BIBLIOGRAPHIC DATA SHEET

1. CONTROL NUMBER	2. SUBJECT CLASSIFICATION (695)
PN-AAH-550	DE10-0000-G831

3. TITLE AND SUBTITLE (240)

Convertible foreign exchange deposit accounts and foreign private loans

4. PERSONAL AUTHORS (100)

Yaser, B. S.

5. CORPORATE AUTHORS (101)

AID/NE/USAID/Turkey

6. DOCUMENT DATE (110)	7. NUMBER OF PAGES (120)	8. ARC NUMBER (170)
1973	19p.	TU332.7.Y29

9. REFERENCE ORGANIZATION (130)

Turkey

10. SUPPLEMENTARY NOTES (500)

(In Discussion paper no. 14)

11. ABSTRACT (950)

12. DESCRIPTORS (920)

Turkey
Foreign exchange
Banks
Credit
Finance

13. PROJECT NUMBER (150)

14. CONTRACT NO.(140)

Turkey

15. CONTRACT TYPE (140)

16. TYPE OF DOCUMENT (160)

AID 590-7 (10-79)

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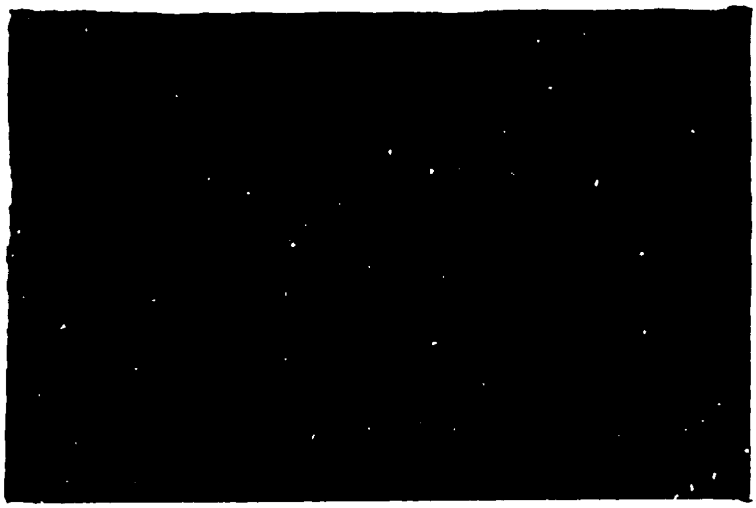

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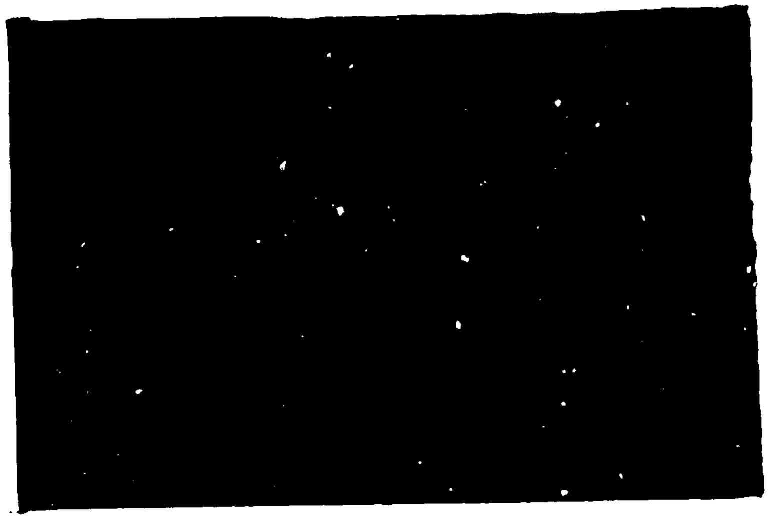

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Discussion Paper No. 14

CONVERTIBLE FOREIGN EXCHANGE DEPOSIT ACCOUNTS AND FOREIGN PRIVATE LOANS

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February 1973

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Betty Slade Yaşer

Introduction

High interest-paying convertible foreign exchange accounts held by foreigners in Turkish banks have been the subject of considerable attention in the last few months for two principal reasons: their use as collateral for relatively low cost Turkish Lira (TL) domestic loans and their encouragement of foreign exchange flows into Turkey which in turn require foreign exchange interest payments abroad. Recently the regulations underlying use of these accounts have been changed in a manner effectively stopping their utilization for the above purposes.

In a related action, the rules and regulations governing borrowing abroad from private foreign sources have been set forth.

