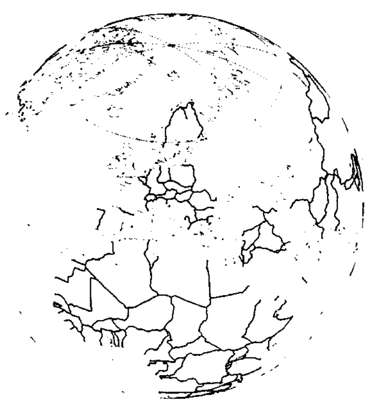

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31 July 1984

MEMORANDUM

Prime Minister Ozal's Economic Reforms and Prospects for the Turkish Economy

Introduction

Turkey is in a transitional period, both politically and economically. Prime Minister Turgut Ozal's victory in the election last November restored civilian government following three years of military rule, and his mandate was reaffirmed by his party's victory in local elections this March. Ozal and President Evren, who retains strong ties with the military, have achieved an acceptable working relationship despite the fact that Ozal was not Evren's favored candidate. Ozal has had a relatively free hand in reorienting the economy along free market lines, although Evren is not entirely comfortable with such policies. In just eight months the new prime minister has instituted sweeping reforms aimed at furthering the 1980 economic stabilization program by relaxing economic constraints and promoting competition. Many of Ozal's policies depart radically from Turkey's tradition of state capitalism and will receive the support of Evren and the public only so long as they produce results. 25X1

Background

Turkey has made steady progress in recovering from the economic crisis of the late 1970s. Policy errors in response to the oil price shocks of the 1970s--expansionary fiscal and monetary policies, price controls, and an overvalued exchange rate--combined with structural problems to produce a balance of payments crisis and triple-digit inflation. The 1980 stabilization program, largely drafted by Ozal as Deputy Prime Minister and "economic czar" in the previous civilian government, emphasized free market policies and exports to generate growth and improve the balance of payments. The program included a substantial devaluation of the lira, the removal of price controls, cuts in government spending, and a sharp rise in interest rates. In a major policy departure, exports were encouraged by maintaining a realistic exchange rate and lowering barriers to foreign investment. 25X1

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The results were dramatic: exports rose sharply and the current account deficit shrank by nearly two-thirds from 1980 to 1982. Inflation fell from a triple-digit level to below 30 percent by the end of 1982, while GNP growth climbed back to an average 4.3 percent per year in 1981 and 1982. 25X1

The economy suffered a setback in 1983 because of policy errors and factors beyond Ankara's control. A loose monetary policy pursued by the military government to rescue failing businesses fueled inflation in the second half of 1983. The inflation rate climbed back to over 40 percent by the end of the year. In addition, the government cut interest rates to help financially troubled firms. This reduction spurred domestic demand and along with rising inflation tamped savings. In addition, exports stagnated as the cash flows of several important Middle East trading partners fell, and bad weather hurt the harvest, reducing Turkey's important tobacco and cotton exports. A slight rise in imports and a sharp drop in worker remittances from abroad helped to boost the current account deficit to $2.1 billion in 1983. 25X1

Ozal's Economic Program

Ozal has moved quickly to reinvigorate the stabilization program. His stated intention is to reduce inflation, generate long-term economic development through increased exports and foreign investment, shrink the large state role in the economy, and reduce high unemployment. To achieve these goals Ozal has introduced a series of bold measures, including reducing many import restrictions, abolishing most foreign exchange controls, and providing new export incentives.* He has continued the policy of adjusting the exchange rate as needed to keep the lira at a competitive level. In addition, he raised interest rates to attract savings and substantially increased the prices of state sector goods to reduce the budget deficit. 25X1

Ozal also has pushed through Parliament a controversial bill permitting the state to sell private investors shares in the State Economic Enterprises (SEEs) and some other government projects such as bridges and dams. In June, Ozal announced a sweeping reorganization of the bureaucracy and SEEs. He abolished more than half the committees, boards, and commissions within the various ministries; eliminated several umbrella organizations within the SEEs; and imposed experience requirements for SEE management positions. We believe the reforms are intended to improve efficiency and strengthen his control over the public sector because he is skeptical of the bureaucracy's commitment to his policies. 25X1

*See Annex II for details of the program.

