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Screening report

Turkey

Chapter 17 – Economic and Monetary Policy

Date of screening meetings:

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I. CHAPTER CONTENT

The *acquis* in the area of economic and monetary policy contains specific rules requiring the independence of central banks in Member States, prohibiting direct financing of the public sector by the central banks and prohibiting privileged access of the public sector to financial institutions. Member States are expected to co-ordinate their economic policies and are subject to the Stability and Growth Pact on fiscal surveillance. New Member States are also committed to complying with the criteria laid down in the Treaty in order to be able to adopt the euro in due course after accession. Until then, they will participate in the Economic and Monetary Union as a Member State with a derogation from the use of the euro and shall treat their exchange rates as a matter of common concern.

The acquis in the area of economic and monetary policy is governed by Art. 4 and Title VII (Art. 98 to 124) of the EC Treaty, and by relevant implementing legislation. Treaty provisions related to the adoption of the euro do not apply to Member States with a temporary derogation as defined in Art. 122 (1) and (3) of the EC Treaty.

The acquis consists mainly of Treaty provisions and protocols, regulations and decisions that do not require transposition into national legislation. Nonetheless, as indicated in Article 109 of the EC Treaty, each Member State shall ensure that its national legislation including the statutes of its central bank is compatible with the EC Treaty and the Statute of the European System of Central Banks (ESCB).

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part is notably based on the information provided by Turkey at the screening meeting of 23 March 2006.

II.a. Monetary policy

The primary objective of the Turkish Central Bank is to achieve and maintain price stability. The central bank also supports the growth and employment policies of the government without prejudice to its primary objective.

Central bank independence is governed by Law No. 1211 from 1970. According to the law the central bank shall enjoy absolute "autonomy" in exercising its powers and carrying out its duties. Third parties do not have a right to give instructions to the central bank, nor to approve, suspend, annul, override, defer or censor decisions of the central bank. Third parties are also not allowed to participate in decision-making bodies with a right to vote. Since January 2006 the central bank operates a fully-fledged inflation targeting system. According to the central bank law, the bank shall determine the monetary policy and the monetary policy instruments on its own discretion. However, the inflation target is set jointly by the government and the central bank, whereas design and practice of the monetary policy are under the sole responsibility of the central bank.

Governors, Vice Governors and other members of the decision-making bodies may not be relieved from office for reasons other than those mentioned in the central bank law.[1] The

[1] The Central Bank law states that the Governor, the Vice Governor and the member of the other decision-making bodies may only be dismissed if they act against the provisions mentioned under Article 27 and paragraph 2 of Article 19 respectively. These two articles basically contain the same provisions. The duties of the Governor, the Vice Governor and the members of the other decision-making bodies may not be reconcilable with any other duty outside the Bank whether of a legislative, official or private nature unless otherwise permitted by a special law. Furthermore, they shall not be allowed to engage in

Constitution warrants that recourse to judicial review shall be available against all actions and acts of the central bank administration. Accordingly, members of decision-making bodies (except the Board – see infra) have a right to have any decision to that effect reviewed by an independent judicial court. Dismissals of the Board members are subject to private law (the Turkish Commercial Code). Therefore, in the event of dismissal of Board members, they do not enjoy the same right of judicial review. Concerning its financial independence the central bank is not subject to the Budget Law. The budget of the central bank is prepared and approved exclusively by the bank itself.

Regarding the *prohibition of monetary financing of the public sector*, the central bank law prohibits the financing of government deficits through central bank credits, by stipulating that the central bank may not grant advances and extend credit to the Treasury and to public institutions and may not purchase debt instruments issued by the Treasury and public institutions in the primary market. Article 15 of the former Banking Law which obliged the Central Bank of Turkey (CBT) to grant advances to the Savings Deposit Insurance Fund has been repealed. Article 131 of the New Banking Law authorizes the central bank to grant advances to the Savings and Deposit Insurance Fund but does no longer oblige it to do so. The Savings and Deposit Insurance Fund is a public entity.

