DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR TURKEY

As approved by the Board of Directors at its meeting on 14 July 2009

TABLE OF CONTENTS

ABBREVIATIONS

AKP	Adalet ve Kalkınma Partisi (Justice and Development Party)
AFD	Agence Francaise De Development
BAS	Business Advisory Services
Bps	Basis Points
BSTDB	Black Sea Trade and Development Bank
CBT	Central Bank of Turkey
CEB	Central Europe and the Baltic States
CEB	Council of Europe Development Bank
CHP	Cumhuriyet Halk Partisi (Republican People's Party)
CITES	Convention on International Trade in Endangered Species
CPS	Country Partnership Strategy
CTF	Clean Technology Fund
DPL	Development Policy Lending
DSI	State Hydraulic Works
EBA	Enforcement and Bankruptcy Act
EC	European Commission
ECOFIN	Economic and Financial Committee of the European Union
EIA	Environmental Impact Assessment
EIB	European Investment Bank
EIF	European Investment Fund
EU	European Union
ESCO	Energy Service Company
FDI	Foreign Direct Investment
FEMIP	Facility for Euromediterranean Investment Partnership
GAP	South Eastern Anatolia Project
GDP	Gross Domestic Product
GEF	Global Environment Facility
FI	Financial Institutions
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
IPA	Instrument for Pre-accession Assistance
IPO	Initial Public Offering
IPP	Independent Power Producer
JV	Joint Venture
KfW	Kreditanstalt für Wiederaufbau
LIS	Legal Indicator Survey
MEI	Municipal & Environmental Infrastructure
MHP	Milliyetçi Hareket Partisi (Nationalist Movement Party)
MoEF	Ministry of Environment and Forestry
MSME	Micro, Small and Medium Enterprises
Mw	Megawatt
NBFI	Non-Bank Financial Institutions
NBG	National Bank of Greece
NGOs	Non-Governmental Organisations
OECD	Organisation for Economic Co-operation and Development

OIB	Turkish Privatisation Administration
PPP	Public- Private Partnership
SME	Small and Medium Enterprises
SPO	State Planning Organisation
TAM/BAS	Turn Around Management/Business Advisory Services
TC	Technical Co-operation
TCDD	Turkish Railways Company
TCK	Turkish Road Authority
TEN	Trans European Networks
TRY	New Turkish Lira
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
WB	The World Bank

EXECUTIVE SUMMARY

Turkey is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank. Significant progress has been achieved since the onset of economic and political liberalisation in the 1980s. The country's reform momentum accelerated in the early-2000s in anticipation of the opening of EU accession negotiations, although the pace of reform has slowed in recent years. The EU accession process remains a key external anchor for Turkey's political and economic reforms.

Although Turkey's macroeconomic fundamentals and financial system are stronger than in the beginning of this decade, when the country was hit by a deep financial crisis, the economy is forecast to slip into recession this year as the global financial crisis takes its toll. While the domestic financial system has shown a fair degree of resilience to the global financial crisis so far, as prudential regulation and supervision were strengthened following the 2001 banking crisis, the real economy has been hit through its trade links with the major industrialised economies. Turkey's industrial production and export potential in the immediate future has been sharply reduced by a substantial fall in external demand for key products; such as the textile, white goods and automotive sectors. In addition, declining consumer confidence and tighter bank lending standards have weakened domestic demand.

Financial stability nothwistanding, the country remains dependent on domestic and external financing to cover its twin fiscal and current account deficits. The fiscal position is deteriorating rapidly as tax revenues have declined on the back of falling economic activity and lower domestic and external demand, while public spending has increased. Public sector debt financing needs are thus increasing, as the fiscal deficit is projected to widen. Furthermore, meeting the country's large external refinancing needs will be challenging under the current global environment. The global credit squeeze, particularly in terms of constrained liquidity and limited risk appetite for emerging markets debt, is having a marked effect on both the access to and cost of external sources of finance for Turkish banks and corporates. As in other countries, external issuance of bonds and foreign purchases of financial assets within the domestic financial markets has declined sharply. The significant shortening in maturities available to banks will exacerbate existing constraints on availability of medium-and long-term credit in the domestic financial markets.

In the short-term, the main macroeconomic risks stem from low consumer and investor confidence and worsening external conditions, including a delayed recovery in Turkey's main export markets and/or lower debt roll-over ratios, which would increase the estimated external refinancing gap.

While Turkey started to implement structural and institutional reforms in the 1980s and the pace of these reforms increased in anticipation of the opening of EU accession negotiations, the overall pace of reform has been significantly slower than in Central Eastern Europe and the Baltic States (CEB) and the reform agenda has been interrupted periodically by economic and political crises. Turkey continues to face significant challenges in decentralising and de-monopolising economic activity and in developing a more open and entrepreneurial economy. Although state interference in the economy has been reduced in recent years as important markets such as electricity, telecommunications, sugar and petroleum have been gradually liberalised, there is still a significant privatisation and structural reform agenda ahead. These reform challenges are particularly great in those parts of the country that are geographically remote.

In line with the key principles that were approved in October 2008 following consideration of the Strategic Review of the Request by Turkey to Become a Recipient Country of the EBRD (CS/FO/08-18 (FINAL), the following five operational priorities will underpin the Bank's activities during the period 2009-2012:

1. in the first instance, increase availability of risk capital and long term funding to the micro, small and medium sized (MSMEs) enterprise sector together with appropriate support to management, especially in the less developed regions.
2. support investment in the enterprise sector with a clear initial focus on agribusiness. Priority will be provided to supporting investment along the food chain (primary agriculture, storage and logistics, processing, branded products, and retail) to strengthen linkages and standards and stimulate supply food meeting European quality standards;
3. in the medium term, promote reform and support a secure and efficient delivery of vital utility services to the population and enterprises in the regions of Turkey on a non-sovereign basis;
4. promote, through its investments, favourable market conditions for the development of energy efficiency instruments across economic sectors and renewable energy; and
5. support the Turkish government's privatisation programme in the enterprise and financial institutions sectors.

The crisis has resulted in the virtual absence of commercial co-financing, including for projects that are IFI-led, which is putting at risk the implementation of a broad range of investments. As a consequence, it is expected that from time to time and on an exceptional basis, approval may be sought for the Bank's participation as a co-financier with other IFIs in projects that fall outside the above scope, but where the Bank's engagement is critical.

Initial work by the Bank in Turkey has confirmed the complementary nature of the relationships with other international financial institutions, particularly given the need for closer co-operation resulting from the effects of the international crisis. The accord between The EC, EIB and the Bank which was signed on 15 January 2009 and which provides a framework for consultation, co-operation and co-financing, has been fully operationalised and is proving to be an effective instrument for promoting efficiencies and ensuring the complementary roles of the parties.

The implementation of these operational objectives will take into account the evolving economic and financial climate as well as the need to retain overall diversification across all countries of operation. Improvement of quality standards, including strong covenants and due diligence requirements, establishment of reference standards for business practices, transparency and corporate governance will be at the core of all Bank activities.

1. THE BANK'S PORTFOLIO

1.1 Overview of Activities to Date

During late 2008 and early 2009, EBRD bankers covering a broad range of sectors have visited Turkey to more closely assess business opportunities and to establish an initial operational pipeline. This pipeline is shown in Annex 5 and is characterised by relatively well advanced transactions for power generation and equity funds, early stage transactions for gas distribution and municipal and environmental infrastructure and a clearly defined range of operations for strengthening the ability of the banking sector to provide appropriate finance for MSMEs in remote areas and for small agriculture. In addition, a number of Agribusiness sector transactions have been identified with a strong regional component. The operations of five existing equity funds already invested by the Bank have been broadened to provide for investment in Turkey and the scope of operation of the Local Enterprise Facility has been enlarged from the Western Balkans to include operation in Turkey. Work has commenced on the development of energy efficiency credit lines and on identification of further private equity funds with a Turkish focus for the Bank's investment.

The scope and nature of potential transactions in the pipeline reflects the effective withdrawal of international commercial funding sources from the Turkish market during recent months. In particular, transactions for which IFI-led loan syndicates had been sought in the power and municipal infrastructure sectors are now not likely to be able to access commercial co-financing and EBRD has been requested to participate in lieu. Within the banking sector, non-IFI finance of longer than 12 month tenure has effectively disappeared from the market, strengthening the demand for IFI-led funding with longer tenure.

Since the beginning of March 2009, Country Team management (Director and Deputy Director) for Turkey has been in place, a resident Agribusiness banker has been appointed and active recruitment is underway to fill all available vacancies. Office premises have been identified and are expected to be functional by the end of April, subject to completion of related agreements with the Government.

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

Unlike the Bank's other countries of operations, Turkey does not have a legacy of communist party rule. However, in other key respects Turkey does share many of the characteristics of the post-communist transition countries, including a legacy of strong state involvement in the economy. The programme of political and economic liberalisation that was unleashed in the 1980s and accelerated in the 1990s dramatically altered the political and economic environment in Turkey. This programme of economic and political liberalisation facilitated strong private sector-led growth in the first half of the 2000s, albeit marked by episodes of financial and economic crisis. Nevertheless, the state continues to have a stronger role in the economy than in most mature market economies and indeed than in some of the advanced transition countries. Furthermore, significant political challenges remain in terms of consolidating the democratic political system, strengthening the rule of law and improving both public and corporate governance.

2.1.1 Political environment

The ruling Justice and Development Party (AKP) swept to power in parliamentary elections in November 2002, taking a plurality of 34 per cent of the national vote and – due to the abnormally high threshold of 10 per cent for entering the Grand National Assembly – 66 per cent (363 of the 550) of the seats in parliament. This allowed the AKP to form the first single-party government in Turkey since 1987, within the context of the first two-party parliament in almost 50 years. The only other party to clear the electoral threshold was the Republican People's Party (CHP), the left-leaning social democratic party originally founded by Mustafa Kemal Atatürk, and which dominated Turkish political life for most of the twentieth century.

In 2002 the AKP was a new political force on the Turkish political landscape, having been formed in 2001 by the then-Mayor of Istanbul, Recep Tayyip Erdoğan, who split off the reformist, liberal wing of the Islamist Virtue Party and pledged to take his new AK Party in the direction of market-oriented and pro-European reform. True to his electoral promises, following the AKP's electoral victory Erdoğan quickly began implementing a programme of political and economic liberalising reforms and intensified Turkey's cooperation with the European Union. In recognition of the successful reform agenda, the European Union granted Turkey official candidate status in 2005, 42 years after Turkey first applied to join the then-EEC.

However, from late-2005 the AKP's reformist drive, and therefore progress toward EU accession, began to slow. The loss of reform momentum was caused by a combination of domestic political pressures in the run-up to the July 2007 parliamentary elections, disappointment among Turkish citizens about the failure to settle the Cyprus dispute prior to (Greek) Cyprus' admission to the EU, and a perceived ambivalence on the part of some EU member states toward Turkey's membership prospects. Nevertheless, on the back of buoyant economic growth, the AK Party significantly increased its vote share in the July 2007 parliamentary election, receiving 47 per cent of the national vote, although their seat share fell to 341, a still-comfortable majority of the 550 seats. Unlike in 2002, in 2007 the third largest party, the right-wing Nationalist Movement Party (MHP), also managed to cross the 10 per cent electoral threshold, increasing their vote share to 14 per cent, while the CHP made more moderate gains.

Despite this strong electoral showing, the AKP's commitment to the European-oriented reform agenda has not strengthened significantly since the July 2007 elections. Turkey's slow progress on political reforms was highlighted by the European Commission's Annual Progress Report issued in November 2008. The Commission expressed serious concerns about Turkey's lack of progress in meeting the Copenhagen political criteria, pointing to limited progress with regard to strengthening democracy and the rule of law. The Annual Report flagged in particular concerns about much-needed constitutional reform; weak protection for the freedoms of assembly and speech; slow progress in judicial reform and anti-corruption activities; and the lack of progress in penal reform. Encouraging statements from the AKP government in early-2009 that it intends to reinvigorate Turkey's EU accession, including the appointment of a new Chief Negotiator, may lead to further progress on the political reform front in the coming years.

See Annex 1 for a more detailed assessment of the political environment.

2.1.2 Business environment

The business environment in Turkey has been improving slowly over recent years. According to the World Bank's Doing Business indicators, Turkey has climbed the global ranking scale from 84th in 2005[1] to 60th in 2008[2] and 59th in 2009. However, significant challenges remain. Licensing and regulation are major areas of concern, with construction permits, labour contracting and liquidating a business well below the median, as well as below the average for the transition region. Both domestic and foreign businesses complain in particular about the onerous labour regulations which make the hiring of foreign employees an extremely prolonged and expensive process.

Corruption is a particular challenge in Turkey. Turkey is ranked in the mid-50s globally on the 'rule of law' and 'control of corruption' measures of the World Bank's Worldwide Governance Indicators, although here the time trend is less clear than on the Doing Business measures, with moderate deterioration on the control of corruption, in particular. This worsening situation with regard to corruption is also reflected in Transparency International's Corruption Perceptions Index, in which Turkey's global ranking declined from the 41st percentile in 2001 to the 64th percentile in 2008, although there was a significant improvement in 2008.

2.1.3 Social issues

Turkey has achieved impressive results in reducing poverty in recent years. However, some social indicators lag behind those of countries with similar incomes, including infant and maternal mortality rates. Extreme poverty is no longer a significant problem. The proportion of the population living on less than US$ 1 a day has declined to negligible levels, standing at zero per cent in 2006 and 2007 (*Table 1*). However, approximately 10 per cent of the population still lives on less than US$ 4.3 a day, while a considerable part of the population, almost 19 per cent, is living below the food and non-food poverty line.

[1] Prior to the revision of the Doing Business methodology in 2008.
[2] After the revision to the Doing Business methodology.

Table 1: Poverty indicators according to poverty line methods

Methods	Poverty Headcount (per cent)					
	2002	**2003**	**2004**	**2005**	**2006**	**2007**
Food poverty	1.35	1.29	1.29	0.87	0.74	0.54
Complete poverty (food+nonfood)	26.96	28.12	25.60	20.50	17.81	18.56
Below 1 US$ per capita per day	0.20	0.01	0.02	0.01	0.00	0.00
Below 2.15 US$ per capita per day	3.04	2.39	2.49	1.55	1.41	0.63
Below 4.3 US$ per capita per day	30.30	23.75	20.89	16.36	13.33	9.53

Source: Results of 2007 Poverty Study, TURKSTAT

Poverty, in general, is more prevalent in rural areas. In 2007, food and non-food poverty was 32 and 11 per cent in rural and urban areas, respectively. There are also large income disparities between geographic regions. Generally, the eastern and south-eastern regions are less prosperous and less developed than those in western Turkey. Inadequate access to social, health and economic infrastructure are still a significant problem in many rural areas of Eastern and South Eastern Anatolia as well as in urban fringes of several major cities, with inadequate municipal services as a result (solid waste, water supply, housing).

In Turkey, infant and under-5 mortality rates have been falling significantly. According to the World Bank's World Development Indicators, in 2000 the under-5 mortality rate stood at 44 (per 1,000 live births) and decreased to 26 by 2006. The reduction is mainly attributed to improvements in health services, immunisation campaigns as well as falling fertility rates.

Life expectancy for the overall population has increased slightly in the last few years; in 2000 it stood at 71 years and by 2006 it was 73.2 years. Life expectancy for the female population has increased the most: in 2000 female life expectancy was 73.1 years and by 2006 it was 75.3 years. The male population's life expectancy has increased from 69 years in 2000 to 71.1 in 2006.

2.1.4 Labour issues

Turkey has been a member of the International Labour Organisation (ILO) since 1932. To date, 56 ILO conventions have been ratified including the eight core conventions out of a total of 188 ILO conventions.