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Early Results

Ozal will need time for his program to work; the results so far have been mixed. He has had success on the balance of payments side, but inflation has risen steadily, drawing intense criticism from labor, business groups, and political opponents. 25X1

Exports for the first five months of 1984 are up nearly 33 percent over the same period last year, while imports have risen just 7 percent. Despite the continued decline in worker remittances, the current account deficit for the first quarter of 1984 has fallen by nearly three-fourths to $148 million. An IMF team recently in Turkey expressed confidence that the external targets would be met, improving the prospects that Turkey will also be able to meet its increased debt service next year when rescheduled debt payments fall due. 25X1

Inflation was boosted in March by Ozal's price increases for public sector goods. Although the increases were badly needed, they pushed the 12-month inflation rate to 60 percent in May. Labor's criticism has grown more vocal, in large part because Ozal has limited wage increases this year to about 30 percent. Blanket bans on collective bargaining and strikes have now been lifted, and unions are anxious to recover some of the real income lost over the past four years. However, although wage negotiations will be a major challenge to the Ozal government, we do not expect serious strike problems because of restrictions imposed by the new labor laws. Unions are now excluded from engaging in political activities, and the requirements for determining a union's authority to bargain have been made tougher. In addition, strikes for political purposes and general strikes are now outlawed, and the number of industries where strikes are banned altogether has been expanded. 25X1

businessmen remain skeptical 25X1 that Ozal can simultaneously slow inflation, reduce unemployment, and stimulate investment. They have begun expressing their doubts publicly and are especially critical of his tight monetary policy because high interest rates and the scarcity of credit have aggravated the financial difficulties of many firms. Gross domestic investment as a share of GNP has declined from about 26.5 percent in 1980 to an estimated 20.5 percent in 1983. 25X1

Although opposition to his policies has increased markedly in the last two months, we do not believe Ozal's government is in jeopardy. His Motherland Party still retains a solid majority in Parliament and President Evren--while publicly distancing himself from Ozal's policies--has shown no inclination as yet to interfere. Ozal has lost some public support, especially as prices have continued to rise, but various polls indicate that a majority of people are still willing to give his policies some more time to work. 25X1

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Economic Prospects

We are cautiously optimistic about the prospects for the Turkish economy so long as the Iran-Iraq war does not spread and domestic stability is maintained as martial law is gradually lifted. Moreover, we believe that while Ozal is in charge, Ankara will not return to the imprudent policies that fostered previous economic crises. We believe that Ozal's policies--given a chance to work--will result in a more efficient economy with higher growth and less inflation, although the results probably will fall short of the ambitious targets set out in the Five-Year Plan for 1985-89--an average GNP growth rate of 6.3 percent per year, exports to increase nearly 16 percent per year, and inflation to fall to 10 percent by 1989. 25X1

The Domestic Economy

We believe that GNP growth in 1984 will be around 3 or 4 percent, with the foreign sector contributing positively. Agricultural production should return to normal--weather conditions permitting--and expand by around 3 percent, while industry is likely to expand at close to the 1983 rate of about 6 percent. This will not be enough, however, to reduce the 20-percent unemployment rate because of the continuing rapid growth of the labor force. Ozal's stricter monetary and fiscal policies should begin to reduce pressures on prices by the end of the year, but inflation will most likely not drop below 40 percent for the year. 25X1

The Balance of Payments

Balance of payments prospects for 1984 are fairly good. Exports are doing well and could rise by as much as 20 percent over last year, reaching about $7 billion. Despite the easing of many restrictions, the steady depreciation of the lira and steep tariffs on several classes of goods, especially "luxury" consumer goods, have helped to limit the inflow of foreign goods.

