INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/395

TURKEY

December 2019

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TURKEY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its December 9, 2019 consideration of the staff report that concluded the Article IV consultation with Turkey.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on December 9, following discussions that ended on October 8, 2019, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 21, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Turkey.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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December 27, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with Turkey

On December 9, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

In the wake of the global financial crisis, growth in Turkey became increasingly dependent on externally-funded credit and demand stimulus, and, as a result, Turkey's economy began running above potential with a large current account deficit and high inflation. These imbalances left the economy susceptible to a change in market sentiment that ultimately triggered sizeable lira depreciation and was accompanied by a recession in late 2018.

Economic growth has since resumed, buoyed by expansionary fiscal policy, rapid credit provision by state-owned banks, and more favorable external financing conditions. The lira also recovered as market pressures abated. Import compression and a strong tourism season have contributed to a remarkable current account adjustment.

Inflation has fallen sharply, and the central bank cut policy rates by 1,000 basis points since July 2019. Inflation peaked at around 25 percent—five times the target—in October 2018 due, in large part, to high exchange rate passthrough and rising inflation expectations. But strong base effects, relative lira stability, and a negative output gap have since contributed to a steep inflation decline, although inflation expectations remain well above target.

Fiscal discipline, a longstanding policy anchor, has been gradually weakening. After declining for several years, the central government primary balance recorded a deficit in 2018, for the first time in almost a decade. Fiscal stimulus continued in the first half of 2019, in contrast to the consolidation planned in the late-2018 New Economy Program.

State-owned banks are supporting rapid credit growth. While private banks have cut back on their lending, state-owned banks have engaged in a major credit expansion which picked up pace in early-2019.

Reserves are low and external financing needs high. Non-financial corporate and bank balance sheets have been stressed by lira depreciation, higher interest rates, and lower growth. While public debt is low, the fiscal deficit has increased and uncertainty over the possible scale of contingent liabilities and potential debt rollover pressures limit available fiscal space.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment[2]

Executive Directors noted that stimulus-driven growth in previous years had contributed to large economic imbalances in the Turkish economy. Following the recession in 2018, expansionary fiscal policy, rapid credit provision by state-owned banks, and more favorable external financing conditions led to a resumption of economic growth. Directors emphasized that the current calm remains fragile and that vulnerabilities persist. These include low reserve buffers, large external financing needs, and stressed bank and corporate balance sheets. Against this background, Directors underscored the importance of prudent policies to address weaknesses and highlighted the need for a comprehensive package of reforms to secure stronger and more resilient growth over the medium term.

Directors emphasized that fiscal policy should remain a key policy anchor. While the recent fiscal stimulus has helped the economy recover, the underlying deficit has increased significantly. Directors recommended a broadly neutral fiscal stance in 2020, combined with tight monetary and quasi-fiscal policies, to strike a balance between supporting the nascent recovery while also containing financing needs and enhancing fiscal space. They noted that a modest consolidation is needed over the medium term to ensure that public debt remains low and stable. Directors welcomed the authorities' efforts to strengthen oversight and management of public-private partnerships.

Given still-high inflation expectations, Directors stressed that monetary policy should focus on durably lowering inflation, which would help permanently lower interest rates. In this context, they noted that recent monetary policy easing has gone too far. Directors also called for clearer monetary and intervention policy to bolster transparency and central bank credibility. They recommended rebuilding international reserves as conditions allow.

Directors emphasized that vigilance is needed in view of the rapid credit growth of state-owned banks. They encouraged taking steps to rein in credit growth and clean up bank and corporate balance sheets to support financial stability and stronger, more resilient growth. Directors generally agreed that a third-party asset quality review and new stress tests are needed to better understand underlying bank health. Additional reforms to improve the insolvency regime and out-of-court restructuring would also help release resources and restart productive lending.

Directors called for focused and carefully sequenced structural reforms to enhance medium-term growth and increase resilience to shocks. In particular, steps to improve product market efficiency, labor market flexibility, the quality of human capital, and female labor force participation would facilitate a reallocation of resources to productive sectors. Governance reforms would also help improve the investment climate and economic efficiency. Directors commended Turkey for hosting a large number of refugees.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Table 1. Turkey: Selected Economic Indicators, 2017–24

Population (2018): 82 million
Per capita GDP (2018): US$9,405
Quota: SDR 4,658.6 million

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
Real sector	*(Percent, unless otherwise noted)*							
Real GDP growth rate	7.5	2.8	0.2	3.0	3.0	3.0	3.5	3.5
Contributions to real GDP growth								
Private consumption	3.7	0.0	-0.1	2.6	2.0	1.9	1.9	1.9
Public consumption	0.7	1.0	0.7	0.1	0.3	0.3	0.5	0.5
Investment (incl. inventories)	2.9	-2.4	-4.7	2.2	1.6	1.3	1.2	1.2
Net exports	0.1	4.2	4.3	-1.8	-0.9	-0.5	-0.2	-0.1
Output gap	2.2	1.5	-1.1	-0.8	-0.5	-0.5	-0.2	-0.1
GDP deflator growth rate	11.0	16.4	14.4	11.8	11.6	10.9	10.8	11.0
Inflation (period-average)	11.1	16.3	15.7	12.6	12.4	11.4	11.0	11.0
Inflation (end-year)	11.9	20.3	13.5	12.0	12.0	11.0	11.0	11.0
Unemployment rate	10.9	11.0	13.8	13.7	12.9	12.3	11.8	11.8
	(Percent of GDP, unless otherwise noted)							
Fiscal sector								
Nonfinancial public sector overall balance	-2.2	-3.8	-5.2	-4.9	-5.3	-5.3	-5.3	-5.2
General government overall balance (headline) 1/	-1.5	-2.4	-3.0	-3.9	-4.6	-4.6	-4.6	-4.5
General government gross debt (EU definition)	28.2	30.1	32.2	33.1	34.1	35.4	36.6	37.3
External sector								
Current account balance	-5.6	-3.5	-0.1	-0.6	-1.3	-1.7	-1.8	-1.8
Gross external debt	53.4	57.6	61.3	55.7	50.7	47.7	46.0	44.2
Gross financing requirement	25.0	26.8	23.5	23.5	22.3	21.5	21.0	20.2
Monetary conditions	*(Percent)*							
Real average cost of CBRT funding to banks	0.4	1.4	...	...	...	...	...	...
Growth of broad money (M2)	16.4	18.4	...	...	...	...	...	...
Growth of credit to private sector	21.0	14.1	...	...	...	...	...	...

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ Headline (or authorities' definition), which includes items excluded from the IMF 'program' definition.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

November 21, 2019

KEY ISSUES

Context: Following the sharp lira depreciation and associated recession in late-2018, growth has improved, helped by policy stimulus and favorable market conditions. The lira recovered and the current account has seen a remarkable adjustment. Turkey remains susceptible to external and domestic risks, however, and prospects for strong and sustainable growth over the medium term look challenging without reforms to address vulnerabilities, strengthen policy credibility, and boost productivity.

Policies: The main policy challenge is to move the focus from short-run growth to higher and more resilient medium-term growth through a comprehensive reform package. This could be achieved through a five-part policy response:

- tight monetary policy to boost the credibility of the central bank, underpin the lira, durably lower inflation, and strengthen reserves;
- broadly neutral fiscal policy in the near term and steps to strengthen the fiscal position over the medium term;
- a comprehensive third-party assessment of bank assets, new stress tests, and follow-up measures, as needed, to further enhance confidence in banks, and efforts to rein in rapid credit growth by state-owned banks;
- additional steps, building on existing reforms, to reinforce the insolvency and corporate restructuring framework; and
- focused structural reforms to support productivity growth.

Approved By
Philip Gerson (EUR) and Mark Flanagan (SPR)

Discussions took place in Istanbul and Ankara during September 12– 23, 2019. The team consisted of Messrs. McGettigan (Head), Culiuc, Guzzo, and Rayner (all EUR), Mr. Hooley (FAD), Mr. Moore (MCM), Mr. Andritzky (SPR), Messrs. Kelmanson, Çeçen and Ms. Akcayoz (Senior Res. Rep. office). Mr. Thomsen (EUR), and Messrs. Bayar and Kaya (OED) participated in some meetings. The mission met with Deputy Minister of Finance and Treasury Aksu, Central Bank Governor Uysal, Chief of Strategy and Budget Ağbal, other senior officials, and private sector representatives. Mses. Kumar and Maneely assisted with the preparation of the staff report.

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TABLES

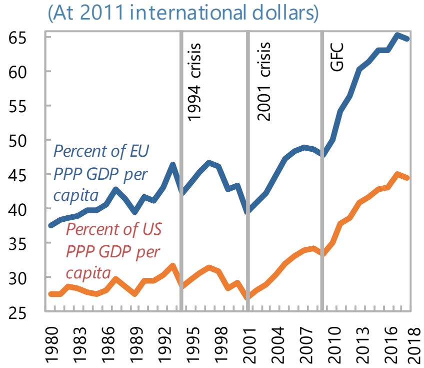
ANNEXES

BACKGROUND—GROWTH AND IMBALANCES

1. **Turkey achieved strong growth over the last two decades, but dependence on demand stimulus has increased over time.** Initially, broad-based macroeconomic and structural reforms supported poverty reduction and income convergence with advanced economies. As reforms waned, however, productivity growth slowed, and the expansion became increasingly dependent on externally-funded credit and demand stimulus.

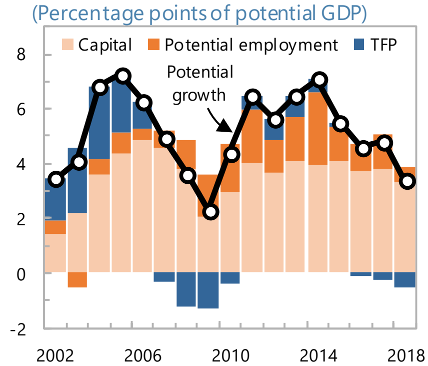
2. **As a result, internal and external imbalances increased.** Turkey entered 2018 with an economy running above potential, a positive credit gap, and high inflation. Large current account deficits, mainly financed by debt, resulted in a weak net international investment position and large currency mismatches, especially in the private sector (see 2018 Article IV). Vulnerability indicators for all but the public sector worsened compared to global financial crisis peaks (see text chart overleaf).

Turkey's PPP GDP per Capita
(At 2011 international dollars)



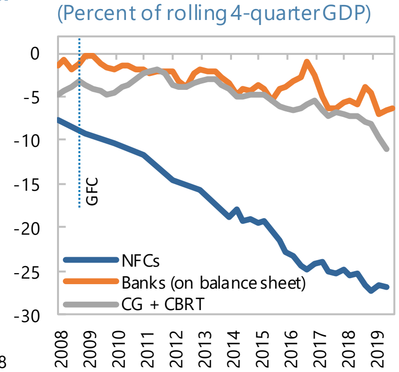
Sources: IMF WEO; and IMF staff calculations.

Potential Output Growth Decomposition
(Percentage points of potential GDP)



Sources: Turkstat; and IMF staff calulations.

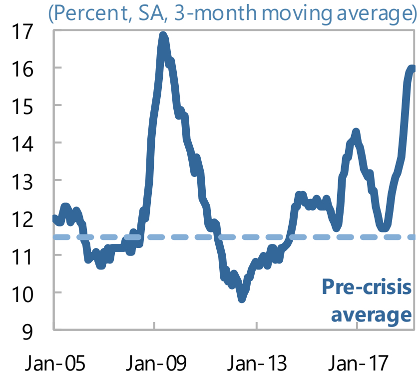
Net FX Position
(Percent of rolling 4-quarter GDP)



Sources: Turkstat; CBRT; and IMF staff calculations.

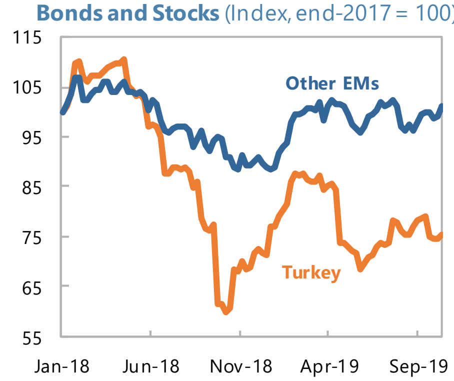
3. **These imbalances contributed to last year's sharp lira depreciation and associated recession.** Turkey's vulnerabilities were exposed by a worsening in market sentiment towards emerging markets and adverse geopolitical developments. This led to a run on the lira, which fell by around 40 percent (in TL/US$ terms) in early August. The exchange rate shock and a necessary, but belated, monetary policy reaction to higher inflation (625 basis points hike in the policy rate in mid-September) were accompanied by a recession in the second half of the year and a sharp increase in unemployment.

Non-Agricultural Unemployment Rate
(Percent, SA, 3-month moving average)



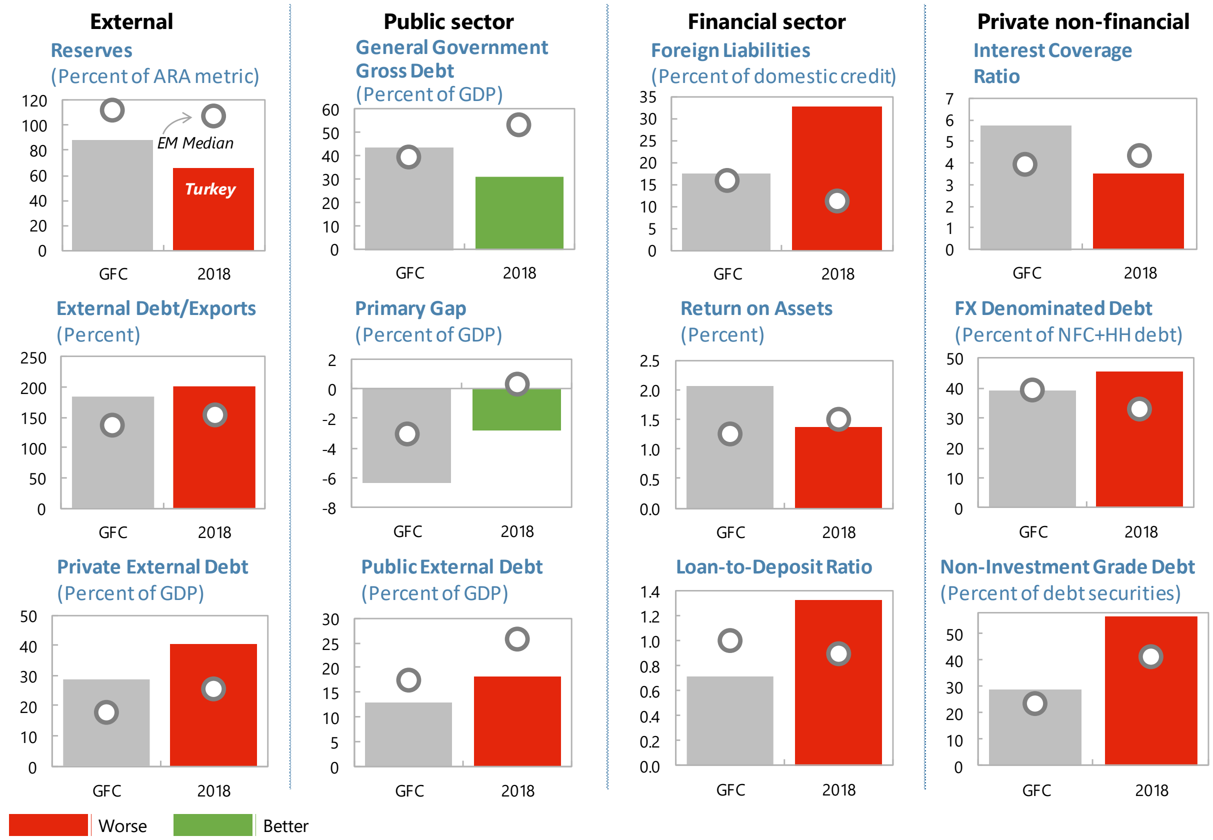
Sources: Turkstat; and IMF staff calculations.

EM Sentiment Proxy: EFPR Allocation of Bonds and Stocks (Index, end-2017 = 100)



Sources: EFPR Global; and IMF staff calculations.

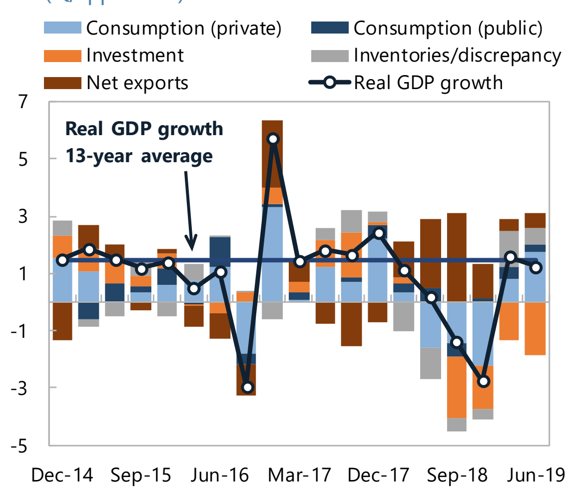
Selected Vulnerability Indicators: Global Financial Crisis vs. 2018



Source: IMF VE Indicator Database. Global Financial Crisis denotes 2008 or 2009, whichever is worse.

RECENT DEVELOPMENTS—STIMULUS AND RECOVERY

Contributions to Real GDP Growth
(Q/q percent)



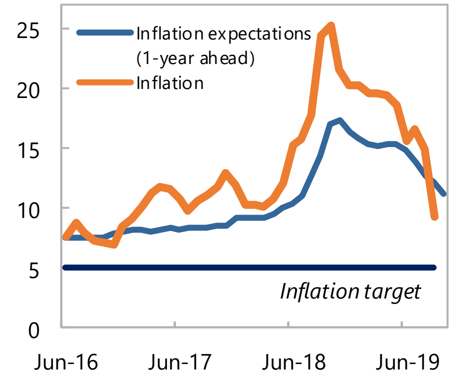
Sources: Turkstat; and IMF staff calculations.

4. **Growth has since resumed, aided by extensive policy support.** Buoyed by expansionary fiscal policy, rapid credit expansion by state-owned banks, and more favorable market sentiment, the economy registered positive growth in the first half of 2019 despite the continued sharp decline in investment. Growth should be slightly positive for 2019 as a whole—about ¼ percent—despite the large negative carryover effects from the 2018 recession.

5. **As market pressures abated, and the current account adjusted, the lira stabilized.** Import compression and strong tourism receipts have led to a major current account adjustment, and only a small deficit is expected for 2019. This adjustment, combined with improved external financing conditions and tight monetary policy, took some pressure off the lira.

6. Inflation has fallen sharply and the CBRT has cut policy rates by 1,000 basis points since July. Inflation had reached about 25 percent—five times the target—in October 2018 due, in large part, to high exchange rate passthrough and rising inflation expectations. But strong negative base effects and a lira recovery have since contributed to steep disinflation, although inflation expectations remain well above the target. Following the dismissal of the central bank governor in July 2019 and changes in senior management in August, the CBRT has delivered large policy rate cuts, bringing the official repo lending rate to 14 percent. It also began providing lira liquidity to primary dealers at 100 basis points below the official policy rate and to all participating banks at rates settled under longer-term FX swaps.

Inflation and Expectations
(Y/y percent change)



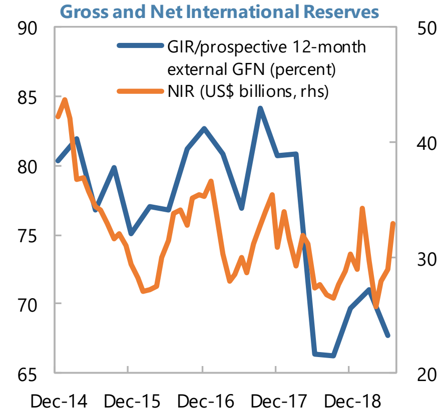
Sources: CBRT; and Turkstat.

Exchange Rate
(Turkish Lira to US Dollar)

Source: CBRT.

7. Reserves remain low, despite recent increases, encouraging the use of unconventional policies. At the height of the depreciation in 2018, the authorities imposed measures on the repatriation and conversion of export proceeds, while the Banking Regulation and Supervision Authority (BRSA) capped banks' swap positions to discourage shorting of the lira in the offshore market. Both measures constitute capital flow management measures under the Fund's Institutional View. In late-March 2019, during a period of lira volatility, reports emerged of large FX interventions through state-owned banks and questions arose over the net reserve position of the CBRT.[1] The recent shift to longer-maturity FX swaps, for which comprehensive and high-frequency data are limited, also complicates the assessment of reserves. In addition, limits on lending lira in offshore markets led to a temporary spike in off-shore lira borrowing rates in March 2019. Recently, the CBRT has started to rebuild reserves, including through the export rediscount credit facility under which credit is provided to exporters in lira and is typically repaid in FX, an indirect form of FX intervention.

Gross and Net International Reserves



Sources: CBRT; and IMF staff calculations.

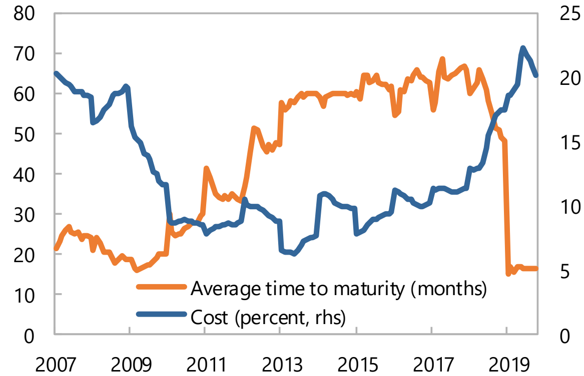
8. Fiscal discipline, a longstanding policy anchor, is weakening. After declining for several years, the primary balance of the central government fell to

[1] Reports also emerged that CBRT net international reserves reflected only the asset leg, not the corresponding liability, of the CBRT's one-week FX swaps with domestic banks. The CBRT reports the forward leg of swap transactions in its monthly International Reserves/Foreign Currency Liquidity table. Although the authorities' accounting methodology is in line with international convention, the definition of net reserves under previous Fund-supported programs with Turkey subtracted the net forward position.

zero in 2018, its lowest level since before the 2001 crisis. Fiscal stimulus continued in the first half of 2019, in contrast to the consolidation planned in the late-2018 New Economy Program, with the primary deficit of the central government widening to 0.7 percent of GDP through end-June.[2] Revenue weakness was driven by low net VAT collection and cuts in Special Consumption Tax rates, while spending growth was driven by overruns on wages and current transfers. Weakness in tax revenues continued in the second half of the year, but was offset by a large transfer from the central bank, counted by the authorities as revenues.

9. The authorities adapted their debt management approach to contain borrowing costs. With the higher fiscal deficit and tight domestic financing conditions, the authorities increased Eurobond issuance (US$11.2 billion by mid-November, above the full-year target) and domestic FX debt issuance, drew down Treasury deposits, and shortened borrowing maturities. The authorities also used unconventional measures, including a large transfer to Treasury of CBRT reserves (around 1 percent of GDP) in addition to dividend payments. Domestic issuance deviated significantly from original borrowing plans, reducing predictability for market participants.

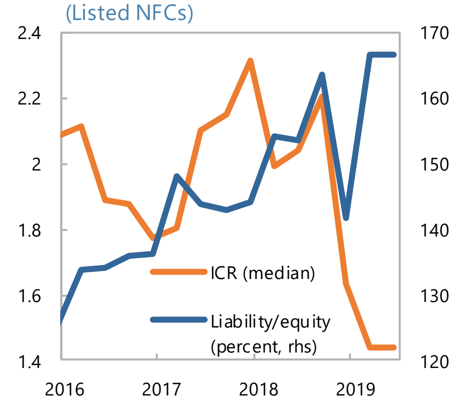
Domestic Borrowing: Cost and Average Maturity of Fixed Interest Instruments



Sources: MOTF; and IMF staff calculations.

10. The balance sheets of non-financial corporates have weakened. Lira depreciation, higher interest rates, and lower growth have weighed on the health of the corporate sector. Given the large open FX position, leverage rose, and interest coverage ratios fell. In response, the authorities strengthened the insolvency regime by abolishing bankruptcy postponement and set up and gradually refined an out-of-court debt restructuring mechanism. They also announced plans to establish centralized asset management companies for non-performing loans (NPLs) in the energy and construction sectors, while a recent decree allows Treasury to acquire holdings in companies by presidential decree.

Corporate Solvency Indicators
(Listed NFCs)



Sources: Bloomberg Financial L.P.; and IMF staff calculations.
Note: ICR computed using EBIT/financial expense.

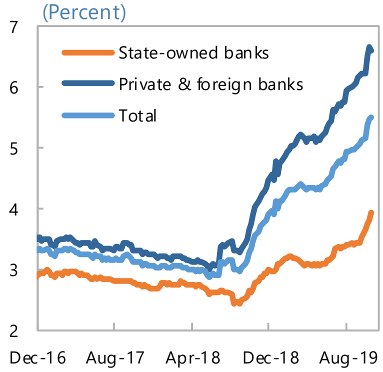
11. Bank balance sheets have also weakened. Banks continue to record broadly stable interest income, adequate capitalization and a moderate NPL ratio of 5.5 percent for all deposit-taking institutions and 3.9 percent for state-owned banks as of mid-October 2019.[3] However, the deterioration in asset quality has not shown up fully on bank balance

[2] Data from the first half of 2019 also show a sharp decline in local government revenue.