Employment indicators for Turkey are presented in *Table 2*. Turkey's labour force participation rate is quite low: close to 48 per cent in 2007. The low levels of employment in Turkey stem mostly from very low levels of female employment, which is only 22.2 per cent, while.the rate of male employment in Turkey (64.3 per cent) is closer to that in the EU. Female labour participation rates in Turkey are falling steadily. The large size of the informal economy may also partly explain these low employment levels. As the social security tax burden is high, it is estimated that about 95 per cent of illiterate workers and 65 per cent of primary school graduates work informally, mostly in primary agriculture, construction and small manufacturing businesses[3]. The size of the informal economy in Turkey has been estimated at almost 45 per cent of the total labour force and a third of the country's GDP.

The low level of female employment in Turkey is not related solely to the limited availability of jobs. Patriarchal cultural values, and gender roles shaped by these values, are highly influential in restricting the forms of employment that are considered suitable for women. There are also large disparities in the level of education between the gender groups. According to the 2006 Household Labour Survey, 19.6 per cent of females and 4 per cent of males in the non-institutional working age population are illiterate. Women's position in society has slipped. According to the United Nations' Development Programme (UNDP) gender index, Turkey has dropped from 59th place in 1975 to the 72nd place in 2006. Only 9.1 per cent of seats in parliament are held by women and women account for about a third of professionals and technical workers. The ratio of estimated female to male earned income is about 0.28.

Turkey's Labour Code establishes the minimum age for employment at 15 years. However, incidences of child labour persist throughout Turkey though it has been declining. According to the results of the Turkish Statistical Institute's Child Labour Force Survey in 2006, around 960,000 children between the ages of 6 and 17 were working compared to 1,630,000 in 1999. In order to meet EU accession conditions, the Government of Turkey has developed a National Time-bound Policy and Program Framework designed to eliminate the worst forms of child labour and the involvement of children under 15 in all forms of work by 2014.

[3] E. Turkan (2005), "Structure and Qualifications of the Labour Force in Turkey", mimeo, Central Bank of Turkey.

Table 2: Developments in the Domestic Labour Market 2005-2007 (in thousands)

	TOTAL			MALE			FEMALE		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Population 15 years and over	50,826	48,485	49,215	25,209	25,601	24,354	25,617	26,067	24,861
Labour Force	24,565	23,250	23,523	18,213	18,297	17,363	6,352	6,480	6,159
Employed	22,046	20,954	21,189	16,346	16,520	15,661	5,700	5,810	5,528
Underemployed	817	835	742	705	770	634	113	119	108
Unemployed	2,520	2,295	2,333	1,867	1,777	1,702	652	670	631
Labour force participation rate (%)	48.3	48.0	47.8	72.2	71.5	71.3	24.8	24.9	24.8
Unemployment rate (%)	10.3	9.9	9.9	10.3	9.7	9.8	10.3	10.3	10.3
Non-agricultural unemployment rate (%)	13.6	12.6	12.6	12.4	11.3	11.4	18.8	17.9	17.4
Employment rate (%)	43.4	43.2	43.1	64.8	64.5	64.3	22.3	22.3	22.2
Underemployment rate (%)	3.3	3.6	3.2	3.9	4.2	3.7	1.8	1.8	1.7
Not in labour force	26,260	25,235	25,692	6,996	7,304	6,990	19,264	19,588	18,702

Source: Household Labour Force Survey, TURKSTAT

2.1.5 Environmental issues

Turkey is facing a number of challenging environmental issues associated with various factors including geography, significant economic growth in the last two decades with little environmental control, poverty pockets in both rural and urban areas, and insufficient capacity. Many of these issues are being addressed through quick changes in the regulatory framework, better governance including capacity building and improved environmental compliance monitoring, increased funding and privatisation of municipal services to the benefit of environmental performance. However, there is still a long way to go, particularly in terms of Turkey's adherence to environmental international agreements and conventions and harmonisation and integration of the EU environmental acquis.

An overarching Environmental Law came into force in 1983, introducing the first detailed regulatory framework for environmental management and protection and natural resources management. It is supported and complemented by a range of regulations which address specific problem areas (air, water pollution, Environmental Impact Assessments (EIA), etc.). Land acquisition and involuntary resettlement are regulated by the Expropriation Law and the Resettlement Law.

The Ministry of Environment was established in 1991 with tasks to protect and improve the environment. Other ministries with environmental responsibilities are Agriculture; Health; Energy and Natural Resources; Industry and Trade; and Tourism. Other important state institutions include the State Planning Organization (SPO), the State Hydraulic Works (DSI), Iller Bank and the GAP Regional Administration. There is a growing number of NGOs active on environmental issues, and public environmental awareness and willingness to engage has in recent years significantly increased, at the local as well as the national level.

Turkey's location, linking Europe and Asia, its varied topography and climate across a land area of 780,000 square kms, and its 7,000km coastline supports a rich and diverse flora and fauna. It is vulnerable to natural disasters, including earthquakes and to a lesser extent flooding and land- or mudslides. The country is urbanizing rapidly. The current population of about 72 million inhabitants grows at about 1 per cent per year.

2.1.6 Legal environment

An assessment of Turkey's commercial laws shows that in some areas, both laws and legal practice are well developed and structured in a manner that is conducive to investment and commercial activity, while in other areas existing laws are in need of significant reform.

In the area of secured transactions, for example, while there is well developed practice and law in relation to security over immovables (mortgages), shares and accounts receivables, security interests over going-concerns remain fraught with difficulties. In addition, enforcing security in Turkey, which in many instances requires some form of court involvement, is perceived to be slow and inefficient. Similarly, while Turkey's company law is at a high level of compliance with OECD principles, the enforcement of minority shareholder rights in the courts is likely to be slow, with defendants having numerous possibilities to obstruct the process.

Legal reform would especially be welcome in the energy and concessions sectors, two sectors of particular relevance to this strategy, and where current laws fall short of generally accepted "bankability" standards. For example, in the electricity generating sector, both the establishment of security, and, more problematically, being able to meaningfully enforce such security, requires the approval of the regulator. For lenders faced with a defaulting borrower, the time limits afforded under Turkish law for conserving value (for example, in a project financing, by finding a replacement operator) are very short, and there is not an established practice of direct agreements. Turkey's concessions laws also fall below what is recognised as international accepted standards. The lack of step-in rights, for example, renders concession based financings difficult to implement without a significant level of sponsor support.

It appears, however, that legal reform is on Turkey's agenda for 2009. As has been the case in many other EBRD countries of operations, the prospect of European Union membership constitutes a powerful incentive in this regard. A new commercial code, for example, incorporating to a large extent European Union *acquis* in relation to company law, has now been finalised, awaiting final ratification. Also, in the areas of concessions, a general framework of laws is currently being prepared, and is expected to be adopted in 2009.

Annex 3 contains a more detailed assessment of Turkey's laws in the areas of capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications.

2.2 Progress in transition and the economy's response

2.2.1 Macroeconomic conditions for the Bank's operations

Real economy: Following a series of severe currency and financial crises culminating in the financial crisis of 2001, Turkey has had six years of uninterrupted growth at an annual average of just under 7 per cent over the period. However, since the middle of 2007, growth has been gradually decelerating. Real GDP growth of 4.5 per cent in 2007 was below the level recorded in previous years and the estimated long-term growth potential of about 5 per cent, and is set to slow further as the global financial crisis takes its toll.

While the domestic financial system has shown a fair degree of resilience to the global financial crisis so far, as prudential regulation and supervision were strengthened following the 2001 banking crisis, the real economy has been hit through the trade channel. Turkey is in a customs union with the EU, which accounts for about 50 per cent of its exports and has strong trade links with Russia. As the recession hit most European countries and Russia's demand dwindled, demand for Turkish textiles, automobiles and automotive components, construction services and consumer durables faltered. While total exports grew by 36 per cent on average in the first half of 2008, they contracted sharply by 13.4 per cent in the last quarter. These trends were mirrored by industrial production data, which recorded a 17.6 per cent decline y-o-y in December 2008 (-0.9 per cent on average in 2008), and by the capacity utilisation rate, which fell to an 18-year low of 65 per cent. In addition, declining consumer confidence and tighter bank lending standards have weakened domestic demand. As a result, GDP growth decelerated from 7.3 per cent y-o-y in Q1 2008 to 1.2 per cent y-o-y in the third quarter, and contracted for the first time since the 2001 crisis by 6.2 per cent in Q4. This translated into an annual GDP growth of 1.1 per cent in 2008.

Developments in the first quarter of 2009 point at a further weakening of the economic outlook. According to preliminary estimates, industrial output collapsed in the first quarter (Q1) of 2009 and the capacity utilisation rate was hovering around an all time low. The unemployment rate jumped to an unprecedented 16.1 per cent in February 2009. The sharp decline in industrial production by 22 per cent y-o-y in Q1 was led by a severe decline in manufacturing output (23.5 per cent y-o-y), with automotive production contracting by 53.1 per cent y-o-y, production of textiles down by 20.4 per cent y-o-y and metal production declining by 27 per cent y-o-y. The pace of contraction in economic activity decelerated in April (-18.5 per cent y-o-y) and leading indicators are showing modest signs of improvement. It is however too early to point at a solid recovery as exports remain subdued and the rebound in domestic demand and production may have been driven by temporary tax cuts and re-stocking activity. Services, which account for around 60 per cent of value added, are also unlikely to provide much support to growth in the upcoming year. Tourism and transport revenues are projected to decline due to weaker global demand and incomes.

Developments in the global economy also influenced the inflation dynamics in 2008. In the face of rising food, energy and commodity prices in the first half of the year, the Central Bank of Turkey (CBT) revised upward the medium term inflation targets from 4 per cent to 7.5 per cent for end-2009, 6.5 per cent for 2010 and 5.5 per cent for 2011.

The inflationary trend reversed however in the last quarter of 2008, as commodity and energy prices fell sharply and world economic activity contracted. CPI inflation declined from a peak of 12.1 per cent at the end of July 2008 to 5.2 per cent by end-May 2009.

Economic policies: As inflation pressures subsided and economic activity slowed, the CBT surprised the markets by cutting interest rates quite aggressively, by 800 basis points (bps) since November 2008 to 8.75 per cent. Real interest rates are at an historic low. This should provide temporary relief to corporates, whose cost of funding (as measured by corporate bond spreads) has increased as a result of the global credit crunch. Indeed, since October 2008, financial de-leveraging has intensified, sovereign risk premia doubled and the Turkish currency lost about 40 per cent of its value against the dollar. Going forward, The CBT indicated that there may be scope for further "measurate" interest rate cuts, as the pass-through from the exchange rate to inflation is rather limited and the consensus view in the market is that the 7.5 per cent inflation target for 2009 may be undershot.

Fiscal discipline has been loosened since the end of the stand-by arrangement programme in May 2008. Thanks to a good track record of primary surpluses and active debt management, the consolidated fiscal deficit fell from 12.1 per cent of GDP in 2001 to 1.9 per cent of GDP in 2008 and public debt fell from 74.1 per cent at the end of 2001 to 38.2 at the end of 2008.[4] Against this positive track record and in response to the economic crisis, the government loosened fiscal policy by increasing public spending and announcing temporary tax cuts and investment incentives aimed at stimulating the economy in the short term. According to the most recent cash-based budget realisations, central government revenues dropped by 4.3 per cent in January-May 2009 compared to the same period of 2008, while expenditures have increased by 15.8 per cent over the same period, with the primary balance switching into a deficit for the first time since the 2001 crisis.

The authorities are currently holding talks with the IMF on an eventual follow-up programme to the stand-by arrangement which expired in May 2008.

External sector: Lower global and domestic economic activity and cheaper commodity prices, are going to impact Turkey's external balance this year. The current account deficit is expected to halve from US$ 41.6 billions recorded in 2008 to less than US$ 16 billions in 2009. In spite of this, meeting the country's external refinancing needs will be challenging in 2009-10, due to constrained global liquidity and limited risk appetite for emerging markets debt. Despite a significant reduction in public external debt, from a peak of 26.5 per cent of GDP in 2002 to 11.5 per cent of GDP by end-2008, the total gross external refinancing needs (debt service and amortization) of both public and private sector amount to more than US$ 110 billion in 2009. Assuming a rollover ratio of about 70 per cent for maturing external debt, a financing gap is likely in the range of US$ 15-20 billion this year, which could be partly met by new IMF funding.

[4] Domestic debt accounts for 70 per cent of total government debt. About a third of it is in foreign currency.

Outlook and risks: In the short-term, the economy is expected to contract by about 5.5 per cent in 2009 and remain flat in 2010, as a result of the global recession and weaker domestic demand. GDP growth could still be sustained by strong agricultural output and some external sector resilience. The economy is going to benefit from lower import demand and commodity prices, especially oil. In the medium-term, the outlook remains positive, as the EU accession process may support convergence and sustainable long-term growth.

The main macroeconomic risks stem from low consumer and investor confidence and worse than expected external conditions, including a delayed recovery in the EU and continued slow-down in Russia and the Middle East and/or lower external debt roll-over ratios, which would increase the external refinancing gap. These risks could be mitigated by a new IMF-supported programme that would help to boost investor confidence and anchor the country's structural reform agenda.

2.2.2 Transition challenges

While Turkey started to implement structural and institutional reforms in the 1980s, the pace of these reforms has increased in anticipation of the EU accession negotiations, and the overall pace of reform has been significantly slower than in Central Eastern Europe and the Baltic States (CEB). The reform agenda has been interrupted periodically by economic and political crises. Turkey continues to face significant challenges in decentralising and de-monopolising economic activity and in developing a more open and entrepreneurial economy. Although state interference in the economy has been reduced in recent years as important markets such as electricity, telecommunications, sugar and petroleum have been gradually liberalised, there is still a significant privatisation agenda ahead.

But significant gaps remain in the way markets, firms and institutions function in Turkey across almost all sectors. Sectoral transition gaps, or challenges, are summarised in Table 3 below. It is important to bear in mind that the transition gap ratings indicated on the table represent an average rating across sub-sectors (i.e., water services, solid waste and urban transport within MEI) and across regions. As a large and unevenly developed country, the levels of market development in Turkey– and therefore sector gaps – may differ substantially between urban and rural localities and between different regions of the country.

Table 3: Summary sector gaps

	Structure and extent of markets	Market-supporting institutions and policies	Overall rating (2009)
FINANCIAL INSTITUTIONS			
Banking	Medium	Small	Medium
Insurance and financial services	Medium	Medium	Medium
MSMEs	Medium	Medium	Medium
Private equity and capital markets	Small	Small	Small
ENTERPRISE SECTOR			
Agribusiness	Medium	Medium	Medium
General industry	Medium	Medium	Medium
Property/Tourism	Small	Medium	Small
Telecoms	Medium	Small	Medium
ENERGY & INFRASTRUCTURE			
Sustainable energy	Medium	Medium	Medium
MEI	Medium	Medium	Medium
Natural resources	Medium	Small	Medium
Power	Medium	Medium	Medium
Transport	Medium	Medium	Medium

Note: Turkey is mapped against two broad dimensions - structure and extent of markets and market-supporting institutions and policies–to determine how large the remaining overall challenges are in each of the 13 sectors in which the Bank operates. The scale goes from negligible, to small, medium and large. "Large" means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

The following sections summarise the rationale underlying these transition gap ratings.

Financial Institutions

The Turkish financial sector is relatively small in size, shallow in terms of financial intermediation and narrowly based. With the exception of private equity and capital markets, overall transition gaps in this sector are medium. The **banking sector,** whose assets in 2008 correspond to 63.4 per cent of GDP (compared with 260 per cent in the Euro area), is highly concentrated. State-owned banks account for about 30 per cent of total assets. The share of foreign banks is increasing but still rather limited. In general, banks have a relatively underdeveloped branch network although the larger banks have engaged in significant branch expansion programmes in recent years. Domestic lending to the private sector is limited: private sector credit amounts only to about 32 per cent of GDP, a level comparable to Georgia or Tajikistan. The tenor of credits is extremely short, with maturities greater than one year accounting for only a third of total credits, reflecting the very short term nature of deposits as well as the relatively short term tenor of syndicated loans to Turkish banks.