This paper is designed to give a brief outline of these developments. Sections A and B describe the original legal foundations of the convertible foreign exchange accounts and their accounting relationships, respectively. Section C deals with these accounts as bases for loans in Turkey and their related economic effects. Section D includes a description of and comments on the new legal arrangements.

A. Original Legal Foundation

Convertible foreign exchange accounts were set up formally on June 9, 1967 by a communique on Decree #17 "Protection of the Value of the Turkish Currency" as an amendment to Article 16 of the said Decree, Series 1, No. 2. This communique appeared in the Official Gazette No. 12617 and authorized the following transactions:

1. Private and legal persons, both resident in Turkey and abroad, may deposit convertible foreign exchange in authorized banks in Turkey. Within 15 days, the banks must transmit the foreign exchange to the Central Bank. Equivalent sums in Turkish liras are credited to the depositers. (See Section B for accounting.)

2. Accounts for persons residing abroad have the following conditions:

a. The legal rate of interest applicable to routine current TL deposits applies; this interest is payable in foreign exchange at the exchange rate applicable at time of accrual.

b. Withdrawals in foreign exchange are possible as drafts and checks to depositor and to other persons abroad; the exchange rate is that at time of deposit.

c. Withdrawals in Turkish liras can be made as credit or guarantee letters, checks and payments to persons in Turkey. The exchange rate is that at time of payment in TL.

d. The source or origin of foreign exchange cannot be sought out or investigated.

3. Accounts "in favor of" residents in Turkey have the following conditions:

a. The source or origin of foreign exchange deposited, transferred or forwarded to these accounts need not be investigated.

b. The same rate of bank interest applicable to routine "current" TL deposits is applied.

c. Time-draft deposit accounts may be set up as counterpart to foreign exchange covered by law 499, [1/] the interest of which is transferable abroad at rate of exchange current on date of interest accrual.

d. Foreign exchange can be transferred abroad (at the exchange rate on the date of deposit) for travel abroad.

e. TL payments are made at rate of exchange current at time of payment.

4. Banks can make payments to residents abroad against counter guaranteed credit coupons if the equivalent foreign exchange is repatriated to Turkey or credited abroad within three months.

5. If foreign exchange deposited is covered by Law 499 and converted permanently to TL, the depositors are covered by Article 3 or Law 499. [1/]

B. Accounting Relationships

It may be helpful in understanding these accounts to trace through the accounting relationships resulting from a "foreign exchange deposit in a TL convertible account." Such a deposit takes the following two forms:

1/ Law 499 of July 22, 1964 deals mainly with loans to workers abroad for housing and small industry based on their foreign exchange deposits in the Turkish Real Estate and People's Bank. Article 3 deals with the possibility of borrowing up to the amount of the workers' deposit interest free.

1. Permanent conversion into TL

Deposit of $10 in a

Commercial Bank

Asset		Liability	
+ $10 cash	(1)	+ $10 foreign exchange deposit	(1)
- $10 cash + TL 140 deposit with Central Bank	(2)	- $10 foreign exchange deposit + TL 140 deposit	(2)

Central Bank

Asset		Liability	
+ $10 cash as Reserves	(2)	+ TL 140 deposit account of commercial bank	(2)

(Step 1) The $10 deposit becomes a $10 cash asset of the commercial bank, and a $10 deposit account is created as its counterpart.

(Step 2) The $10 foreign exchange is sent to the Central Bank to be exchanged for TL. The Central Bank acquires $10 in foreign exchange reserves and credits the commercial bank's deposit account with TL 140. Thus the $10 cash and $10 foreign exchange deposit account are cancelled.

(Step 3) The final accounts look like this:

Commercial Bank

Asset		Liability	
TL 140 deposit with Central Bank	(3)	TL 140 original depositor's account	(3)

Central Bank

Asset		Liability	
$10 reserves	(3)	TL 140 deposit account of commercial bank	(3)

2. Convertible TL Accounts
Deposit of $10 in a Commercial Bank

Asset		Liability	
+ $10 cash	(1)	+ $10 foreign exchange deposit of original depositor	(1)
- $10 cash + TL 140 deposit with Central Bank	(2)	- $10 foreign exchange deposit +TL 140 deposit of original depositor	(2)

Central Bank

Asset		Liability	
+ $10 cash in reserves	(2)	+ TL 140 deposit account of commercial bank	(2)
+ TL 140 counterpart of $10 foreign exchange "memory account"	(3)	+ $10 foreign exchange "memory" account" as payables against TL convertible account	(3)

Step (1) The $10 foreign exchange deposit of original depositor is credited as cash asset and deposit liability.