With regard to the *prohibition of privileged access* of the public sector to financial institutions, as of 16 November 2005 banks shall not be obliged to hold government securities with the central bank. However, the implementing regulation on the principles applicable to the establishment and operations of Pension Investment Funds states that Pension funds' participants have to invest 30 % of their contribution to those funds investing minimum 80% on government borrowing instruments including reverse repurchase agreements. Also the regulation on the Investor Protection Fund stipulates that assets of the Fund shall be invested in state bonds, treasury bonds or deposits or in reverse repurchase agreements in the state-owned banks.

Furthermore, brokerage houses have to deposit a collateral consisting of government borrowing instruments and/or letters of guarantee and/or units of mutual funds other than the mutual funds founded by these brokerage houses to the ISE Settlement and Custody Bank.

The regulations on the Istanbul Stock Exchange, Derivative Exchanges and Istanbul Gold Exchange oblige exchange members to deposit collateral consisting of cash or government borrowing instruments or irrevocable and unconditional letters of guarantee in the name of the exchange to a bank. The Turkish authorities also mention problematic provisions in the Regulation on Establishment and Operation Principles of Insurance and Reinsurance Companies, in the Regulation on the Traffic Insurance Guarantee Account, in the Regulation concerning the Establishment and Operation Principles of Securities Exchanges, as well as in the Decree-Law concerning Securities Exchanges.

Currently there are six state-owned banks: three commercial banks and three investment and development banks. In each of these state-owned banks, the Treasury holds the majority of the shares. In two commercial banks, Ziraat Bank and Halkbank, government securities amount to more than 50% of total assets. Turkey plans to continuously reduce these shares in the coming years. The outstanding amounts of Government Borrowing Securities held by the CBT correspond to euro 11.5 billions as of 31 January 2006.

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trade, nor shall they become shareholder in banks or companies. Duties in charitable associations and in foundations with charitable, social or educational purposes and partnership in non-profit-making cooperative companies are excluded from these provisions.

The Central Bank may provide unlimited liquidity to the commercial banks through the late liquidity window facility against collateral. The use of this facility is closely monitored by the Central Bank, which in turn has the right to suspend or limit the use of this facility in accordance with monetary conditions and its monetary policy goals.

Although the central bank accounts have been audited by external auditors in practice, external audit is not mandatory according to the Central Bank Law.

As regards the *integration of the national central bank into the ESCB* the Turkish authorities acknowledge that it is necessary to complement the Law on the CBT with the necessary provisions ensuring integration of the CBT into the ESCB and notably reflecting its subordination to the guidelines and instructions of the ESCB and ECB as from the date of euro adoption. However, the necessary legal amendments are not expected to be initiated before several months or years. The authorities did not want to commit themselves at the present stage on a precise date in this respect

II.b. Economic policy

Turkey participates in pre-accession economic policy co-ordination as regards the production of Pre-accession Economic Programmes and fiscal notification. The medium-term fiscal framework adopted by the Government sets objectives in line with acquis reference values. The government's basic objectives of fiscal policy aim at strengthening fiscal discipline, generating a high primary surplus, reducing the public debt stock below 60% of GDP by 2008 and completing reform activities in public financial management.

The new Public Financial Management and Control Law was adopted in 2003 and all provisions came into force on 1 January 2006. This legal act seeks to ensure harmonisation with EU practices and international standards in this field and to ensure accountability and transparency. Against this background it regulates the structure and functioning of the public financial management, the preparation and implementation of the government budget, the internal financial control mechanisms (ex-ante financial control and a functionally independent internal audit system) and the accounting and reporting standards of all financial transactions. The new law integrates for the first time the concept of multi-annual budgeting into Turkey's financial management system. Following the provisions of the law on Public Financial Management and Control the government implemented a new accounting system.

The tax policy is in the process of being reformed. On the one hand, new taxes have been introduced, such as a special consumption tax and a new withholding tax. On the other hand, some taxes are reduced or even removed. Statutory rate of Corporate Income Tax was lowered from 30% to 20% through Law No.5520 published in the Official Gazette No.26205 dated 21.06.2006, following a reduction from 33% to 30% in 2005. The tax burden on dividends was reduced from 65% in 2001 to 34% in 2006. And, in order to broaden the tax base, exemptions as well as allowances concerning the CIT are going to be narrowed and the Investment Tax Allowance will be removed completely.