[3] On September 17, 2019, the BRSA announced that the impact analysis conducted on the July 2019 financial statements of the banks would increase the level of NPLs to 6.3 percent.

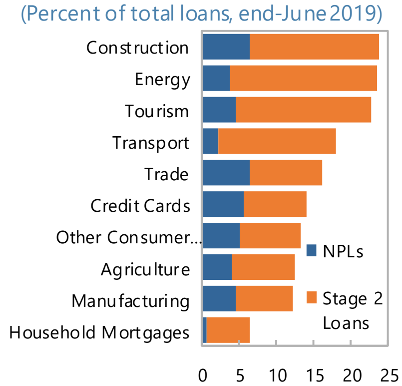
sheets as the current regulatory framework offers discretion in recognizing impairment, allowing banks to deal with their problematic loans over time.[4] More broadly, recession and financial market dislocation typically affect borrowers' capacity to repay, and NPLs, with a lag. Stage 2 loans have climbed steadily to about 11½ percent of total loans as of June 2019, pointing to a build-up of credit risk.[5] Conditions appear to be particularly challenging for the construction sector, where the combined NPL and stage 2 loan ratio is approaching 25 percent.

Banking Sector NPL Ratios
(Percent)



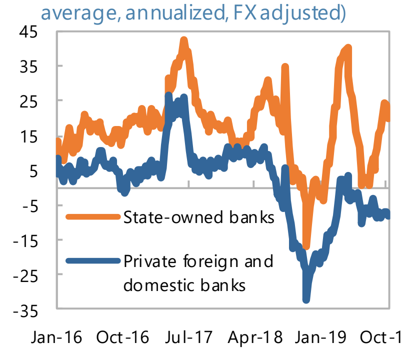
Sources: BRSA; and IMF staff calculations.

NPLs and Stage 2 Loans by Sector
(Percent of total loans, end-June 2019)



Sources: BRSA; and IMF staff calculations.

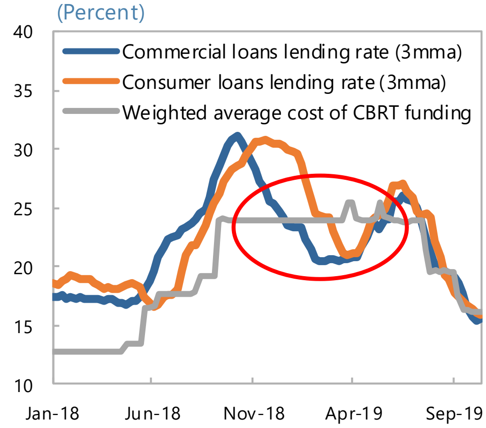
Credit Growth: Private vs Public Banks
(W/w percent change, 13-week moving average, annualized, FX adjusted)



Sources: BRSA; and IMF staff calculations.

12. Despite the difficult backdrop, state-owned banks have been called upon to support rapid credit growth. While private banks have cut back on their lending given deteriorating asset quality, state-owned banks have engaged in a major credit expansion. State-owned banks have provided credit to consumers and corporates at rates well below the cost of funding from the CBRT, blunting the monetary transmission mechanism. As a result, although the credit gap of private banks has shrunk, the gap for state-owned banks is estimated to remain large (Box 1). In August, to further support credit growth, the CBRT introduced lower TL reserve requirements for banks with credit growth in a higher range.[6]

State-Owned Banks' Lending Rates and Funding Cost
(Percent)



Sources: CBRT; and IMF staff calculations.

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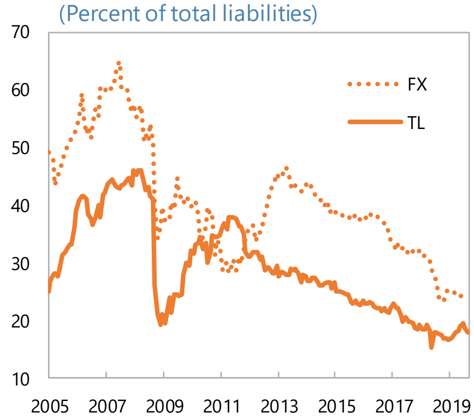
[4] According to amendments introduced in August 2018: (i) restructured stage 2 loans may be reclassified as performing loans after only 3 months (standard probation period is at least 1 year) without being subject to a minimum payment; and (ii) performing loans whose contractual conditions are modified may continue being classified as performing loans.

[5] Stage 2 loans are loans for which credit risk has increased significantly but are still not considered impaired.

[6] For banks whose loan growth is between 10 percent and 20 percent, TL reserve were set at 2 percent, while they were left unchanged at higher levels for other banks.

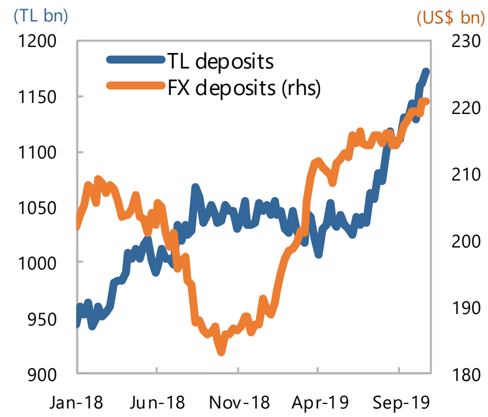
13. Rapid credit growth by state-owned banks has weakened their balance sheets, hampered needed deleveraging, and fueled dollarization. New lending and restructuring deals have eroded capital, and TL 28 billion (0.7 percent of GDP) was injected into state-owned banks in April 2019 to strengthen their capital base. To support net interest margins while providing credit below the cost of CBRT funding, state-owned banks kept lira deposit rates low, and borrowed heavily in FX, contributing to a sharp increase in deposit dollarization. Banks' funding is increasingly short term and concentrated in FX deposits against declining liquid assets, worsening liquidity conditions.[7]

State-Owned Banks' Liquid Assets
(Percent of total liabilities)



Sources: BRSA; and IMF staff calculations.

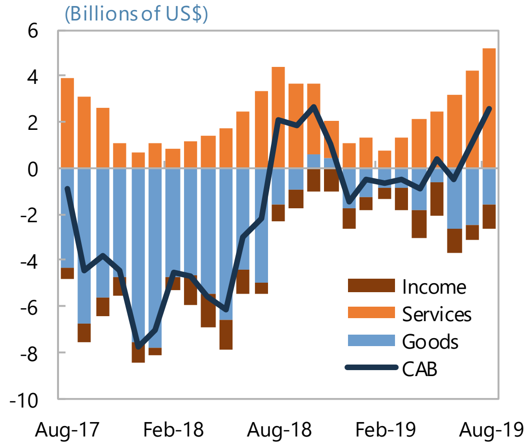
Banking Sector Deposits By Currency



Sources: BRSA; and IMF staff calculations.

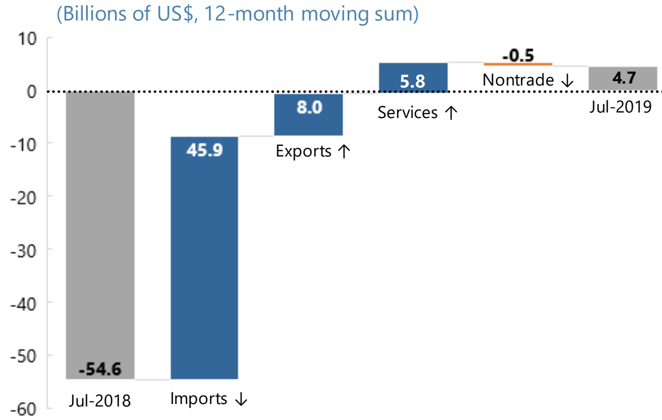
14. External flow imbalances have narrowed, although much of the improvement appears cyclical. Lira depreciation and weak domestic demand led to strong import compression and a marked improvement in the current account, which was also helped by strong tourism receipts and a normalization of gold imports. While Turkey's external position in 2018 was broadly in line with the level implied by fundamentals and desirable policies (Annex II), Turkey's real effective exchange rate is estimated to have been undervalued by about 10 to 20 percent, and the effective exchange rate stood at about the 2018 average at end-September 2019.

Current Account
(Billions of US$)



Sources: CBRT; and IMF staff calculations.

Current Account
(Billions of US$, 12-month moving sum)

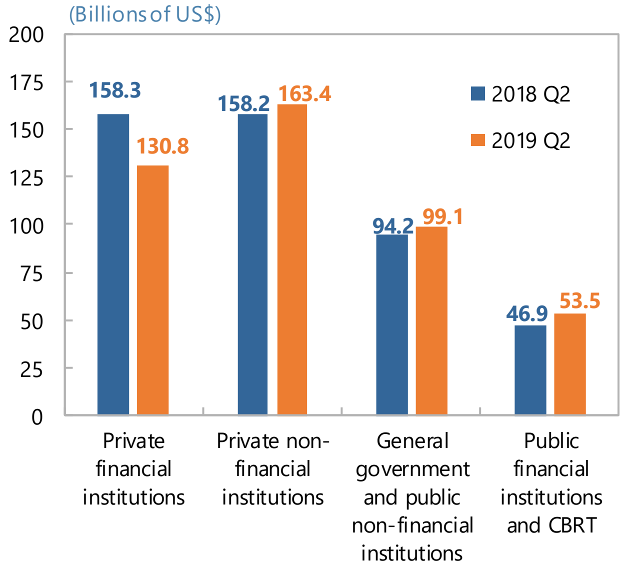


Sources: CBRT; and IMF staff calculations.
Note: End-July is chosen to contrast the pre- and post-depreciation current account balances.

[7] Liquid assets include cash; receivables from CBRT, money market, banks, securities interbank and reverse repo; as well as securities held at fair value and required reserves. Under a narrow definition of liquid assets, required reserves and some securites may be excluded.

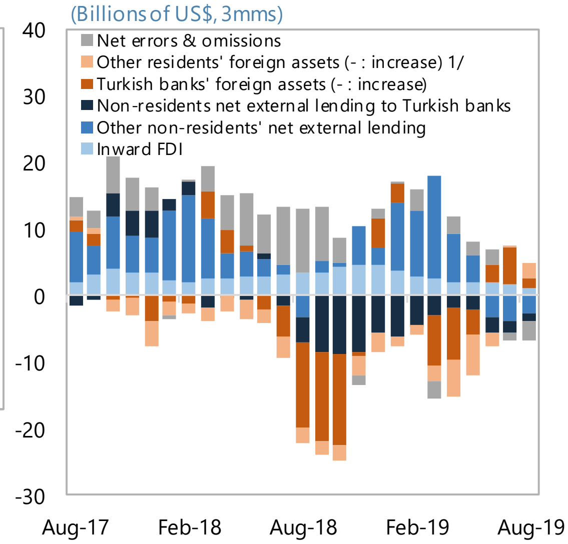
15. Although external flow imbalances have improved, large stock imbalances remain. While private banks have reduced external debt, reflecting needed deleveraging, other sectors have increased external borrowing. In particular, non-financial corporates have shifted trade financing abroad and state-owned banks have used external financing to support credit expansion, while the government has relied on external financing to help fund the growing fiscal deficit. And, amid subdued investor confidence, the quality of Turkey's external financing worsened. External debt has been rolled over at shorter tenors and higher rates, while errors and omissions have been an important financing source and net FDI remains subdued, with much of it in real estate, rather than in areas that support productive capacity.

External Debt, by Sector
(Billions of US$)



Sources: CBRT; and IMF staff calculations.

Resident and Non-Resident Flows
(Billions of US$, 3mms)



Sources: CBRT; and IMF staff calculations.
1/ Including outward FDI.

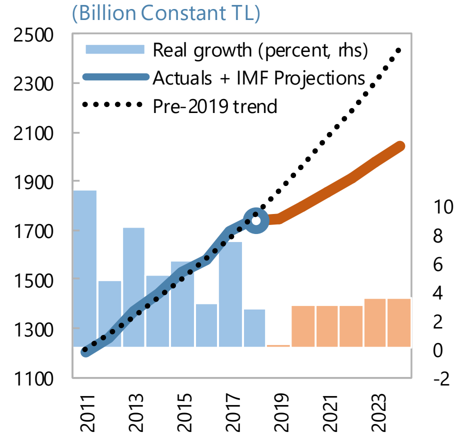
OUTLOOK—CHALLENGES REMAIN

16. The current calm appears fragile. Reserves remain low and private sector FX debt and external financing needs remain high. Non-financial corporate balance sheets have been stressed by lira depreciation, higher interest rates, and lower economic growth. Banks report adequate capitalization and moderate NPLs but loan restructuring has increased and the lagged effect of the recession and the weaker lira are expected to continue to put strains on asset quality. High dollarization reflects, among other things, weaker domestic sentiment and state-owned bank funding needs. And, while public debt is low—a key strength for Turkey—the fiscal deficit has increased and uncertainty over the possible scale of contingent liabilities and potential debt rollover pressures limit available fiscal space.

17. Prospects for strong sustainable growth have weakened. Despite the recent turnaround, without consistent execution of a comprehensive package of reforms, medium-term growth is likely to be subdued and volatile given balance sheet strains and weaker buffers. A return to the pre-2019 output trend (when growth averaged 5½ percent) appears unlikely, as cross-country experiences suggest that Turkey could follow a shallow L-shaped recovery from its balance sheet recession (Box 2). The authorities disagreed; in their view, drawing parallels to shallow recoveries following banking crises elsewhere is inappropriate in Turkey's case.

18. Turkey remains exposed to domestic and external risks. Domestic risks relate to possible policy implementation and political developments. External risks include a deterioration in sentiment towards emerging markets and adverse geopolitical developments (Annex I).

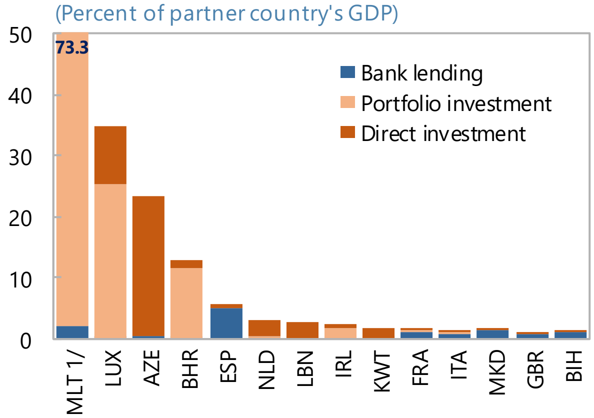
Turkey Real GDP
(Billion Constant TL)



Sources: Turkstat; and IMF staff calculations.

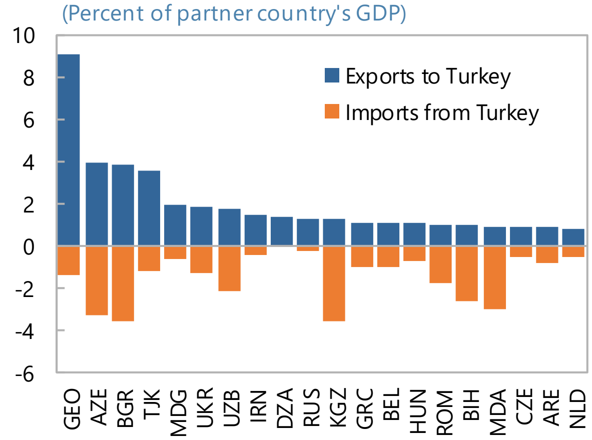
19. The materialization of risks in Turkey could result in outward spillovers. Trade links with neighbors and financial exposures through direct investment (Azerbaijan) as well as portfolio investments, especially with Malta and Luxembourg, are possible spillover channels. Exposure through bank lending is mostly linked to stakes in Turkish banks of euro area financial institutions. Despite limited spillovers from Turkey's recent episodes of volatility, a severe financial dislocation could affect other vulnerable emerging markets through confidence channels, although most observers still see Turkey's difficulties as largely idiosyncratic.

Financial Exposures in Turkey
(Percent of partner country's GDP)



Sources: BIS; IMF CDIS; IMF CPIS; and IMF staff calculations.
1/ Portfolio investment for Malta is as of 2016.

Trade Exposures
(Percent of partner country's GDP)



Sources: IMF DOTS; IMF WEO; and IMF staff calculations.

POLICIES—SECURING STRONGER AND MORE RESILIENT GROWTH

Although Turkey's vulnerabilities have increased, they are by no means insurmountable. A concerted set of reforms would help materially address existing weaknesses, restore policy credibility, and set the economy on a path to stronger and more resilient growth.

20. The focus on policy stimulus to boost short-run growth appears unsustainable. The favorable external financial environment has allowed the authorities to use more expansionary fiscal, quasi-fiscal, and monetary policies to boost near-term growth. Stimulus-driven growth will, however, likely lead over time to lower policy credibility, dwindling buffers, and rising solvency and liquidity strains for state-owned banks. Expansionary policies also slow needed deleveraging and reallocation of resources to more productive sectors. Furthermore, the use of unconventional policy measures (e.g., FX contract limitations, price controls and inspections, and credit-growth-linked reserve requirements) has undermined policy credibility.

21. The main policy challenge is, therefore, to move the focus from short-run growth to higher and more resilient medium-term growth through a comprehensive reform package. This requires repairing private balance sheets, further increasing public balance sheet strength, and ultimately restoring the credibility, independence and rules-based functioning of economic institutions. This could be achieved through a five-part policy response: (i) tight monetary policy to boost the credibility of the central bank, underpin the lira, durably lower inflation, and strengthen reserves; (ii) broadly neutral fiscal policy in the near term and steps to strengthen the fiscal position over the medium term; (iii) a comprehensive third-party assessment of bank assets, new stress tests, and follow-up measures as needed, to further enhance confidence in banks, and efforts to rein in rapid credit growth by state-owned banks; (iv) additional steps, building on existing reforms, to reinforce the insolvency and corporate restructuring framework; and (v) focused structural reforms to support productivity growth.

22. These reforms would inevitably involve trade-offs. The proposed policy response would likely sacrifice some near-term growth in favor of stronger and more resilient medium-term growth. Specifically, tight monetary and quasi-fiscal policies would accelerate deleveraging and reduce near-term demand, although these would be partly offset by a less contractionary near-term fiscal stance. Structural reforms may also involve some near-term costs as resources are reallocated away from less productive to more productive sectors. Medium- and long-term benefits of strengthened policy credibility and higher productivity would outweigh the near-term costs, however, and would include lower downside risks, faster and more durable disinflation, stronger bank and corporate balance sheets, higher reserve buffers, a stronger external position, lower fiscal contingent liabilities and, ultimately, higher and more sustainable growth. There appears to be a window of opportunity for such reforms from a political economy perspective, as the next major elections are scheduled for 2023. Should downside risks materialize, the appropriate policy response would depend on the nature of the shock (Annex I).

Authorities' Views

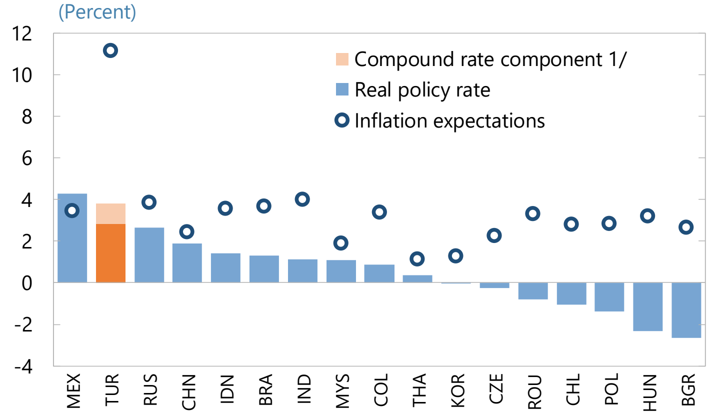
23. The authorities believe policies are already on the right track. They particularly emphasized the success of policies in mitigating what they saw as speculative exchange rate attacks and in supporting economic activity. They viewed monetary policy as sufficiently tight to restore price stability while also supporting economic growth and credit expansion, citing falling inflation and inflation expectations as evidence. They underscored the importance of fiscal discipline. They understood the justification of a third-party asset quality review but underscored the strength of their supervisory framework and the competency of the supervisors. They agreed with the importance of focused structural reforms, and emphasized the need for sectoral support and strategic projects. The authorities' policy program, announced after the Article IV mission was concluded, is laid out in its latest New Economy Program and envisions a rapid return to high growth (Box 3).

A. Monetary Policy—Strengthening Credibility

Strengthening monetary policy credibility is a key priority. This would help underpin the lira, durably lower inflation and inflation expectations, allow reserves to be rebuilt, address dollarization, and, crucially, bring down interest rates in a lasting manner.

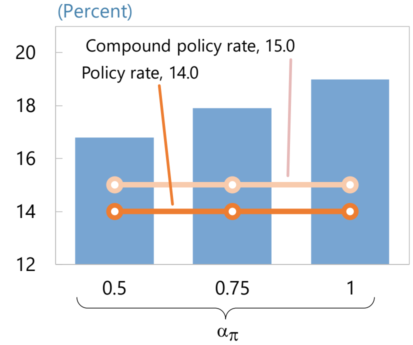
24. Rates are too low to strengthen monetary policy credibility and lower inflation durably. The CBRT easing cycle has been too aggressive given the importance of building credibility and mitigating macro-financial risks. A simple Taylor rule analysis, for example, would suggest that rates, while positive in real terms, are now well below those needed to support a durable reduction in inflation and inflation expectations (Box 4).

Ex-Ante Real Policy Rates and Inflation Expectations
(Percent)



Sources: CBRT; Consensus Forecasts; Haver; and IMF staff calculations.
1/ Annual compound real rate.

Taylor Rule-Based Interest Rate
(Percent)

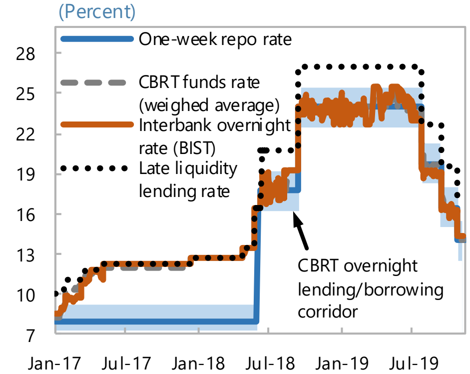


Source: IMF staff calculations.
Note: r*=3.5% is the staff-estimated neutral rate; π =12% and π^* =8.5% are the NEP inflation forecasts for 2019 and 2020, respectively; α_π is the weight on the inflation policy gap and 1-α_π is the weight on the output gap.

25. To strengthen credibility, monetary policy needs to be not just tight but also more clear. Although the official policy instrument is the one-week repo facility, the CBRT provides most of its liquidity through other facilities, including subsidized lending to primary dealers, FX swap instruments of various maturities, and longer-term export rediscount credits. Reducing the many instruments and rates through which liquidity is provided would help clarify the policy stance, as would high-frequency publication of amounts and rates of all instruments used by the CBRT.

26. The CBRT should use a transparent framework for FX intervention to replenish reserves. With global yields at historical lows, a tight monetary stance, allied with broader policy reforms, could help promote high-quality capital inflows. To better benefit from these flows, the export rediscount credit facility, which effectively acts as an

Monetary Policy Rates
(Percent)



Sources: CBRT; and Haver Analytics.

important FX intervention facility, should be replaced with a transparent framework for pre-announced and sterilized FX purchases from a broader set of market participants. Remaining measures aimed at containing excessive volatility in capital flows (i.e., limit on banks' swap transactions with foreign investors and export surrender/repatriation requirements) should be phased out as macroeconomic and financial conditions improve.

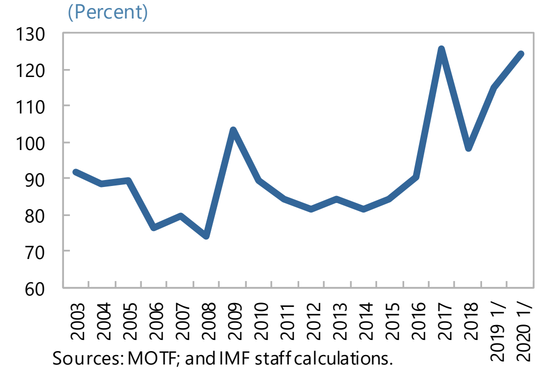
Authorities' Views

27. The authorities agreed with the need to strengthen monetary policy credibility and lower inflation durably. Focusing on what they saw as a reasonable real policy rate, they viewed the trajectory of monetary policy as sufficiently tight to restore price stability, while also considering the need to support economic growth and credit expansion. They agreed with the need to rebuild reserves, as economic and financial conditions permit, but saw merit in continuing with export rediscount credits.

B. Fiscal Policy—Preserving the Anchor

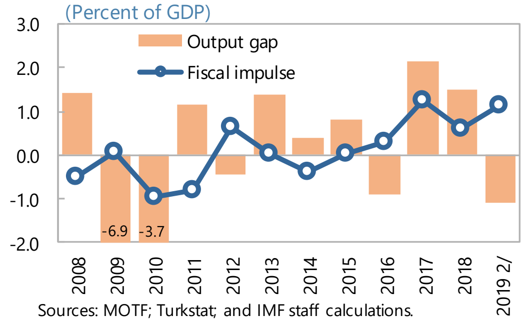
Fiscal policy—a longstanding strength in Turkey—should remain a key policy anchor. In the near term, a broadly neutral fiscal stance, combined with tight monetary and quasi-fiscal policies, would strike a balance between supporting the nascent recovery while also containing financing needs. Over the medium term, the focus should shift to stabilizing debt and enhancing fiscal space, which calls for a modest fiscal consolidation, supported by more transparency and control of quasi-fiscal activity.