Step (2) The $10 foreign exchange cash is sent to the Central Bank to be exchanged for TL. The Central Bank acquires $10 in foreign exchange reserves and credits the commercial bank's deposit account with TL 140; thus the $10 cash and $10 foreign exchange.

Step (3) Because a potential foreign exchange liability exists the Central Bank sets up a $10 liability account as payables against the TL convertible account outstanding. A balancing item of TL 140 counterpart is put into their asset account. The final accounts look like this:

Commercial Bank

Asset	Liability
TL 140 deposit with Central Bank	TL 140 deposit of original depositor

Central Bank

Asset	Liability
$10 cash reserves	TL 140 deposit account of commercial Bank
TL 140 counterpart of $10 memory account	$10 foreign exchange memory account as payable against TL convertible accounts

C. Convertible Foreign Exchange Deposit Accounts as Bases for Loans

1. Original Communique

According to the original communique cited above, loans could be made to firms in Turkey while the foreign exchange deposit itself of one year or more received an annual seven percent interest payable in foreign exchange. 1/ The loan based on this account could be commercial or industrial credit to any Turkish firm specified by the depositor for the period of time and interest rate negotiated by the concerned parties, with the approval of the Ministry of Finance and the Central Bank. 2/ For example, if a foreign firm deposited $100,000 with a Turkish bank,

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1/ These deposits were generally recorded as interbank deposits. No reserve requirement was stipulated in the Communique.

2/ In accordance with Law 499, deposited workers remittances could also serve as collateral against housing loans by the Real Estate Bank and agricultural loans by the Agriculture Bank.

the TL equivalent could be lent to a Turkish firm if the Ministry of Finance - Central Bank approved.

2. Legal Modifications of Original Communique

A new communique was issued in the Official Gazette on July 27, 1972 which modified the conditions of the convertible deposits in the following way:

a. The long-term convertible deposit interest rate paid to non-residents was lowered to 5 percent.

b. The maximum time period of the deposit was restricted to one year.

c. The transactions based on such deposits could be carried out among the bank, the depositor and the borrower without Central Bank and Ministry of Finance interference.

d. Loans based on convertible accounts were restricted to no more than 80 percent of the deposited amount.

e. It was specified that if a non-resident of Turkey desired a deposit with more than a one year maturity period, he could apply to the Central Bank and Ministry of Finance for special permission. No such pending request was granted, although several were made.

Comments on the July 27, 1972 Modifications:

These modifications came after a period of complete suspension of the opening of new foreign exchange convertible accounts and any transactions based on them. Therefore these modifications were not unexpected.

It was being generally stated in official circles that the high level of foreign exchange reserves made it no longer necessary to try to attract foreign exchange with the use of interest rate margins. The lowering of the interest rate was in part an attempt to discourage "hot money", a potential destabilizing force, as well as to decrease the amount of foreign exchange interest being paid out. However, the lowering of the interest rate payable on the deposit (from 7 percent to 5 percent) also decreased the cost of these funds to the bank thus allowing for a lower charge to the customer. It has been pointed out however that this lowering of the rate was coupled with a 20-25 percent reserve requirement so that only 75-80 percent of the deposit could be lent (versus 100 percent before) while interest had to be paid on the entire deposit. That is, previously to earn the interest alone the bank had to charge 7 percent on 100 percent. After the change it would have to charge 6-2/3 percent on the 75 percent lent to cover interest at 5 percent on the whole deposit. However since the Central Bank paid 6½ percent interest on time reserve deposits, the difference could be maintained (in Turkish Liras).

The one-year time limitation on the foreign exchange deposit made it necessary for the Turkish Bank to obtain further guarantees that the firm borrowing against these accounts could repay promptly. In some cases, gentlemen's agreements were arrived at so that the original depositor agreed to pay if the debtor company defaulted. There was further manueverability in that if an account was closed within one year it could be opened again the next day. Although the limitation of the time period and imposition of reserve requirements on the deposit theoretically allowed for more control on the credit flow and as a result a decrease in inflationary pressures, these aims did not seem to be achieved through the July 27, 1972 regulations.

The turning over of the risk and responsibility to the banking system was seen as a liberal move which took the bureaucratic hand out of every individual decision. It should be noted that the selection of credit recipients was left outside the planning mechanism as a result.