To enhance the administrative capacity and efficiency the government has set up a new Revenue Administration. It is a semi-autonomous organisation under the Ministry of Finance, which should establish a more direct link between headquarters and local offices and which focuses on administrative issues only, whereas the policy function remains with the Ministry of Finance. This new administration should improve tax collection. Also the new Public Financial Management and Control Law aims at strengthening the supervision and auditing base and the efficiency of public financial management

III. Assessment of the degree of alignment and implementing capacity

Turkey has achieved a limited degree of alignment with the acquis. Special efforts have to be made by Turkey to ensure full Central Bank independence, in particular in relation to the setting of inflation targets as well as the personal independence of the governor, members of the Monetary Policy Committee and the Board members. Moreover, Turkey needs to further strengthen its administrative capacity to be able to implement the EMU acquis and to improve the economic policy co-ordination mechanisms for the sustainable implementation of a coherent set of economic policies.

As noted in the Commission's Progress Report of November 2005, Turkey can be regarded as a functioning market economy, as long as it firmly maintains its recent stabilisation and reform achievements. This is an important requirement for the negotiations in this chapter.

III.a. Monetary policy

The alignment with the *acquis* in the area of monetary policy has recently improved but continues to be limited.

In Art 4 of the Law on the CBT, the primary objective of the CBT is to achieve and to maintain price stability, while the secondary objective refers to the growth and employment policies of the Turkish Government. However, the secondary objective should refer to the general economic policies in the Community and take precedence over the current national economic objective as from the date of the introduction of the euro.

In addition, Art 40 III) a) and b), which allow the CBT to determine the interest rates to be charged by commercial banks in credit operations and deposit-taking as well as the terms and types of deposits in banks and the terms of participation funds in financial houses, are contrary to Art 4 of the EC Treaty and Art 2 ESCB on free market economy. The Articles of Association of the Central Bank of the Republic of Turkey should be amended accordingly, as well as the Communiqué 2005/1 on reserve requirements, the Law about coins and commemorative coins and the provisions of the CBT (Circular N° I-M) concerning Turkish currency, foreign exchange, precious metals, stones and articles.

As regards the *independence of the national central bank* the Central Bank’s statute must be revised in order to ensure full central bank independence:

- With view to *institutional independence*, in Art 4.2, the absolute "autonomy" granted to the CBT is not comparable to the genuine and entire independence required under Art 108 EC. Given the importance of the independence principle, a drafting very close to Art 108 EC is necessary. In Articles 4.2 b) and 22 A) b), the setting of the inflation target constitutes a joint decision of both the CBT and the Government (Art 108 EC). This provision is contrary to Art 108 EC. In addition, Art 22 A) c) could usefully specify that the reporting obligations can only be ex-post; otherwise it would offer the possibility for the Government of influencing the CBT policies, which would be contrary to Art 108 EC.

  In Art 26.2, the possible role of the Prime Minister as an arbitrator in the event of disagreement between the Governor and the Board is contrary to the principle of central bank independence (Art 108 EC). In Art 27, the possible duties of the CBT Governor at the inter-ministerial committee should be clarified so as to prevent that his independence could be hampered or jeopardised, which would be contrary to Art 108 EC.

In Art 41 I), a safeguard clause should preferably be introduced so to ensure that in its role as a financial and economic advisor of the Turkish government, the CBT should fully preserve its independence. In Art 42 par. 3 and 4, the obligation for the CBT to report to the Council of Ministers on the monetary policy to be followed is contrary to the principle of central bank independence. Reporting obligations should only be ex-post, otherwise the Council of Minister would have the possibility of influencing the CBT in its tasks of defining and implementing the monetary policy of Turkey.

- Concerning *financial independence*, under Art 41 III), the CBT executes, free of charge, collections and disbursements and all the Treasury operations both within the country and abroad, as well as domestic and foreign money transfers and remittances of all types on behalf of the State. This lack of remuneration for the CBT on operations implemented on behalf of the State somehow affects the CBT's financial independence (Art 108 EC), even though funds of the public sector are deposited with the CBT without any interest or remuneration to be paid by the CBT on these deposits. It would be preferable that all tasks implemented by the CBT on behalf of the State be remunerated at normal conditions.