Domestic Rollover Ratio
(Percent)



Sources: MOTF; and IMF staff calculations.
1/ Projection.

Fiscal Impulse[1/] and Output Gap
(Percent of GDP)



Sources: MOTF; Turkstat; and IMF staff calculations.
1/ Negative change in central government overall cyclically-adjusted balance, excluding one-off CBRT revenues.
2/ Projection.

28. A broadly neutral stance in 2020 would help contain rising debt and financing needs without undermining the nascent recovery. The authorities' announced fiscal plan for 2020 appears to be contractionary. Maintaining the headline overall balance for 2020 at 2019 levels, despite the expected loss of one-off CBRT transfers equivalent to about 1½ percent of GDP (Box 3), would require expenditure cuts or revenue increases and would imply a negative fiscal impulse for the real economy.[8] Postponing some planned spending cuts, particularly on investment, would allow a central government overall balance of around 4 percent of GDP in 2020.

29. After weakening over the past five years, the trajectory of the deficit needs a medium-term course correction. While the discretionary fiscal

[8] The authorities classify one-off CBRT transfers above the line, contrary to *Government Finance Statistics* conventions.

stimulus in 2019 aided the economic recovery, it could have been communicated better in order to strengthen policy credibility. New spending commitments, such as increases in the public wage bill, holiday payments to pensioners, and subsidies to companies for social security payments would, without changes, have a lasting impact on the budget, while some consumption tax cuts have yet to expire. Overall, the structural primary balance has deteriorated by around 1½ percentage points over the past two years.

30. A medium-term consolidation strategy is needed to improve debt dynamics. Turkey has some fiscal space, although it is limited by increased gross financing needs and uncertainty over the scale of contingent liabilities. Without credible medium-term consolidation measures, Turkey's debt will continue to rise, and exceed 37 percent of GDP by 2024 (Annex III). Measures yielding about 1½ percent of GDP would help stabilize the debt burden around current levels and reduce gross financing needs. Potential measures could include the following:

- ***Revenues.*** Broadening the VAT base by streamlining the widespread exemptions and raising and unifying the reduced VAT rates would increase revenues. Higher revenues would also create space, over time, to clear the large stock of deferred VAT credits, which distort and undermine VAT efficiency. There is also scope for personal income tax reform to enhance collection and improve progressivity.

- ***Spending.*** Eliminating backward-looking public wage indexation would help achieve savings and lower the cost of disinflation. Ad-hoc subsidies and holiday pension increases should also be eliminated and transfers to other government entities contained, while making space to increase and better target social assistance spending. Procurement by public-private partnerships needs to be better integrated with the public investment management framework and budgeting decisions.

Turkey: Recommended Medium—Term Fiscal Measures
(Percent of GDP)

Recommended medium-term adjustment to structural primary balance	**1.5**
Consolidation measures	2.0
Revenue options	
i) Personal Income Tax reform	0.1
ii) VAT reform and streamlining VAT exemptions (net of arrears clearance)	0.9
Expenditure options	
iii) Wage bill controls	0.3
iv) Contain net lending	0.2
v) Rationalization of transfers/subsidies	0.5
Additional spending	
Increase in social spending to support implementation of structural reforms (provided overall adjustment need met)	-0.5

Source: IMF staff estimates.

31. Fiscal structural reforms would help enhance fiscal space. Increasing publicly-available information regarding contingent liabilities and fiscal risks would help strengthen fiscal governance and increase fiscal space. The scope and role of all non-central government entities need to be carefully defined and monitored. Investments and borrowing by the recently-established Turkey Wealth Fund should be integrated into the budget, while the Wealth Fund's governance should be refined to limit potential conflicts of interest. The authorities' efforts to strengthen oversight and management of public-private partnerships, including plans to publish a monitoring report and introduce a new law, are welcome. It is important for the legislation to ensure that public-private partnerships are fully integrated with the budget, including authorization and appraisal. A fiscal risk statement should also be published. Finally, on the financing side, debt management practices should also return to a focus on transparency and predictability while seeking opportunities to lengthen maturities to help reduce near-term financing needs.

Authorities' Views

32. The authorities underscored the importance of fiscal discipline. They noted that fiscal policy successfully supported economic activity in 2019 and agreed with the goals of fiscal consolidation and maintaining public debt at low and stable levels. As they expected relatively high growth in 2020, they viewed an unchanged overall balance as an appropriate fiscal stance. They underlined the importance of revenue mobilization, including through revenue administration improvements. The authorities agreed that greater transparency for contingent liabilities, primarily for public-private partnerships, would enhance fiscal credibility.

C. Financial and Corporate Sector Policies—Stability and Rebalancing

Efforts to boost credit, including through state-owned banks and the Credit Guarantee Fund, have hampered needed deleveraging. A third-party asset quality review is needed to get a better sense of bank balance sheet health. Further moves to strengthen bank regulation, resolution and AML/CFT frameworks are also needed. Improvements to the insolvency regime and out-of-court debt restructuring mechanisms are welcome and should continue.

Financial Sector

33. Rapid credit growth by state-owned banks should be reined in, as should other moves that inhibit needed deleveraging and balance sheet cleanup. Following rapid credit growth in recent years, state-owned banks are already stretched, with a large positive credit gap and emerging balance sheet and liquidity strains, including lower profit margins, increased dollarization, and high lira loan-to-deposit ratios. Credit provided to overleveraged corporates is unlikely to be used for much more than refinancing, limiting resource allocation to more productive firms. More cautious lending by state-owned banks would also contain contingent liabilities for the sovereign. More broadly, efforts to expand lending through the Credit Guarantee Fund and financial incentives should be limited. For example, the recent move that lowered TL reserve requirements for banks with credit growth in a higher range should be dropped.

34. A third-party asset quality review and new stress tests are needed to thoroughly assess the health of bank balance sheets. Given the discretion in recognizing loan impairment, a comprehensive third-party assessment of bank assets, new stress tests, and follow-up measures as needed, would further strengthen confidence in banks. In the event that any actual or potential capital needs are identified, they should be addressed in line with international best practice.

35. Stronger bank regulation and supervision would also help clarify the underlying health of the sector. Tighter loan classification and provisioning rules should be put in place to encourage timely recognition of loan losses and minimize evergreening. Restructuring agreements should be monitored closely to ensure that they support repayment capacity in a durable manner. More broadly, the BRSA should prioritize financial sector stability over financial sector development. Looking further ahead, efforts are also needed to strengthen the bank resolution framework. Legislation is being drafted to help clarify resolution agency responsibilities, supervisory legal protections and coordination across agencies and with foreign supervisors, which is helpful. These changes should be put in place in a timely manner.

36. The authorities should continue to strengthen the AML/CFT framework. Measures to improve relevant legislation are welcome, including on money laundering offenses, in line with earlier FSAP recommendations, as are efforts to increase staffing and training for law enforcement on AML/CFT. Further actions should be pursued to ensure compliance with relevant UN Security Council Resolutions, strengthen border controls on currency transportation, and mitigate financial integrity risks related to virtual assets. Turkey's comprehensive AML/CFT assessment was recently discussed at the FATF October 2019 Plenary and the publication of the FATF report is expected for December 2019.

Authorities' Views

37. The authorities believe the financial system is sufficiently strong to support further credit growth. They disagreed with staff's assessment of a continued positive credit gap. While acknowledging the potential positive effect of an asset quality review for market confidence, they stressed that supervision is already strong, helped by recent alignment with IFRS9. In particular, they noted that regular onsite examinations that entail detailed loan credit reviews already take place and that an effective stress test framework is also operational. On AML/CFT, the authorities indicated that draft legislation is being prepared, including to address requirements for politically exposed persons.

Non-financial Corporate Sector

38. Recent improvements to the insolvency regime are welcome and should be complemented by new creditor safeguards. The 2018 repeal of bankruptcy postponement, previously used to delay the liquidation of enterprises, is helpful. However, the composition procedure (*konkordato*) continues to allow debtors to stay enforcement proceedings for around two years. Since insolvency resolution indicators are weak and have deteriorated, the insolvency legislation, revised piecemeal since 2004, should be reviewed in its entirety. The ongoing review of legislation provides a good opportunity to improve creditor protection (e.g., by raising the bar for extension of stays).

39. The framework for out-of-court restructuring is improving. The Banks Association of Turkey produced Restructuring Framework Agreements initially for larger and subsequently for smaller firms. These have been made more practicable by allowing foreign creditor participation, by granting tax exemptions, and by stronger legal protection for bank officials writing down debt. Nevertheless, room for improvement remains. For instance, lower hurdles for write-downs and debt-for-equity swaps could facilitate more durable restructurings, while participation of foreign experts and the use of hybrid mechanisms (with court involvement) could raise foreign creditor involvement. The use of out-of-court debt restructuring mechanisms could be helped by making the insolvency regime more creditor friendly and by tightening NPL rules. The authorities' reluctance to use public funds, beyond tax incentives, as part of loan restructurings, is warranted. And the focus on out-of-court restructuring, rather than on centralized asset management companies, is also appropriate given broader concerns associated with such companies, including transfer pricing and governance difficulties. However, financial restructuring alone may be insufficient to turn around overindebted sectors. A greater focus on operational restructurings should be supported by structural reforms.

40. While corporate borrowing has slowed, policy should be framed to help prevent a repeat of lending excesses in the future. This could include the following: (i) extending limits on FX loans beyond small and medium-sized enterprises and reducing exemptions for such enterprises; (ii) improving corporate governance and transparency, including through stronger auditing standards; and (iii) developing a home-grown investor base and domestic financial markets (e.g., encouraging equity financing, promoting the voluntary pension system, and deepening the insurance and asset management sectors), which could also foster, over time, increased domestic savings.

Authorities' Views

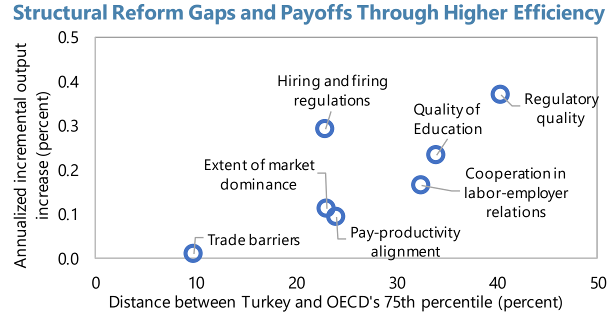
41. The authorities noted progress to date on the insolvency regime and out-of-court debt restructuring mechanisms, and signaled further improvements to come. They indicated that amendments to the insolvency regime, currently under review, aim to better balance debtor and creditor rights, speed up insolvency proceedings, and reduce costs. They also noted that specialized courts, along with other parts of the ongoing reform of the judicial system, aim to speed up the resolution of commercial disputes and otherwise enhance efficiency. Meanwhile, the development of domestic financial markets will be fostered through changes to the legal and institutional infrastructure of capital markets.

D. Structural Reforms—Boosting Productivity

Focused structural and governance reforms would help foster stronger sustainable growth and increase the economy's resilience to shocks.

42. Switching to a productivity-led growth model calls for focused and carefully-sequenced structural reforms with an initial emphasis on product markets. Productivity improvements are likely to be greatest where estimated payoffs and policy gaps (between Turkey and a selected benchmark) are highest. According to staff analysis, the largest long-run gains are likely to come from improving the business and regulatory environment, labor market flexibility, and the quality of human capital (Selected Issues Paper).[9] Specifically:

Structural Reform Gaps and Payoffs Through Higher Efficiency



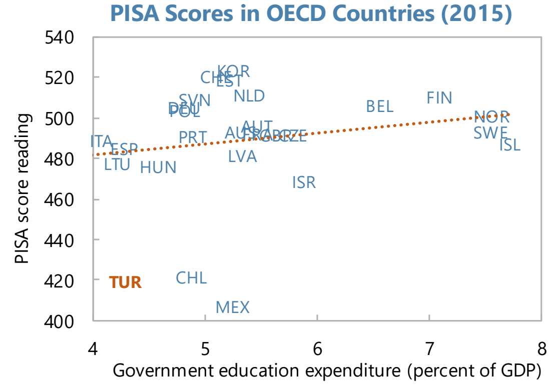
Sources: OECD; and IMF staff calculations.
Note: For each policy variable, the scatter plot presents Turkey's distance from the 75th percentile of OECD countries; and the estimated increase in the annualized incremental real GDP level increase if half of the policy gap is closed in the long run (20 years).

- *The business and regulatory environment* and product market efficiency could be enhanced by further simplifying business entry and exit and by addressing administrative and regulatory barriers to competition. Product market reforms would also contribute to resolving the corporate debt overhang. For example, delayed energy price adjustments have aggravated financial strain in some energy-generation companies. Energy prices should therefore follow an automatic pricing mechanism, which would improve efficiency and help contain contingent sovereign liabilities.

- *Labor market flexibility* could be improved by eliminating backward-looking public wage indexation and by aligning minimum wage increases with expected inflation and productivity. A review of the many employment incentives schemes could help streamline the system. Severance pay should be reformed as it is burdensome for formal sector employers and discourages labor mobility because of non-transferable built-up rights.

- The *quality of human capital* could be improved by upgrading education and on-the-job training. The ongoing curriculum review is a good opportunity to strengthen Turkey's education outcomes.

Government Education Expenditure vs. PISA Scores in OECD Countries (2015)



Sources: OECD; and World Development Indicators.

[9] As discussed in the Selected Issues Paper, given potential endogeneity issues and smaller gains found elsewhere in the literature (see for example, IMF WEO Chapter (2019)), these precise findings should be interpreted with caution.

- *Female labor force participation* has been gradually improving over the years, albeit from a low base, compared to G20 peers. Staff welcomes initiatives under consideration that envision the expansion of early childhood education and childcare, as well as the introduction of flexible working arrangements for women.

Reforms should be sequenced carefully to alleviate short-term trade-offs, while also factoring in budgetary implications. In particular, given short-term macroeconomic challenges, labor market reform strategies would need to be carefully calibrated.[10] Given a medium-term fiscal consolidation need, all else equal, priority should be given to reforms with little or no fiscal costs (e.g., minimizing direct government support to specific sectors).

43. Focused structural reforms would also increase the economy's resilience to shocks. Staff analysis shows, for example, that the responsiveness of manufacturing exports to the real exchange rate should increase with structural reforms, helping the reallocation of resources to the tradable sector following external shocks (Box 5).

44. Governance reforms would also help growth prospects. Improving regulatory predictability, simplifying administrative procedures, and reducing corruption vulnerabilities, including through fiscal transparency and governance reforms, would help improve the investment climate and economic efficiency. Minimizing regulatory forbearance and direct government support to selected sectors would also help. And, given complementarities, improvements in governance could also magnify payoffs to other structural reforms (October 2019 WEO Chapter 3).

Authorities' Views

45. The authorities acknowledged the importance of improving productivity. They highlighted a series of policy initiatives and targeted subsidies for strategic projects aimed at diversifying the economy into high value-added tradable sectors, which would also help further reduce external imbalances. They recognized the need to upgrade the quality of human capital, and are undertaking an overhaul of the curriculum, as well as an expansion of vocational training. Plans to extend universal education to pre-school grades will also help foster female labor force participation. The authorities have announced their intention to reform severance pay as labor market conditions permit, and potential solutions are being discussed with stakeholders. Ongoing judicial reform aims to strengthen the independence of the judiciary while fostering increased transparency and efficiency in legal procedures, including in the resolution of commercial disputes.

STAFF APPRAISAL

46. Turkey's stimulus-driven growth in recent years has contributed to large economic imbalances that left the economy susceptible to shocks. As growth became increasingly dependent on externally-funded credit and demand stimulus Turkey's economy began running above potential with a large current account deficit and high inflation. These imbalances left the

[10] See, for example, Bouis et al (2012), Dabla-Norris et al (2013), Banerji et al (2016), IMF WEO Chapter (2016), Duval and Furceri (2018), and IMF WEO Chapter (October 2019) for discussions on the dynamic impact of structural reforms.

economy susceptible to a change in market sentiment that triggered sizeable lira depreciation and associated recession in late-2018.

47. Since the currency shock and recession in 2018, growth has resumed, aided by significant policy stimulus, and the lira recovered. Buoyed by expansionary fiscal policy, rapid credit provision by state-owned banks, and more favorable external financing conditions, the economy is growing again. The lira also recovered as market pressures abated. Import compression and a strong tourism season have contributed to a remarkable current account adjustment.

48. But the current calm appears fragile. Underlying vulnerabilities are generally higher than at the peak of the global financial crisis. Reserves are low and external financing needs are high. Non-financial corporate and bank balance sheets have been stressed by lira depreciation, higher interest rates, and the recession. While public debt is low, the fiscal deficit has increased and uncertainty over the possible scale of contingent liabilities and potential debt rollover pressures limit available fiscal space.

49. Prospects for strong sustainable growth have weakened, with risks on the downside. Despite the recent turnaround, and without consistent execution of a comprehensive package of reforms, medium-term growth is likely to be subdued and volatile given balance sheet strains and weaker buffers. Risks include a deterioration in sentiment towards emerging markets, possible policy implementation risks, and adverse domestic or geopolitical developments.

50. The main policy challenge is to secure stronger and more resilient growth over the medium term, rather than focusing on boosting short-term growth. Although needed reforms may come with short-term output tradeoffs, the growth payoffs over the medium and longer term are likely to be large, and downside risks would also be more limited. Moreover, the many benefits of strengthened policies would include faster and more durable disinflation, stronger bank and corporate balance sheets, higher reserve buffers, a stronger external position, lower fiscal contingent liabilities and, ultimately, higher and more sustainable growth.

51. Monetary policy should focus on strengthening credibility and durably lowering inflation to help permanently lower interest rates. The CBRT easing cycle has been too aggressive given the importance of lowering still-high inflation expectations and mitigating macro-financial risks. Real policy rates are now well below levels that would underpin the lira, durably reduce inflation and inflation expectations, allow reserves to be rebuilt, and support de-dollarization. Clearer monetary and intervention policy are also needed to strengthen central bank credibility. Remaining measures aimed at containing excessive volatility in capital flows should be phased out as macroeconomic and financial conditions improve.

52. Fiscal policy—a longstanding strength for Turkey—should remain a key policy anchor. The recent fiscal stimulus has helped the economy recover, but the underlying deficit has increased significantly. A broadly neutral fiscal stance in 2020, combined with tight monetary and quasi-fiscal policies, would support the nascent recovery while containing financing needs and enhancing fiscal space. Over the medium term, a modest consolidation is needed to ensure that public debt remains low and its dynamics stable, supported by increased transparency and control of quasi-fiscal activity.

53. Policies to boost lending should be reined in and steps taken to clean up bank and corporate balance sheets to support financial stability and stronger, more resilient growth. Efforts to further expand lending, including through state-owned banks and the Credit Guarantee Fund, should be limited to allow needed deleveraging to take place and to help strengthen the financial soundness of state-owned banks. A third-party asset quality review and new stress tests are needed to better understand underlying bank health. This should be accompanied by efforts to further strengthen the regulatory, resolution and AML/CFT frameworks.

54. Additional reforms to improve the insolvency regime and out-of-court restructuring would help release resources and, over time, restart productive lending. Ongoing efforts, including a comprehensive review of existing insolvency legislation, could incentivize the use of out-of-court debt restructuring mechanisms by making the insolvency regime more creditor friendly. Tighter NPL classification and enforcement would help inform better pricing of NPLs, increase the attractiveness of out-of-court solutions, and encourage more durable restructurings.

55. Focused structural reforms would improve medium-term growth prospects and increase resilience to shocks. Steps to improve product market efficiency, labor market flexibility, the quality of human capital, and female labor force participation would facilitate a reallocation of resources to productive sectors and support higher, more resilient growth. Increasing regulatory predictability, simplifying administrative procedures, and reducing corruption vulnerabilities would improve the business environment and investment climate. Improvements in governance could also magnify structural reform payoffs.

56. It is recommended that the next Article IV consultation with Turkey be held on the standard 12-month cycle.

Box 1. State-Owned Bank Balance Sheet Expansion: Some Implications

State-owned bank credit growth has contributed to the recovery, but at the same time increased economic imbalances. Staff analysis indicates that this credit growth has been associated with the persistence of a positive credit gap, increasing reliance on FX deposits and on shorter-term funding against declining liquid assets.

State-owned banks are lending at a rapid pace. While the value of TL loans offered by private banks has hardly advanced over the last three years, that of state-owned banks has more than doubled (Box Figure 1). As a result, the share of state-owned banks in the total TL loan market has reached 44 percent, up from 32 percent in early 2016.

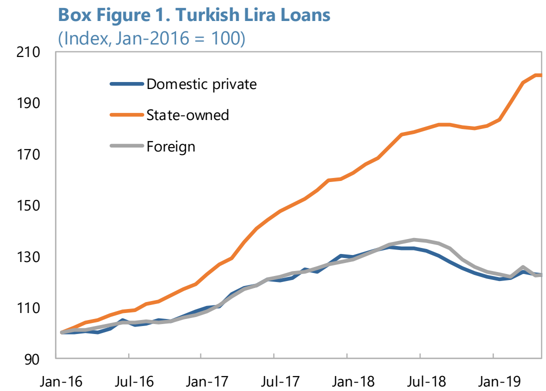
Such rapid credit growth has maintained a sizable wedge between the level of private sector debt and that justified by fundamentals. Staff analysis suggests that, owing to state-owned banks' credit expansion, Turkey's state-owned bank credit gap remains wide, at around 15 percent of GDP (Box Figure 2).

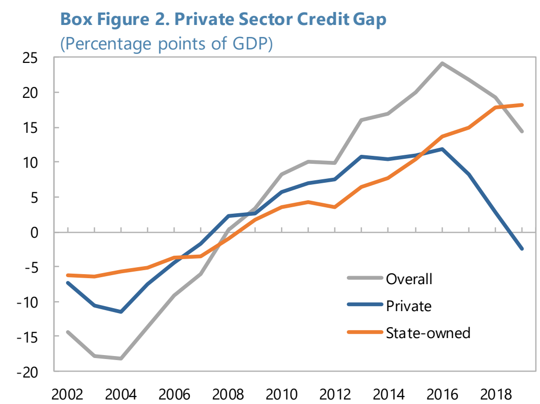
Against the backdrop of rapid credit growth, state-owned banks have increasingly covered their funding needs with FX deposits. The share of TL deposits in total liabilities has declined from 40 percent in January 2016 to 29 percent in August 2019, largely offset by a large rise in the share of FX deposits (Box Figure 3).

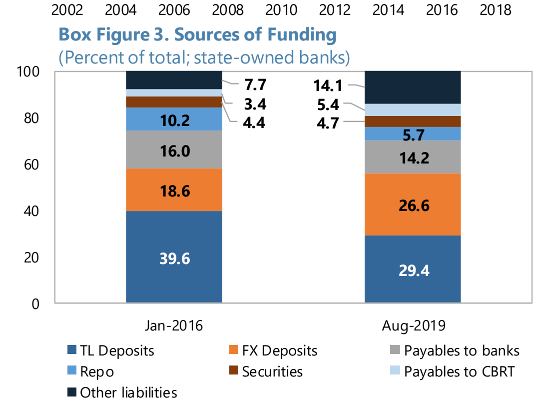
This has resulted in higher dollarization ... The TL loan to deposit (LTD) ratio for state-owned banks peaked at more than 156 percent in May 2019, 30 percentage points higher than in 2016, as LTDs for other banks fell. In turn, the large shift, combined with relatively low TL deposit rates, has driven state-owned banks' dollarization ratio close to 46 percent, up 16 percentage points from three years earlier (Box Figure 4).

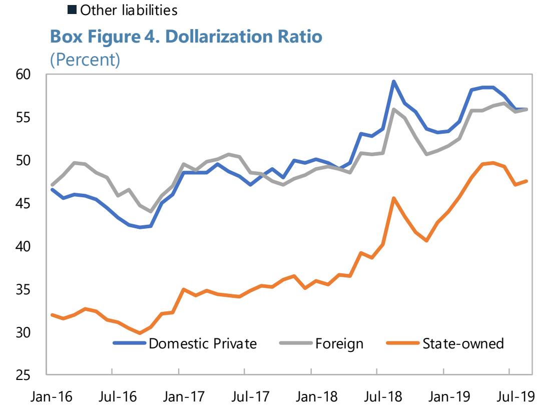
... and a large on-balance sheet open FX position. As state-owned banks need to swap a growing amount of liquidity, their traditionally muted on-balance sheet open FX position has climbed from TL 20 billion in November 2018 to close to TL 100 billion in April 2019.

A structural maturity mismatch has also built over time. At around 20 percent of total deposits, the share of demand deposits offered by Turkish banks remains







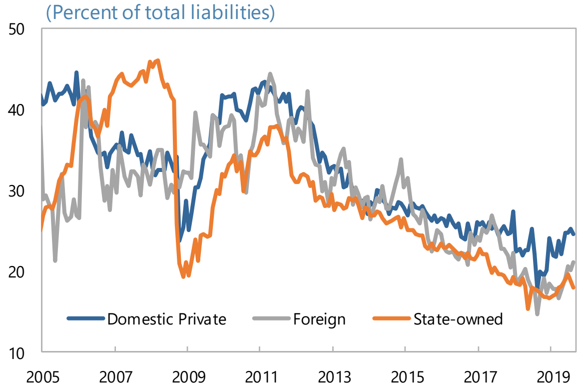


Sources: BRSA; and IMF staff calculations.