Although Turkish banks are not reliant on wholesale international funding and foreign currency risks are well contained (the net open FX position for the banking system is very low), the system may not be immune from the impact of the global credit crisis. Credit growth has been very rapid since 2002 and Turkish Corporates have relatively large open long-term FX positions, which in turn may result in a sharp deterioration in the quality of the portfolio of Turkish banks in the coming months. The rapid growth in consumer and credit card portfolios also contains risks. Non-performing loans increased to a average of 4.67 per cent from 3 per cent at the end of 2008, and can be expected to further increase. On the other hand, capital adequacy ratios are on average at 17 per cent at end June, 2009; profitability is strong and the system is largely deposit funded (the loan to deposits ration is about 70 per cent), providing a relatively stable base from which the impending effects of the crisis can be addressed. All major banks have, since around October 2008, sharply curtailed their lending activity, have husbanded liquidity and have slashed branch expansion activities.

The majority of loans provided to **MSMEs** comes from commercial banks (80%) and government agencies (19%), however financial intermediation is still low and there is limited MSME financing outside the major cities. Although policymakers have made progress in encouraging public and private banks to improve credit lines for MSMEs (including a government-sponsored micro-credit facility), access to finance is still an impediment to business investment and expansion. MSMEs suffer from a lack of funds to invest and/or upgrade their equipment and improve competitiveness. Access to credit has been a particular problem for MSMEs in rural areas, one reason being an antiquated legal regime for pledges. During the past two years however, a few of the larger banks, including Ziraat Bank, Finans Bank, Guaranti Bank and Deniz Bank, have introduced micro and small loan programs that have resulted in a substantial growth rate in lending for this sector, albeit from a relatively low base. These programs are normally based on credit scoring techniques, include a broad range of products targeting sectors and regions and take advantage of advanced information technology. A few other banks are in the process of introducing similar down-scaling programs. Improved coverage of credit information services, better enforcement of bankruptcy laws as well as an operating, geographically unified collateral registry would help minimise the banks reluctance to provide long-term financing.

The role of **non-banking financial services** has been growing but remains rather limited. Financial sector assets outside the banking sector accounted for about 10 per cent of GDP in 2008. At around 1.5 per cent, the ratio of insurance premia to GDP is relatively low, mostly accounted for by non-life insurance products (around 85 per cent). State-owned insurance companies need to be de-monopolised, restructured and privatised. Other non-banking financial institutions such as pension funds and leasing services are underdeveloped.

The domestic **equity market** is among the deepest and most liquid of any country of operation. Average daily trading volumes on the equity markets amount to US$ 2.1 billion (2008) and a total of 317 companies were traded (2008) on the Istanbul Stock Exchange (ISE), comparable to the Russian Trading System (RTS). The domestic corporate bond market is extremely small, as credit to the private sector is dominated by the banking sector.**Private equity/Venture Capital** in Turkey is still at an early stage and the foundation of the sector is more fragile and less developed than in most new EU member states. The inherent structural weaknesses which have to be overcome, are: (i) few, and generally inexperienced, local private equity managers; (ii) limited liquidity in local capital markets for flotation of private equity backed enterprises; (iii) lack of experience of entrepreneurs and business owners in dealing with private equity with its disciplined capital (including requirements for transparency, corporate governance); and

(iv) absence of local institutional investors willing to commit permanent risk capital to funds.

Enterprise sector

The **agricultural sector** employs about one-quarter of the labour force, but it remains inefficient and in need of modernisation. Although over 30 per cent of Turkey's land is arable, the lack of proper irrigation, the relatively small and uneconomic size of individual family-owned farms and the undersupply of capital for employment of modern production inputs, techniques and machinery prevent the country from realising its full agricultural potential. In the food processing sector, the landscape is scattered with small family-owned enterprises that do not meet western hygiene or efficiency standards. Nevertheless, in recent years, major industrial conglomerates have started investing in and consolidating the food processing sector, reflecting the price inefficiencies and the potential for high margins in the sector. Food retailing is still dominated by family owned small shops, particularly outside the main metropolitan centres. Progress of large-scale retail is impeded by difficulties in acquiring business permits, restricting supermarket development to high density inner-city locations.

In the **corporate sector**, there are still dominant state-owned enterprises in some sectors, particularly in infrastructure where monopoly concessions and anti-competitive privileges are common. Insufficient progress has been made in reforming these areas to date. The legislative and regulatory framework for starting and operating a private business requires strengthening, particularly the implementation of existing laws and enforcement of contracts. Restructuring of enterprises and improvements in corporate governance and business conduct are also significant challenges to raise productivity and competitiveness of Turkish firms. Despite repeated delays, privatisation has progressed in recent years in some sectors. The Turkish Privatisation Administration (OIB) privatised 51 per cent of Petkim Petrokimya Holding Co., a state-owned petrochemicals company, in 2007 while the state-owned tobacco company, Tekel, was sold in an auction for €1.7 billion to BAT in February 2008[5].

The **tourism sector** is relatively well developed although there are inequalities in the development between the major cities and the coast and the rest of the country. The legislative and regulatory environment regarding **property markets** needs to be improved. Mortgage financing is relatively underdeveloped; however, Parliament passed new mortgage legislation in February 2007 that should begin to improve conditions for property finance. The new law will allow for new funding mechanisms including mortgage-backed securities and mortage-covered bonds. The law also introduced tighter supervision of operations within the primary mortgage market. The legislative and regulatory environment regarding the property market requires improvement as buildings in Turkey are often constructed without permits and processes for land acquisition are time consuming.

[5] Other transactions underway are the privatisation of several seaports, including Izmir, Serince, Bendirma, Samsun, Iskenderun and Galata; the privatisation of the first bloc of six power distribution companies; the National Lottery; and several sugar factories.

Despite rapid recent growth, **the fixed-line telephony sector** is still characterised by low penetration rates of around 24 per cent (2008). In 2003, local and international voice telephony markets were liberalised and subsequently the monopoly fixed line operator has been privatised, but this has not yet resulted in meaningful competition in the sector. Turkey's **mobile telephony market** was liberalised ahead of fixed telephony services in 1994 and has enjoyed strong growth since then, with a penetration rate of 94.3 per cent. There are three mobile phone operators, the largest of which has a 56.2 per cent market share. Competition is increasing in this sector and recent regulatory changes are promoting this.

Energy and Infrastructure

Until very recently, the general approach of Turkey's energy policy has been highly supply-oriented, with emphasis placed on ensuring additional energy supply to meet growing demand, while **energy efficiency** has been a lower priority. Over the period 1990 to 2006, electricity consumption has risen by an annual rate of 7.2 per cent while carbon emissions have risen by 74 per cent. Energy efficiency needs to be raised, particularly through reduction of heating losses, improvements in large enterprises and reduction in losses of the national power transmission and distribution systems. The energy intensity of the Turkish economy has been relatively stable for the last two decades, at levels roughly equal to the EU-27 average. An energy efficiency law has been approved and basic institutions for EE established (e.g. energy efficiency agency), but further work is still required (e.g. indicative targets for energy savings and instruments to achieve these). Energy tariffs are adequately reflecting costs and provide incentives for low cost efficiency measures, but still do not reflect environmental costs. Turkey has recently ratified the Kyoto protocol. Remaining challenges are to achieve more effective EE project implementation and support climate change institutional and project deployment.

Although municipalities are responsible for the delivery of services in the areas of **municipal and environmental infrastructure**, there remains a high degree of fiscal centralisation and corporate governance of municipal companies – especially in smaller municipalities – falls far short of international best practice. For **water, wastewater, and solid waste services**, medium-sized and large municipalities are able to cover the costs of services but poorer municipalities struggle to cover on-going asset maintenance and investment projects. Private sector participation in water services is very limited and has had a mixed success to date. While the regulatory framework for PPPs has been evolving, very few projects are being implemented. Turkey's current approach to the granting of concessions, which involves considerable uncertainties as to terms, and strong and unilateral governmental termination rights, is not optimal for private sector financing and could be improved. The municipal debt market is under-developed. Long term capital is only available through government sources (in Turkish Lira) and international financial institutions (in dollars or euro), generally on a concessional basis. The municipal debt market is under-developed. The low utilisation of local commercial banks illustrates lack of long-term funds and weak municipal creditworthiness. The ability of municipalities to raise long-term finance needs to be enhanced. The situation is not uniform across the country, with the metropolitan municipalities relatively better placed in financial terms. In **urban transport**, it is necessary to enhance the efficiency of private sector operators and to ensure an appropriate level of municipal planning and regulation, while guaranteeing the funding of projects in the wake of the credit crisis.

In the **natural resources** sector, Turkey has significant lignite and some hard coal resources and other minerals including 60 per cent of the world's borax reserves, 20 per cent of bentonite and 50 per cent of perlite. Other mineral exports include natural stones (primarily marble), chromites, copper, magnesite, zinc and feldspar. Only relatively small amounts of oil and natural gas reserves have been found. State-sector companies dominate coal, borax and oil&gas production. Turkey intends to expand its role as a transit country for oil and gas and to continue to develop a supportive regime for extractive industries. This process will require *inter alia* an increased degree of corporatisation and enhanced corporate governance within state-owned companies, development of new environmental legislation in line with established best international standards, privatisation of mining assets and establishment of transparent regulatory mechanisms, including for the setting of oil and gas transport tariffs.

The **electricity sector** continues its structural and operational transition to a competitive market system. Notable milestones achieved thus far include: (i) unbundling of the sector into a generation company, a transmission company, a trading/contracting company holding IPP contracts and liabilities, and a distribution company; (ii) establishment of a regulatory authority which is licensing participants and approving market rules; and (iii) launch of the balancing market with trial operations of a transitional balancing and settlement system; and (iv) start of the privatisation process for power distribution companies, whereby three (out of 21) companies have been privatised in H1 2009 while tenders have been opened for another three. However, the transition to a market-based regime is being complicated by past long-term contracts with private investors and heavy state involvement in the sector. As far as **renewable energy** is concerned, Turkey has a large hydro, wind, geothermal, and solar power potential and would benefit from private capital investment in renewable energy. Turkey has yet to take advantage of this potential, as biomass/waste, geothermal, solar and wind currently comprise less than 1 per cent of electricity consumed, although the Government has announced plans to develop the country's hydro potential and connect 20GW of wind to the grid by 2023.

Some key **transport** modes retain a significant degree of state control. However there are on-going efforts to further increase participation of the private sector in both the ownership of transport assets and provision of transportation services.

The **railway network** in Turkey is owned and operated by the loss-making state railways company, TCDD. To become a commercial enterprise, the railway will need to be restructured. An action plan has been adopted which aims to initiate the reform programme for the railway sector and sets out a road map for legislative alignment with the revised railways "acquis". The various activities of TCDD (railways, ports management, etc.) have not yet been unbundled. The gathering pace of railway reform is expected to provide future opportunities for supporting emerging private sector rail operations.

Road financing on a non-sovereign basis with transparent private sector participation needs to be developed. The Turkish Road Authority (TCK) is responsible for most highway projects, usually financed by commercial consortia under a sovereign guarantee. The length of the road network has increased little over the past several decades; however, road surfaces have been improved and more than 11,000 Km of roads have been converted into dual carriageways. The Ankara-Istanbul toll road (motorway) has been completed.

Ports and transport by sea are important for domestic and international trade and travel, and the on-going concessioning of the management of state-owned ports and establishment of private ports has gone some way towards mitigating overcrowding and inefficiency in recent years. Although some of the largest port facilities are still managed by TCDD, out of the seven key ports under its management (Bandirma, Haydarpasa, Derince, Iskenderun, Izmir, Mersin and Samsun), several are in the process of being concessioned, with the concession for Mersin already awarded in 2007 for a period of 36 years to a consortium of the Singapore Port Authority and Akfen, a Turkish construction company. The finalisation of the concession for the port of Izmir, in particular, is expected to be affected by the financial market crisis. The port concessioning programme, as well as plans for new port development under private ownership, are therefore likely to provide future transition intensive investment opportunities. As discussed in Annex 3 however, there are major deficiencies in Turkey's legal framework for concessions. The Bank will work closely with the Government in order to address these deficiencies in a timely manner in order to ensure that the required investment finance can be made available in support of the privatisation programme.

The state-controlled national carrier, Turkish Airlines, dominates domestic air transport. Some 51 per cent of Turkish Airlines has been privatised following two public offerings, in 2004 (23 per cent stake) and 2006 (28 per cent stake). The Privatisation Administration retains a 49 per cent stake. Although most **airports** in the country are owned and run by the state, several high-profile PPP's took place in the sector (e.g. Turkish TAV, one of the leading private airport operators, holds the airport concessions in Istanbul, Ankara and Izmir).

2.3 Access to Capital and Investment Requirements

Although the domestic financial system has significantly strengthened since the 2001 crisis, Turkey remains dependent on external financing to cover its large investment needs.

Constrained global liquidity and limited risk appetite for emerging market debt are affecting both the ability and cost of accessing the external financial markets by Turkish banks and corporates. Although the country continues to have access to external sources of finance – the sovereign[6] raised €2.5 billion of Eurobonds so far this year – the roll-over ratio for the non-bank private sector declined to about 73 per cent in January-March 2009 and modestly recovered to 77 per cent in April, from almost 200 per cent in

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[6] Both Fitch and Standard & Poor's (S&P's) currently rate Turkey's foreign currency sovereign credit risk at BB-. S&P's revised its outlook from stable to negative in November 2008. Moody's Turkey sovereign rating is Ba3.

September 2008.[7] Banks have also started paying down their long-term external loans and have become more cautious in their domestic lending, especially to new clients. The absence of recent public offerings of equity is a strong indicator of the current lack of new equity capital for the corporate sector.

Table 4 below illustrates how investment and access to capital have been affected since the intensification of the global financial crisis in September-October 2008. The last two columns of the Table shows a marked slowdown in capital inflows and lending activity in the last quarter of 2008 and first quarter of 2009, compared to the first three quarters of 2008.