3. <u>General Economic Ramifications of Convertible Accounts</u>

a. <u>Foreign Exchange Reserves</u>

The convertible foreign exchange deposits become official reserves upon their placement with the Central Bank. At the same time a foreign exchange liability is shown in the Central Bank "miscellaneous foreign exchange liabilities" account. This latter account is not taken into consideration in the calculation of the net foreign exchange position, even though they are a potential claim on reserves. (In middle December

1972 the Minister of Finance stated a figure of $380 million for this potential claim.) It is suggested that a figure net of these claims is closer to the net foreign exchange reserve position of the Central Bank.

b. Credit and Interest Rates

It is clear that the use of these accounts as collateral allows for greater credit availability at less expensive rates (say 7-10% compared with rates of 12-20% from domestic sources). As a result the borrowing firms have more favorable terms for their short-term working capital needs than from the domestic money market. Furthermore the availability of these funds is less in doubt. The "interest rate structure" is circumvented by the existence of a cheap source of funds to the bank which allows the bank to lend at lower rates and maintain the normal profit margins.

c. Money supply and inflation

The creation of a TL deposit as counterpart to the convertible foreign exchange deposit is an increase in the money supply by definition in Turkey. Furthermore the lending base of the bank involved is increased at "cheap rates". Thus a typical "cheap money" situation is created which, with the assumption of a simple positive relationship between money and prices, is inflationary. The initial deposit transaction is beyond Central Bank control legally and only the reserve requirement weapon can be used. 1/

Since inflation is a serious issue

1/ The original communique (June 9, 1967) contained no legal reserve requirement. The Jan. 3, 1973 communique stated the necessity to conform with "Para. 11a, Article 40 of Law 1211" thus legally imposing the general reserve requirement on convertible deposits.

in Turkey, this lack of specific control on a money-creating process has troubled concerned government officials.

d. <u>Development Sector Priorities</u>

Since in most cases the loans involved were directed to the sectors (firms) selected by the depositor, there was no official "guiding" mechanism available to influence private sector activity to be in accordance with Plan objectives.

D. Decree of January 3, 1973 and Related Communiques

A Council of Ministers Decree #7/5399 entitled "Private Foreign Credits and the Interest Equalization Fund" and a Communique from the Ministry of Finance "amending Article 16 of the Decree on the Protection of the Value of the Turkish Currency" were published separately on January 3, 1973 in the Official Gazette. The first communique relative to Decree 7/5399 was issued on January 4, 1973. A communique relative to the amendment of Article 16 was published on January 24, 1973.

1. The Communique of January 3, 1973 forbids the opening of new "foreign exchange convertible deposit accounts with the conditions stipulated by Article 16" by non-residents of Turkey. [1/] Residents in

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1/ The exact statement in Article 16 is as follows: "The provisions of this Article do not apply to the real and legal persons residing abroad, to real and legal persons residing abroad who have opened a branch or participated in a company or established a joint venture in Turkey by investing in the capital, or those real and legal persons who have not invested any capital in Turkey but are operating in Turkey through their bureaus, agencies or representatives."

Turkey (defined as Turkish citizens) continue to be authorized to open such accounts and the 7% long term interest rate was reestablished. Non-residents are allowed to open non-interest bearing regular foreign exchange accounts. 1/ All other regulations remained the same.

2. Decree 7/5399 sets out the conditions or "new system," of obtaining direct loans from foreign private sources by both the public and private sectors with the intermediation of Turkish banks for the financing of specific projects. 2/ The Ministry of Finance approves the use of such credits as being within the scope of and amount allowed by annual programs. The Government guarantees the transfer of foreign exchange for repayment while the Turkish bank guarantees TL repayment. The intermediating bank service charge cannot exceed one percent of the loan transaction. If the interest rate on the foreign credit is lower than the domestic rate, the intermediating bank must collect and then deposit the "difference" in the Central Bank in the "Interest Equalization Fund" to be used to subsidize priority sector projects as identified in annual programs. All foreign firms except those under Law 6224 are also subject to these regulations.

1/ Existing convertible foreign exchange accounts of non-residents had to be liquidated immediately.

2/ This decree is reportedly an attempt to clarify the methods of and eligibility for obtaining loans from foreign private sources.