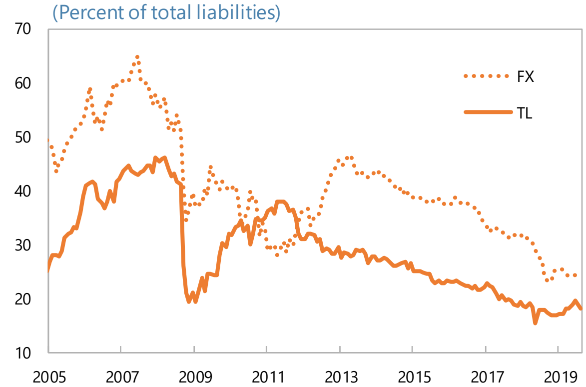
Box 1. State-Owned Bank Balance Sheet Expansion: Some Implications (Concluded)

contained. However, TL liquid assets have been on a steady declining trend since 2011, falling to a low of 15 percent of total liabilities in May 2018 and recovering only marginally since then. FX liquid asset coverage has seen an even steeper decline (Box Figures 5 and 6).

Box Figure 5. TL Liquid Assets
(Percent of total liabilities)



Box Figure 6. State-Owned Banks' Liquid Assets
(Percent of total liabilities)



Sources: BRSA; and IMF staff calculations.

Box 2. Benchmarking Medium-Term GDP Projections Against Banking Crisis Episodes

With medium-term projections especially uncertain in times of economic stress, staff uses experiences of many past banking crises to help inform medium-term projections for Turkey. While Turkey has not undergone a banking crisis, Turkey's output and credit developments in 2019 are similar to—if not worse than—developments recorded in the first year of typical banking crises. The analysis suggests a possible sharp slowdown in medium-term growth compared to pre-crisis trend should Turkey follow the typical post-crisis growth pattern.

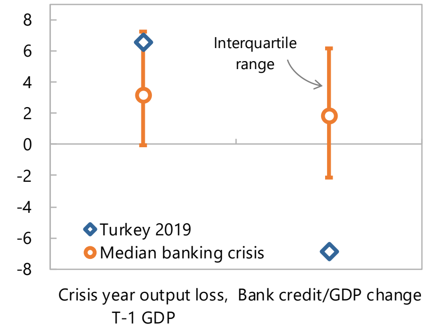
Macroeconomic forecasts in times of economic stress are especially unreliable. Past crisis experiences may provide a benchmark, however, for assessing possible medium-term repercussions of economic and financial shocks.

While Turkey has not experienced a systemic banking crisis, the economy is behaving similarly to such cases. Turkey's output and credit developments in 2019 are similar, or even worse than, developments recorded in the first year of typical banking crises (Box Figure 1), validating their use as a benchmark. (By contrast, Turkey's growth and credit developments do not mirror a typical currency crisis.) We therefore estimate output losses in banking crises to help inform Turkey's medium-term output path (see technical notes below).

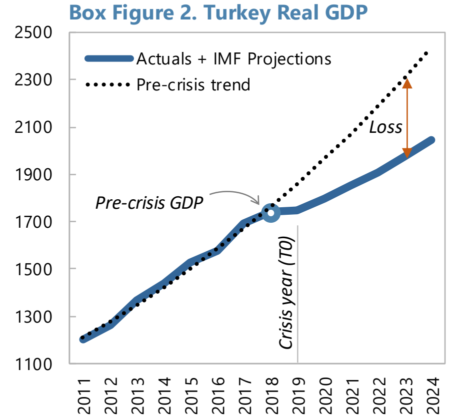
A banking crisis has both level and growth effects on output. First, staff confirms a common finding in the crisis literature that recovery following banking crises is typically L- shaped; output does not revert to pre-crisis trend. Staff finds that higher pre-crisis growth is associated with a larger drop in the post-crisis growth rate. These two features are reflected in medium-term projections (Box Figure 2). Also, rapid pre-crisis credit growth is damaging, while global post-crisis developments in trading partner growth and global interest rates also have an impact.

Applied to Turkey, findings suggest that 2023 output could be 17 to 20 percent below the (admittedly rapid) pre-crisis trend. The main explanatory factors behind Turkey's output "loss" are: (i) the scale of the shock in 2019 (an output loss, relative to trend, of around 8 percent of 2018 GDP), and (ii) the rapid pre-crisis trend growth rate of 5½ percent. Depending on whether global variables are included when generating short-term projections, the analysis suggests average output growth of between 2.0 and 2.9 percent for 2020–23 (Box Figure 3), although staff opts for higher medium-term growth rates under its baseline.

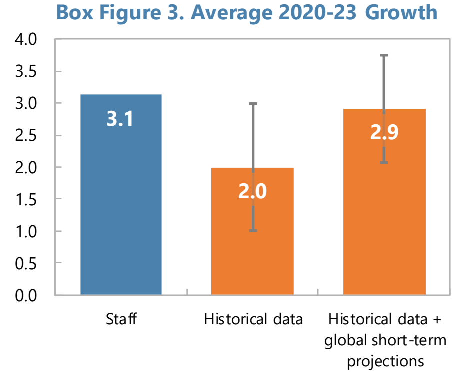
Box Figure 1. Turkey vs. Banking Crises



Box Figure 2. Turkey Real GDP



Box Figure 3. Average 2020-23 Growth



Sources: Turkstat; and IMF staff calculations.

Box 2. Benchmarking Medium-Term GDP Projections Against Banking Crisis Episodes (Concluded)

Technical notes

The analysis builds upon Abiad et al. (2009). The sample includes 76 banking crises in advanced and emerging economies from Laeven and Valencia (2018). The dependent variable is the output loss in the 4th year following the crisis (2023 for Turkey). Output loss is defined as the deviation from pre-crisis trend, expressed in percent of pre-crisis GDP (2018 for Turkey).

The box table presents two specifications: the first relies on historical variables, and the second incorporates projections for short-term global variables (partner growth and change in ST reference interest rate).

Multiple machine learning techniques provided robustness checks for OLS results and informed the list of regressors.

Box Table 1. Medium-Term Output Loss Estimation Results

	Historical data	Historical data + Global ST proj.	Turkey 2019 values
GDP loss in T0 (crisis year)	0.831***	1.026***	6.9
	(0.137)	(0.132)	
Pre-crisis trend growth	4.606***	4.410***	5.5
	(0.604)	(0.517)	
EM dummy	-2.499	-2.241	1
	(3.643)	(3.244)	
Log GDP/capita, PPP in T-1	3.262	2.294	10.1
	(2.182)	(1.671)	
Private credit/GDP, change between T-4 and T-1	0.154***	0.096**	0.36
	(0.047)	(0.042)	
US yield curve (T-1)	-2.598**		0.94
	(1.203)		
Trading partner GDP growth in T+1		-2.607***	1.72
		(0.757)	
Base currency real ST rate change T-1 to T0		2.163***	-0.34
		(0.454)	
Constant	-36.337	-27.705	
	(22.998)	(17.243)	
Observations	76	75	
R^2	0.667	0.739	

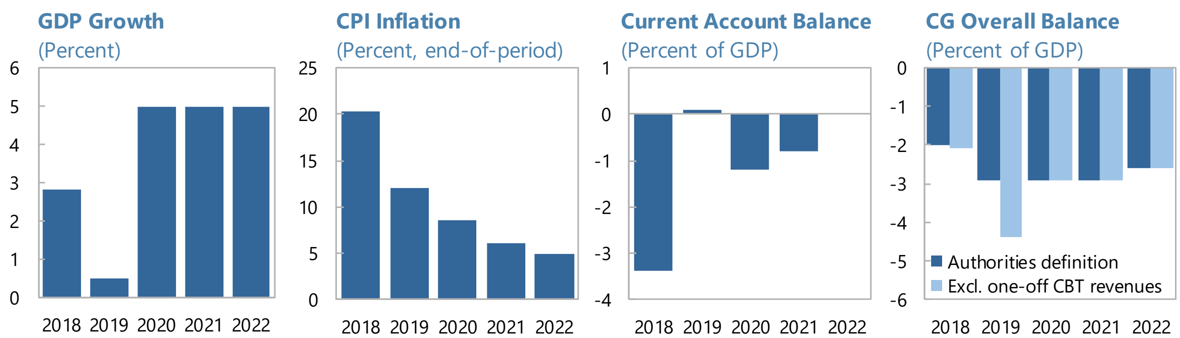
Source: IMF staff calculations.
Robust standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.1

Box 3. The Macroeconomic Scenario Under the New Economy Program 2020–22

The authorities released on September 30 the New Economy Program (NEP) for 2020–22, which forecasts strong near- and medium-term growth, low inflation, and a broadly balanced current account. The NEP assumes that deleveraging has largely been completed and that further rebalancing will be achieved through high productivity growth in the tradable sector, mostly on account of policy initiatives, including further credit expansion. According to the authorities, tradable sector growth would result in strong import substitution, reducing external imbalances, while the expansion of domestic food production and a shift towards renewable sources of energy should lower food and energy price inflation.

The NEP forecasts a considerable public sector consolidation over 2020–22. Specifically, the NEP envisages a modest consolidation of 0.3 percent of GDP in the central government headline balance, but nearly 2 percent of GDP in terms of the impact on the real-economy, i.e., once one-off revenues from the central bank are stripped out.[1] Central bank revenues are expected to decline significantly in 2020 while other revenues are forecast to increase, possibly reflecting base-broadening measures (including elimination of unspecified exemptions). The consolidation is therefore expected to come from both tax revenue increases (0.5 percent of GDP) and spending cuts (1.2 percent of GDP), including unspecified current expenditure-side measures.

Box Figure 1. Selected NEP Projections



Sources: CBRT; Turkstat; and IMF staff calculations.

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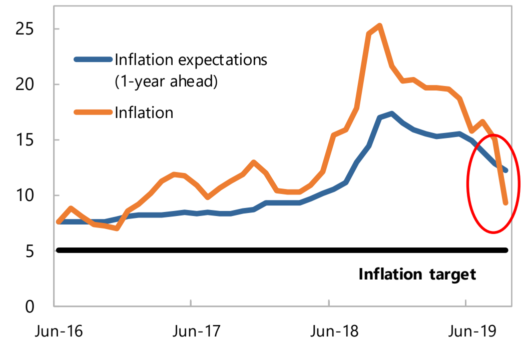
[1]One-off revenues from the CBRT in 2019 amounted to around 1½ percent of GDP, comprising TL40 bn in precautionary reserves transfers and around TL 20 bn in above-normal profit transfer.

Box 4. The Importance of Managing Inflation Expectations

Managing inflation expectations is critical for bringing inflation under control and lowering disinflation costs. Reining in expectations would allow for sustainably lower interest rates, a key priority of senior policymakers.

Despite the recent drop in inflation, inflation expectations remain high. In late-2018 as inflation rose above 25 percent, inflation expectations also increased to over 17 percent. Recently, inflation has fallen significantly, but inflation expectations remain high (Box Figure 1).

Box Figure 1. Inflation Expectations
(Percent)



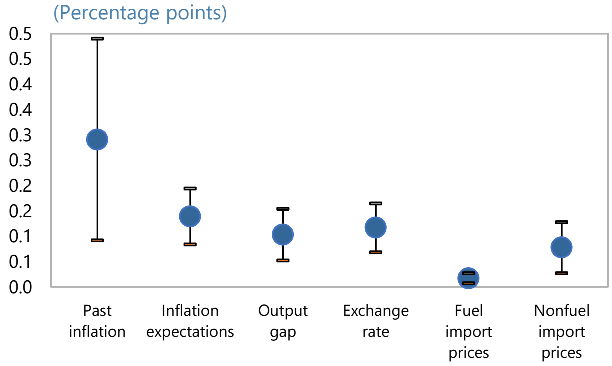
Sources: Bloomberg Financial L.P.; and Turkstat.

Empirical estimates underline the importance of inflation expectations in controlling inflation. A reduced-form Phillips curve is used to decompose inflation into contributions from its determinants:

$$\pi_t = \beta_1 \pi_{t-1} + \beta_2 \pi_t^e + \beta_3 y_t + \Sigma_{i=0}^{1} \beta_{i+4} \Delta e_{t-i} + \beta_6 p_t^f + \beta_7 p_{t-1}^{nf} + \varepsilon_t,$$

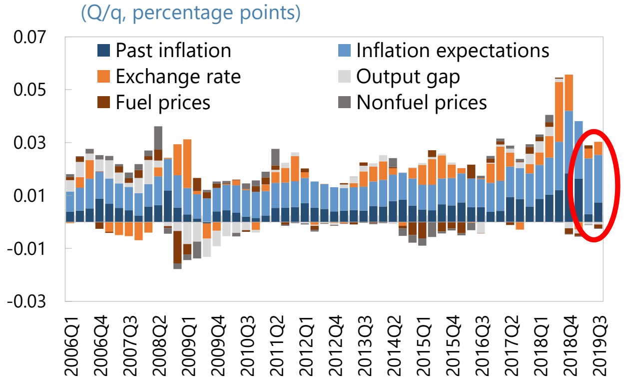
where π_t is seasonally-adjusted core (B-index) inflation; π_t^e represents one-year ahead inflation expectations; y_t is the output gap; e_t is the quarterly average exchange rate (TL/US$); p_t^f is the average petroleum spot price; and p_t^{nf} is the nonfuel import price deflator. The model is estimated on quarterly data for the inflation-targeting period, which started formally in 2006. Results suggest that inflation in Turkey has strong inertia, with the coefficient on past inflation around 0.3 (Box Figure 2 and Box Table 1). Inflation expectations also play an important role, with a coefficient of around 0.1, and the largest contribution to recent inflation comes from inflation expectations (Box Figure 3).

Box Figure 2. Coefficient Estimates
(Percentage points)



Source: IMF staff calculations.
Note: Results from model 1 of Table 1. The dots denote the estimated coefficients and the dashes the 90 percent confidence interval.

Box Figure 3. Contributions to Inflation
(Q/q, percentage points)

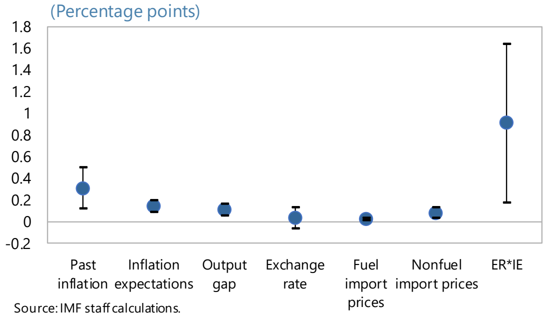


Source: IMF staff calculations.
Note: Results from model 1 of Table 1.

Inflation expectations may also indirectly affect inflation through exchange rate passthrough. An interaction term of inflation expectations with the exchange rate suggests that each percentage point increase in inflation expectations increases exchange rate passthrough by 0.9 percentage points (albeit with large uncertainty, Box Figure 4). There also appears to be evidence of higher passthrough during depreciation episodes (Box Figure 5). Furthermore, there appear to be non-linearities in the relationship between the output gap and inflation, with relatively small output gaps having no significant effect on inflation (Box Figure 6).

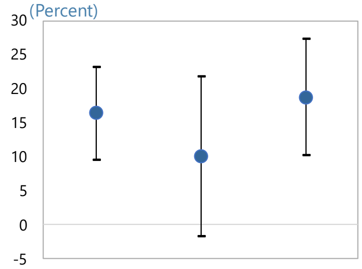
Box 4. The Importance of Managing Inflation Expectations (Continued)

Box Figure 4. Expectations and Passthrough
(Percentage points)



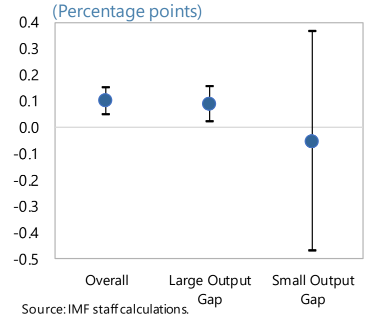
Source: IMF staff calculations.
Note: Results based on model 6 of Table 1.

Box Figure 5. Exchange Rate Passthrough
(Percent)



Source: IMF staff calculations.
Note: Long-term passthrough. Based on models 1 and 5.

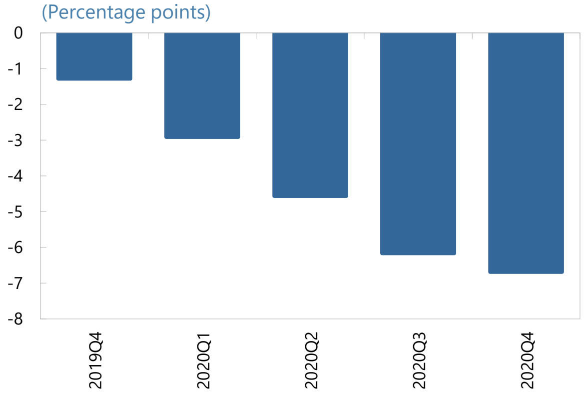
Box Figure 6. Output Gap
(Percentage points)



Source: IMF staff calculations.
Note: Small OG between +/-1 percent. See models 1 and 7.

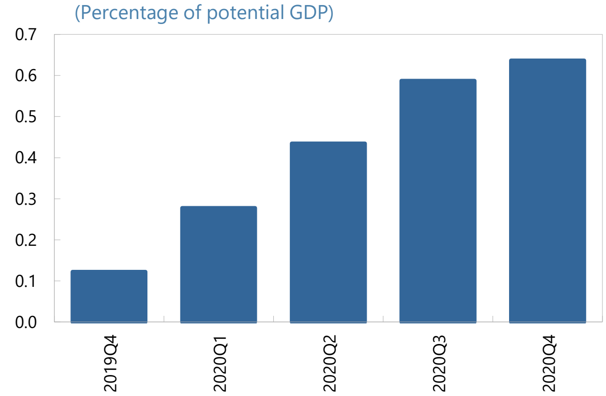
Lower inflation expectations would help lower inflation and reduce the output costs of disinflation (Box Figures 7 and 8). Model-based inflation simulations suggest that lower expectations would help to reduce inflation faster and would reduce the output loss needed to achieve the inflation target. Reducing inflation expectations is therefore an important way of sustainably lowering interest rates.

Box Figure 7. Inflation Benefit of Lower Expectations
(Percentage points)



Source: IMF staff calculations.
Note: Results based on model 6 of Table 1. Represents inflation effect of expectations reverting to the inflation target (5 percent).

Box Figure 8. Output Benefit of Lower Expectations
(Percentage of potential GDP)



Source: IMF staff calculations.
Note: Results based on model 6 of Table 1. Represents the reduced output costs of disinflation with expectations reverting to target.

Box 4. The Importance of Managing Inflation Expectations (Concluded)

Box Table 1. Regression Output

Dependent Variable: Core Inflation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
L.Core inflation	0.291**	0.597***	0.460***	0.754***	0.304**	0.305**	0.339**
	(0.119)	(0.068)	(0.108)	(0.052)	(0.118)	(0.115)	(0.132)
Inflation expectations 1-year ahead	0.139***				0.122***	0.134***	0.134***
	(0.033)				(0.036)	(0.032)	(0.039)
L.Economic Policy Uncertainty Index		0.013***					
		(0.004)					
Standard deviation of inflation expectations			0.749***				
			(0.244)				
D.Inflation expectations 1-year ahead				0.073			
				(0.120)			
Output Gap	0.103***	0.060*	0.093***	0.051	0.102***	0.105***	
	(0.030)	(0.030)	(0.033)	(0.033)	(0.030)	(0.029)	
Fuel import inflation	0.017***	0.023***	0.020***	0.025***	0.018***	0.014**	0.018***
	(0.006)	(0.006)	(0.006)	(0.006)	(0.006)	(0.006)	(0.006)
L.Nonfuel import inflation	0.077**	0.097***	0.070**	0.081**	0.076**	0.074**	0.091***
	(0.030)	(0.032)	(0.032)	(0.035)	(0.030)	(0.029)	(0.031)
Exchange rate (avg., LTL/US$)	0.059***	0.068***	0.062***	0.081***		-0.028	0.061***
	(0.014)	(0.015)	(0.016)	(0.016)		(0.044)	(0.016)
L.Exchange rate (avg., LTL/US$)	0.058***	0.052***	0.054***	0.047***		0.059***	0.050***
	(0.014)	(0.015)	(0.015)	(0.017)		(0.014)	(0.015)
Appreciation (TL/US$)					0.070		
					(0.049)		
Depreciation (TL/US$)					0.058***		
					(0.018)		
L.Depreciation (TL/US$)					0.072***		
					(0.017)		
IE*ER						0.906**	
						(0.439)	
Large Output Gap							0.091**
							(0.040)
Small Output Gap							-0.051
							(0.249)
Adj. R-sq	0.93	0.92	0.92	0.91	0.93	0.94	0.92
N	55	55	55	55	55	55	55

Source: IMF staff calculations.

Standard errors in parentheses, * p<0.10, ** p<0.05, *** p<0.01

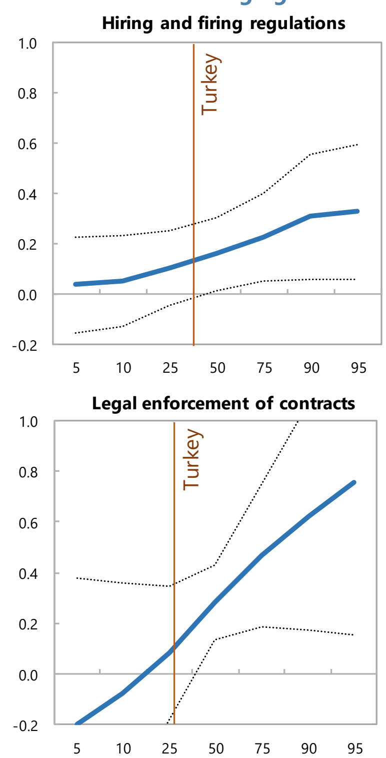
Box 5. How to Maximize Economic Gains After a Large Currency Depreciation

To take full advantage of the expenditure switching effect of a large depreciation, countries need to meet several conditions: (i) the economy needs to be sufficiently flexible to facilitate timely resource reallocation, (ii) the financial sector needs to be strong enough to finance the expansion of the tradable sector, and (iii) policies should provide a clear outlook for the economy, fostering needed new investments.

Large depreciations affect output through negative balance sheet and positive expenditure-switching effects. Expenditure switching is weak at the outset, and external adjustment typically comes initially from import compression (IMF Crisis Program Review 2015, Tressel et al., 2014). However, currency crises can still lead to a stronger tradable sector down the road. Indeed, the expenditure switching effect gains strength over the years following large depreciations (Culiuc, forthcoming). However, research points to several challenges that certain countries, including Turkey, may encounter with such expenditure switching.

Structural rigidities can slow the reallocation of resources to the tradable sector. Culiuc and Kyobe (2017) find that elasticity of exports with respect to the real effective exchange rate increases with improvements in certain structural indicators. Box Figure 1 shows how measured elasticities change across the distribution of two structural indicators for around 100 advanced and emerging market countries (the horizontal axis plots percentiles of countries for each indicator). For instance, moving from the 25th to the 75th percentile of the distribution in terms of hiring and firing regulations is associated with a doubling in the export response to a given real exchange rate depreciation. Improvements in the legal enforcement of contracts are associated with even larger effects. Turkey is in the second quintile on both indicators. With resource reallocation hindered by rigidities, depreciations tend to benefit incumbent exporters, while the Schumpeterian growth (creative destruction) channel (à la Melitz, 2003) remains muted. This suggests large possible export gains from implementing structural reforms.

Box Figure 1. Elasticity of Manufacturing Export w.r.t Real Effective Exchange Rate for Advanced and Emerging Markets



Source: IMF staff calculations.

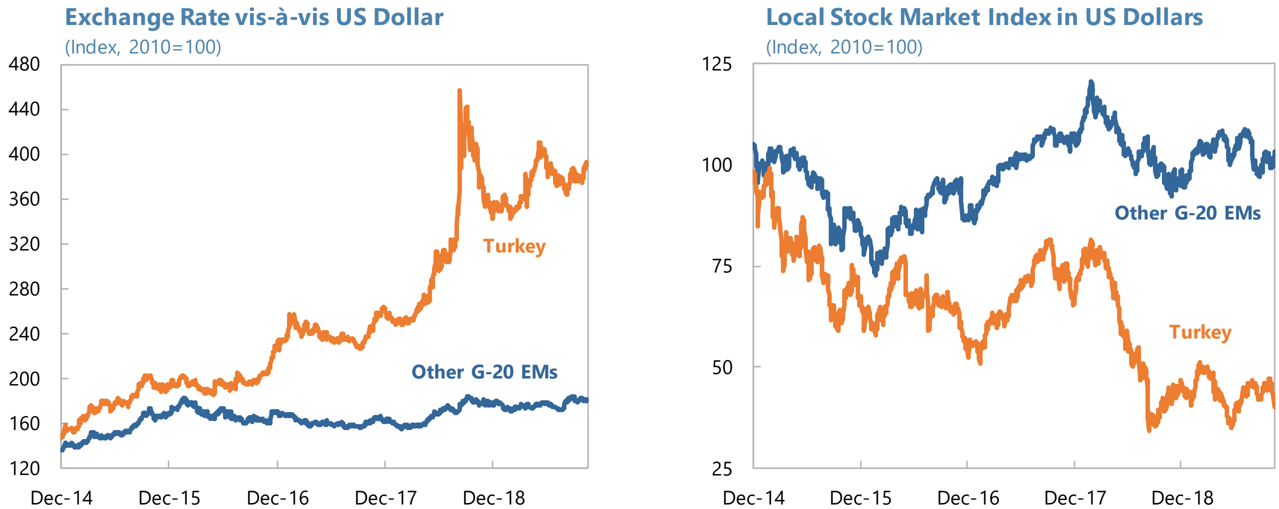
Financial stress blunts the competitiveness effect. Depreciation typically hits banks' balance sheets, limiting credit to exporters, especially entrants, that are willing to capitalize on improved competitiveness. Iacovone and Zavacka (2009) find a significant negative effect of banking crises on export growth, as sectors reliant on external financing are hit harder by credit contraction.