Table 4: Indicators of investment and access to capital

	2007	2008	2008		2009
			Q1-Q3	Q4	Q1
Gross fixed capital formation (in per cent of GDP)	**25.73**	**24.28**	**24.5**	**23.7**	**…**
public	3.3	3.7	3.3	5.1	…
private	22.4	20.6	21.2	18.6	…
Capital flows					
Gross FDI (net inflow in bln US$)	**22.1**	**18.0**	**13.9**	**4.3**	**2.3**
in % of GDP	*3.4*	*2.5*	*2.4*	*2.9*	*1.8*
Portfolio investments (net inflow in bln US$)	**2.8**	**-3.5**	**1.9**	**-5.7**	**-2.1**
in % of GDP	*0.4*	*-0.5*	*0.3*	*-3.8*	*-1.6*
Equity	*5.1*	*0.7*	*2.1*	*-1.4*	-0.4
Bonds (Eurobonds and Global Bonds)	*0.9*	*0.6*	*1.1*	*-0.5*	1.0
borrowing	4.6	4	4	0	1.0
repayments	-3.7	-3.4	-2.9	-0.5	0.0
Non-resident holding of domestic bonds	*-3.3*	*-4.8*	*-1.3*	*-3.8*	-2.6
Medium and long-term loans (net inflow in bln US$)	**29.0**	**24.0**	**27.4**	**-3.3**	**-3.4**
in % of GDP	*4.5*	*3.3*	*4.7*	*-2.2*	*-2.6*
General Government	*-3.9*	*0.7*	*1.7*	*-0.9*	-0.6
Banks	*7.3*	*0.5*	*3.3*	*-2.8*	-0.8
Private sector	*25.7*	*22.8*	*22.4*	*0.5*	-2.0
Other capital (net in bln US$)[1]	**-7.6**	**2.1**	**-3.3**	**5.2**	**3.4**
in % of GDP	*-1.2*	*0.3*	*-0.6*	*3.4*	*2.7*
Banking sector loans to the private sector (end of period, in bln TRY)	285.0	367.6	332.7	367.6	366.9
in % of GDP	*37.9*	*32.6*	*46.3*	*32.6*	*39.4*
of which:					
local currency loans (share of total)	*76.1*	*71.4*	*74.1*	*71.4*	*70.3*
foreign currency loans (share of total)	*24.1*	*28.7*	*25.9*	*28.7*	*29.7*
consumer loans (share of total)	*33.3*	*31.9*	*34.6*	*31.9*	*32.3*
SMEs loans (share of total)[3]	*28.3*	*23.8*	*28.6*	*23.8*	*22.9*
Memoranda:					
GDP in US$ billion	647	732	582	150	127
Reserve Assets in US$ billion	73.4	70.4	76.7	70.4	67.4
Exchange rate (TRY/US$) end of period	1.16	1.54	1.23	1.54	1.67

1 Other capital includes the asset side of all capital account transactions; short-term loans, currency and deposits and other liabilities not included elsewhere, plus net errors and omissions from the Balance of Payments, which partly captures foreign exchange borrowing by residents from foreign branches of Turkish banks.

2 Banking Regulation and Supervision Agency data.

3 Loans in cash only.

The inflow of gross foreign direct investment (FDI) fell from US$ 22 billion at the end of 2007 to US$ 18 billion in 2008. There has also been a reversal of net portfolio

7 Data refer to maturing long-term external debt.

inflows, mainly triggered by a sell-off of domestic bonds by non-residents (US$ -5.7 billion in Q4 2008) and a decline in portfolio equity holdings (US$ -1.4 billion in Q4 2008). Since September, it has become more difficult to attract longer term external loans for both Turkish banks and corporates. Long-term funding has been substituted by increased net short-term borrowing, as Turkish corporates and households have repatriated part of their offshore deposits[8] and the roll-over ratio of short-term trade credits to Turkish importers has declined in line with domestic activity.

The shortening in maturities available in banks' funding is likely to translate into the type of credit available in the domestic financial markets.

Credit to the economy grew rapidly up to the third quarter of 2008. By the end of September 2008, total banking sector loans to the private sector had grown by 17 per cent with respect to end-2007 but then decelerated to 12 per cent in the last quarter. Adjusted for the concomitant depreciation of the nominal exchange rate against the dollar, this meant an even sharper decline in total lending to the private sector. Since 2005, banks have had an increased appetite for lending to consumers and SMEs. Lending to consumers, including credit cards, mortgages, unsecured general-purpose consumer lending and car loans equalled 32 per cent of total loans at the end of 2008 and has remained flat since then. Lending to SMEs sharply declined in the last quarter of 2008 and first quarter of 2009, reaching 22.9 per cent of the total, significantly down from a 28.6 per cent share in total loans to the private sector a year earlier. Turkish commercial banks are funded mainly by retail deposits. Customers' deposits grew by 28 per cent in 2008, leaving the loan to deposit ratio at a relatively comfortable level of 86 per cent.

As mentioned in Section 2.2.2, the role of the non-banking financial sector in raising finance is minimal. Private equity and venture capital in Turkey are still at an early stage. Stock market capitalisation declined to about TRY 182 billion in 2008 (18.6 per cent of GDP), from TRY 336 billion in 2007 (39.4 per cent of GDP). In percentage of 2008 GDP, this is higher than Hungary (13 per cent) but less than Poland (21 per cent).

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

In line with the analysis of the transition challenges conducted in section 2, the Bank will focus its attention on the sectors and product areas where there are significant transition gaps and it where it can leverage its experience in structuring bankable projects which encourage entrepreneurship. The Bank will focus on the private sector with an emphasis on the regions of Turkey. It will strive to accelerate the delivery on a commercial basis of core utilities, infrastructure and services (water and waste water, urban transport, gas, electricity, other municipal services,) to the population and enterprises with particular attention to cities outside the large metropolitan areas. Improvement of quality standards, including strong covenants and due diligence

[8] The Turkish private sector holds substantial overseas assets, including bank deposits of US$ 82 billion as of end 2008, which may be used as collateral for borrowing from foreign banks.

requirements, establishment of reference standards for business practices, transparency and corporate governance will be at the core of all Bank activities.

Consistent with the key principles that were approved in October 2008 following consideration of the Strategic Review of the Request by Turkey to Become a Recipient Country of the EBRD (CS/FO/08-18 (FINAL), the following five operational priorities will underpin the Bank's activities during the period 2009-2012:

1. in the first instance, increase availability of risk capital and long term funding to the micro, small and medium sized (MSMEs) enterprise sector together with appropriate support to management, especially in the less developed regions.

2. support investment in the enterprise sector with a clear initial focus on agribusiness. Priority will be provided to supporting investment along the food chain (primary agriculture, storage and logistics, processing, branded products, and retail) to strengthen linkages and standards and stimulate supply food meeting European quality standards;

3. in the medium term, promote reform and support a secure and efficient delivery of vital utility services to the population and enterprises in the regions of Turkey on a non-sovereign basis;

4. promote, through its investments, favourable market conditions for the development of energy efficiency instruments across economic sectors and renewable energy; and

5. support the Turkish government's privatisation programme in the enterprise and financial institutions sectors.

In its operations, the Bank will give close consideration to addressing financing gaps that have occurred as a result of the international crisis. An emerging feature of the crisis is the virtual absence of commercial co-financing, including for projects that are IFI-led, which is putting at risk the implementation of a broad range of investments. Initial work by the Bank in Turkey has confirmed the complementary nature of the relationships with other international financial institutions, particularly given the need for closer co-operation resulting from the effects of the international crisis. The accord between The EC, EIB and the Bank which was signed on 15 January 2009 and which provides a framework for consultation, co-operation and co-financing; has been fully operationalised and is proving to be an effective instrument for promoting efficiencies and ensuring the complementary roles of the parties.

Despite the current market situation, the Bank will seek to mobilise commercial co-financing on a systematic basis in order to foster increased participation of local and international intermediaries in the less traditional market segments and therefore broaden their respective market reach and penetration. The Bank's operations are not expected to include sovereign guaranteed lending.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Financial Institutions

Transition Goals: Improve the availability of risk capital and long term funding for the micro, small and medium-sized enterprise sector, agricultural sector, for energy efficiency instruments and with a more broadly-based regional distribution. A particular focus in this regard will be on providing finance in direct support of bank lending programmes to MSMEs in regions and sectors which are most likely to face curtailed lending programmes as a direct result of the effect of the global crisis.

In the banking sector: The Bank has significant scope in the financial sector, given the relatively low level of financial intermediation, nascent capital markets, and early stage development of the nonbank financial institution area. The present market is straitened by the reduction of capital volume and tenor in Turkey and this situation is now exacerbated by the global liquidity constraints. During the latter part of 2008 and early 2009, Turkish banks were able to achieve a 100 per cent roll-over rate on maturing foreign loans, albeit normally for only 12 month tenor. The relatively low proportion of bank debt held as foreign loans and the relatively high proportion of funding from deposits leaves the banking sector relatively well positioned to handle refinancing risk. However, the long-term open foreign currency positions of corporate clients is likely to result in deterioration of loan portfolio quality within the sector, as is the recent growth in credit card and consumer loan receivables. The response of the banks to this situation has been to curtail portfolio growth and branch network expansion and to sharply reduce growth of new lending programmes including for MSME lending.

While the MSME sector constitutes a significant part of the economy, their growth remains constrained by the low level of financial intermediation generally and, particularly in eastern and southeastern regions, by their limited access to finance. This is even more significant for smaller enterprises and for the agricultural sector. Support for energy efficiency instruments is also limited and could be advanced through tailored Bank financial intermediary support.

Policy dialogue related to banking operations will focus on implementation of the recently enacted Mortgage law and on strengthening the effectiveness of the legal framework for pledges on moveable assets. The process of privatizing Halk bank and Vakif Bank will also be on the policy agenda.

Operational Priorities: The Banks operations in the financial institutions sector will focus on the areas in which it can have the most impact. Given that the volume of Bank lending available to Turkish banks during the initial years of EBRD operation in Turkey will be a relatively insignificant proportion of the total assets in the system, operations will be targetted toward ensuring that longer term finance is available to support maintenance, initiation and expansion of the following:

- **Micro, small and medium sized enterprise (MSME) financing.** MSMEs have been financed primarily by the two leading state banks although private banks have entered the market in the last two years. Banks are the primary conduit of finance for MSMEs as there is no legislation supporting non bank microfinance institutions. The Bank will seek to provide funding to the leading banks (possibly including one state-owned bank) with existing MSME programs with large distribution networks where it can play a role in expanding capital flows to MSMEs in targetted regions or sectors (eg small agriculture, women entrepreneurship). The funding will include for technical assistance when necessary. It will also seek to establish new MSME programs, again with possible use of technical assistance with commercial banks which are planning to target this sector. A key objective of the related bank operations will be to promote increased competition from privately-owned banks toward the state-owned banks in the regions and sectors currently dominated by the latter. Subject to market conditions, the Bank will endeavour to maximize the extent to which these operations are undertaken through TL-denominated loans. A further key objective of these operations will be to extend the tenor of loans available from international syndication partners for the Turkish banking sector.

- **Energy Efficiency**. The Bank will support the development of Energy Efficiency instruments through financial intermediaries to increase the energy efficiency of industries and the residential sector. The Bank will work in co-ordination with the IFC in Turkey to leverage US$ 125 million subsidised funding through the Clean Technology Fund. Specifically the EBRD and IFC will jointly provide US$ 500 million over 4 years to leverage the CTF funds. The Bank may also consider working with other funding agencies active in the sector including Agence Francaise de Development (AFD).

- The Bank will also, on a selective basis seek **equity investments** in financial intermediaries where, through Bank presence, it can increase the institutional strength and corporate governance of the institution; and increase the number of stronger intermediaries servicing the MSME sector or the Energy Efficiency sector. One or two of these equity participations may be on a pre-privatisation basis with Vakifbank and/or Halk Bank.

Non Bank Financial Insitutions. The Bank will seek to develop the NBFI sector in Turkey. The Bank will initially seek to further develop the leasing industry, which is an existing conduit for MSME finance and that holds significant potential for financing of agribusiness-based assets. Initially the Bank will work only with leasing companies that are bank subsidiaries.

Private equity and venture capital: the Bank will address the structural issues described above by expanding local private equity capacity with a particular emphasis on developing local fund management capability, implementation of good corporate governance and managerial/financial skill transfer, and policy dialogue to expand the universe of local investors able to invest in the asset class. Policy dialogue will also include capital market development, both to improve liquidity for private equity backed firms and to provide market funding for equity for smaller firms.

3.2.2 Enterprise Sector

Transition Goals: To support private entrepreneurship across a range of industries, with a special focus on agribusiness and the food chain.

Operational Priorities: The Bank will focus on supporting the private enterprise sector which has been hit hard by the ongoing economic crisis. As articulated in the Strategic Review (CS/FO/08-18 (FINAL), initial emphasis will be given to the development of the agribusiness sector with private partners along the entire food chain. A particular focus will be provided to food processing as well as organised food retail in less developed regions with backward linkages to primary production. The Bank's projects and policy dialogue in the sector will seek to (i) address the state involvement and intervention in agribusiness; (ii) encourage greater private sector dynamism and entrepreneurship to fully develop the sector's potential; (iii) bring agribusiness practices and quality standards in line with international best practice; and (iv) support and develop market-based institutions for financing and trade.
In order to achieve these objectives the Bank will focus on the following areas with an emphasis on providing loans, equity risk capital and advisory services to enterprises through the Turn Around Management and Business Advisory Services programmes (TAM/BAS). Annex 4 provides a summary of the proposed approaches under these programmes:

- creation of logistic centres, including provision of agricultural inputs, crop storage and cold storage, waste reduction, and transport;
- food processing, particularly with strong linkages to local agriculture and with a special focus on fruit, including fruit juice, vegetable, dairy, edible oil, bakery products and meat sub-sectors as well as frozen food production in line with government priorities;
- support improvements in the availability and quality of milk (only 25 per cent of the 12 million tons of milk produced meets EU standards) and promote animal husbandry to increase meat supply and quality;
- agribusiness development in southern and south-eastern Anatolia where a significant potential exists with a view to allow the region to improve its competitiveness in export markets;
- development of modern retail formats in the remote regions;
- support processing and export of farmed sea products; and
- high modern food packaging investments meeting EU standards.

In light of recent trends toward higher food prices on world markets, the Bank's activities in Turkey will help to stimulate a more effective supply response and exploit Turkey's competitive advantage as an exporter of quality agricultural products.

3.2.3 Infrastructure and Energy

Transition Goals: Support the delivery of vital utilities to the population and enterprises in the regions of Turkey and where the Bank is additional to fill funding gaps for infrastructure projects as the credit crisis restricts access to private sector funding.

Municipalities

There is little IFI presence on a direct and non sovereign basis outside the municipalities of Istanbul, Izmir, Antalya and Samsun. Accordingly, municipalities in the more remote regions have very limited access to finance on commercial terms. To address this, the Bank's co-operation with other institutions including EIB, KfW and AFD will be important for the effective delivery of funding for municipalities with a broad-based geographic coverage, particularly in central and eastern Anatolia.

Operational Priorities:
Beyond the municipalities in the regions, the Bank will play an important role assisting infrastructure project sponsors to cope with the credit crisis. Several projects have already faced funding gaps in late 2008 and early 2009 due to the diminished lending capacity of commercial banks. The Bank will be highly additional contributing in cooperation with other IFIs to fill such funding gaps likely to arise at larger municipal infrastructure projects.

Finally, private sector participation in municipal infrastructure is an essential area for development. After several unfortunate precedents over the last few years (notably in the water sector), the credibility of private sector participation needs to be rebuilt and the Bank will know-how contribute to a fair, transparent and balanced involvement of private sector operator in municipal infrastructure, notably water, wastewater and solid waste.

Given the differences across sub-sectors and municipalities and the work carried out by other institutions, the transition gaps identified in section 2.2.2 will be best addressed if the Bank's priorities focussed on:

- work with municipalities on a non-sovereign basis to complete tariff reforms and institution building (cost recovery and removal of cross-subsidies) and improve organisation and accountability of delivery of municipal services;
- assist municipalities to face the credit crisis by contributing highly additional gap funding in cooperation with other IFIs to allow the completion of essential urban projects; and
- support entry of private operators, particularly into the water and wastewater treatment sectors and solid waste collection and management.

Power
The Bank will play a role for the private sector in both the generation and distribution areas, as lack of debt and equity capital and the fragmented profile of the sector's players represent major challenges to the realisation of the country's reform objectives. More than half of the companies who have been granted permits for generation have not yet implemented projects due to lack of funding, reflecting the potential for Bank activity in this sector and, inceasingly, reflecting the effect of the global crisis. The Bank will also support Turkey in unlocking its renewable potential, particularly in wind power. The Bank will compound its impact by assisting the sector regulatory body in the implementation of a regulatory environment reflecting recent experience and international best practice based on that experience. As Turkey is an observer in the Energy Community , the Bank could play a role in financing investments associated with the country's aspirations to become a full member.
Operational priorities:

- seek to fill financing gaps for projects meeting the descriptions herein, that have financing packages under consideration from other IFIs but for which the withdrawal of commercial co-financing as a result of the global crisis has placed completion of these financings at risk;
- investment in selected privatised (or under privatisation) electricity distribution companies and in newly created private gas distribution companies;
- support to generation projects which intend to sell electricity on the liberalised market;
- support for renewable energy projects, particularly wind and hydro, to assist Turkey in diversifying away from dependence on expensive imported fuels; and
- support for institutions that facilitate transition to a market based system – e.g., the regulator.