  Under Art 58, the balance sheet and income statement of the CBT is submitted to the Prime Minister before its submission to the General Assembly. This submission, which entails the approval of the Prime Minister, could be problematic with respect to Art 108 EC, since it could pose a risk for the CBT's financial independence.

  Under Art 61, the unrealized valuation gains and losses, arising from the revaluation gold and forex reserves due to a change in the value of the Turkish currency, in the event they are realised, shall be transferred to the income statement of the CBT and thus become subject to distribution. This situation could affect the CBT's financial independence. Only in the event of a loss, should this be reflected in the profit and loss account of the CBT and be covered, if necessary, by the general reserve of the Bank, and as a last resort, by the State budget (Art 108 EC).

- Regarding the *personal independence* of the CBT, in Arts 19 and 22 A), the grounds for dismissal for the board members and for the monetary policy committee members should preferably be mentioned and correspond to those stipulated in Art 14.2 ESCB for the Governor, while consideration should be given to introducing judicial referral mechanisms into the CBT Law for any decision relieving from office the members of the CBT decision-making bodies dealing with ESCB-related tasks (Art 108 EC).

  Under Art 20, the term of office of Board members is only three years, which is not in line with the requirements of Art 108 EC and Art 14.2 ESCB. In Art 28, the grounds for dismissal of the Governor refer to the possible existence of a conflict of interest and to the impossibility for him/her to perform his/her duties. They should be aligned with those stipulated in Art 14.2 ESCB.

Concerning the *prohibition of monetary financing of the public sector* under Art 4.2 d) of the Law on the Central Bank of Turkey (CBT) and Art 131 of the Banks Association of Turkey, Banking Law N° 5411, the CBT is allowed to provide financing to the Savings Deposits Insurance (SDI), in case of extraordinary circumstances. Since the SDI is a public entity, this provision of the CBT Law is contrary to Art 101 EC on the prohibition of monetary financing. Moreover, such financing puts the financial independence of the CBT at risk.

Under Art 4.2 e) and 40 I c), the CBT has, under the lender of last resort function, the possibility of granting credits to banks in case of liquidity problems or general lack of confidence in the financial system. Since the provision of liquidity to banks could become an (ex-post) form of monetary financing (if the loans are not repaid – i.e. when a liquidity crisis is linked to solvency problems), a safeguard clause is needed, so as to avoid that the CBT might eventually end up bearing financial costs which are in principle to be borne by the state. Otherwise, monetary financing (prohibited by Article 101 EC) would be involved and the financial independence of the CBT would be at risk.

With regard to the *prohibition of privileged access of public authorities to financial institutions* as of 16 November 2005 banks shall no longer be obliged to hold government securities with the Central Bank. Nonetheless, a number of obstacles remain:

In Article 10 on the Regulation on the Traffic Insurance Guarantee Account, the Compensation Fund (Guarantee Fund) is established in order to compensate citizens when they are injured by uninsured or stolen vehicles. The fund is subject to the legislation on management of its funds, and hence, it has to invest in Ziraat Bank A.S., the biggest state-owned bank in Turkey. Moreover, the legislation also regulates that the investment portfolio has to be composed of T-Bills, Treasury Bonds and Bank Deposit. This limited list of assets is tantamount to creating a situation of privileged access contrary to Art 102 EC.

Under Article 21 a) of the implementing Regulation on the Principles Applicable to the Establishment and Operations of the Pension Investment Funds (Capital Market Boards), not more than 10 % of the funds' assets shall be invested in the money and capital market instruments of a single issuer. Furthermore, the total amount of the money and capital market instruments of companies in which more than 5 % of the Fund has been invested shall not exceed 40% of the funds' assets. However, these restrictions are not applicable to state bonds (for domestic borrowing). The latter state bonds therefore benefit from a privileged status vis-à-vis the other assets, which is contrary to Art 102 EC on the prohibition of privileged access. A similar comment applies to the last paragraph of the same article. Finally, the Turkish authorities should clarify that the maxima for the assets mentioned under g), h), i) and j) do not constitute an indirect obligation to purchase public securities.