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Although invisible earnings continue to fall--worker remittances in the first quarter were down 21 percent from the year-earlier period--the extent of the decline is deceptive. A large portion of such "lost" foreign exchange returns to Turkey in the form of foreign currency deposits through a scheme Ankara has worked out with West German banks. Tourism continues to be weak, despite Turkey's enormous potential in this area. Development of this potential will be a long-term project requiring a substantial expansion of tourist facilities coupled with a major promotional effort. 25X1

Prospects beyond this year are less certain, although Ozal's efforts to tackle the economy's structural problems provide some grounds for optimism. His recent reorganization of the state sector is aimed at gaining greater control over the bureaucracy to enable him to implement his free market policies and improve

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efficiency. Eventually he intends to sell some of the SEEs to the private sector, but he first must improve their profitability to attract potential investors. Reform of the public sector, however, is where Ozal is likely to meet his greatest resistance. Feelings of etatism run deep in the bureaucracy, and, more important, Evren and the military may not permit Ozal to implement fully economic liberalization. We expect Ozal to have some success in trimming the government's role in the economy, but progress will be slow. 25X1

There are many downside risks in Turkey's payments position, most of them related to an uncertain international environment. Turkey must continue to boost exports to reduce the current account deficit and thus keep foreign borrowing needs low. Rescheduled payments on Turkey's $18.5-billion debt begin to fall due later this year, and debt service will rise sharply in 1985. Ankara will continue to need substantial Western aid--from the IMF, the World Bank, the OECD, and the United States--to cover its international payments problems over the next several years. 25X1

An IMF team was recently in Turkey, however, and indicated that Ankara should have no difficulty in receiving another tranche under its present one-year $230-million standby agreement with the Fund, since Turkey has remained within the IMF's targets and ceilings. And Ozal almost certainly will continue to adjust the exchange rate daily to keep exports competitive. In addition, he has actively pursued new opportunities for Turkish exports, concentrating on Middle East markets. These have boomed since 1980 and now account for almost 40 percent of Turkey's exports. Iran and Iraq together account for almost a fourth of total exports. 25X1

Another area of fragility also relates to the Middle East. Turkey imports about 85 percent of its oil, over a third of total imports, of which Iran and Iraq supply 70 percent. A significant oil supply disruption due to the Iraq-Iran war would have serious repercussions for the Turkish economy. 25X1

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ANNEX I

Foreign Investment Opportunities

The Ozal government is encouraging foreign investment in Turkey. New regulations build on the 1980 program by eliminating many restrictions on the repatriation of profits and reducing red tape and other obstacles. Ozal hopes to eliminate remaining barriers, and legislation reducing the tax differential between foreign and domestic investors is currently under review. The response thus far has been slow. Foreign investors are still hesitant about Turkey, largely because of its history. For many years, Ankara discouraged outside investment by maintaining a wide range of bureaucratic obstacles. As a result, direct foreign investment in Turkey in the 30 years to 1980 totaled only $200 million. Investors are also waiting to see if the return to democracy will bring long-term political stability. 25X1

Ankara is most anxious to attract foreign capital in the energy sector, agriculture, transportation, and communications. Ankara is particularly interested in joint ventures to gain the capital and technology needed to improve productivity and promote growth. Although investors and exporters will generally find new opportunities in Turkey, many barriers still exist. The liberalization of imports is genuine, but many important categories of goods are still restricted and others face significant tariff barriers. Higher debt service payments over the next few years will also restrain Turkey's import capacity, and it remains to be seen how effectively the new foreign investment rules will be implemented because many Turkish bureaucrats still harbor negative attitudes on this subject. 25X1

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ANNEX II

Ozal's Program - Trade and Foreign Exchange Provisions

Exports

-- Authority over exports has been centralized in the new Undersecretariat of Treasury and Foreign Trade.

-- Tax rebates to exporters are to be reduced in steps to 45 percent.

-- The list of exports subject to license is reduced to 11 items. In addition, permission must be obtained for temporary exports, transit trade, re-exports, and contract sales.

-- Responsibilities for formalities are to be gradually passed to exporters' organizations such as the Chambers of Commerce and Industry and exporters' unions.

-- Only firms having exports at over $50 million in 1983 are permitted to trade with state trading (i.e., Communist) countries.

-- Companies with over $30 million in exports in 1983 are entitled to additional incentives with respect to special credit funds, duty-free imports, and foreign exchange. [redacted] 25X1

Imports

-- The general rule is that all goods may be imported unless they are specifically listed as being prohibited or subject to licensing; previously the opposite approach was followed--a product had to be specifically listed to be freely importable.

-- Import licensing procedures have been simplified, including authorizations and access to foreign exchange.