Natural Resources

A key transition goal in the Natural Resource sector will be to promote the corporatisation, privatisation and enhanced transparency of the sector through selective engagement with private-sector managed enterprises.

Operational priorities:

- investment in private sector projects which will address energy security issues, both for the domestic and regional markets. This will include new, as well as upgrading of existing hydrocarbon pipelines, storage facilities, and related infrastructure and distribution centers. To meet the growing domestic and regional hydrocarbon demands, the Bank should support new offshore upstream oil and gas projects.
- investments will also focus on addressing energy efficiency and environmental issues, especially in the refining sector where improvements are needed.
- the mining sector is underdeveloped and very fragmented. The Bank will support those projects which have important demonstration impacts in areas which are currently lagging behind best industry practices. These include operational, environmental, social, corporate governance and transparency elements. The further development of the mining sector will be important to underdeveloped regions where most of the mining opportunities exist, in terms of employment opportunities and development of skills. If approached properly, many mining developments will be important catalysts in further regional development by fostering new SMEs related to the service sector.

3.2.4 Energy Efficiency and Renewable Energy

Transition Goals: Promote energy efficiency and renewable energy across all economic sectors

Operational Priorities: The Bank will focus on enhancing energy efficiency by pursuing energy efficiency investments in a broad range of sectors and through support for the development and implementation of comprehensive energy efficiency policies going beyond the investment financed by the EBRD.
Operations will focus on use of market-based financing mechanisms for energy efficiency and renewable energy including:

- Energy efficiency and renewable energy credit lines through the Turkish banking sector including technical cooperation support. These financing facilities will be targeted to: (i) enhance industrial energy efficiency, particularly in medium size enterprises; (ii) fund small scale renewable energy projects; and (iii) improve energy efficiency in existing buildings. Financing facilities will allow a more effective and expanded implementation of thermal insulation regulation standards with significant energy saving results. This approach will also complement the shift from coal to natural gas for residential heating which has important efficiency and environmental benefits. In contrast with some other countries of operations, this will build on the pre-existing practice of energy audits and the incipient development of an energy management approach at the corporate level, which have been introduced in Turkey over the past ten years.
- Direct financing of energy efficiency projects in the industrial sector through the Bank's industrial energy efficiency programme – using targeted energy audits and technical support from the Bank (including energy management training) to assist general industry clients to identify and implement energy efficiency investments as a component of projects financed by the Bank.
- Direct financing to renewable energy projects. The recently adopted Renewable Energy Law provides a basis for the development of this sector. In addition, there is a large potential for the use of heat from renewable sources (geothermal, solar thermal and biomass) which will be examined.
- Conditions in Turkey are favourable for a more dynamic development of Energy Saving Companies (ESCOs). Based on its experience, the Bank will support the development of a class of private investors focused on the delivery of energy efficiency projects through ESCOs.
- Direct financing of energy efficiency projects in the power and municipal infrastructure sectors. The main focus will be on the rehabilitation of thermal power plants to achieve specific gains in generation efficiency and on public transport.
- Investment in sustainable energy transformation utilising Clean Technology Fund (CTF) money. Turkey is one of the countries eligible for access to the CTF and the Bank will enhance its operations in intermediated finance and direct lending through use of CTF money.
- Improving the investment framework through policy-dialogue. The Bank will pursue policy dialogue in the field of sustainable energy to improve the framework for such investment where this is needed.

3.2.5 Support to Privatisation

Transition Goals: Support the Turkish government's privatisation programme in the enterprise and financial institutions sector.

Operational Priorities:
The Bank will share its significant privatisation experience in sectors like power with the OIB to prepare privatisations, but more importantly in helping OIB attract foreign strategic investors, who have been notably absent to date. The Bank will also participate in some of these privatisations alongside investors in the form of long term debt as well with equity. It should be noted that this area represents a significant potential for co-operation with both EIB and IFC given the magnitude of thelikely financing required.

Given the current dominance of the state in the transport sector and the operational inefficiencies which could be addressed by private sector involvement, EBRD is well placed to support the ongoing privatisation programme (mostly under PPP concession schemes). This includes the concessioning of selected ports under TCDD ownership, potential road and airport PPPs as well as ambitious new transport network development projects similar to the Istanbul Strait Road Tunnel Crossing, recently tendered on a PPP basis and expected to reach financial close by the end of 2009, subject to market.

4. ACTIVITIES OF OTHER IFIS AND BILATERAL FINANCING INSTITUTIONS

Coordination with other IFIs active in Turkey will be paramount in making the EBRD's potential involvement successful and value-added. At the same time, it is important to recognise that Turkey is a very large country with significant transition challenges and which can absorb much larger amounts of IFI finance than it is currently receiving, even in sectors where others are already investing. The European Investment Bank/European Investment Fund (EIB/EIF) and the World Bank Group (IFC and IBRD) have the strongest presence and most prominent role among IFIs in Turkey. KfW, Agence Francaise de Development (ADF) and the Council of Europe Development Bank are among the more prominent European and bilateral institutions active in Turkey. The accord between The EC, EIB and the Bank which was signed on 15 January 2009 and which provides a framework for consultation, co-operation and co-financing; has been fully operationalised and is proving to be an effective instrument for promoting efficiencies in ensuring the complementary roles of the parties.

4.1 European Union

Turkey has been a member of a customs union with the EU since 1995, which has increased its volume of trade with the EU Member States. Turkey's main industrial imports from the EU are machinery, automotive products, chemicals, iron and steel. Its main agricultural imports from the EU are cereals. Major EU imports from Turkey include textiles and cloth, machinery, and transport equipment. In 2008, EU imports from Turkey amounted to €43.3 billion while EU exports to Turkey reached €55.2 billion, making Turkey one of the EU's ten largest trade partners and the EU Turkey's largest.

The customs union agreement covers trade in manufactured products and entails alignment by Turkey with certain EU policies, such as technical regulation, competition and intellectual property rights. Trade between the EU and Turkey in agriculture and steel products is regulated by separate preferential agreements.

Turkey was officially recognised as a candidate country at the Helsinki European Council of December 1999 following its application in 1987. Accession negotiation started in October 2005 and since then ten negotiation chapters have been opened and one closed. An Accession Partnership was adopted by the Council of the EU in March 2001 and revised in 2003, 2006 and 2008. In the latest Annual Progress Report on Candidate Countries, published in November 2008, the EC highlighted the fact that reforms in Turkey have slowed down since 2005.

As a candidate country, as of 2007 Turkey benefits from IPA as the pre-accession financial assistance instrument to help meet the membership criteria. EU pre-accession assistance provides support for institution building, investment to strengthen the regulatory infrastructure, investment in economic and social cohesion and rural development and the promotion of civil society dialogue. The identified priorities for Turkey include supporting the implementation of the Copenhagen political criteria; supporting economic and social cohesion by targeting the poorest regions in Turkey; promoting the implementation of the "acquis" related to the customs union, the internal market, agriculture, environment; and promoting political and social dialogue between the EU and Turkey. Priorities for pre-accession financial assistance to Turkey are set out in the Multi-annual Indicative Planning Document (MIPD) 2009-2011 which will allow for the following allocation:

*The Turkey Multi-Annual Indicative Financial Framework**

Component	2009	2010	2011	Total
I – Institution Building	233.2	211.3	230.6	**675.1**
II – Cross-border cooperation	9.4	9.6	9.8	**28.8**
III – Regional Development	182.7	238.1	291.4	**712.2**
IV – Human Resources Development	55.6	63.4	77.6	**196.6**
V – Rural Development	85.5	131.3	172.5	**389.3**
Total	**566.4**	**653.7**	**781.9**	**2002**

** Figures are in current prices, million €*

Around €1.15 billion of EU financing is currently being managed in Turkey for projects committed between 1996 and 2004 inclusive. The budgetary allocations for 2005 and 2006 were €300 million and €500 million, respectively. Since 2007 Turkey has been a beneficiary of the new Instrument for Pre-accession Assistance (IPA). Under IPA, it is expected that the average annual allocation for Turkey will increase from €497 million in 2007 to €781.9 million in 2011.

4.2 International Monetary Fund

Turkey has been one of the IMF's most active countries, and for a considerable period of time the largest borrower. A number of IMF programs have followed one another over the years and the latest program of US$ 10 billion was signed in May 2005. This 3-year programme has ended in May 2008. The authorities are now negotiating a follow-up stand-by programme.

The IMF sees Turkey's medium-term challenge to be to combine continued macroeconomic policy discipline with the right set of microeconomic reforms to improve the country's resilience to shocks while boosting potential growth.

4.3 World Bank Group: IBRD

Turkey is one of the largest middle-income partners of the World Bank Group being the third largest World Bank borrower in terms of active portfolio with average new commitments of US$ 1.5 billion per year during the last three years.

The goal of the new Bank Group Country Partnership Strategy (CPS) for 2008-2011 is to partner with Turkey to achieve fast and sustained growth with equity. The CPS is shaped directly by Turkey's Ninth Development Plan and aims at contributing to three main development pillars:

- improved competitiveness and employment through measures such as:
  - improving the investment climate and decrease informality of the economy;
  - increasing labour market flexibility;
  - improving soundness of financial system and improved access to finance;
  - technology and innovation;
  - efficient and sustainable energy; and
  - promotion of off-farm employment creation and increase of competitiveness of farm and off-farm sectors.

- equitable human and social development through measures such as:
  - enhancing the social security and health system;
  - improving the educational system; and
  - improving income distribution, social inclusion and poverty alleviation.

- efficient provision of high-quality public services through measures such as:
  - improving the effectiveness of public expenditure;
  - ensuring local delivery of public services;
  - reducing regional disparities; and
  - environment protection and disaster management.

Naturally, several activities will contribute to the achievement of more than one development objective. The CPS envisages IBRD engagement through free-standing and programmatic economic and sector work, technical assistance and advice, capacity building, investment and policy lending at the project, programme, sector, local, and country level, contingent financing tools (such as for catastrophic risks), as well as banking advisory services.

The CPS envisages IBRD financing equivalent to new commitments up to US$ 6.2 billion during FY08-11, with an expected share of around 50 per cent in development policy lending (DPLs). IBRD financing up to these levels—assuming Turkey's historical disbursement and amortisation schedules—is projected to increase IBRD exposure to Turkey between end-FY07 and FY11 by up to US$ 4.5 billion—reflecting both the demand of the government of Turkey for IBRD financing and IBRD's financial considerations. The phasing of IBRD financing and the mix of DPLs and investment financing will be flexible. Thus, IBRD financing may be front-loaded, back-loaded, or evenly phased, and the share of DPLs may exceed or fall short of the expected 50 per cent average, in any one year and over the 4-year CPS period—depending on the economic circumstances in Turkey and the substantive content and pace of implementation of the Turkish authorities' economic reform and investment programs. The total amounts of US$ 1.8 billion each in FY08 and FY09 and US$ 2.6 billion during FY10-11 are indicative of the extent to which the Turkish authorities expect possible frontloading of IBRD financing during the CPS period. The levels of actual IBRD financing will also depend substantially on the availability and terms of other financing, such as from domestic and international financial markets, the EIB, EU, EBRD and other development partners and will be adjusted accordingly depending on needs.

Implementation of the CPS FY08-11 is on track, with US$ 1.9 billion of financing so far approved between July 1, 2008 and December 31, 2009 and well above US$ 1 billion planned for January - June 2009. A CPS FY08-11 Progress Report is under preparation and expected to be available in Fall 2009.

4.4 World Bank Group: IFC

Investment activity

Cumulative IFC investments in Turkey amounted to US$ 4.4 billion at end June 2008, US$ 680 million of which was invested during FY 2008. Turkey is currently IFC's fifth largest exposure after Russia, India, China and Brazil. As of June 2008, IFC's portfolio totalled US$ 1.8 billion. IFC uses Istanbul as its regional hub for the Southern Europe and Central Asian operations since 2001.

The annual investments of IFC in Turkey increased from around €100 million before 2005 to around €300 million per year in 2005 and 2006. Annual investment reached an unusually high level of €775 million in FY 2007 driven by two large investments, one in the financial sector (Finansbank equity of €188 million in connection with its acquisition by National Bank of Greece) and the other in the telecommunications sector (Avea debt, €288 million). One large loan of US$ 250 million in the power sector provided for 36 per cent of the value of IFC's new business during 2008.

The size of IFC's investments in Turkey was quite constant before 2005 with an average deal size of about €22-25 million. After 2005 this average has risen to around €55 million, mainly due to a few projects larger than €150 million (in transportation, finance, power and telecom). The total number of investments per year has risen, from five to six deals before 2001 to 10 deals since then

As a general trend, the size of IFC's investments in Turkey has increased. Whereas before 2005 only 5 per cent of total investments were in transactions larger than €100 million (1 deal in 1993), after 2005 this has risen to 40 per cent (2 deals in 2007 and 1 deal in 2008 before June).

Type of investments

An overwhelming majority of IFC's financing is in the form of debt. Only 7 per cent of its cumulative investments in Turkey have been done in the form of equity (94 per cent of equity investments were made after 2005).

The investment profile of IFC by sector has not changed much throughout the years. Only the telecoms and energy sectors have seen an increase since 2005. The greatest proportion of investments have been into the financial sector including credit lines for on-lending to the SME sector. IFC is not particularly active in the agribusiness sector, neither in the property sector. Most investee companies are located in the larger western urban centres rather than the regions.

Technical assistance

The advisory activities of IFC in Turkey have been mainly related to the organisation and sponsoring of conferences on relevant topics. IFC organised and sponsored a Global Microfinance Conference in 2003 and hosted the 2007 Turkey Housing Finance Conference in Istanbul. IFC also helped authorities modify draft legislation regarding provision of Microfinance in the country.

4.5 EIB/EIF

Investment activity

As a Pre-Accession country, the EIB's activities in Turkey gradually increased in recent years and showed a significant increase in 2006, 2007 and 2008 making it the largest recipient country of EIB lending outside the EU. EIB's lending strategy is aimed at preparing the country for EU membership, in line with the EU accession process. Priority objectives in Turkey are same as those in the EU covering six main objectives:

- Support for economic and socials cohesion and convergence in the enlarged Union;
- knowledge economy;
- development of Trans European Networks (TEN's);
- support for SME's;
- environmental protection; and
- promoting sustainable, competitive and secure energy.

EIB, together with its subsidiary the EIF, offers various financing instruments in Turkey to eligible targets, similar to its activities within the EU. The EIB finances both private and public sector operations and its instruments cover a range of products from senior loans to venture capital and guarantee structures. While the EIB does not provide direct equity, it can provide funding for equity funds for private and public sector operations through the EIF such as the investment in Turkven Venture Capital Fund and Istanbul Venture Capital Initiative. EIB's large investments are focused on connecting the major urban centres of Istanbul and Ankara, in line with its TEN's objective. EIB also promotes private sector industry through supporting FDI into Turkey and JV's as well as SME's.

The EIB's annual business volume for Turkey in 2006 was €1.8 billion, €2.2 billion in 2007 and €2.7 billion in 2008. The EIB's 2008 business was dominated by large infrastructure transactions including a €700 million project for the extension of Istanbul's public transport system. This project represents EIB's first municipal loan without a third party guarantee. Further operations were a framework for €200 million for private energy/environmental investments, €200 million for a major automotive JV and €300 million to improve the resistance of Istanbul's hospitals and schools against major earthquakes.