Under Article 22 of the implementing Regulation on the Principles Applicable to the Establishment and Operations of the Pension Investment Funds (Capital Market Boards), the participants shall invest maximum 15 % of their contribution shares in funds whose portfolios consists of minimum 80% foreign money and capital market instruments; and shall invest minimum 30% of their contribution shares in funds whose portfolios consists of minimum 80% state bonds for domestic borrowing, including reverse repo. This requirement is tantamount to creating a situation of privileged access contrary to Art 102 EC.

Art 16 of the Communique n° 2003/1 concerning the pension plans prohibits that funds composed of government securities (including reverse repo) for at least 80 % represent less than 30 % in the participant's individual's pension account.

Article 17 of the Law on individual pension savings and investment system mentions the possible existence of minimum percentages of public debt instruments in the pension funds portfolios. Such minimum percentages for public debt instruments are prohibited under Art 102 EC.

In Art 22 of the Pension Fund Law N° 5434, 7th part, the assets of the pension funds shall be invested at least partially into capital companies where the State has capital contributions (paragraph I b 1) or into private capital companies after having received the permission of the Council of Ministers in advance (paragraph I b 2), into State bills and bonds and revenue partnership bills of public investment (paragraph II c), into obligations of the companies which have been founded with State capital (paragraph II ç). The public character of most companies or assets in which the pension funds shall be invested offer the possibility for the State of raising capital directly or indirectly, in a way which is tantamount to creating a privileged access situation, contrary to Art 102 EC.

Under item VII of the New Turkish Lira Interbank Money Market at CBRT, at least 50 % of the total collateral of a bank must be in the form of government fixed-income securities. For the remaining 50%, the participants are allowed to choose the combination of collateral they want to provide, among different types of possible collaterals, most of which are government debt instruments. This provision is incompatible with Art 102 EC.

Under Art 24 of the Capital Markets Boards' Regulations on the Derivatives Exchange, members of the exchange have to deposit collateral in the form of T-bills, to be transformed into cash at any time, or in the form of a credit letter of a bank, to meet losses arisen from misconduct of the member. The restrictive list of possible collaterals is tantamount to constituting a form of privileged access contrary to Art 102 EC.

Provisional article 2 of the Law N° 4487 of 12/99, complementing Law N° 2499 on Capital Market, stipulates that a special fund will be established to reimburse claims of creditors arising from capital market activities of intermediary institutions whose certificates of authorisation have been cancelled. The Istanbul Stock Exchange was expected to grant 10 trillion Turkish Liras to this Fund. The Fund was expected to be invested by the Presidency of the Istanbul Stock Exchange in the deposit account of a public bank or in government paper. The limited list of assets mentioned in this provision is tantamount to constituting a particular form of privileged access, contrary to Art 102 EC.

Under Art 12 of the Regulation concerning the establishment and operating principles of securities exchanges (general regulations), members of the exchange are under the obligation to deposit collateral in the form of cash or easily realizable government bonds or, otherwise, perpetual, irrevocable and unconditional bank letter of credit guarantee (in the CBT, or where there is no CBT branches in a state-owned bank being the correspondent of the CBT) as a security for the damages that may be incurred by their clients or the Exchange due to their trading transactions in the Exchange. While there is no obligation to purchase government bonds and T-bills, the list of collateral is very restrictive and and the scope of the eligible assets should be brought closer to the categories (Tier I and Tier II) defined by the ECB.

Under Art 12 of the Decree-Law concerning the securities exchange, exchange members shall be under the obligation to deposit collateral in cash or in the form of government bonds or letters of guarantee, in the CBT or in a state-owned bank, against the damages and losses that may be maliciously or deliberately caused by them in the course of their exchange transactions and dealings. While there is no obligation to purchase government bonds and T-bills, the list of collateral is very restrictive and the scope of the eligible assets could be brought closer to the categories (Tier I and Tier II) defined by the ECB.