Uncertainty can also delay the export response. Baldwin and Krugman (1989) invoke the sunk cost of exporting to explain the sluggish reaction of exports to large and volatile real exchange rate movements. Uncertainty, including that related to policy, about the exchange rate tends to delay decisions to incur fixed costs associated with exporting. This, again, would be of particular importance to potential new entrants, who have yet to incur such costs.

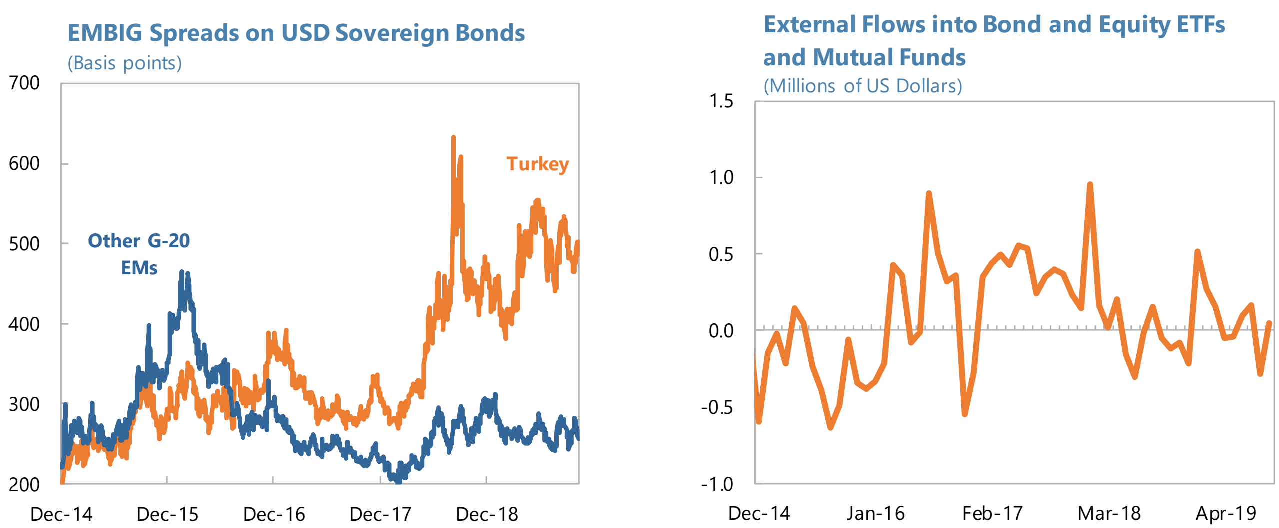
Structural reforms, a cleanup of the financial sector, and improved policy credibility could help strengthen the positive expenditure-switching effect. Such policy measures would strengthen the export response to the large real depreciation Turkey has experienced. This, in turn, would support a sustainable external position with less compression of domestic absorption and GDP.

Figure 1. Turkey: Financial Markets

Turkish financial markets have underperformed other large emerging markets over the last few years, although conditions have stabilized in recent months.



The risk premium relative to peers increased sharply in 2018 and remains high. External portfolio flows to Turkey have been volatile and underperformed developments in the broader emerging markets asset class.



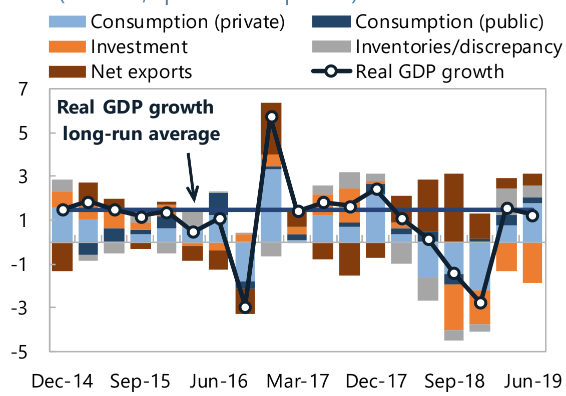
Sources: Bloomberg Financial Market L.P.; Haver Analytics; and IMF staff calculations.
Notes: Average of data for other G-20 emerging markets covers Brazil, Mexico, India, Indonesia, and South Africa.

Figure 2. Turkey: Real Sector Developments

After the late-2018 recession, growth rebounded on the back of domestic demand and import compression.

Contributions to Real GDP Growth

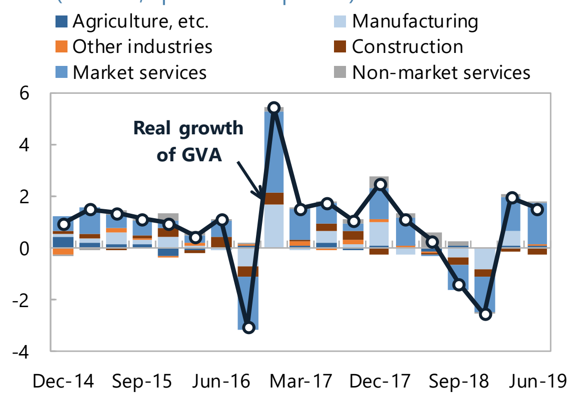
(Percent, quarter-on-quarter)



On the supply side, the main growth drivers were services, followed by manufacturing; construction has been a drag on growth since mid-2018.

Contributions to Real GVA Growth

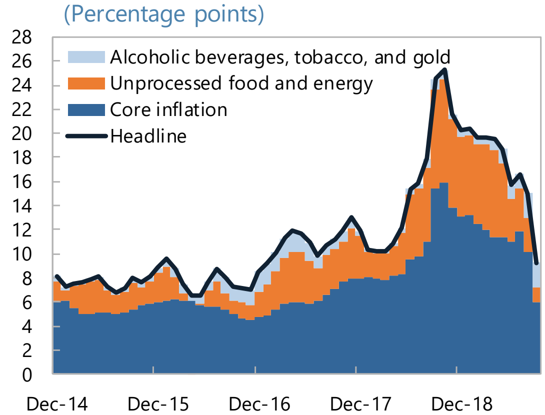
(Percent, quarter-on-quarter)



After the late-2018 surge, inflation came down sharply due, in part, to base effects, especially in late 2019.

Contributions to Inflation

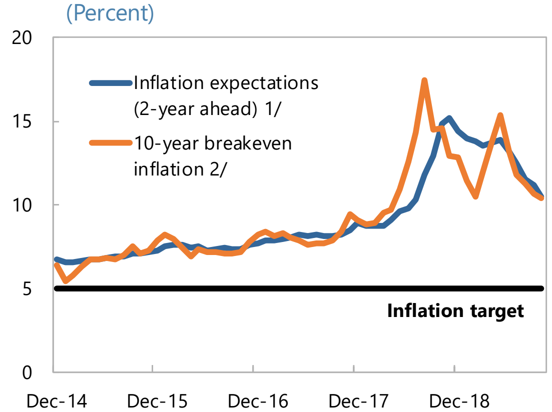
(Percentage points)



Inflation expectations are well above the central bank target.

Inflation Expectations

(Percent)

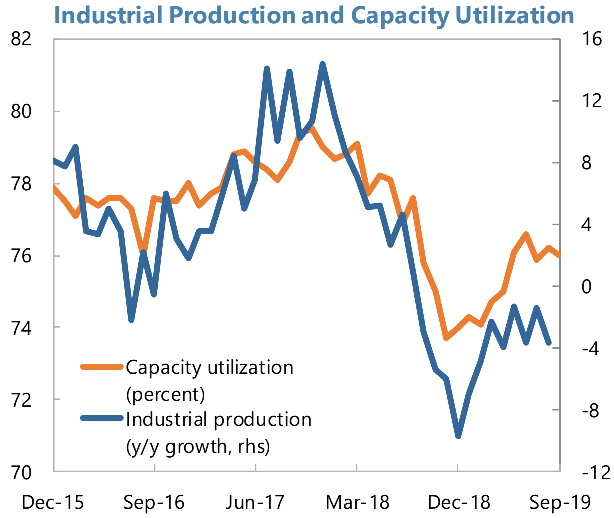


Sources: Bloomberg Financial Markets L.P.; CBRT; European Commission; TurkStat; and IMF staff calculations.

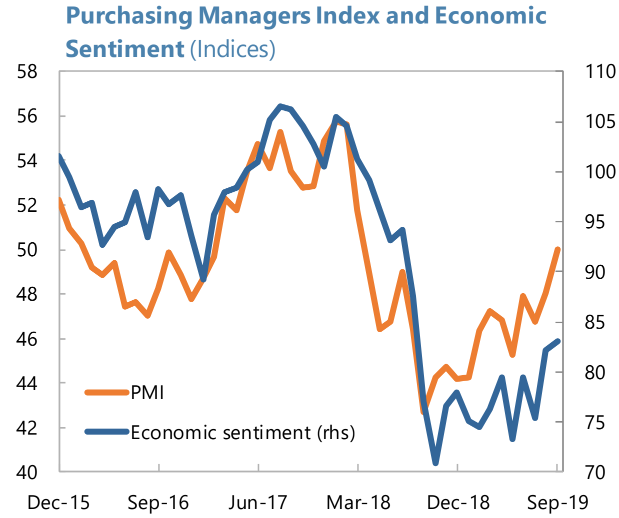
Notes: 1/ Average of 12-month ahead and 24-month ahead, end-period inflation expectations; 2/ Difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond.

Figure 3. Turkey: Coincident and Leading Indicators

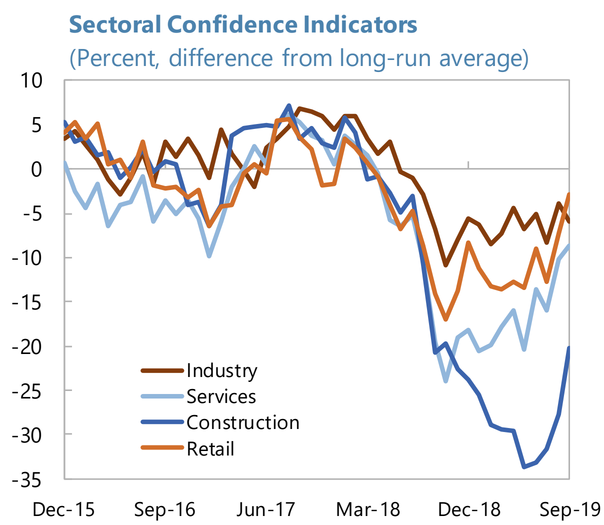
Industrial activity appears to have bottomed out recently …



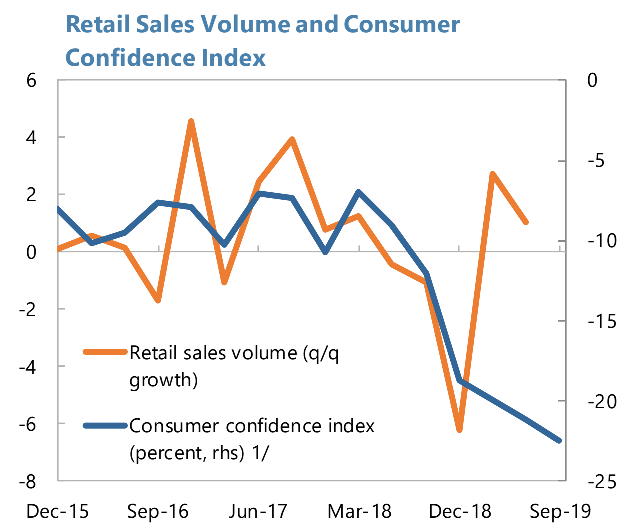
… but forward-looking indicators are still relatively weak, despite improvements.



Survey-based confidence indicators have improved, but remain negative, especially for construction.



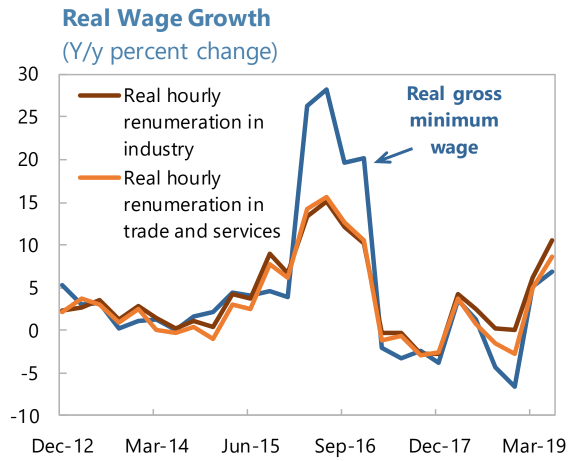
Retail sales have rebounded strongly, although consumer confidence is still falling.



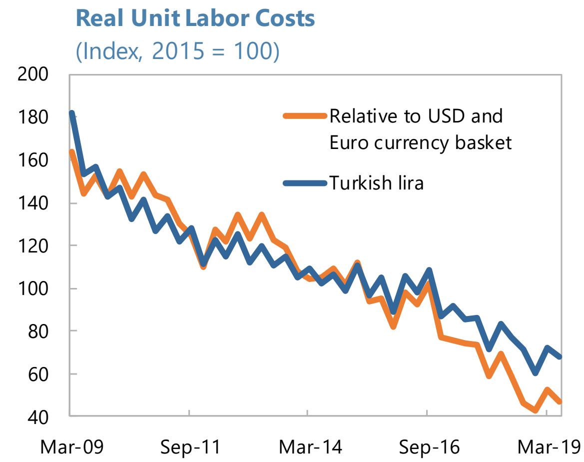
Sources: TurkStat, Haver Analytics, and IMF staff calculations.
Notes: 1/ Balance of opinion.

Figure 4. Turkey: Labor Market Developments

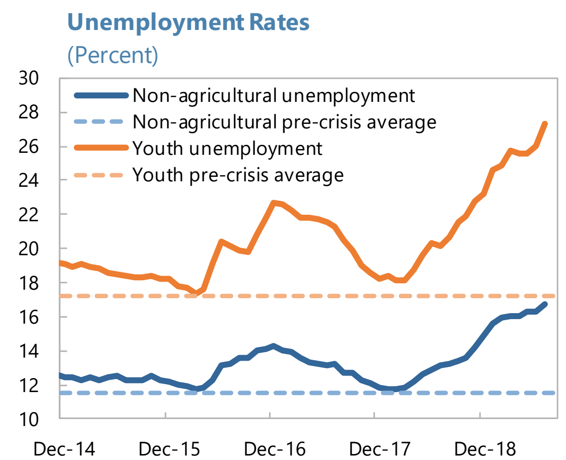
Real wages rebounded in Q1.



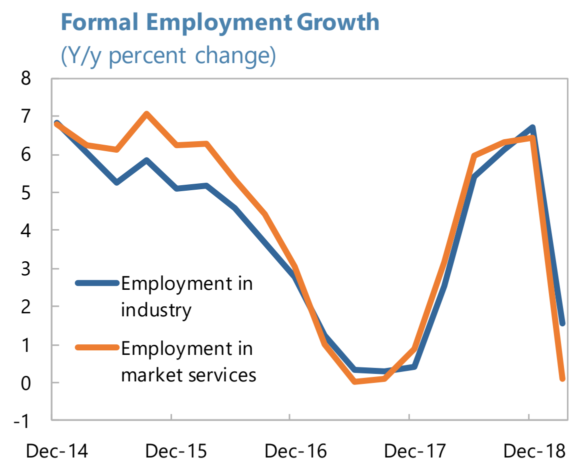
Despite the wage increase, unit labor costs points to improving competitiveness.



The unemployment rate has increased sharply ...



... and formal employment growth has declined in recent months.

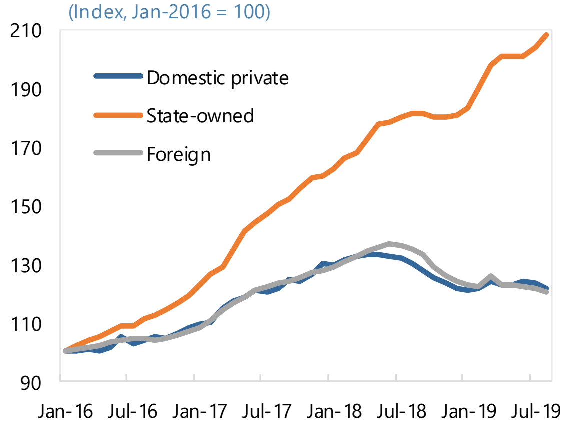


Sources: Turkstat; and IMF staff calculations.

Figure 5. Turkey: Financial Sector

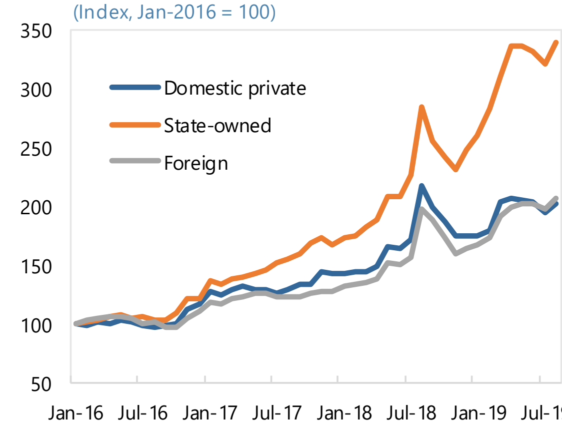
State-owned banks have lent at a rapid pace relative to private banks ...

Turkish Lira Loans
(Index, Jan-2016 = 100)



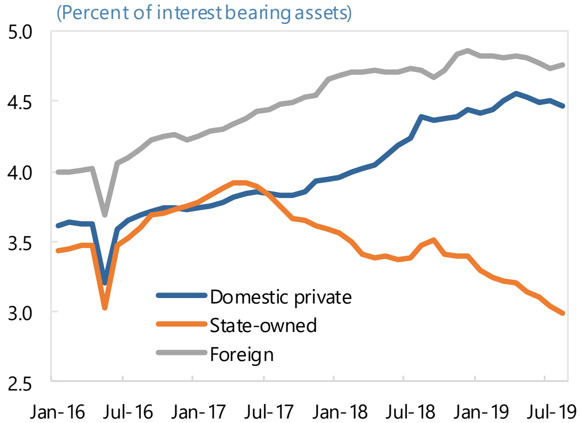
... and large resulting funding needs have increasingly been covered with FX deposits.

FX Deposits
(Index, Jan-2016 = 100)



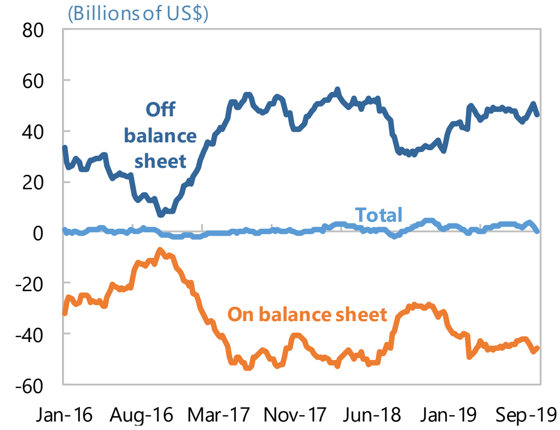
Net interest margins have fallen and have diverged from private banks.

Net Interest Margins
(Percent of interest bearing assets)



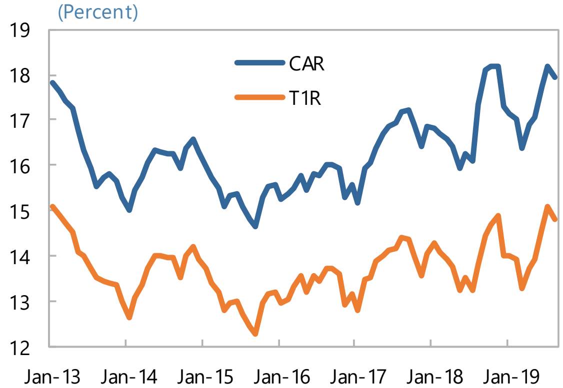
FX funding across the banking sector has also led to large on-balance sheet open FX positions.

Net FX Position
(Billions of US$)



Banks continue reporting adequate capitalization ...

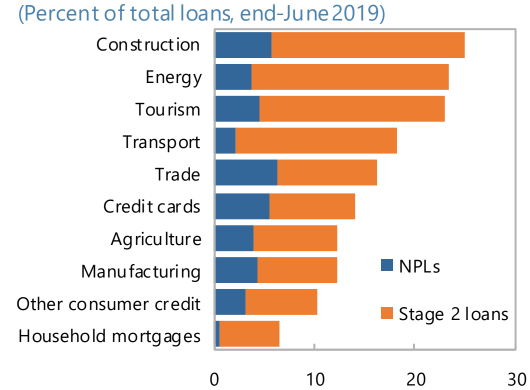
Capital Adequacy Ratios
(Percent)



Notes: Monthly EOP NSA. CAR= Regulatory Capital/RWA. T1R= T1 Capital/ RWA.

... and moderate NPL ratios, but Stage 2 loans are much higher, especially in the construction sector.

NPLs and Stage 2 Loans by Sector
(Percent of total loans, end-June 2019)



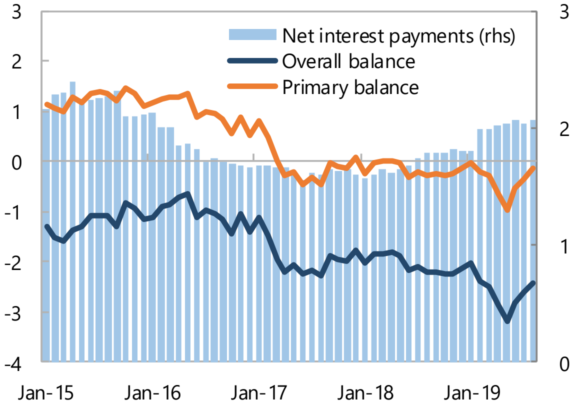
Sources: BRSA; and IMF staff calculations.

Sources: BRSA; CBRT; and IMF staff calculations.

Figure 6. Turkey: Fiscal Stance

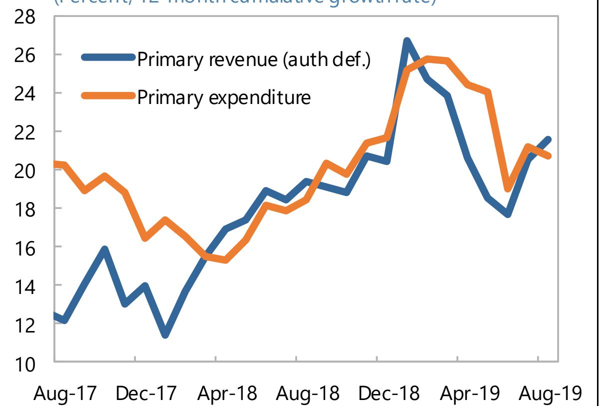
Fiscal balances have deteriorated with a further increase in the deficit this year …

Central Government: Fiscal Balance
(Percent of GDP, 12-month cumulative, authorities' def.)



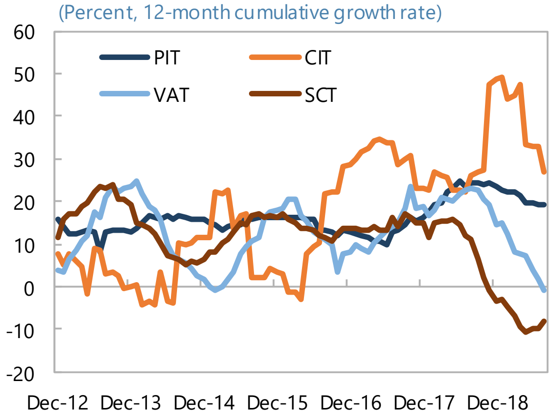
… reflecting a sharp fall in revenue growth combined with elevated expenditures in early 2019.