Technical Assistance

Technical Assistance was provided in the past funded from budgetary sources of the EU within the FEMIP (Facility for Euromediterranean Investment Partnership) framework for a total of €12 million covering the budgetary years 2003 and 2004. Such TC funds are no longer available.

4.6 Council of Europe Development Bank

The Council of Europe Development Bank (CEB) is a multilateral development bank placed under the authority of the Council of Europe. The CEB participates through loans in the financing of social projects and responds to emergency situations, thus contributing to improving living conditions and social cohesion in the less advantaged regions of Europe. The CEB grants loans in the member states of the Council of Europe.

The CEB has an exclusively social vocation and thus has three main fields of action: (i) strengthening social integration, including aid to refugees; (ii) managing the environment; and (iii) developing human capital including education, training and health. In its investment decision process, the CEB aims to strike a balance between profitability and its social vocation.

CEB lending in Turkey over the past decade has been focusing on projects related to natural disaster mitigation, rural modernisation, environmental and urban infrastructure, health, education, and job creation in SMEs. CEB financing to Turkey amounted to €217 million during FY 2008.

4.7 Agence Française de Développement

Mission

The Agence Française de Développement (AFD) is a French public financial institution which has a mission to finance projects of economic and social development in foreign countries.

Strategy 2009/2011 for Turkey

The AFD Group, including its subsidiary Proparco, has been present in Turkey since 2004 and has a representative office at Istanbul. The AFD supports the following priorities:

- Financing of municipal investments, within the framework of the process of current decentralization. AFD operations promote and support autonomy and sustainability of municipal enterprises.
- The financing of investments to reduce pollution, with particular attention paid to greenhouse gas emissions, energy savings and industrial energy efficiency projects.

- The promotion of economic activity, through investments in enterprises, in particular in the less developed regions.
- Finally, a new area of activity could include energy efficiency for social housing.

Methods of financing

AFD establishes partnerships with banks, municipalities and Turkish companies. The amount of the loans is on average between €20 million and €50 million and SMEs and small municipalities are lent to through banks. Maturity of AFD loans is normally between 12 and 15 years with grace periods up to five years. All loans are provided without sovereign guarantee and some loans carry lower than market interest rates.

AFD has committed €762 million to Turkish projects since 2004 and has planned to commit a further €150 million per annum for the period 2009-2011.

4.8 KfW Bankengruppe Activities in Turkey

KfW Bankengruppe is the promotional bank owned by the German government (80 per cent) and the federal states (20 per cent). The Turkey Portfolio of the KfW Bankengruppe reached UR 8,3 billion in 2008.

KfW Entwicklungsbank (one of the brand names of KfW Bankengruppe) is active in three major fields in Turkey:

- Municipal infrastructure projects
- SME finance (through financial sector)
- Energy Efficiency and Renewable Energy (through financial sector)

KfW Entwicklungsbank finances the investments above on behalf of the German Federal Ministry for Economic Cooperation and Development within the framework of Turkish-German Financial Cooperation. The German government thereby intends to support the Turkish government in fulfilling its development objectives in these areas

In some of the SME projects, KfW Entwicklungsbank cooperates with the European Union. In the second phase of “Small Enterprise Loan Programme - SELP”, via partner banks Akbank, Garantibank, Isbank and Sekerbank, almost €90 million will be provided to Turkish SMEs. The funds will benefit SMEs in the 49 poorest provinces and improve their access to loans. A structured investment fund will be established under the framework of this Programme that provides continuous refinancing to the partner banks. IFIs will be invited to participate when the fund is in place.

KfW IPEX-Bank conducts export and project finance activities of KfW Bankengruppe that are carried out on commercial terms. KfW IPEX-Bank takes also part in major syndication deals of private sector companies (in energy, transportation) in Turkey.

ANNEX 1: POLITICAL ASSESSMENT

Compliance with Article 1

Turkey is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement Establishing the Bank. However, some challenges in the areas of democratic governance and civil and human rights remain.

Turkey has held seven parliamentary elections as well as regular local elections since the period of military rule between 1980-1983. The most recent parliamentary elections in 2002 and 2007 were deemed by international observers from the OSCE's Office of Democratic Institutions and Human Rights (ODIHR) to be generally in line with Turkey's international commitments. ODIHR stated that the 2002 elections "demonstrated the vibrancy of Turkey's democracy" while the 2007 elections "demonstrated the resilience of the election process in Turkey, characterised by pluralism and a high level of public confidence." ODIHR also noted some shortcomings, including limits on the scope of political debate imposed by the broader legal framework which placed some constraints on the exercise of Turkish citizens' democratic rights.

Political Accountability

The Turkish Constitution provides political accountability through the separation of executive, legislative and judicial powers and regular, direct, contested elections for the legislature, the Grand National Assembly. Under the Constitution, the President appoints the Prime Minister, the Ministers of the Government (on the Prime Minister's recommendation), the members of the Constitutional Court and the Chief of the General Staff of the armed forces. However, real political power is vested in the Prime Minister and Government; the President has historically played a largely symbolic role as the guardian of the constitutionally enshrined principles of the secular and unitary Turkish state.

The Grand National Assembly is composed of 550 deputies elected for a four-year term on the basis of party list proportional representation with a party threshold of 10 per cent of eligible national votes. Until constitutional amendments of May 2007, the President was elected by and from the membership of the Grand National Assembly, but henceforth will be elected directly by the national electorate, which will strengthen the separation of powers and provide for increased political accountability.

The parliamentary elections of 2002 marked a watershed in Turkey's democratic history. The opposition Justice and Development Party (AKP) won just over one-third of the vote. However, only one other party, the Republican People's Party (CHP), succeeded in crossing the 10 per cent electoral threshold. As a result, the AKP took a majority of seats in the first two-party parliament in modern Turkish history. The AKP was committed to reinvigorating Turkey's political and economic reform agenda and accelerating Turkey's European Union accession talks, and the new government rapidly embarked on this reform agenda. Although it faced some opposition, the government made sufficient progress in both democratic and market-oriented reforms by 2005 to be invited to accession talks by the European Union.

Since late-2005, however, the implementation of democratic reforms has slowed. The European Union has repeatedly highlighted the need for the Turkish authorities to reinvigorate the democratic, constitutional reform agenda in a manner consistent with the Copenhagen political criteria for EU accession.

The Rule of Law

The Turkish Constitution provides for the formal independence of the judiciary from legislative or executive interference. However, the European Commission's 2008 Progress Report for Turkey highlighted concerns about the composition of the High Council of Judges and Prosecutors and the reporting lines of judicial inspectors.

Judicial reform has been underway for several years in Turkey, and in May 2008 the Ministry of Justice promulgated a draft judicial reform strategy which covers issues related to the independence, impartiality and effectiveness of the judiciary and improvements to the management of the legal system to bolster public confidence and thus facilitate improved access to justice. As of June 2009, opinions on the proposed draft judicial reform strategy have been received from the High Court, local courts, thirty-two Law Faculties and other related agencies. While welcoming the principles contained in the draft strategy, the European Commission and European Parliament have also expressed their concern about the slow pace of concrete reform implementation.

Both administrative and high-level corruption are moderate problems in Turkey. According to Transparency International's Corruption Perceptions Index (CPI), in 2008 Turkey was ranked 58th out of 180 countries globally, on a par with Poland and Lithuania. This represents the high water mark for Turkey's rating since the CPI was introduced in 1995: since the AKP came to power in 2002, Turkey's ranking on the CPI has been steadily climbing, thanks in part to the government's efforts to combat administrative corruption.

One area that has received attention is civil-military relations and civilian control of the armed forces. The definition of 'national security' contained in the laws on the Turkish Armed Services Internal Service and the National Security Council give the armed forces broad powers to intervene in domestic political developments, and has led to the Army's occasional engagement in civil and political debate.

Civil and Human Rights

Civil and human rights are enshrined in the Turkish constitution and Turkey has ratified all major international human rights conventions, which have primacy over Turkish domestic law according to the Constitution, and the protection of Turkish citizens' rights has improved in recent years. However, international human rights monitors continue to express concerns related primarily to three areas: the rights of minority ethnic and religious groups; the right to freedom of speech; and the treatment of prisoners in pre-trial detention and the penal system.

Turkey has effective laws enshrining freedom of speech and the media, although concerns about inconsistent application of these laws have been voiced by international media watchdogs.

The European Commission's 2008 Progress Report and a December 2008 Human Rights Watch report raise significant concerns with regard to the continuing problem of police violence and the treatment of detainees in pre-trial detention and Turkey's penal system. The UN Human Rights Council's Working Group on Arbitrary Detention issued a detailed report in 2007 which praised progress made over the preceding 15 years. At the same time, the report expressed concerns about the treatment of individuals accused of terrorism offences as well as individuals detained outside the penal system. Significant steps have been taken with regard to training for judges, prosecutors and forensic experts. While some prosecution cases against police and prison guards alleged to have taken part in torture and/or degrading treatment have been opened, the number of convictions remains low.

ANNEX 2: ENVIRONMENTAL AND SOCIAL DEVELOPMENTS

1. Introduction

Turkey is facing a number of challenging environmental and social issues associated with various factors including geography, political history, significant economic growth in the last two decades with little environmental control, poverty pockets in both rural and urban areas, and insufficient capacity. Many of these issues are being addressed through quick changes in the regulatory framework, better governance including capacity building and improved environmental compliance monitoring, increased funding and privatisation of municipal services to the benefit of environmental performance. Sustained economic growth and increased community awareness are powerful drivers to these changes. The EU Accession process also contributes to progress: while the environment specific chapter of the 33 point negotiation agenda is not being discussed yet and a lot remains to be achieved in terms of Turkey's adherence to environmental international agreements and conventions, the country is progressing towards harmonisation and integration of the EU acquis.

2. Environmental and Social Legislation, Policies and International Commitments

The Environmental Law, which came into force in 1983, introduced the first detailed regulatory framework for environmental management and protection and natural resources management. The Environmental Law adopts the "polluter pays" principle and defines activities to prevent and solve environmental problems. It is supported by a range of regulations which address specific problem areas. These include the Air Quality Control Regulation (1986), the Water Pollution Control Regulation (1988), the Noise Control Regulation (1986), the Control of Solid Waste Regulation (1991), the Environmental Impact Assessment Regulation (1993), the Regulation on Control of Medical Waste (1993), the Control of Hazardous Wastes Regulation (1993). These regulations are often based on international norms and are regularly updated and amended. The Environmental Law is complemented by other laws (e.g. on forestry) and international conventions (e.g. Ramsar and CITES). Turkey is harmonizing its environmental laws and regulations with international norms. It is a signatory to 76 multilateral and 25 bilateral agreements plus 5 bilateral agreements on forestry.

Land acquisition and involuntary resettlement are regulated by the Expropriation Law (significant amendments in 2001) and a 2007 Resettlement Law. Recent practice indicates that a significant amount of expropriation cases end up before local courts, with a potential for significant delays in project implementation as a result.

The Ministry of Environment was established in 1991 with tasks to protect and improve the environment. In 2003, it was combined with the Ministry of Forestry to form the Ministry of Environment and Forestry (MoEF). The prerogatives of MoEF relate primarily to:

- ensuring appropriate land use;
- protecting natural resources, protect flora, fauna and biodiversity;
- preventing pollution;
- protecting and enhancing forest areas;
- developing the villages within and near forest areas; and

- ensuring sufficient supply of forestry products and developing the forestry industry.

The Ministry of Environment and Forestry is supported by special consultative institutions such as the Environment Council; the Higher Council for the Environment; Iller Bank; and Local Environment Committees. Other ministries with environmental responsibilities are Agriculture; Health; Energy and Natural Resources; industry and Trade; and Tourism.

Other important state institutions include the State Planning Organization (SPO), State Hydraulic Works (DSI), the GAP Regional Administration, an intergovernmental agency dealing with all aspects of economic development in South East Anatolia and the Agency for the Protection of Special Areas.

3. EU Accession

The Helsinki European Council of December 1999 granted Turkey the status of candidate country and accession negotiations, which began in 2005, are ongoing. In the initial phase, the country's preparedness to start negotiations on an initial 33 chapters (i.e. specific issues, including environment) was assessed and negotiations were opened on 10 chapters; these do not include environment yet. The Accession Partnership provides guidance on necessary reform priorities and monitors progress.

The 'Turkey 2008 Progress Report' by the European Commission states under 'Environment' that '*in the field of horizontal legislation some progress can be reported. The Environmental Impact Assessment (EIA) Directive has been transposed to a large degree. However, procedures for consulting the public and transboundary consultations are not fully aligned. …... Transposition of the Strategic Environmental Impact Assessment (SEIA) Directive is at an early stage. There has been no progress on transposition of the acquis on environmental liability, public participation and public access to environmental information.*'.[9]

The Progress Report also mentions that good progress was made in aligning the air quality framework legislation and associated Directives. Progress has been made in the area of waste management (e.g. with regard to hazardous substances) but there is still no national waste management plan. Little progress is reported in the area of aligning water quality legislation. Limited progress is reported with regard to nature protection; a framework law on nature protection and implementing legislation on birds and habitats has not yet been adopted, neither has the national biodiversity strategy and action plan. The Progress Report stated that '*The continuing loss of habitat is a cause for concern. The list of potential Natura 2000 sites has not yet been compiled.*' No progress has been reported in the areas of industrial pollution and risk management or Genetically Modified Organisms.

4. General Environmental and Social Setting

Turkey's location, linking Europe and Asia, the Mediterranean and the Black Sea, and its varied topography and climate across a land are of 780,000 square kms support a rich

[9] Since the Turkey 2008 Progress Report was published, the Kyoto Protocol has been ratified by the Turkish Parliament on 5 February 2009.

and diverse flora and fauna. The country has a coastline of more than 7,000 km, with the Aegean and Mediterranean shores accounting for more than 4,500 km and the Black Sea for 1,600 km. The country's climate ranges from temperate with year-round rain to subtropical with dry summers. Much of the land has steep slopes, even in coastal areas and only 10 per cent of the country is less than 250 metres above sea level, with high mountain ranges in Central and Eastern Anatolia. Forests cover over 26 per cent of the land area, but much of this is degraded and unproductive. The country's significant agricultural sector is restricted to less than a quarter of its surface area, much of which is prone to erosion. Fish fauna is diverse but under pressure due to a large fishing industry.

Turkey is vulnerable to natural disasters, including most prominently earthquakes and to a lesser extent flooding and land- or mudslides. Preparedness has, however, progressed in the recent years.

The country is still urbanizing rapidly, with more than 70 per cent of the population living in urban areas concentrated in four provinces (Istanbul; Ankara; Izmir; Adana). The current population of about 72 million inhabitants has one of the highest growth rates among OECD countries (net growth rate: 1.02 per cent).

Turkey has succeeded in reducing poverty. It is estimated that fewer than 10,000 people, or less than 0.01 per cent of the population, are extremely poor, living on US$1 or less a day. At the same time, some social indicators lag behind those of countries with similar incomes. For example, infant and maternal mortality rates are well above those of most middle-income countries, inequality remains high, and there are significant regional differences:

- Poverty and inadequate access to social, health and economic infrastructure are still a significant problem in many rural areas of Eastern and South Eastern Anatolia, particularly where the physical environment is challenging and results in isolation.
- Waves of migration from the Turkish countryside, which peaked in the nineties as a result, amongst others, of insecurity in South Eastern Anatolia, swelled urban fringes in several major cities (Istanbul, Diyarbakir), with inadequate municipal services as a result (solid waste, water supply, housing).