Under item III B) iii) of the implementation instructions for open market operations, intermediary institutions shall hold a certain amount of government securities that can meet at least 10 percent of the paid-up capital. In item IV (sub-items C and D) of the implementation instructions for open market operations, operations other than the issuance and/or early redemption of the liquidity bills shall only be realised against government securities. In item VII A) and B) of the implementation instructions for open market operations, the securities to be considered as collateral are nearly exclusively public securities. These provisions are tantamount to constituting cases of privileged access contrary to Art 102 EC.

Under Art 12 of the Regulation of the Istanbul Stock Exchange, the types of collaterals to be deposited prior to the issuance of a membership certificate need to take the following forms: cash, letter of credit from a bank (unconditional commitment at call), government bonds, T-bills and foreign currencies. While there is no obligation to purchase government bonds and T-bills, the list of collateral is very restrictive and and the scope of the eligible assets should be brought closer to the categories (Tier I and Tier II) defined by the ECB.

In Art 16 of the Regulation of the Istanbul Gold Exchange, the transaction guarantees are Turkish Lira, cash and foreign exchange, bank letters of guarantee and government securities and T-bills of any kind. While there is no obligation to purchase government bonds and T-bills, the list of collateral is restrictive and and the scope of the eligible assets should be brought closer to the categories (Tier I and Tier II) defined by the ECB.

Under Article 11 of the Regulation on the Investors' Protection Fund (CMB), the Fund's properties and assets of the Fund shall be invested in state bonds, treasury bonds or deposits, or in reverse repurchase agreements in the state-owned banks. This list is very restrictive and is tantamount to constituting a privileged access and to being contrary to Art 102 EC.

Art 19 of the Regulation on the establishment and the Operating Principles of Insurance and Reinsurance Companies specifies a list of assets, including government bonds, T-bills and other securities to be issued by the State, into which the insurance companies have to invest their deposits. Since it is not clear that the provision offers a possibility of choice between all these assets ("and" instead of term "or"), it could create a privileged access situation contrary to Art 102 EC. As a minimum, clarifications are necessary.

As concerns the i*ntegration of the national central bank into the ESCB* it is necessary to ensure the CBT's integration into the ESCB and to reflect its subordination to the guidelines and instructions of the ESCB and ECB as from the date of the introduction of the euro in Turkey, even though such amendments need only enter into force by the date at which the country actually adopts the euro.

The main incompatibilities in this area are related to the absence of reference to the CBT as an integral part of the ESCB and to its subordination to the ECB's legal acts (Articles 3, 4.2, 15, 16b, 26.2 and 62). They are notably also related to:

- the definition of monetary policy: Articles 4, 22 a), 22 c), 22 A a) and b), 39, 41;
- the conduct of foreign exchange policy and operations: Articles 4.1 b), 22 A d), 39, 53 a);
- the holding and managing of foreign reserves: Articles 4.1 e), 22 c), 39, 53 b);
- the right to authorise the issue of banknotes and the volume of coins: Articles 4.2 a), 22b), 36, 37, 59;
- the definition of the currency unit: Art 53 a);
- the monetary functions, operations and instruments of the ESCB: Articles 4, 22a), 22 c), 39, 40 II, 45, 52;
- the imposition of sanctions: Articles 4.2, 40 II, 64;
- the financial provisions of the ESCB: Articles 42 (auditing) and 59 (accounting);
- other issues: Articles 4.1 f), 22 e) (payment systems), 35 (professional secrecy), 43 (statistical role of the ECB and the EC Council), 41 and 55 (additional functions to be performed by the CBT).

III.b. Economic policy

Turkey submitted a 2005 Pre-Accession Economic Programme (PEP) to the Commission as part of the requirements emanating from the Pre-Accession Fiscal Surveillance Procedure.

The PEP is expected to help the Turkish authorities to conceive and implement a consistent set of economic policies. However, the structures responsible for the economic policy coordination within the Government are still very fragmented which constitutes a major obstacle to the efficiency and the effectiveness of policy formulation, co-ordination and implementation.

Nonetheless, the establishment of the new Revenue Administration and the new Public Financial Management and Control Law contribute to improving the administrative capacities in the area of fiscal policy.