Central Government: Primary Revenue and Expenditure
(Percent, 12-month cumulative growth rate)



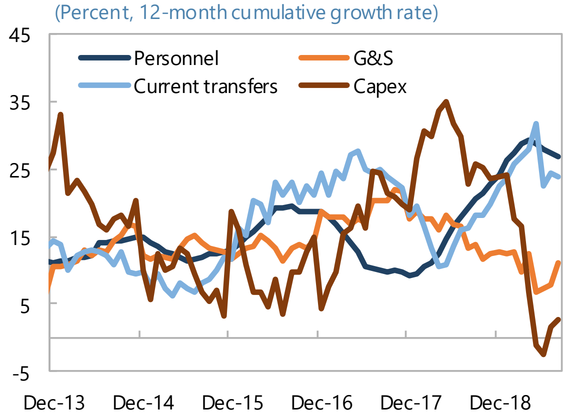
Slow growth in revenues was largely driven by weak VAT collection and temporary cuts to excise (SCT) taxes …

Central Government: Tax Revenue Components
(Percent, 12-month cumulative growth rate)



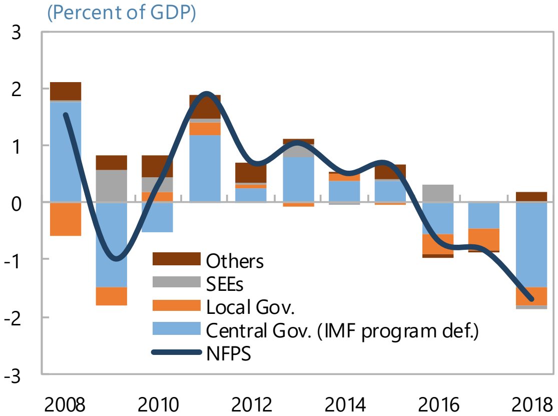
… while wage and transfer spending kept expenditure growth elevated.

Central Government: Expenditure Components
(Percent, 12-month cumulative growth rate)



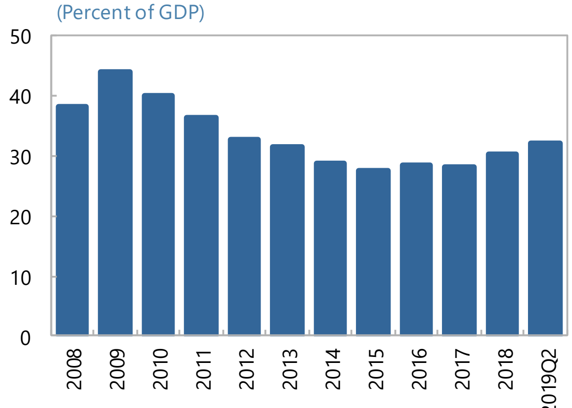
Fiscal balances outside of central government have also deteriorated …

Non-Financial Public Sector Primary Balance
(Percent of GDP)



… contributing to a modest increase in public debt.

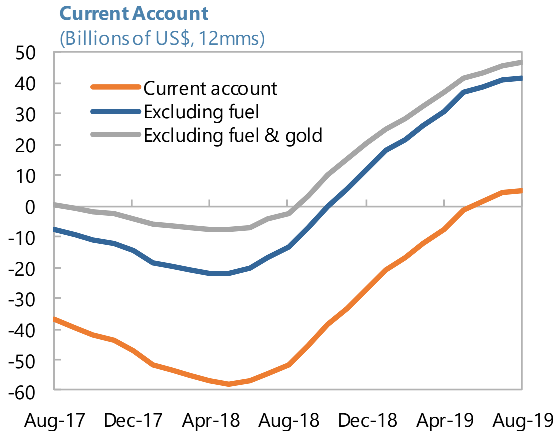
General Government Gross Debt, EU Definition
(Percent of GDP)



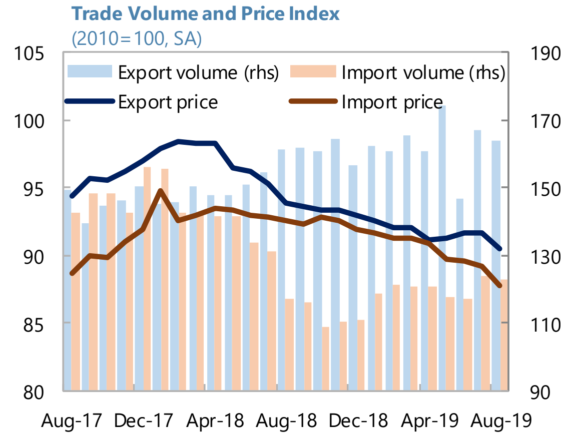
Sources: Ministry of Treasury and Finance; and IMF staff calculations.

Figure 7. Turkey: External Sector

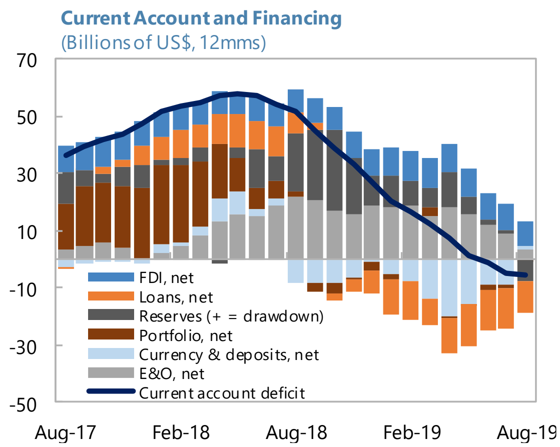
The overall current account balance has continued to improve, although the pace of improvement has slowed.



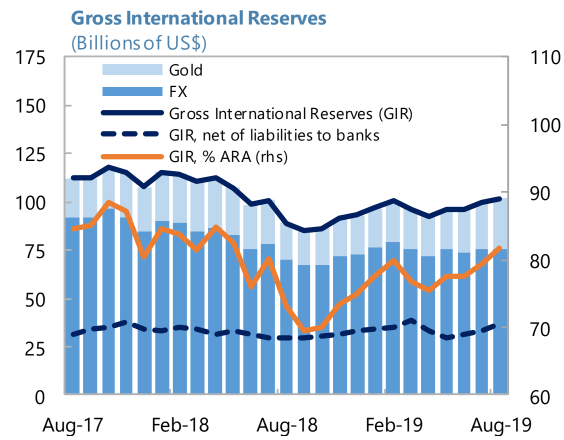
The sharp adjustment of the trade balance was mainly achieved by import compression.



Cumulatively, reserve drawdown and errors and omissions have funded much of the current account since late-2018.



Gross international reserves remain below levels recommended by the Fund's Assessment of Reserve Adequacy (ARA) measure.



Sources: CBRT; and IMF staff calculations.

Table 1. Turkey: Selected Economic Indicators, 2017–24

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
Real sector				(Percent)				
Real GDP growth rate	7.5	2.8	0.2	3.0	3.0	3.0	3.5	3.5
Final domestic demand	6.6	0.7	-3.9	4.7	4.0	3.6	3.7	3.6
Private consumption	6.2	0.0	-0.2	4.5	3.4	3.3	3.3	3.2
Public consumption	5.0	6.6	5.0	0.4	1.7	2.1	3.1	3.1
Investment	8.2	-0.6	-16.0	7.9	6.4	5.3	4.9	4.7
Exports	12.0	7.8	4.8	3.8	4.3	5.0	5.8	6.1
Imports	10.3	-7.8	-9.4	9.8	7.4	6.9	6.4	6.2
Contributions to real GDP growth 1/								
Private consumption	3.7	0.0	-0.1	2.6	2.0	1.9	1.9	1.9
Public consumption	0.7	1.0	0.7	0.1	0.3	0.3	0.5	0.5
Investment (incl. inventories)	2.9	-2.4	-4.7	2.2	1.6	1.3	1.2	1.2
Net exports	0.1	4.2	4.3	-1.8	-0.9	-0.5	-0.2	-0.1
GDP deflator growth rate	11.0	16.4	14.4	11.8	11.6	10.9	10.8	11.0
Nominal GDP growth rate	19.2	19.7	14.7	15.1	15.0	14.3	14.7	14.9
Inflation (period-average)	11.1	16.3	15.7	12.6	12.4	11.4	11.0	11.0
Inflation (end-year)	11.9	20.3	13.5	12.0	12.0	11.0	11.0	11.0
Unemployment rate	10.9	11.0	13.8	13.7	12.9	12.3	11.8	11.8
Output gap (percent of potential GDP) 1/	2.2	1.5	-1.1	-0.8	-0.5	-0.5	-0.2	-0.1
				(Percent of GDP)				
Fiscal sector								
Nonfinancial public sector								
Primary balance	-0.8	-2.3	-3.4	-2.4	-2.3	-2.3	-2.2	-2.1
Overall balance	-2.2	-3.8	-5.2	-4.9	-5.3	-5.3	-5.3	-5.2
General government structural primary balance 2/	-1.6	-2.5	-2.9	-1.9	-1.8	-1.7	-1.8	-1.8
General government gross debt (EU definition)	28.2	30.1	32.2	33.1	34.1	35.4	36.6	37.3
External sector								
Current account balance	-5.6	-3.5	-0.1	-0.6	-1.3	-1.7	-1.8	-1.8
o/w Nonfuel current account balance	-1.7	1.5	4.4	3.8	2.7	2.1	1.9	1.8
Gross international reserves (billions of US dollars)	107.7	93.0	101.7	105.6	108.3	112.7	115.9	120.4
Ratio to ARA Metric for emerging markets (percent)	80.3	75.6	...	...	...	...	...	...
Gross financing requirement	25.0	26.8	23.5	23.5	22.3	21.5	21.0	20.2
Gross external debt 3/	53.4	57.6	61.3	55.7	50.7	47.7	46.0	44.2
Net external debt	35.6	38.6	39.6	35.4	32.1	30.3	29.4	28.4
Net international investment position	-54.4	-48.1	-45.6	-42.3	-39.3	-38.0	-37.7	-37.4
Short-term external debt (by remaining maturity)	21.1	22.6	25.1	23.4	21.4	20.2	19.4	18.6
Terms of trade (year-on-year percent change)	-7.0	-8.3	-4.4	4.4	0.9	0.2	0.1	0.0
REER (CPI-based, 2003=100)	90.2	77.2	...	...	...	...	...	...
Monetary conditions				(Percent)				
Real average cost of CBRT funding to banks	0.4	1.4	...	...	...	...	...	...
Nominal growth of M2 broad money	16.4	18.4	...	...	...	...	...	...
Memorandum items								
GDP (billions of U.S. dollars) 3/	853	771	...	...	...	...	...	...
GDP (billions of Turkish lira)	3,111	3,724	4,273	4,919	5,656	6,466	7,415	8,517
Real effective exchange rate (year-on-year percent change)	-10.3	-14.4	...	...	...	...	...	...

Sources: Turkish authorities; and IMF staff estimates and projections.

1/ Staff estimates.

2/ In percent of potential output.

3/ The external debt ratio is calculated by dividing external debt in US$ by staff-estimated GDP in US$. GDP in US$ is calculated as GDP in TL divided by the annual average exchange rate.

Table 2. Turkey: Summary of Balance of Payments, 2017–24

(Billions of US$, unless otherwise noted)

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
Current account balance	-47.3	-27.0	-0.5	-4.8	-11.4	-16.4	-18.7	-20.1
Balance on goods and services	-39.0	-16.1	9.6	4.0	-0.8	-5.2	-6.8	-7.3
Goods, net	-59.0	-41.9	-21.6	-28.7	-34.8	-39.9	-43.4	-45.7
Exports of goods	166.2	174.6	181.7	185.5	192.5	202.1	214.7	230.0
Imports of goods	225.1	216.5	203.3	214.2	227.3	242.0	258.1	275.7
of which Fuel imports	37.2	43.0	38.7	40.2	40.5	41.4	43.1	45.2
Services, net	19.9	25.8	31.2	32.7	34.1	34.7	36.5	38.4
Credit	43.7	48.6	55.0	58.6	62.6	67.3	72.5	78.7
Debit	23.7	22.8	23.9	25.9	28.6	32.6	36.0	40.3
Primary income, net	-11.0	-11.8	-11.3	-9.9	-11.8	-12.4	-13.0	-14.0
of which interest expenditure	-6.3	-7.7	-7.5	-7.2	-8.8	-8.8	-8.9	-9.0
Secondary income net	2.7	0.9	1.2	1.2	1.2	1.2	1.2	1.2
Capital account	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	0.6	19.1	1.8	0.0	0.0	0.0	0.0	0.0
Financial account balance	-46.7	-7.9	1.3	-4.8	-11.4	-16.4	-18.7	-20.1
Direct investment, net	-8.8	-9.4	-5.1	-7.0	-6.8	-7.5	-7.9	-8.3
Portfolio investment, net	-24.5	3.1	-1.2	-4.9	-4.4	-6.9	-6.8	-9.4
of which government eurobonds, net	-5.8	-3.9	-6.3	-3.9	-2.7	-4.4	-3.2	-4.6
Other investment, net	-5.2	8.8	1.5	3.3	-3.0	-6.4	-7.2	-7.0
of which short-term borrowings	-3.9	5.9	1.4	0.9	0.1	-0.6	-0.2	-0.2
Reserve assets	-8.2	-10.4	6.2	3.9	2.7	4.4	3.2	4.6
				(Percent of GDP)				
Current account balance, *of which*	-5.6	-3.5	-0.1	-0.6	-1.3	-1.7	-1.8	-1.8
Nonfuel current account balance	-1.7	1.5	4.4	3.8	2.7	2.1	1.9	1.8
Goods and services balance	-4.6	-2.1	1.3	0.5	-0.1	-0.5	-0.7	-0.7
				(Percent year-on-year)				
Export value growth	11.9	6.4	5.9	3.3	4.5	5.6	6.6	7.5
Import value growth	16.7	-3.8	-4.2	4.7	6.6	7.3	7.1	7.5
Export of goods, volume growth	8.8	4.7	3.7	3.2	3.8	4.8	5.9	6.2
Import of goods, volume growth	9.4	-9.4	-10.5	10.6	7.9	7.3	6.7	6.4
Oil price (US$ per barrel)	52.8	68.3	61.8	57.9	55.3	54.6	54.7	55.3
Change in terms of trade	-7.0	-8.3	-4.4	4.4	0.9	0.2	0.1	0.0
Gross international reserves (billions of US dollars)	107.7	93.0	101.7	105.6	108.3	112.7	115.9	120.4
Ratio to ARA Metric for emerging markets (percent)	80.3	75.6	…	…	…	…	…	…
Net international reserves	31.0	30.2	34.2	38.1	40.8	45.2	48.4	53.0
Net international reserves (exl. govt. FX deposits)	29.4	27.1	…	…	…	…	…	…
Ratio of external debt service to exports (percent)	82.0	83.9	76.8	79.3	77.9	75.3	71.8	68.2

Sources: Turkish authorities; and IMF staff estimates and projections.

Table 3. Turkey: External Financing Requirements, 2017–24
(Billions of US$, unless otherwise noted)

	2017	2018	2019	2020	2021	2022	2023	2024
					Proj.			
Gross external financing requirements	213.1	206.7	174.8	191.2	201.5	210.4	217.6	221.9
Current account deficit	47.3	27.0	0.5	4.8	11.4	16.4	18.7	20.1
Government eurobonds (amortization)	3.8	3.8	4.4	6.1	7.3	5.6	6.8	5.4
Medium- and long-term debt amortization	60.3	56.2	53.1	43.2	43.9	43.3	43.4	43.8
Government 1/	3.7	2.4	2.4	2.7	2.5	2.3	2.0	1.9
Banks	36.7	36.9	31.7	24.6	25.8	25.4	25.4	25.4
Other sectors	19.9	16.8	19.0	15.9	15.6	15.6	16.0	16.5
Short-term debt amortization	101.6	119.7	116.8	137.1	138.8	145.1	148.6	152.6
Government 1/	0.4	1.8	5.9	6.8	6.8	6.8	6.8	6.8
Banks	60.7	67.2	57.1	64.9	68.9	74.5	76.4	78.0
Other sectors	40.2	50.7	53.7	65.4	63.1	63.8	65.4	67.7
Available financing	213.1	206.7	174.8	191.2	201.5	210.4	217.6	221.9
Sale of assets (net) 2/	-7.7	-12.9	-13.9	2.4	-0.2	2.3	0.8	1.7
Foreign direct investment (net)	8.8	9.4	5.1	7.0	6.8	7.5	7.9	8.3
Portfolio flows	27.9	3.8	9.8	11.4	12.1	12.9	14.1	15.3
Government eurobonds (drawings)	9.7	7.7	11.2	10.0	10.0	10.0	10.0	10.0
Domestically-issued government bonds (net)	7.3	-0.9	-2.1	0.0	0.0	0.0	0.0	0.0
Banks' equity and bonds (net)	7.4	-1.8	1.1	1.0	1.5	2.1	3.1	4.1
Other sectors' equity and bonds (net)	3.6	-1.1	-0.5	0.4	0.6	0.8	1.0	1.2
Medium and long-term debt financing	59.6	52.8	39.8	34.9	39.8	43.0	44.9	45.5
Government 1/	2.1	1.6	0.8	0.5	0.5	0.4	0.4	0.3
Banks	36.8	28.2	19.7	20.9	24.5	25.4	25.4	25.4
Other sectors	20.7	23.0	19.3	13.5	14.8	17.2	19.2	19.8
Short-term debt financing 3/	119.6	116.8	137.1	138.8	145.1	148.6	152.6	155.1
Government 1/	1.8	5.9	6.8	6.8	6.8	6.8	6.8	6.8
Banks	67.2	57.1	64.9	68.9	74.5	76.4	78.0	79.6
Other sectors	50.7	53.7	65.4	63.1	63.8	65.4	67.7	68.7
Other	-3.4	26.4	3.1	0.5	0.5	0.5	0.5	0.5
GIR change (- denotes increase)	8.2	10.4	-6.2	-3.9	-2.7	-4.4	-3.2	-4.6
Memorandum items:								
Net public sector financing (incl. IMF, excl. reserves)	8.0	9.4	12.5	9.1	8.0	10.0	8.9	10.4
Government debt rollover rate (in percent)	170	192	148	111	104	118	110	121
Banks' loan rollover rate (in percent)	107	82	95	100	105	102	102	101
Other sectors' loan rollover rate (in percent)	119	114	116	94	100	104	107	105
Gross external financing requirements (percent of GDP)	25.0	26.8	23.5	23.5	22.3	21.5	21.0	20.2
International Investment Position (percent of GDP)	-54.4	-48.1	-45.6	-42.3	-39.3	-38.0	-37.7	-37.4

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ Includes CBRT and the general government, excluding eurobonds issuance.
2/ Includes sales and purchases of portfolio assets by the government, banks, and other private sectors; and sale of assets classified under Other Investments.
3/ Includes currency and deposits of non-residents.

Table 4. Turkey: Public Sector Finances, 2017–24
(Percent of GDP)

	2017	2018	2019	2020	2021	2022	2023	2024
			Proj.					
Nonfinancial public sector primary balance	-0.8	-2.3	-3.4	-2.4	-2.3	-2.3	-2.2	-2.1
Central government	-0.5	-1.5	-3.0	-2.0	-2.0	-2.0	-2.0	-1.9
Primary revenue	19.4	18.9	17.8	18.3	18.3	18.3	18.4	18.4
Tax revenue	17.3	16.7	15.6	16.1	16.1	16.1	16.2	16.2
Personal income taxes	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Corporate income taxes	1.7	2.1	1.9	1.9	1.9	1.9	1.9	1.9
VAT	5.0	4.8	4.1	4.4	4.4	4.4	4.4	4.5
Special consumption tax	4.4	3.6	3.4	3.6	3.7	3.7	3.7	3.7
Other	2.5	2.5	2.4	2.4	2.4	2.4	2.4	2.4
Nontax revenue 1/	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Primary expenditure, *of which:*	19.8	20.4	20.8	20.3	20.3	20.3	20.3	20.3
Personnel	6.1	6.3	6.9	6.9	6.9	6.9	6.9	6.9
Goods and services	2.0	1.9	1.6	1.6	1.6	1.6	1.6	1.6
Current transfers, *of which*:	8.6	8.8	9.4	9.1	9.1	9.1	9.1	9.1
Social security institutions	4.1	4.1	4.4	4.4	4.4	4.4	4.4	4.4
Agricultural subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Transfers of revenue shares	2.3	2.6	2.3	2.3	2.3	2.3	2.3	2.3
Capital transfers	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital expenditure	2.3	2.4	2.1	1.9	1.9	1.9	1.9	1.9
Net lending	0.4	0.6	0.4	0.4	0.4	0.4	0.4	0.4
Rest of the public sector	-0.4	-0.8	-0.4	-0.4	-0.3	-0.3	-0.3	-0.2
Extrabudgetary funds	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
Revolving funds	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.1	-0.1	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Local governments	-0.4	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
State owned enterprises	0.0	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Nonfinancial public sector overall balance 1/	-2.2	-3.8	-5.2	-4.9	-5.3	-5.3	-5.3	-5.2
Interest expenditure (net)	1.4	1.5	1.8	2.5	3.0	3.0	3.1	3.1
Memorandum items:								
Revenues excluded from IMF 'program definition'	0.8	1.6	2.5	1.0	0.8	0.8	0.8	0.8
Central government primary balance (headline) 2/	0.3	0.0	-0.5	-1.0	-1.2	-1.2	-1.2	-1.1
Central government overall balance (headline) 2/	-1.5	-2.0	-2.9	-3.9	-4.5	-4.5	-4.5	-4.4
Central government cyclically-adjusted primary balance (headline) 2/3/	-0.2	-0.4	-1.7	-0.8	-1.1	-1.1	-1.1	-1.1
Central government cyclically-adjusted overall balance (headline) 2/3/	-2.0	-2.4	-4.1	-3.7	-4.4	-4.4	-4.5	-4.4
General government primary balance (headline) 2/	0.1	-0.3	-0.4	-0.9	-1.1	-1.1	-1.1	-1.1
General government overall balance (headline) 2/	-1.8	-2.4	-3.0	-3.9	-4.6	-4.6	-4.6	-4.5
General government cyclically-adjusted primary balance (headline) 2/3/	-0.4	-0.8	-1.6	-0.7	-1.0	-1.0	-1.0	-1.0
General government cyclically-adjusted overall balance (headline) 2/3/	-2.3	-2.9	-4.1	-3.7	-4.4	-4.5	-4.5	-4.5
General government structural primary balance 4/	-1.6	-2.5	-2.9	-1.9	-1.8	-1.7	-1.8	-1.8
General government structural overall balance 4/	-3.0	-4.0	-4.7	-4.3	-4.7	-4.8	-4.8	-4.8
General government gross debt	28.2	30.1	32.2	33.1	34.1	35.4	36.6	37.3

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ IMF program definition which excludes several items from non-tax revenue and the primary balance, including privatization proceeds, transfers from CBRT, dividend payments from Ziraat Bank and interest receipts .
2/ Headline or authorities' definition which includes items excluded from the IMF 'program' definition.
3/ The cyclically-adjusted balance adjusts for the economic cycle and excludes one-off CBRT revenues.
4/ The structural primary balance adjusts for the economic cycle and excludes items from revenue that staff assess as 'one-off' or financing items.

Table 5. Turkey: Financial Soundness Indicators, 2011–19
(Percent)

	2011	2012	2013	2014	2015	2016	2017	2018	2019 Aug
Capital Adequacy									
CAR	17	18	15	16	16	16	17	17	18
CT1R	15	15	13	14	13	13	14	14	15
RWA / Assets	78	80	84	83	83	82	76	77	77
Asset Quality									
NPLs / Gross Loans	2.7	2.9	2.8	2.9	3.1	3.2	3.0	3.9	4.6
Provisions / Gross NPLs	79	75	76	74	75	77	79	68	68
Profitability									
Total Int. Income / Int. Bearing Assets (av) 1/ 2/	8.2	9.1	7.6	7.9	7.8	8.3	8.8	10.5	11.3
Cost / Income (Efficiency) 3/	74	73	71	74	76	72	73	77	80
ROAA 1/ 4/	1.7	1.8	1.6	1.3	1.2	1.5	1.6	1.4	1.2
ROAE 1/ 4/	14	14	13	11	11	13	15	14	11
Funding and Liquidity									
Loan-to-Deposit ratio	98	103	111	118	119	119	123	118	108
Loan-to-Deposit ratio (TL)	105	113	127	133	142	134	148	138	136
Loan-to-Deposit ratio (FX)	84	82	84	92	89	99	90	96	82
Non-Core / Core Liabilities 5/	45	44	52	55	56	56	57	57	52
Non-Core / Core Liabilities (TL) 5/	29	26	29	30	32	29	32	33	31
Non-Core / Core Liabilities (FX) 5/	87	91	103	113	101	106	101	94	79
Leverage Ratio 1/ 6/	5.3	5.0	5.2	5.7	5.3	5.1	4.8	5.1	5.5
Liquid Assets / Assets 7/	26	26	24	23	22	21	23	21	22
Assets / Liabilities (3 months, int. sensitive)	72	82	79	75	74	76	73	78	73
FX Risk									
FX Assets / FX Liabilities (on-balance sheet) 6/	92	94	91	91	91	94	88	91	89
NOP / Regulatory Capital	0.4	2.0	-0.6	-2.2	0.9	-1.2	0.5	2.8	1.7
NOP before hedging / Regulatory Capital	-22	-14	-29	-29	-30	-22	-44	-34	-42
Balance Sheet					*(Percent of GDP)*				
Total Assets	87	87	96	98	101	105	105	104	102
o/w Gross Loans	49	51	58	61	63	66	68	65	61
Liabilities	77	76	85	86	90	93	93	93	91
o/w Deposits	50	49	52	51	53	56	55	55	56
Shareholders' Equity	10	12	11	11	11	12	12	11	11
Off-Balance Sheet					*(Percent of GDP)*				
o/w Commitments	102	110	90	84	89	95	104	96	...
o/w Contingencies	16	15	18	19	20	21	21	21	...
Miscellaneous									
Deposit Interest Rate (Percent) 8/	10.6	7.6	8.0	9.5	11.0	9.6	12.8	22.5	17.0
Loan Interest Rate (Percent) 9/	17	12	13	13	16	15	18	32	19

Sources: BRSA data; and IMF staff calculations.
1/ Current year data are annualized using 12-month rolling sums.
2/ Net of NPL provisions.
3/ Other non-interest income added to expenses when <0.
4/ Net income as a share of average assets or equity over last 12 months.
5/ Core liabilities include deposits and shareholders' equity.
6/ Proxied by T1 Capital over last 2 months average balance sheet assets and average off-balance sheets exposures (> 3 percent).
7/ Liquid assets as reported by the BRSA in their liquidity position table.
8/ On TRY only, excluding sight and interbank.
9/ Consumer Loans (Personal+Vehicles+Housing).