5. Non-Governmental Organisations and Public Participation

There is a growing number of NGOs active on environmental issues. The 1998 National Environmental Action Plan (NEAP) mentions that 7 per cent of the known 60,000 voluntary organisations are active on environmental issues. The Regional Environmental Centre (in its 2002 strategic paper on "REC Extension to Turkey") estimated that 110 to 160 organisations are active in the environmental field in Turkey. The majority of these Foundations and Associations were said to be located in Ankara, Istanbul, Izmir, Marmara and Aegean Regions, with much less activity in the Black Sea, East and Southeast Anatolia Region. Both the NEAP and REC estimates are likely to be well out of date as public environmental awareness and willingness to engage has in recent years significantly increased, at the local as well as the national level. A key area of NGO concern has been land management and habitat protection, particularly in coastal areas.

Larger environmental NGOs with a longer track record include:

- The Environment Foundation of Turkey (TCV),
- The Foundation for the Protection and Promotion of the Environmental and Cultural Heritage (CEKUL);
- The Society for Protection of Nature (DHKD, a member of WWF, founded in 1961),
- The Turkish foundation for Combating Soil Erosion for Reforestation and Protection of Natural Habitats (TEMA) and
- The Regional Environmental Centre (since 2004).

The Black Sea Environmental Programme (BSEP) was set up by UNDP with financial assistance of the Global Environment Facility. BSEAP was tasked with strengthening the management of the Black Sea ecosystem; to develop a framework for assessing, controlling and preventing pollution; to maintain and enhance biodiversity; and to facilitate the preparation of sound environmental investments. The achievements of the BSEP include the Regional Strategic Action Plan for the Rehabilitation and Protection of the Black Sea which was signed by the Black Sea coastal countries in 1996.

In addition to bilateral assistance with, inter alia, environmental objectives (such as that provided by the German Development Cooperation Agency GTZ), Turkey is supported by a range of UN institutions such as UNEP, UNDP and GEF.

6. Areas of Concern and Priorities

The environmental issues of concern are characteristic for a country which is rapidly urbanising, and which has a rapidly developing industry inclusive of a significant and expanding tourism industry. The 1998 National Environmental Action Plan (NEAP) in its ‘environmental profile of Turkey’ lists the urban environment; natural resource management; marine and coastal resources; and cultural and natural heritage sites as key areas of concern.

With regards to the urban environment, key issues are:

- Air quality: problems are emissions of particulates/SO2/NO2 and greenhouse gases from inefficient fuel (low grade high sulphur indigenous coal) and rapidly increasing emissions from vehicles.
- Water supply and wastewater treatment: Although there is sufficient overall supply of water for human consumption and for agricultural (irrigation) and industrial use, there are problems with the supply of safe drinking water in rural areas and in rapidly developing urban areas. Existing water supply networks experience significant losses of water, and sewage collection and treatment systems are often lacking or inadequate.
- Waste management: Most urban areas have a functioning household solid waste collection system and also for collection and recycling of materials such as paper, cardboard, metals, glass, plastics. Recycling rates for non-household waste are more limited. Most of the solid waste goes into landfills, many of which do not meet international standards.
- Pockets of poverty within the urban fabric: in spite of recent progress in providing social housing in the recent years, some of the major cities still have poverty stricken areas with generally inadequate housing and services.

With regard to natural resource management key issues are:

- Water resources: Many habitats and their species are under threat from urban and industrial development; deforestation and poor farming accelerates erosion; and uncontrolled run-off and discharge of pesticides and fertilizers pollute surface water;. Better water basin management and an effective application of EIA and SEA could improve this situation.
- Soil and land: Erosion is the key problem. Main causes are unsatisfactory agricultural practises and limited investment in soil conservation and land rehabilitation. Excessive use of fertilizers impairs the soil quality. Poorly controlled irrigation may lead to salination and excessive soil exploitation (requiring even more fertilizers). Fertile farmland is lost to development (housing; industry; tourism). Some pastures and rangeland suffer from overgrazing.
- Forests: Almost all forestry land is owned and managed by the State Forestry Commission. Only about half of the forest area is classified as productive. Generally, forests are under threat from illegal farming and fuel harvesting and from soil degradation and erosion. Reforestation was based on monocultures which has reduced habitat diversity. There are also losses due to forest fires.
- Biodiversity: Turkey contains around 75 per cent of all plant species found in Europe and has a large and diverse range of invertebrates, fish species, birds, amphibians and mammals.

With regard to <u>marine and coastal resources</u> key issues are:

- Development: rapid urbanization, tourism and industrial development puts significant and increasing pressure on coastal areas (land use; infrastructure including roads and sea-filling; water use and seasonal demand peaks particularly in tourism areas; waste water and solid waste disposal).
- Discharges and spillages: Domestic and industrial waste discharges and spills, including oil and other hazardous substances (e.g. from industry or maritime transport) are a significant risk to coastal habitats.
- Fishing: Current practises involve over-fishing, particularly in the Black Sea, and unplanned fish farms, and are unsustainable.

With regard to <u>cultural and natural heritage sites</u> key issues are

- Development; Many of the country's cultural and natural heritage sites (natural parks and monuments; wildlife preservation areas; archaeological sites; architectural heritage etc.) are under threat from development (housing; industry; tourism; infrastructure; and irrigation).
- Natural disasters: fires, earthquakes, floods and landslides pose a threat to unprotected areas.
- Poor management of sites and theft.

ANNEX 3: LEGAL TRANSITION

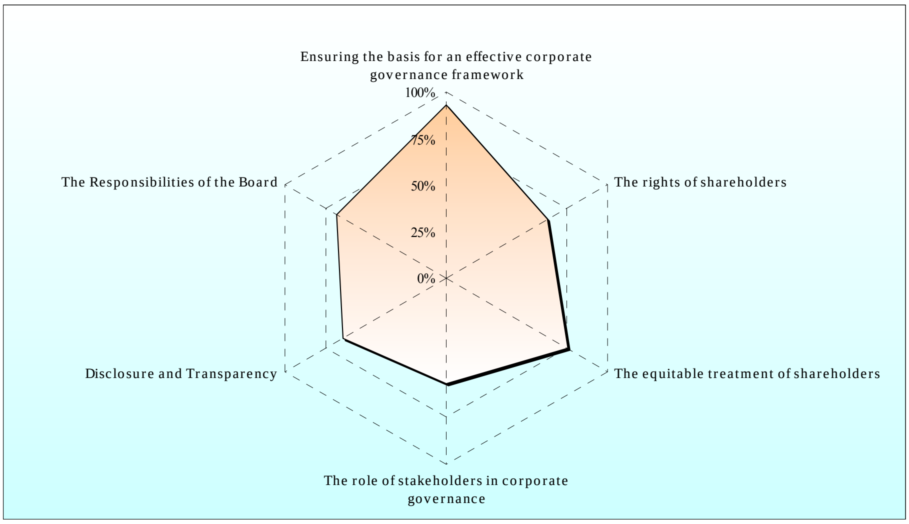
The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of such laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Turkey, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Company Law and Corporate Governance

The principal legislation concerning corporate governance in Turkey is essentially included in the Commercial Code, which has been amended several times since its enactment in 1956. A draft new commercial code has been recently prepared and is currently pending before the Turkish Grand National Assembly.

In June 2003, the Capital Market Board enacted the "Corporate Governance Principles", which have been further revised in February 2005 to reflect the revisions made to OECD Principles in November 2004.[10] The Listing Rules of the Istanbul Stock Exchange require companies to report their compliance with the Principles under the so-called "comply or explain" rule.

Quality of corporate governance legislation – Turkey (2008)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the more closely the corporate governance laws of the country approximate these principles. Source: EBRD Corporate Governance Sector Assessment, 2008.

The latest EBRD's Corporate Governance Sector Assessment, under which the quality of corporate governance legislation in force in November 2008 was assessed, found Turkey in high compliance with the OECD Principles of Corporate Governance, but very close to the medium compliance category. As shown in the chart above, improvements are needed, especially with reference to the "right of shareholders" and "the role of stakeholders in corporate governance".

In 2008, the EBRD conducted a case study for testing how the Turkish corporate governance legislation works in practice. A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information, understand if a related-party transaction was indeed entered into by the company and how it was possible to obtain compensation in case damage was suffered. The case study revealed that minority

[10] The Principles are available on the EBRD website at: http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm

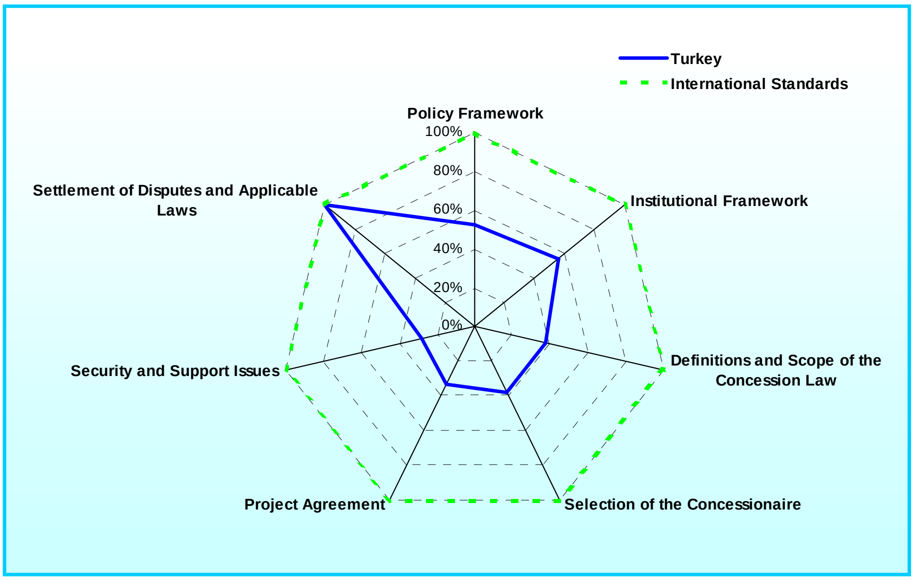
shareholders have limited action to obtain disclosure. Only a request to the court for the appointment of an independent auditor seems to provide some effective results. The framework for obtaining redress offers however some avenues but the procedure can be lengthy and enforceability of judgements can be a problematic issue as it relies on the capacity and experience of court executors, which considerably vary among courts and jurisdictions. When turning the analysis to the institutional framework, the survey revealed that the competence and experience of courts, prosecutors and market regulator need to be improved. Judicial proceedings are slow, providing the defendant with numerous possibilities for obstruction. Other enforcement mechanisms are hardly more efficient: arbitration is only available when a shareholder agreement including a specific clause has been concluded, while an action before the market regulator is not efficient as fines are inadequate to discourage illicit behaviour. The Government has prepared a draft Law of Mediation of Legal Disputes, which is currently being considered by the Parliament and has other actions under way, in consultation with international agencies to address related issues.

Concessions

Turkey does not currently have a single-act concessions law. Instead, the country takes a sector-by-sector approach in regulating concessions, which includes specific laws for infrastructure and public services, power plants, electricity and highways. In addition, Turkey has two public procurement laws, which however do not directly apply to the granting of concessions. Generally, local public services are regulated under the municipality laws which entitle the municipalities to grant concessions to public transportation services, water supply and waste water treatment. It should be noted that a general framework on concessions is now being prepared and is expected to be enacted in 2009.

The EBRD's 2008 Assessment of Concessions Laws undertaken to evaluate the applicable regime throughout Turkey rated the country's concessions laws as being in "low compliance" with internationally accepted standards (see chart below).

Quality of concession legislation – Turkey (2008)



Note: The extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2008

As can be seen from the chart, while rules covering settlement of disputes in concession related arrangements are regulated comprehensively, most other areas, in particular, selection of a concessionaire, the project agreement and security and support issues need dramatic improvement in order to meet the requirements of a modern legal framework facilitating private sector participation.

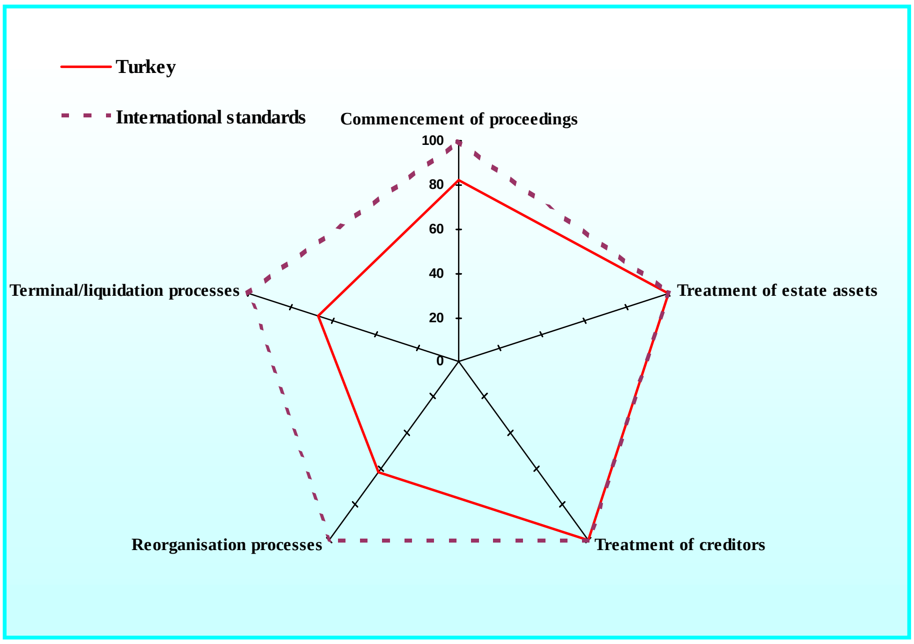
According to the EBRD's 2008 Legal Indicator Survey, concessions are being granted in practice, including for ports, airports, electricity and gas distribution and municipal sector. However, some major issues affecting projects' bankability are reported, such as the lack of lenders step-in rights in contractual agreements and the lack of direct agreements between lenders and granting authorities.

Insolvency

Insolvency in Turkey is primarily governed by the Enforcement and Bankruptcy Act (EBA) of 1932, as amended in 2003 and 2004. The Turkish Commercial Code, Code of Obligations, Code of Civil Procedure and the Banking Act also govern some aspects of the insolvency system. Recent EBRD assessments indicate that the EBA and related legislation work together to form a generally sound insolvency regime, but specific improvements are needed. The Government is in the process of preparing new draft legislation that would seek such improvements and this new legislation could be placed before Parliamewnt during 2010.

The Turkish Insolvency laws "on the books" are in medium compliance with recognised international standards of best practice. Provisions for treatment of estate assets and creditors are fully compliant with international standards but, as shown below, there is significant room for improvement in legislation governing case commencement, liquidation and reorganisation processes.

Quality of insolvency legislation – (2008)



Note: The extremity of each axis represents an ideal score, *i.e.*, corresponding to international standards such as the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Legislative Guide on Insolvency Law, and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment 2008.

In addition to the EBRD's assessment of the laws "on the books" described above, the EBRD also conducted a case study to understand how the EBA is applied in practice. This study used two hypothetical scenarios which focused on bankruptcy proceedings initiated by a debtor and creditor, respectively. The case study revealed that parties tend to have confidence in the system, but cost, inefficiencies and delays make the regime less effective.

Secured Transactions

The Civil Code is the main source of law governing secured transactions – both pledges (that is, security rights over movable property) and mortgages (security rights over immovable property). The fundamental approach to pledges is to require the possession of the collateral to be transferred to the creditor (or a person appointed by the creditor) for the entire duration of the pledge. Ways to circumvent this requirement have been designed by practitioners and the legislator, but these alternatives are necessarily complex and restricted.

Specific types of pledges have been created by statute to serve a particular segment of the economy, such as, for example, the commercial enterprise pledge. With this instrument, the pledgor can continue to use the pledged assets. Pledges over shares are treated as any other pledges , and taking security over intangible assets such as accounts receivable (usually by way of assignment) or bank accounts (by pledge) is a well-established practice. In all these instances however, there are numerous limitations to their practical usefulness.