3.3 Communique I to Decree 7/5399 gives general and specific conditions concerning the private foreign loan system of which the following are notable: (1) Credits are in cash (Article 1), longer than two years (Article 3c), at rates no more than 1% above the Euro-market rate (Article 3d), through authorized Turkish banks who can charge only 1% for all services (Article 6),[1/] and limited to 60% of the value of the project (except for projects in backward regions which could be up to 80%)(article 3A). Application for use of private foreign credit is to the Ministry of Finance. Firms whose projects are within the Central Bank-Ministry of Finance definition of priority areas may receive an interest rebate on the portion that they have paid into the Interest Equalization Fund.[2/]

4. The Communique of January 24, 1973 sets April 5, 1973 as the new deadline for liquidation of all convertible foreign exchange time deposit accounts in the Turkish banking system held by non-residents. Additions to demand deposits in this type of account are forbidden in accordance with the January 3, 1973 Communique. Existing depositors are

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1/ Apparently, however, authorized banks will be able to charge for related services, i.e., guarantees, etc.

2/ Article 7 of Decree 7/5399 states: "the rules concerning the manner in which this fund shall be utilized shall be determined jointly by the Ministry of Finance and the Central Bank of Turkey." Communique #1 to this decree simply adds: "the interest rate difference to be placed in this account during 1973 may be rebated for certain "projects." The table following article 497 of the 1973 Annual Program lists eligible sectors and applicable incentive measures. However, no notations were made for interest rebate eligibility. For the time being projects will probably be examined on an ad hoc basis.

called on to apply for authorization to utilize these funds under the regulations of the new decree 7/5399. This action is in response to the considerable difficulties encountered by banks in liquidation of these accounts and of borrowers in finding new working capital credit.

C. Comments on Latest Communiques and Decrees

The cessation of foreigners' convertible exchange accounts will result in withdrawal of foreign exchange from the Central Bank, extinguishing of the TL deposit equivalent, and accordingly any outstanding loans based on the accounts. In this way the measure contains a sharp counter-inflationary element.

Associated with this measure is the cutback in financial resources available to Turkish firms. The decree on private foreign credit is set forth to provide a substitute for this source as well as to clarify and regulate conditions of obtaining such credit from abroad. An examination of this decree reveals several factors that may have a tendency to lower very considerably the inflow of private foreign loans. 1/ These factors are discussed below.

The comparatively low interest rate which legally binds the lender no more than (one percent above Euro-market rate) may reduce the number of available

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1/ It is argued by some knowledgeable people that some 150 firms (many with foreign interests) had used the convertible foreign exchange accounts as loan bases. These firms most likely would use these same funds in the "new system," but at considerably more expensive rates.

lenders, while the low (one percent) service charge allowed to intermediating banks reduces their incentive to handle the loan.

There is an argument that the interest rate differential charged will not bring the cost of the foreign loans to levels of domestic loan costs (which are higher than the nominal rate because of extra charges by banks) so that foreign loans remain attractive to borrowing firms.[1/] However limitations (not seen in use of convertible accounts) on the nature of project and size of loan may reduce the number of eligible borrowers. The fact that "projects" must be prepared coupled with a minimum two-year maturity period for the loan changes the nature of the loan, i.e., it has been generally assumed that the convertible account-based loans were used for short-term working capital purposes but these new loans will most likely be medium to long-term investment credits.

The mechanics of handling the application for loans are quite likely to cause difficulty. The firm will first determine its eligibility, make an investment project, feasibility report and credit agreement, seek out an authorized intermediating bank and then apply to the Ministry of Finance. A section of the Ministry, probably the banking transactions sections, will accept requests, examine them for their

1/ Decrees 7/5822, 7/5823, and 7/5825 of February 12, 1973 provide for sharply lower costs (interest rates, bank charges, etc.) to priority sector borrowers. This fact may offset the attractiveness of foreign loans.

eligibility, determine applicable domestic interest rate differential payable as well as maximum amount of loan and check if foreign lender's rate is no more than one percent above the current Euro-market lending rate (for that currency).

One further consideration will be the specification of a "total" amount of such loans which can be utilized in one year. If demand is great, these loans will have to be "rationed." In this case criteria other than inclusion in the General Incentives Table must be resorted to.

There will no doubt be further elaboration on the procedures to be followed within this new foreign private loan system as experience is gained and problems arise.[1/]

1/ The decision to keep the TL at the old parity with the 10% devalued dollar (February 15, 1973) raises some difficulties in utilization of foreign credits by Turkish firms. (It also creates a TL 500 million additional burden on the government because of the "parity guarantee" existing on outstanding convertible deposit accounts, according to the Minister of Finance, Ziya Muezzinoğlu.)

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