Annex I. Risk Assessment Matrix

	Source of Risks	Likelihood	Time Horizon	Impact	Policy Response
Global	**Sharp rise in risk premia.** An abrupt deterioration in market sentiment (e.g., prompted by policy surprises, renewed stresses in emerging markets, or a disorderly Brexit) could trigger risk-off events such as recognition of underpriced risk. Higher risk premia cause higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; disruptive corrections to stretched asset valuations; and capital account pressures—all depressing growth.	High	Short Term	High	• Tighten monetary policy. • To the extent net international reserves allow, use FX reserves to smooth volatility in disorderly market conditions. • Allow automatic fiscal stabilizers to operate and provide targeted, temporary support. • Use exchange rate as a shock absorber.
	Rising protectionism and retreat from multilateralism. In the near term, escalating and unpredictable trade actions and a WTO dispute settlement system under threat imperil the global trade system and international cooperation. Additional barriers, including investment and trade restrictions in technology sectors, and the threat of new actions reduce growth both directly, and through adverse confidence effects and financial market volatility. In the medium term, geopolitical competition, protracted tensions, and fraying consensus about the benefits of globalization lead to economic fragmentation and undermine the global rules-based order, with adverse effects on investment, growth, and stability.	High	Short to Medium Term	Low	• Further diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports.
	Further build-up of financial vulnerabilities. Although the turn in the monetary policy cycle toward easing provides a reprieve for risky assets, it encourages risk taking through underpricing of risk and reduces financial resilience to shocks and risk-off events.	High	Medium Term	Medium	• Preemptively increase FX reserves through pre-announced and sterilized intervention, as appropriate. • Preemptively strengthen bank and non-financial corporate balance-sheets through restrictions on the composition of liabilities and higher risk weights and provisioning on lending to such corporates in FX. Undertake third-party asset quality review, followed by rigorous stress tests and follow up measures as needed. • Structural reforms should aim at raising the economy's competitiveness. • Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports.
	Intensification of geopolitical tensions and security risks (e.g., in the Middle East) cause socio-economic and political disruption, disorderly migration, volatile commodity prices, and lower confidence.	High	Short Term	High	• Tighten monetary policy. • Use exchange rate as a shock absorber. • To the extent net international reserves allow, use FX reserves to smooth volatility in disorderly market conditions. • Allow automatic fiscal stabilizers to operate and provide targeted, temporary support.

	Source of Risks	Likelihood	Time Horizon	Impact	Policy Response
	Weaker-than-expected global growth. • **Europe:** Weak foreign demand, Brexit, or concerns about some high-debt countries makes some euro area businesses delay investment, while faltering confidence reduces private consumption. Inflation expectations drift lower, and the region enters a prolonged period of anemic growth and low inflation. • **U.S:** Confidence wanes against a backdrop of a long expansion with stretched asset valuations, rising leverage, and policy uncertainty, leading to weaker investment and a more abrupt closure of the output gap. • **China:** In the near term, further escalation in trade tensions not only reduce external demand, disrupt supply chains, and depresses confidence and investment, but potentially also trigger tighter financial conditions, a sharp downturn in the property market, renewed PPI deflation, and a drop in commodity prices. In the medium term, weaker external demand, the potential reversal of globalization, and the increasing role of the state could weigh on growth prospects. Moreover, excessive policy easing—reversing progress in deleveraging and rebalancing—increases risks over time of a disruptive adjustment or a marked growth slowdown.	**High** **Medium** **High**	**Short to Medium Term** **Short to Medium Term** **Short to Medium Term**	**Medium** **Medium** **Medium**	• Use exchange rate as a shock absorber. • Allow automatic fiscal stabilizers to operate and provide targeted, temporary support. • Structural reforms should aim at raising the economy's competitiveness. • Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports.
Domestic	**Premature easing of overall macroeconomic stance.** • Premature easing of monetary policy could further erode confidence, more rapidly weaken the currency, and exacerbate currency mismatches on private balance sheets. • Large fiscal expansion could run into financing constraints, as foreign appetite diminishes, and banks are unable to raise necessary funding.	**High**	**Short to Medium Term**	**High**	• Restore tight monetary policy and normalize the framework. • Adopt a credible medium-term fiscal plan that is growth-friendly and enhances fiscal space to mitigate the slowdown and protect the most vulnerable. • To the extent net international reserves allow, use FX reserves to smooth volatility in disorderly market conditions.
	Disorderly macro-financial cycle of deleveraging and income compression: A sharp unwinding of lending practices could trigger a vicious cycle between deleveraging and lower domestic demand, incomes, and asset prices. Possible triggers include domestic policy mistakes (including an inadequate policy response to re-emerging market pressures) and/or external financing pressures giving rise to rapid exchange rate depreciation, which weakens corporate balance sheets and worsens bank asset quality, triggering sharp deleveraging and slowdown of economic activity.	**High**	**Short to Medium Term**	**High**	• Tighten monetary policy. • Use exchange rate as a shock absorber. • Allow automatic fiscal stabilizers to operate and provide targeted, temporary support. • Undertake third-party asset quality review, followed by rigorous stress tests and follow-up measures as needed. • Promote out of court debt workouts. • Adopt a medium-term fiscal plan that creates additional fiscal space to help with the fallout from the private sector.

Annex II. External Sector Assessment

Overall Assessment: *The external position in 2018 was broadly in line with the level implied by fundamentals and desirable policies.* This reflects the ongoing and lagged adjustment of external balances following the sharp REER depreciation in 2018, which is projected to gradually unwind. Large external financing needs and relatively low reserves make Turkey vulnerable to financial account reversals. Developments so far in 2019 indicate, on a preliminary basis, a broadly unchanged overall assessment.

Potential Policy Responses: Despite a broadly in line external position in 2018, a comprehensive policy package is needed to strengthen external resilience and support a sustainable rebalancing of the economy. To this end, monetary policy should aim to reduce inflation durably and strengthen central bank credibility, while rebuilding reserves. Meanwhile, focused structural reforms are necessary to enhance productivity and ensure more stable domestic funding sources. Specifically, efforts are needed to reduce labor market rigidities and improve the business climate, including by reforming insolvency and corporate restructuring frameworks.

Foreign Asset and Liability Position and Trajectory	**Background.** After peaking at –54 percent of GDP at end-2017, Turkey's NIIP narrowed to –48 percent of GDP at end-2018. This mostly reflected valuation effects from the lira's sharp depreciation in 2018, as a higher share of external assets relative to external liabilities are denominated in FX (a portion of the liabilities are in the form of Turkish equities and lira-denominated debt securities).[1] Total foreign liabilities reached 78 percent of GDP in 2018, dominated by debt, which, at 55 percent of GDP, remains sustainable over the medium term. Private external debt service is vulnerable to global financial conditions as much of the debt is in FX, a significant portion is short term (around 20 percent of GDP), and much of the long-term debt (about 40 percent) is at variable rates. **Assessment.** The size and composition of external liabilities, coupled with low reserves, expose Turkey to liquidity shocks, sudden shifts in investor sentiment, and increases in global interest rates. The FX exposure of nonfinancial corporates is high, with the potential to worsen bank asset quality. Turkey's NIIP is projected to gradually fall to about –40 percent of GDP by 2021, driven by a decline in liabilities, mainly loans, as the economy rebalances.
2018 (% GDP)	NIIP: –46.5 ‖ Gross Assets: 30.2 ‖ Res. Assets: 12.1 ‖ Gross Liab.: 76.6 ‖ Debt Liab.: 55.3
Current Account	**Background.** The CA deficit, after averaging 4 percent during 2014–16, widened sharply to 5.6 percent of GDP in 2017 as policy stimulus resulted in overheating. The CA deficit narrowed to 3.5 percent in 2018, supported by a steep lira depreciation and associated import compression in 2018:H2. Staff expects a small CA deficit in 2019, reflecting the continuation of these cyclical factors, strong tourism receipts, and a normalization of gold imports.[2] **Assessment.** The EBA CA model estimates a norm of –1.6 percent of GDP, with a large standard error of close to 2 percent. With a cyclically adjusted CA deficit in 2018 of –2.5 percent of GDP, the CA gap is estimated at –0.9 percent of GDP. After taking into account the temporary large imports of gold (0.7 percent of GDP higher than normal), staff assesses the 2018 CA to be broadly in line with fundamentals and desired policies, with a gap in the range of –1.2 to 0.8 percent of GDP. Preliminary EBA CA model estimates based on projected values for 2019 indicate a cyclically-adjusted CA of -1.1 percent against a CA norm of -1.5 percent, suggesting an unadjusted gap of 0.4 percent.
2018 (% GDP)	Actual CA: –3.5 ‖ Cycl. Adj. CA: –2.5 ‖ EBA CA Norm: –1.6 ‖ EBA CA Gap: –0.9 ‖ Staff Adj.: 0.7 ‖ Staff CA Gap: –0.2
Real Exchange Rate	**Background.** In 2018, the average REER depreciated by 14 percent relative to 2017, standing some 37 percent below its 2010 peak. After depreciating sharply in 2018:Q3, the REER appreciated in 2018:Q4, reflecting in part the lagged effects of exchange rate pass-through to inflation. As of September 2019, the REER has broadly recovered to the 2018 average. **Assessment.** The EBA REER index and level approaches suggest the REER was undervalued in 2018 by 21 to 23 percent, albeit with large uncertainties. The staff-assessed CA gap suggests a REER gap close to zero, reflecting the ongoing and lagged adjustment of external balances to the REER depreciation. Giving more weight to the EBA REER approaches as the CA continues to adjust, staff assesses the REER to be undervalued in the range of 10 to 20 percent in 2018, with a midpoint around 15 percent.
Capital and Financial Accounts: Flows and Policy Measures	**Background.** Net capital flows switched from an inflow of US$39 billion (5 percent of GDP) in 2017 to an outflow of US$4 billion (0.5 percent of GDP) in 2018 (both excluding reserves and E&O). However, positive E&O, likely reflecting repatriation of foreign assets and unrecorded capital inflows, increased from US$0.6 billion in 2017 to US$19.1 billion in 2018, moderating the impact of the change in recorded flows. This slowdown of net inflows was driven by net portfolio outflows and a decline in banks' external loans, with spreads rising significantly and external rollovers of long-term debt by banks falling as low as 42 percent in September. Net FDI flows remained low at about 1 percent of GDP. To address currency volatility, Turkey introduced a capital flow management measure in the form of limits to bank swaps and other derivative transactions with foreign counterparties in August 2018. This measure was partially unwound as volatility receded. **Assessment.** After deteriorating in 2017, the quality of financing worsened further in 2018 following the market turmoil in 2018:Q3, with the maturity structure of external debt shortening, rollover rates of external bank funding dropping, and financing dominated by E&O and reserve drawdown. With annual gross external financing needs of about 22 percent of GDP, Turkey remains vulnerable to adverse shifts in global investor sentiment.
FX Intervention and Reserves	**Background.** The de facto and de jure exchange rate is floating. Reserves were impacted by several measures to support FX liquidity, changes to required reserves and the Reserve Option Mechanism aimed at releasing FX liquidity,

Level	and accepting lira payments for US dollar–denominated export rediscount credit repayments. The central bank also provides direct sales of FX to energy-importing SOEs. While likely having a stabilizing impact in the short term, these measures have contributed to a decline in gross reserves to US$93 billion (12 percent of GDP) at end-2018, US$14.7 billion (1.9 percent of GDP) lower than at end- 2017. Net international reserves stood at US$30 billion (3.9 percent of GDP) at end-2018, declining by US$0.8 billion (0.1 percent of GDP).[3] **Assessment.** Gross reserves amounted to 76 percent of the IMF's ARA metric at end-2018, down from 80 percent at end-2017, and reserve coverage of external financing requirements dropped to 45 percent in 2018, from 51 percent the year prior. As of November 2019, gross reserves amount to about 80 percent of the IMF's ARA metric. Accumulation of reserves over the medium term is needed given sizable external liabilities and dependence on short-term and portfolio funding.

[1] Despite persistent CA deficits, the NIIP has fluctuated with no clear trend during 2009–18, due to a mix of positive valuation effects and large net BOP E&O.

[2] Gold imports increased in response to elevated uncertainty following the 2016 coup attempt and subsequent economic overheating. Staff estimates the additional cyclical contribution to the CA deficit due to gold imports in 2018 at 0.7 percent of GDP, based on the average annual 1999–2016 gold trade deficit of 0.4 percent of GDP compared with 1.1 percent of GDP in 2018.

[3] Net international reserves is defined as gross international reserves minus the central bank's FX liabilities to banks, including the Reserve Option Mechanism.

Annex III. Public Debt Sustainability Analysis

Turkey's public debt and gross financing are currently low but set to rise over the medium term, reflecting an underlying deterioration in public finances. The public DSA suggests that although Turkey's government debt remains below vulnerability benchmarks under the baseline and most shock scenarios, it is on an upwards trajectory and does not stabilize over the medium term. Although the debt composition is generally low-risk, it has shifted over the past year to shorter maturity domestic borrowing and a higher reliance on external borrowing, increasing pass-through to the budget from interest rate and exchange rate shocks and vulnerability to domestic rollover risk. While all public debt profile indicators are below high-risk benchmarks, high external financing requirements point to vulnerabilities arising from the country's external debt position. Large quasi-fiscal operations in recent years as well as ongoing financial stress increase Turkey's exposure to a contingent liability shock.

Baseline and Realism of Projections

1. Debt levels. Turkey's debt-to-GDP ratio was 30.1 percent at end-2018 and 32.2 percent at end-Q2 2019 (latest data). Staff projects that the ratio will increase to nearly 38 percent of GDP over the medium term because of projected elevated primary deficits, a more depreciated exchange rate and a more modest growth outlook.

2. Growth. Growth is expected to be slightly positive in 2019, before recovering to around 3– 3½ percent over the medium term. The output gap is also projected to turn negative in 2019, and close only gradually, as the economy slowly deleverages. This, together with the high sensitivity of public debt to swings in GDP growth, highlights the relevance of growth shocks in the stress tests.[1]

3. Sovereign yields. Over the past year Turkey's yields have increased significantly and have also been volatile. The yield on domestic bonds increased by more than 10 percentage points in 2018 to above 25 percent, although they have fallen back recently, but still much higher than the level observed in early 2018. The effective interest rate is projected to increase over the medium term because of the higher bond spreads.

4. Fiscal adjustment. In the baseline, the general government primary balance is expected to deteriorate in 2019 because of the impact of the economic downturn on revenue collection and tax cuts and expenditure increases earlier in the year. The structural primary deficit (which adjusts for the cycle and one-off revenue items) is also expected to deteriorate in 2019 to close to 3 percent of GDP and, without credible consolidation measures, to remain at that level over the medium term, at around 1½ percent, which is insufficient to stabilize debt.

5. Maturity and rollover. The current public sector debt composition is associated with moderate pass-through of interest rate and exchange rate movements. Average maturity of the

[1] Past projections of growth outcomes show significant forecast errors, possibly because of high volatility of GDP in Turkey and the national accounts revisions in 2016. However, abstracting from the national accounts revisions, past growth projections do not seem to have any systematic bias that undermine the assessment of sustainability.

central government debt profile at end-2018 was 6.4 years, 75.3 percent was fixed interest and 46 percent was denominated in foreign currency. However, sensitivity to interest rate and exchange rate shocks has increased over the past year, mainly because of a decline in the maturity of new domestic issuance and a higher share of FX debt issuance.

Shocks and Stress Tests

6. The public DSA suggests that Turkey's government debt will remain below vulnerability benchmarks under the baseline and under various individual shock scenarios. Among all individual shock scenarios (Table 1), interest rate, growth and contingent liability shocks lead to relatively larger increases in debt and gross financing needs than primary balance and exchange rate shocks. However, under a combined macro-fiscal shock, debt would exceed 60 percent of GDP by end-2024, while under a more extreme, combined macro-fiscal-contingent liability shock, debt would breach the 70 percent threshold in the medium term. Also debt does not stabilize by 2024, absent policy adjustment.

- **Primary balance shock.** A worsening of the primary balance by 1 standard deviation over 2020–21 would raise medium-term public debt by around 1.3 percent of GDP. Under this scenario, sovereign borrowing costs are also raised by 25 basis points for each 1 percentage point of GDP worsening in the primary balance. The impact on gross financing needs levels by 2024 is modest.

- **Growth shock.** Real output growth rates are lowered by 1 standard deviation, or 4½ percentage points, for 2 years starting in 2020. The primary balance deteriorates significantly compared to the baseline (to close to -6 percent of GDP by 2021) as nominal revenues fall against unchanged expenditures. This also leads to higher sovereign borrowing costs. The debt-to-GDP ratio increases to 42 percent during the growth shock and to over 45 percent by the end of 2024. Gross public financing needs climb to 13 percent of GDP before gradually declining.

- **Interest rate shock.** The real effective rate is assumed to reach similar levels to those prevailing in 2009, which implies a permanent increase in spreads by about 850 basis points. The government's interest bill reaches an implicit average interest rate of over 18 percent in the medium term. The debt-to-GDP ratio climbs to around 43 percent, and gross public financing needs increase to around 13 percent of GDP in the medium term.

- **Contingent liability shock.** The shock could be seen to cover a combination of hypothetical contingencies, related to the financial sector, public-private partnership projects, or non-financial state-owned enterprises. A one-time assumption of contingent liabilities is assumed to increase non-interest expenditures by 10 percent of GDP in 2020.[2] This is combined with a negative real GDP growth shock (1 standard deviation for 2 years). Sovereign borrowing costs increase (by 25 basis points for each 1 percent of GDP worsening in the primary

[2] Absent detailed information on the size of contingent liabilities, staff applies a standard shock.

balance) while inflation declines (by ¼ percentage points for each percentage point decrease in GDP growth). Debt rises to 45 percent of GDP in 2020 and gradually rises to 54 percent in the medium term. Gross public financing needs peak in 2020 before declining to about 14 percent of GDP over the medium term.

- **Combined macro-fiscal shock.** A combined macro-fiscal shock incorporates the largest effect of the individual macro-fiscal shocks (i.e., excluding the contingent liability shock) on all relevant variables (real GDP growth, inflation, primary balance, exchange rate, and the interest rate). Public debt would reach 62 percent of GDP over the medium term. Gross financing needs would rise to 18 percent over the medium term.

- **Combined macro-fiscal-contingent liability shock.** This extreme combined shock incorporates the largest effect of the above shocks, including the contingent liability shock, on all relevant variables. Public debt would breach the 70 percent of GDP benchmark by 2024 under this shock scenario. Gross financing needs would also increase to above 20 percent of GDP.

Figure 1. Turkey Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

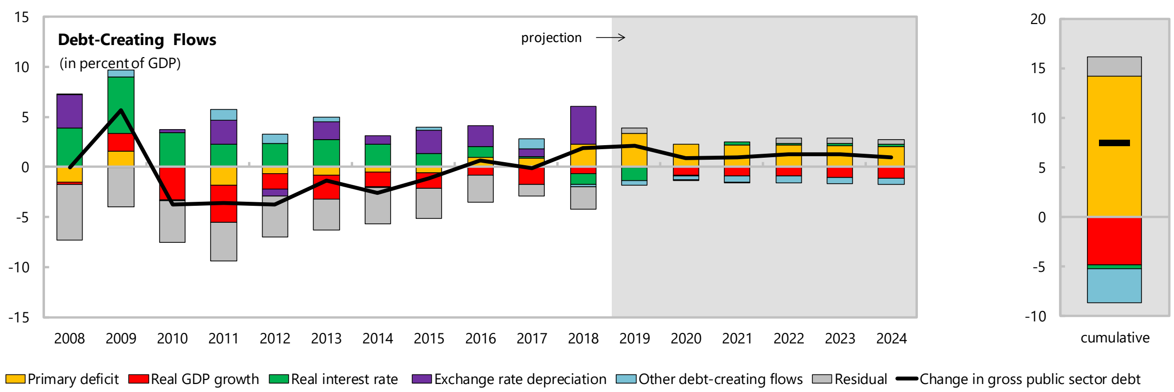
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2008-2016 2/	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	34.2	28.2	30.1	32.2	33.1	34.1	35.4	36.6	37.6
Public gross financing needs	9.9	5.0	6.5	7.5	9.2	10.2	10.4	10.6	10.0
Real GDP growth (in percent)	4.8	7.5	2.8	0.2	3.0	3.0	3.0	3.5	3.5
Inflation (GDP deflator, in percent)	7.7	11.0	16.4	14.4	11.8	11.6	10.9	10.8	11.0
Nominal GDP growth (in percent)	12.9	19.2	19.7	14.7	15.1	15.0	14.3	14.7	14.9
Effective interest rate (in percent) [4/]	10.8	8.1	9.0	9.6	11.9	13.1	12.0	11.9	12.0

As of November 13, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		415
5Y CDS (bp)		316
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	B+	BB-
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2008-2016 2/	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.1	-0.1	1.9	2.1	0.9	1.0	1.3	1.2	1.0	7.5	
Identified debt-creating flows	2.7	1.0	4.1	1.6	1.0	1.0	0.8	0.7	0.5	5.5	
Primary deficit	-0.4	0.9	2.3	3.4	2.3	2.2	2.2	2.1	2.1	14.2	-1.5
Primary (noninterest) revenue and grants	31.6	30.8	30.6	28.8	29.2	29.3	29.3	29.3	29.4	175.2	
Primary (noninterest) expenditure	31.3	31.7	32.8	32.2	31.5	31.5	31.4	31.4	31.4	189.5	
Automatic debt dynamics [5/]	2.7	-0.8	2.1	-1.3	-0.9	-0.6	-0.7	-0.8	-0.9	-5.3	
Interest rate/growth differential [6/]	1.3	-1.6	-1.8	-1.3	-0.9	-0.6	-0.7	-0.8	-0.9	-5.3	
Of which: real interest rate	2.8	0.2	-1.1	-1.3	-0.1	0.3	0.2	0.2	0.2	-0.4	
Of which: real GDP growth	-1.5	-1.8	-0.7	-0.1	-0.8	-0.9	-0.9	-1.1	-1.1	-4.9	
Exchange rate depreciation [7/]	1.4	0.8	3.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	1.0	-0.2	-0.5	-0.4	-0.7	-0.7	-0.6	-0.6	-3.4	
General Government: Net Privatization Proceeds (negative)	-0.5	-0.4	-0.2	-2.0	-1.2	-1.0	-1.0	-0.9	-0.9	-7.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General Government: Financing: Net Acquisition of Financial Assets	0.8	1.4	0.0	1.6	0.8	0.3	0.3	0.3	0.3	3.6	
Residual, including asset changes [8/]	-3.8	-1.1	-2.2	0.5	-0.1	0.0	0.5	0.6	0.5	1.9	



Source: IMF staff.

1/ Public sector is defined as General Government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

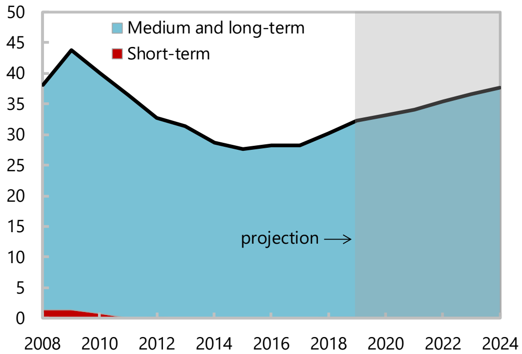
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

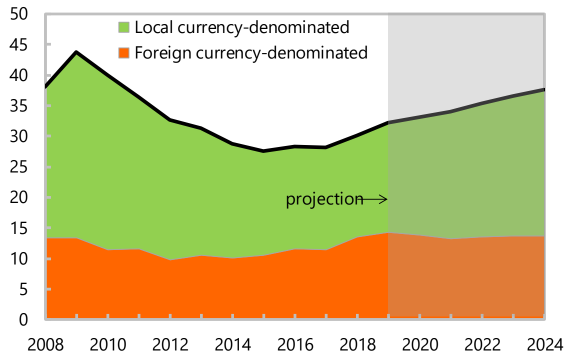
Figure 2. Turkey Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



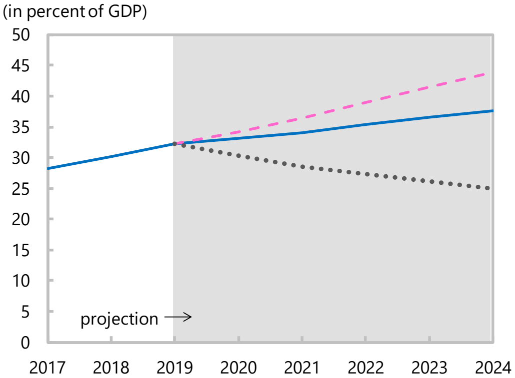
By Currency
(in percent of GDP)



Alternative Scenarios

Baseline   Historical   Primary Balance shock

Gross Nominal Public Debt
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary Balance	-3.4	-2.3	-2.2	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	13.1	12.0	11.9	12.0
Primary Balance Shock						
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary Balance	-3.4	-2.9	-2.8	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	13.2	12.2	12.1	12.1

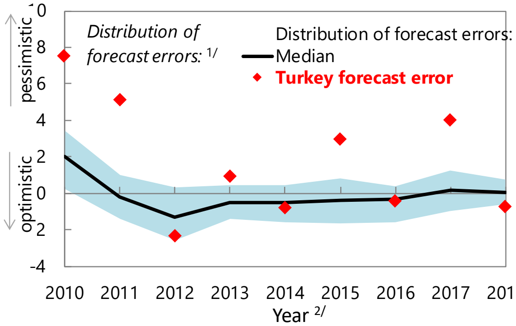
Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.2	5.3	5.3	5.3	5.3	5.3
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary Balance	-3.4	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	9.6	11.9	13.2	12.2	12.1	12.1

Source: IMF staff.