Mortgages are the preferred type of security rights over real estate (buildings and land) and the system is well established. The system is fairly similar to that found in other European countries. The Law Amending the Laws Related to Housing Finance, widely know as the Mortgage Law, was enacted in 2007.

Modes of enforcement of security rights are in line with the civil law tradition. The *Lex Commissaria* rule applies, which means it would be invalid in the security agreement to provide that in case of default, the creditor is entitled to receive the property's ownership in lieu of payment. The creditor could, however, purchase the collateral during realisation. In theory, out-of-court enforcement and direct sale is legally possible but this requires the consent of all related parties (including that of the pledgor) at the time of default. In practice, such cooperation is unlikely. Enforcement is therefore mostly conducted by the courts' enforcement offices and the property is sold by public auction. Enforcement appears to be slow and inefficient, despite the fact that the law provides that it should happen within one month. Enforcement is also relatively expensive – especially if it is a maximum amount mortgage that is being enforced as the creditor must deposit over 5 per cent of the claim in order to be able to proceed. Appraisal (collateral evaluation) is reported to be problematic. This is significant because on enforcement, the collateral may be sold at auction at 60 per cent of the appraised value (first auction) and 40 per cent at the second auction. Creditors generally do not expect that the property will be sold at market value.

In conclusion, although the market players have found ways around the law in order to secure their transactions, there is an obvious need to, liberalise, simplify, and streamline the current legal framework in order to make the system legally efficient for the benefits of both lenders and borrowers.

Securities Markets

The primary legislation governing securities markets in Turkey is the Capital Markets Law issued in 1981 and lastly amended in 2008.

The Capital Markets Board is the Turkish securities markets regulator. Banks are supervised by the Banking Regulation and Supervision Agency and insurance companies, pension companies and pension system are under the supervision of the Treasury. The Capital Markets Board has the authority to issue secondary legislation (so called "Communiqués") setting standards in accordance with the general principles set by the Capital Markets Law.

The 2008 EBRD Securities Markets Legislation Assessment found Turkey to be in "high compliance" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) showing only minor weaknesses in the legislation on Self Regulatory Organizations (SROs).

In order to understand how securities markets legislation works in practice, the EBRD recently concluded a Legal Indicator Survey ("the LIS"). Practitioners in the region were asked to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company's Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the Survey concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator. The LIS revealed that IPOs in Turkey are a common source of corporate funding and that disclosure practices follow good standards. Financial statements are reported according to international standards and the prospectus is considered generally reliable but it misses some key information: there is no special section on the company's risk factors and beneficial shareholdings is not disclosed. The regulator is generally independent but has limited resources to properly investigate breaches of securities law involving international components. Courts and the regulator are developing their expertise in investigating securities cases but the corresponding capacity of prosecutor needs to be improved. Private enforcement mechanisms (i.e. legal action before a court) can be lengthy and characterised by heavy burdens of proof, which can diminish the effectiveness of the action.

Telecommunications

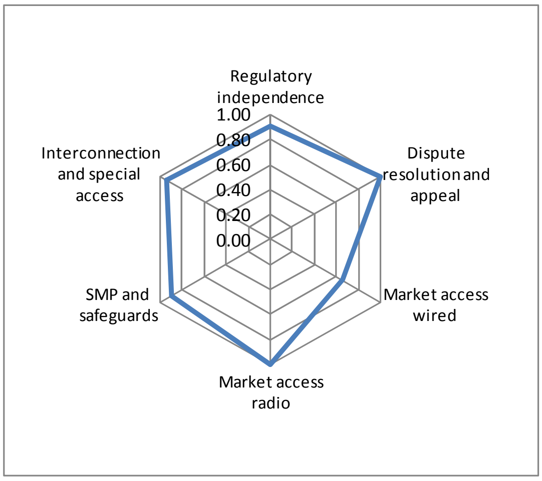
The Ministry of Transport defines the state policies and strategies for the telecommunications sector. The Government retains a 30 per cent ownership in the incumbent operator Türk Telekom, controlled by the Treasury. The Government also remains an important shareholder in several other operators. Furthermore, one golden share in Türk Telekom is controlled by the Ministry of Transport. The Information and Communication Technologies Authority, established in the year 2000, exercises regulatory functions in the telecommunications sector.

The provision of domestic long distance and international networks and services was liberalised from 1st January 2004, and the liberalisation of local services was formally introduced in July 2005. In practice, the licensing framework for local services was only adopted in August 2007. So far, no licences for the provision of local telephone services have been issued and Türk Telekom remains the only provider.

One of the key outstanding issues has been the adoption of the new electronic communications law, pending since October 2005, which would ensure a sound legal basis for application of the principles of the EU 2003 regulatory framework. Other aspects include the authorisation regime, including the authorisation of alternative local telephone networks and services and addressing the problem of high communications taxes imposed on operators which are detrimental to market entry, the implementation of universal service in compliance with the EU framework and the effective independence of regulatory body from the Government (which remains an important shareholder in several operators).

In a 2008 assessment of the communications sector of EBRD Countries of Operation the sector regulatory regime in Turkey was deemed to have "High compliance" when measured against international best practice.

Quality of telecommunications regulatory framework (2008) – Turkey



This spider diagram includes six main group indicators. For each indicator, the diagram presents the scores as per centages of the maximum achievable score. The scores begin at zero at the centre of the chart and reach 1.00 at the outside, so that in the overall chart, the wider the web, the better the score in the assessment. Source: EBRD 2008 Telecoms Regulatory Assessment

(see http://ebrd.com/country/sector/law/telecoms/assess/index.htm for more details).

ANNEX 4: Turkey – TAM/BAS Brief

Overview

The TAM/BAS Programme supports economic transition by achieving enterprise change in potentially viable micro, small and medium enterprises (MSMEs) in the EBRD countries of operation.

TAM

TAM supports the introduction of management best-practice within MSMEs with strong potential, based on the use of international advisors and specialists. These individuals have 15-20 years professional experience in the relevant sector. TAM projects typically last around 18 months. The Programme also carries out seminar and training activities promoting international best-practice by disseminating successful case-studies to entrepreneurs.

The TAM Programme has not yet initiated activities in Turkey, but will do so as soon as funding becomes available. TAM will shortly carry out enterprise screening in Turkey with a view to submitting project proposals to potential donors.

BAS

BAS acts as a facilitator for the use of local, private-sector consultants by MSMEs, helping them to obtain a diverse array of services. BAS works on both the demand and the supply side. By assisting individual enterprises to engage with local consultants on narrowly-based, specific projects with a rapid payback, it stimulates demand and an improved understanding of the potential benefits of using external consultants. It also directly increases the supply and quality of local advisory services through targeted market development activities. BAS-supported projects typically last around four months.

The BAS Programme has not yet initiated activities in Turkey, but will do so as soon as funding becomes available.

Recommendations for future TAM/BAS interventions

The complementary TAM and BAS Programme instruments can be flexibly designed to addressed the problems faced by Turkish enterprises and give much-needed momentum to the development of private-sector MSMEs.

Consistent with the EBRD's operational priorities for 2009-10, TAM/BAS will provide support to viable MSMEs, especially those in less developed regions. This will include the management advice and mentoring that is the primary expertise of TAM, and the consultancy market development activities that are a key competence of BAS.

The strategic economic importance of agriculture and food-processing activities in Turkey creates potential for TAM/BAS to support MSMEs along the food chain, from primary agriculture, to processing, storage and warehousing and wholesale and retail activities. This could incorporate a focus on supply chain management and helping companies to meet minimum EU quality standards for export. In terms of MSMEs representation and potential, other key industrial sectors of the Turkish economy include furniture, textiles, leather and agricultural machinery. In terms of services, TAM/BAS will attempt to focus on viable enterprises in markets where Turkish performance has been strong relative to the rest of the world, such as the Travel and Transport sectors.

TAM/BAS expertise is likely to be important in the areas of organisational strategy, quality management and certification, raw materials management and international best practices, including access to better technology and capital equipment. Other anticipated areas of need are market analysis, business planning and HR. TAM/BAS may also be able to address problems regarding corporate governance.

Cross-cutting issues

Rural development will be a key aspect of TAM/BAS's proposed activities in Turkey. Given the importance of agriculture as a tool of employment and output generation, and Turkey's potential to compete internationally as a major agricultural exporter, TAM/BAS will attempt to target its assistance towards viable rural enterprises, especially those with high export potential.

Although Turkey's energy intensity, measured in terms of energy consumption per unit of real output, is higher than the average of International Energy Agency (IEA) member countries, it falls well below the IEA average when output is adjusted for purchasing power parity. There is significant scope for TAM/BAS to promote energy efficiency as part of its project assistance, particularly when working with enterprises engaged in heavy industry.

Women are relatively well-represented in senior management positions in Turkish MSMEs, but more effort is needed to improve the participation of women in employment more generally, and to increase the proportion of women participating in ownership of firms. TAM/BAS has the ability to promote gender equality as a component of its project assistance.

Initiation of TAM and BAS activities

Subject to donor funding being available, the TAM Programme plans to support the transfer of management skills to MSMEs in Turkey. In tandem with TAM's focus on management skills, BAS would seek to act as a catalyst for the much-needed development of the local consultancy market. TAM/BAS aims to promote its Programme and support its priorities through visibility activities aimed at MSMEs and a focus on market development and dissemination, particularly where a particular expertise gained from a TAM/BAS project can be shared among several enterprises.

Contribution to EBRD's policy dialogue

The TAM/BAS Country Brief strengthens the EBRD's policy dialogue toolkit by analysing the business environment and identifying key challenges faced by the MSME sector. Key challenges for the government are identified as reforming the taxation, and improving law enforcement, transparency with respect to property rights, and access to finance. In addition, the position of women entrepreneurs (and young entrepreneurs) could be advanced by efforts to encourage banks to accept a wider range of assets as collateral for loans.

An input for enhancing linkages with banking

TAM/BAS can contribute to strengthened linkages with EBRD banking activities by referring successful Turkish enterprises it works with to the EBRD, or EBRD-related financial institutions, for investment consideration. TAM/BAS can also provide project assistance to enterprises in the EBRD's pre- or post-investment phases.

In line with TAM/BAS Strategic Plan 2008-2010, TAM/BAS will continue to assist the Bank to meet its objective of creating a commercially viable project pipeline for the Bank by (1) helping to identifying potential pipeline (pre-investment), (2) providing “consulting and business” services for the preparation and support of Bank private enterprise financing projects and for the enterprises themselves, and (3) providing candidates for non-executive board member positions.

TAM/BAS will link MSMEs in need of finance with available EBRD instruments, including direct investments, as well as credit lines from EBRD-supported local banks.

ANNEX 5: SELECTED ECONOMIC INDICATORS

	2003	2004	2005	2006	2007	2008	2009
						Estimate	*Projection*
Output and expenditure	*(Percentage change in real terms)*						
GDP	5.3	9.4	8.4	6.9	4.6	1.1	-5.5
Private consumption	10.2	11.0	7.9	4.6	4.1	na	na
Public consumption	-2.6	6.0	2.5	8.4	6.5	na	na
Gross fixed capital formation	14.2	28.4	17.4	13.3	5.5	na	na
Exports of goods and services	6.9	11.2	7.9	6.6	7.3	na	na
Imports of goods and services	23.5	20.8	12.2	6.9	10.7	na	na
Industrial gross output	7.8	11.8	8.7	10.2	5.8	na	na
Agricultural gross output	-2.0	2.8	7.2	1.4	-6.9	na	na
Employment	*(Percentage change)*						
Labour force (end-year)	-0.6	1.7	1.5	-0.2	1.2	3.4	na
Employment (end-year)	-0.8	2.0	1.6	0.2	1.1	0.6	na
	(In per cent of labour force)						
Unemployment (end-year)	10.5	10.3	10.2	9.9	9.9	12.3	na
Prices and wages	*(Percentage change)*						
Consumer prices (annual average)	25.3	8.6	8.2	9.6	8.8	10.4	6.2
Consumer prices (end-year)	18.4	9.4	7.7	9.7	8.4	10.1	6.4
Producer prices (annual average)	na	14.6	5.9	9.3	6.3	12.7	na
Producer prices (end-year)	13.9	15.4	2.7	11.6	5.9	8.1	na
Gross average monthly earnings in economy (annual average)	32.2	7.6	12.5	na	na	na	na
Government sector	*(In per cent of GDP)*						
General government balance	-8.8	-5.4	-1.3	-0.8	-1.7	-1.9	-6.5
General government expenditure	30.9	25.2	22.5	23.1	23.5	23.3	na
General government debt	62.2	56.6	51.1	45.5	39.1	38.2	na
Monetary sector	*(Percentage change)*						
Broad money (M2, end-year)	33.7	31.2	120.0	24.7	15.7	22.7	na
Domestic credit (end-year)	16.9	18.9	28.1	17.2	19.7	16.0	na
	(In per cent of GDP)						
Broad money (M2, end-year)	18.2	19.4	36.8	39.3	40.3	44.5	na
Interest and exchange rates	*(In per cent per annum, end-year)*						
Discount rate	43.0	38.0	23.0	27.0	25.0	16.3	na
Interbank money market rate	26.0	18.0	13.5	17.5	16.0	15.6	na
Deposit rate	37.7	24.3	20.4	21.6	22.6	22.7	na
Lending rate	48.0	35.0	26.0	28.0	27.0	26.5	na
	(Liras per US dollar)						
Exchange rate (end-year)	1.4	1.3	1.3	1.4	1.2	1.5	na
Exchange rate (annual average)	1.5	1.4	1.3	1.4	1.3	1.3	na
External sector							
	(In millions of US dollars)						
Current account	-7,515.0	-14,431.0	-22,137.0	-31,893.0	-38,219.0	-41,623.0	-15,491.4
Trade balance	-13,489.0	-22,736.0	-32,988.0	-40,941.0	-46,677.0	-53,174.0	-24,443.8
Merchandise exports	52,394.0	68,535.0	78,365.0	93,611.0	115,364.0	140,748.0	119,022.3
Merchandise imports	65,883.0	91,271.0	111,353.0	134,552.0	162,041.0	193,922.0	143,466.0
Foreign direct investment, net	1,252.0	2,005.0	8,967.0	19,065.0	19,940.0	15,400.0	7,000.0
Gross reserves, excluding gold (end-year)	33,991.0	35,669.1	50,579.0	60,891.9	73,383.9	70,976.2	na
External debt stock	144,266.0	160,760.0	168,716.0	205,548.0	247,094.0	285,130.9	na
	(In months of imports of goods and services)						
Gross reserves, excluding gold (end-year)	5.6	4.2	4.9	5.0	5.0	4.0	na
	(In per cent of exports of goods and services)						
Debt service due	10.2	7.9	7.9	8.2	7.8	6.8	na
Memorandum items	*(Denominations as indicated)*						
Population (end-year, million)	65.9	66.9	67.9	68.1	68.9	69.7	70.5
GDP (in billions of liras)	454.8	559.0	648.9	758.4	853.6	950.1	na
GDP per capita (in US dollars)	4,599.0	5,861.5	7,112.9	7,792.4	9,506.8	10,499.4	na
Share of industry in GDP (in per cent)	24.9	24.8	24.7	24.9	24.6	na	na
Share of agriculture in GDP (in per cent)	9.9	9.5	9.4	8.3	7.5	na	na
Current account/GDP (in per cent)	-2.5	-3.7	-4.6	-6.0	-5.8	-5.7	-2.8
External debt - reserves (in US$ million)	110,275.0	125,090.9	118,137.0	144,656.1	173,710.1	214,154.7	na
External debt/GDP (in per cent)	47.6	41.0	34.9	38.7	37.7	39.0	na
External debt/exports of goods and services (in per cent)	204.9	175.7	160.7	172.8	171.6	162.4	na