-- The requirement to prepay in local currency the equivalent of the foreign exchange for which a letter of credit has been opened has been eliminated.

-- Import duties and production tax rates have been modified. [redacted] 25X1

[redacted] 25X1

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The 1984 import regime contains three lists and a fourth category consisting of all other goods.

-- The first list is composed of articles whose importation is prohibited; it includes such items as foodstuffs, leather and leather goods, textiles and clothing, and other finished products.

-- The second list is composed of goods which can be imported only with specific licensing by the Undersecretariat of Treasury and Foreign Trade; it includes such items as raw materials, parts, intermediate goods and tools for industry, and some electrical equipment.

-- The third list consists of goods whose importation is free after payment of a specific surcharge in addition to custom duties; it is made up of luxury consumer goods.

-- All other goods not included in the three lists are freely permitted with payment of custom duties. [redacted]

<u>Foreign Exchange</u> 25X1

-- Travel abroad by Turks is now unrestricted.

-- Travelers may legally convert up to $1,000 in foreign currency and can carry up to $3,000 abroad.

-- Turkish citizens can now hold foreign currency, open foreign currency bank accounts in Turkey or abroad, and receive interest paid in that currency within Turkey.

-- There are no longer limits on the amount of foreign currency which can be brought into Turkey.

-- Stocks and bonds purchased in Turkey with foreign exchange can be taken out of Turkey.

-- Exporters are permitted to keep 20 percent in foreign exchange of the amount of foreign exchange they bring into Turkey.

-- Foreign residents in Turkey will be able to purchase foreign currency for Turkish lira.

-- Commercial banks are now free to buy and sell foreign currency within a band of ± 6 percent (± 8 percent for transactions in bank notes) around the official or "central" rate of the Central Bank; the spread between the buying and selling rates at a commercial bank cannot exceed 2 percent. [redacted] 25X1

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Turkey: Projected Debt Service Payments on Existing Medium- and Long-Term Debt, 1983-88*

(In millions of US dollars)

	1984	1985	1986	1987	1988
Debt service payments					
including IMF	2,563	3,073	2,920	2,843	2,550
Principal	1,495	2,129	2,083	2,125	1,993
Interest	1,068	944	837	718	557
Memorandum item:					
Debt relief	580	150	--	--	--
Principal	580	150	--	--	--
Interest	--	--	--	--	--

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* Projections are based on disbursed and undisbursed external debt as of September 30, 1983. The projections assume LIBOR of 10 percent for dollars, 5.25 percent for Deutsche Marks, and 3.25 percent for Swiss francs.

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TURKEY: BALANCE OF PAYMENTS, 1977-84

(in millions of US Dollars)

	1977	1978	1979	1980	1981	1982	1983[a]	1984[b]
Trade balance	-4,044	-2,311	-2,808	-4,999	-4,230	-3,097	-3,508	-2,800
Exports, f.o.b.	1,753	2,288	2,261	2,910	4,703	5,746	5,727	6,900
Imports, c.i.f.	-5,797	-4,599	-5,069	-7,909	-8,933	-8,843	-9,235	-9,700
Services Balance	618	792	1,158	1,319	1,888	1,844	1,427	1,490
Workers' remittances	982	983	1,694	2,071	2,490	2,187	1,554	1,500
Interest payments (before debt relief)	-360	-489	-1,010	-1,138	-1,443	-1,565	-1,345	-1,350
Tourism	-65	145	179	212	277	262	284	325
Other Services (net)	61	153	295	174	564	961	934	1,015
Current Balance	-3,426	-1,519	-1,650	-3,680	-2,342	-1,252	-2,081	-1,310
Capital account (long- and medium-term)	1,533	1,184	680	2,342	1,049	1,119	505	825
Of Which:								
Debt repayments (before debt relief)	-214	-451	-945	-1,556	-1,185	-1,502	-2,080	-1,880
Debt Relief	--	295	924	1,450	850	750	1,000	580
Principal	--	--	(460)	(980)	(600)	(650)	(930)	(580)
Interest	--	--	(464)	(470)	(250)	(100)	(70)	(--)
Overall Balance	-1,892	-335	-702	-370	-65	277	-238	665

a estimate

b projection

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