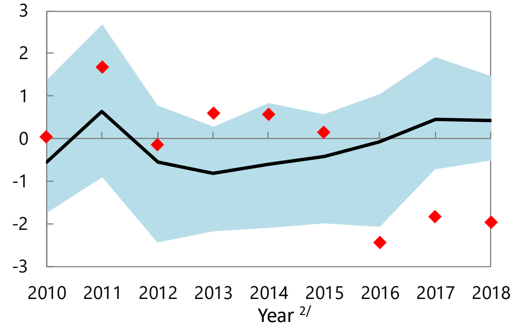
Figure 3. Turkey Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus all countries

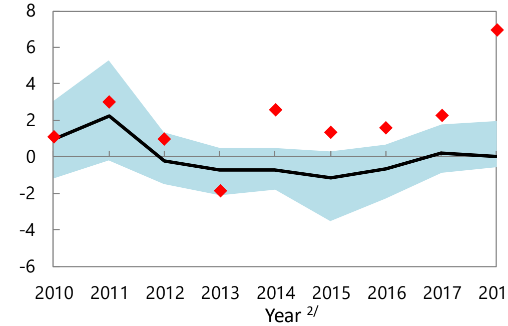
Real GDP Growth
(in percent, actual-projection)
Turkey median forecast error, 2010-2018: **0.96**
Has a percentile rank of: **88%**



Primary Balance
(in percent of GDP, actual-projection)
Turkey median forecast error, 2010-2018: **0.04**
Has a percentile rank of: **57%**

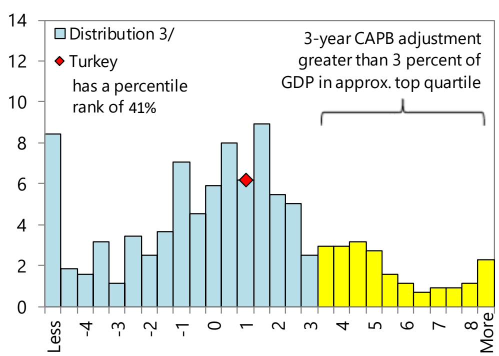


Inflation (Deflator)
(in percent, actual-projection)
Turkey median forecast error, 2010-2018: **1.57**
Has a percentile rank of: **84%**

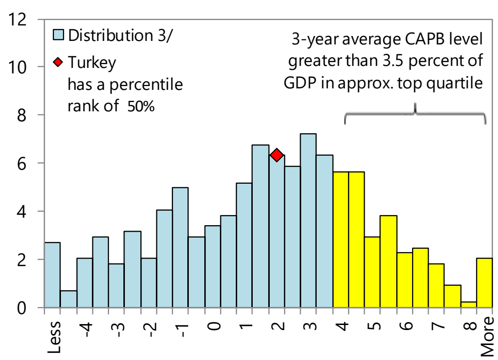


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



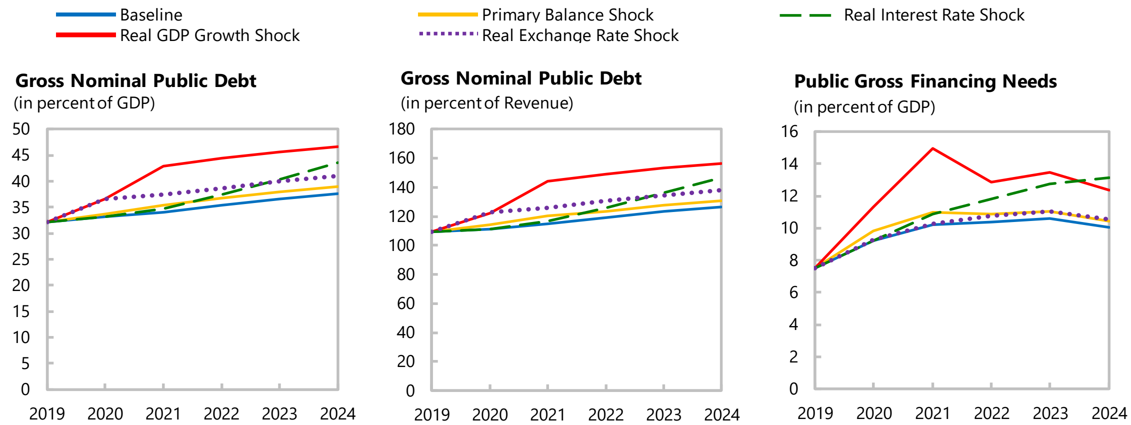
3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



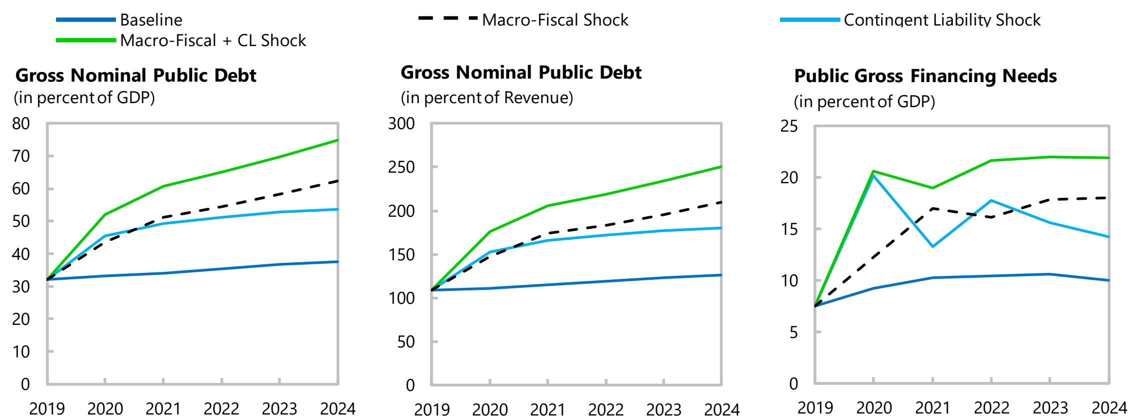
Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Turkey Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2019	2020	2021	2022	2023	2024
Baseline						
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary balance	-3.4	-2.3	-2.2	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	13.1	12.0	11.9	12.0
Real GDP Growth Shock						
Real GDP growth	0.2	-1.4	-1.4	3.0	3.5	3.5
Inflation	14.4	10.7	10.5	10.9	10.8	11.0
Primary balance	-3.4	-4.0	-5.7	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	13.3	12.7	12.5	12.3
Real Exchange Rate Shock						
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	21.3	11.6	10.9	10.8	11.0
Primary balance	-3.4	-2.3	-2.2	-2.2	-2.1	-2.1
Effective interest rate	9.6	12.9	11.9	11.3	11.4	11.6
Contingent Liability (CL) Shock						
Real GDP growth	0.2	-1.4	-1.4	3.0	3.5	3.5
Inflation	14.4	10.7	10.5	10.9	10.8	11.0
Primary balance	-3.4	-12.3	-2.2	-2.2	-2.1	-2.1
Effective interest rate	9.6	13.9	14.7	13.7	12.8	12.5

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary balance	-3.4	-2.9	-2.8	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	13.2	12.2	12.1	12.1
Real Interest Rate Shock						
Real GDP growth	0.2	3.0	3.0	3.0	3.5	3.5
Inflation	14.4	11.8	11.6	10.9	10.8	11.0
Primary balance	-3.4	-2.3	-2.2	-2.2	-2.1	-2.1
Effective interest rate	9.6	11.9	15.3	16.5	17.4	18.4
Macro-Fiscal Shock						
Real GDP growth	0.2	-1.4	-1.4	3.0	3.5	3.5
Inflation	14.4	10.7	10.5	10.9	10.8	11.0
Primary balance	-3.4	-4.3	-6.0	-2.2	-2.1	-2.1
Effective interest rate	9.6	12.9	14.4	16.3	17.2	18.1
Macro-Fiscal + Contingent Liability Shock						
Real GDP growth	0.2	-1.4	-1.4	3.0	3.5	3.5
Inflation	14.4	10.7	10.5	10.9	10.8	11.0
Primary balance	-3.4	-12.6	-6.0	-2.2	-2.1	-2.1
Effective interest rate	9.6	12.9	15.9	17.5	18.1	18.8

Source: IMF staff.

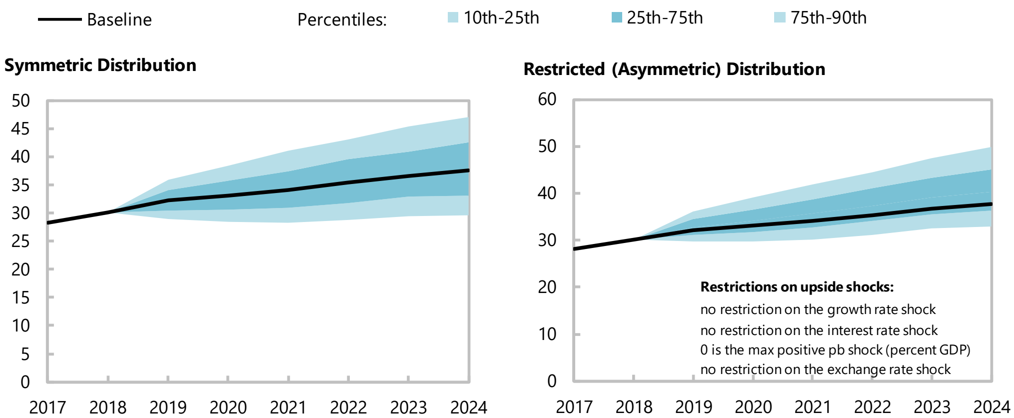
Figure 5. Turkey Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

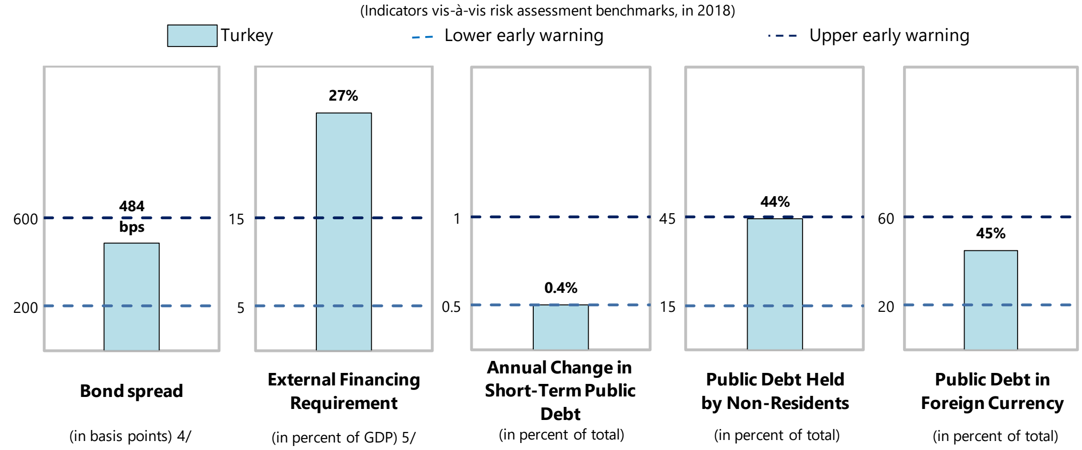
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 15-Aug-19 through 13-Nov-19.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex IV. External Debt Sustainability[1]

Turkey's external debt, while sustainable under the baseline, is high and vulnerable to valuation shocks. External debt increased sharply to nearly 58 percent of GDP in 2018. Under the baseline scenario, external debt declines to around 44 percent of GDP over the medium term, as growth picks up and the real exchange rate appreciates. External debt sustainability remains sensitive to a large lira depreciation, and large external financing needs of more than 20 percent of GDP per year expose the economy to liquidity risk, in particular against the backdrop of low international reserves.

Background

1. External debt has been increasing. Since 2008, external debt had been increasing gradually. As lira depreciation accelerated, external debt increased more rapidly, reaching 58 percent of GDP at end-2018. A large share of external debt, about 21 percent of GDP, is owed by banks who intermediate capital inflows into domestic loans. In parallel, external debt owed by nonfinancial corporations has risen significantly from 15 percent at end-2008 to 20 percent of GDP at end-2018.

2. Driven by the private sector, the share of short-term debt is set to increase. Capital flows indicate a trend towards shorter maturities, with the share of short-term external debt projected to increase from 26 percent in 2018 to 32 percent in 2024. Net non-debt creating inflows, mostly FDI, have weakened, from a long-term average of around 1.5 percent to 1.1 percent of GDP. Despite recent Eurobond issuance at shorter tenors, the average time to maturity of the government's external debt stock remains high at above nine years. In contrast, about 35 percent of external debt owed by the private sector is short term.

Assessment

3. Turkey's external debt, while sustainable under the baseline, is vulnerable to lira depreciation. Turkey's historically high current account deficit, averaging 4.3 percent of GDP (excluding interest payments) over 2009–18, has narrowed sharply. Turkey's external debt trajectory declines under the baseline, which assumes continued lower current account deficits and modest rollover rates. Standard stress tests suggest that the debt level could increase substantially under a real depreciation shock given that most external debt is foreign-currency denominated. A permanent lira depreciation of 30 percent over the baseline would push the external debt stock temporarily to around 90 percent of GDP by end-2020, before subsequently falling. A steep increase in fuel prices, which would widen the oil trade deficit by around 1 percent of GDP, would increase the external debt ratio relative to the baseline, leaving external debt around 50 percent of GDP by end-2024.

[1] This external debt sustainability analysis is based on the definition of external debt used by the authorities, covering liabilities arising from loans obtained from nonresidents and liabilities related to bonds issued in international capital markets. Government securities issued in Turkish lira are excluded, while eurobonds held by domestic banks are included in this presentation of external debt.

4. Turkey's external debt sustainability remains susceptible to liquidity risks. Around one quarter of Turkey's external debt remains short term, including because of large bank borrowing at shorter tenors, large deposits by non-residents, and trade credits). This implies gross external financing needs of about US$191 billion (about 23.5 percent of GDP) in 2020, exposing the economy to liquidity risks, especially given that international reserves are low relative to the Fund's ARA metric.

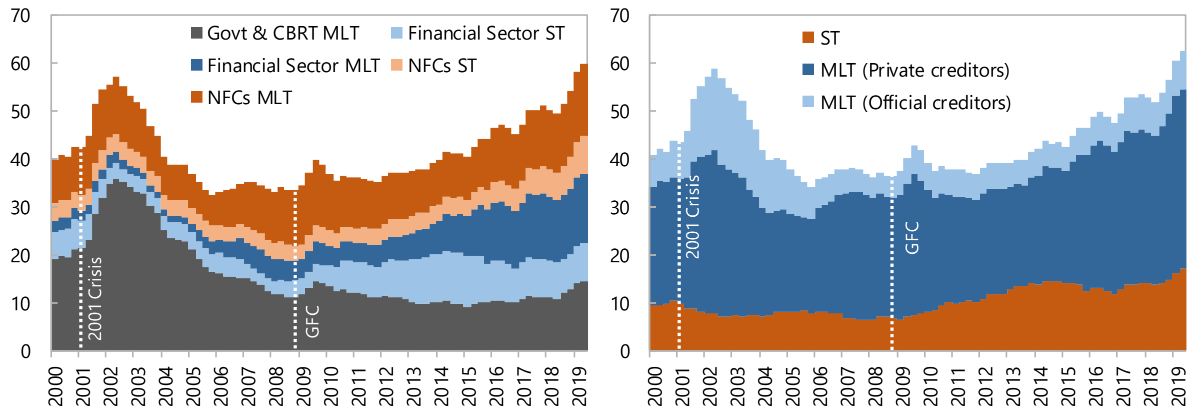
Annex Box 1. External Debt and Balance Sheet Issues

The debtor composition of Turkey's external debt has shifted sharply (Box Figure 1). The sovereign (general government plus CBRT) deleveraged considerably between the 2002 peak and the global financial crisis with external public debt falling from 36 to 11 percent of GDP, although this increased to 15 percent of GDP recently. External private sector debt increased to an all-time high of about 45 percent of GDP in 2019:Q2, up over 20 percentage points since end-2008 (Box Figure 1, rhs).

Box Figure 1. Long-Term External Debt Developments

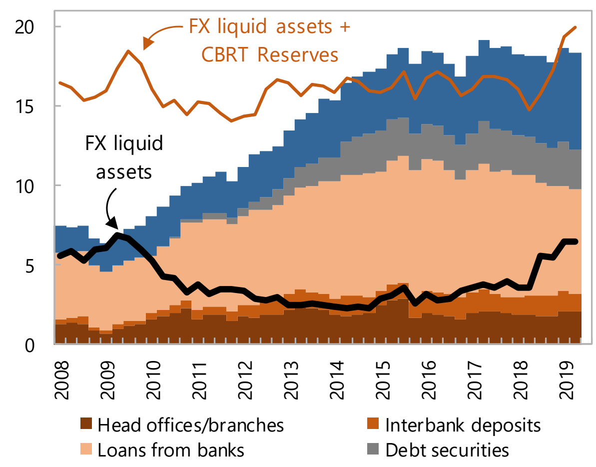
External Debt by Debtor and Maturity
Percent of GDP

External Debt by Original Maturity
Percent of GDP



Sources: CBRT; and IMF staff calculations.

Banks' External Liabilities & Liquid Assets
Percent of GDP

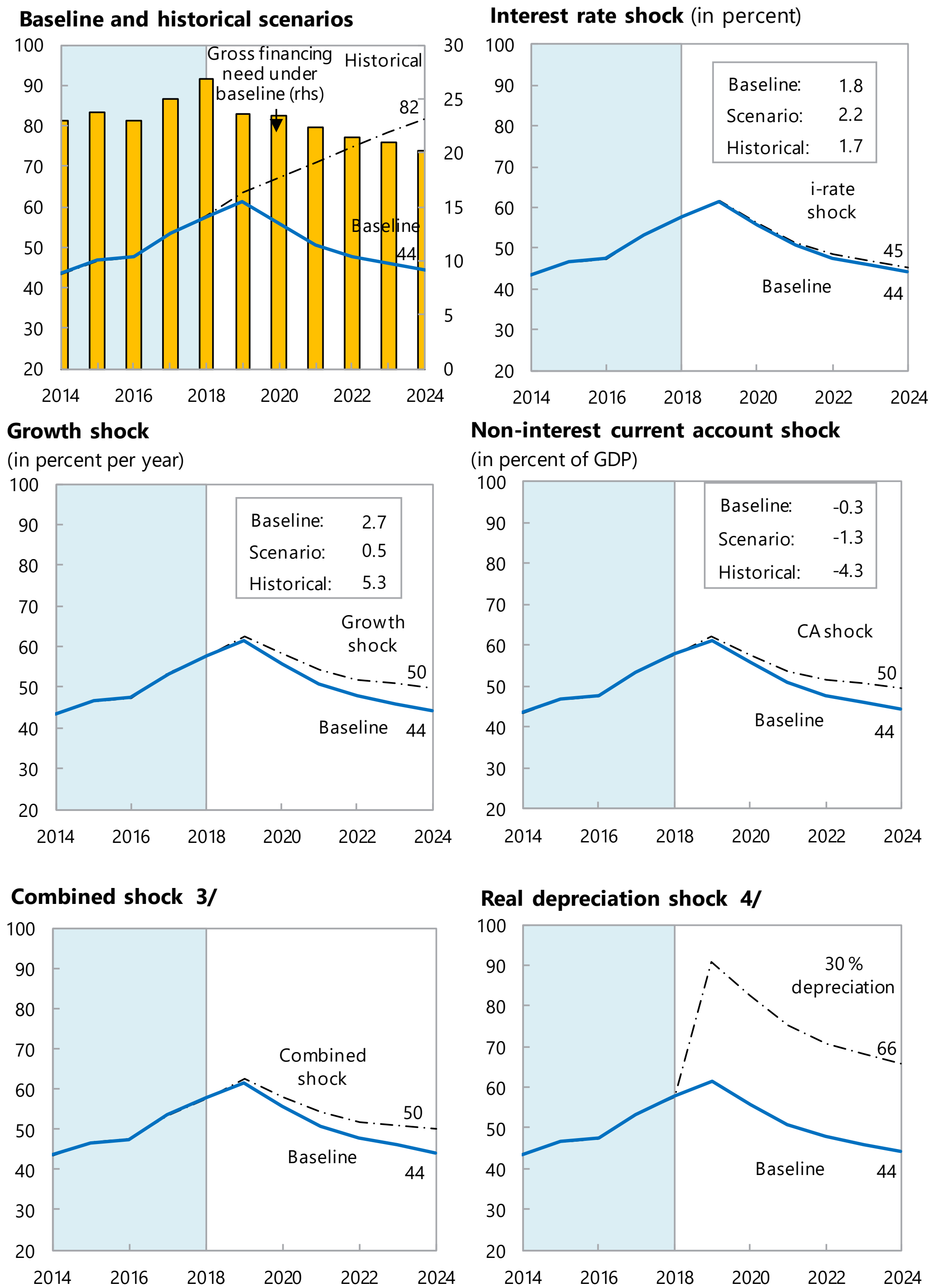


Sources: CBRT; and IMF staff calculations.

- **Financial sector** debt (mainly banks) accounts for the bulk of the net external debt increase, reaching 22 percent of GDP in 2019:Q2, up 15 percentage points since end-2008. Most of the increase was in the form of wholesale funding (10 percent of GDP), of which about a fifth is from parents/branches abroad (text chart). Much of the lending was then directed to corporates in the form of FX loans (23 percent of GDP, up from 11 percent in 2010).
- **Non-financial corporates,** in addition to borrowing in FX from domestic banks, also borrowed externally directly (14 percent of GDP as of 2019:Q2), bringing FX debt to 37 percent of GDP (USD 267 billion), excluding trade credits. FX assets did not increase as much, resulting in the widening negative open net FX position to 26 percent of GDP.

Figure 1. Turkey: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. The shocks to interets rate was increased to 1 standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2018.

Table 1. Turkey: External Debt Sustainability Framework, 2014–24

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2014	2015	2016	2017	2018			2019	2020	2021	2022	2023	2024	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	43.5	46.6	47.5	53.4	57.6			**61.3**	**55.7**	**50.7**	**47.7**	**46.0**	**44.2**	**-2.8**
Change in external debt	2.1	3.1	0.9	5.9	4.3			3.6	-5.5	-5.0	-3.0	-1.7	-1.8	
Identified external debt-creating flows (4+8+9)	4.1	5.5	2.0	4.2	7.0			-0.9	-2.0	-1.0	-0.5	-0.5	-0.4	
Current account deficit, excluding interest payments	4.1	3.1	3.2	4.8	2.5			-0.9	-0.3	0.3	0.8	0.9	1.0	
Deficit in balance of goods and services	4.0	2.8	3.0	4.6	2.1			-1.3	-0.5	0.1	0.5	0.7	0.7	
Exports	23.6	23.1	21.7	24.6	28.9			31.8	30.0	28.2	27.5	27.7	28.1	
Imports	27.6	25.9	24.7	29.2	31.0			30.5	29.5	28.3	28.1	28.4	28.7	
Net non-debt creating capital inflows (negative)	-0.9	-1.4	-1.3	-1.4	-1.1			-0.8	-0.9	-0.7	-0.8	-0.8	-0.8	
Automatic debt dynamics 1/	0.9	3.7	0.1	0.8	5.6			0.9	-0.8	-0.5	-0.5	-0.7	-0.7	
Contribution from nominal interest rate	0.6	0.6	0.6	0.7	1.0			1.0	0.9	1.0	0.9	0.9	0.8	
Contribution from real GDP growth	-2.2	-2.9	-1.5	-3.6	-1.7			-0.1	-1.7	-1.5	-1.4	-1.6	-1.5	
Contribution from price and exchange rate changes 2/	2.5	6.0	0.9	3.6	6.3			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-1.9	-2.4	-1.1	1.8	-2.8			4.5	-3.6	-4.0	-2.5	-1.2	-1.4	
External debt-to-exports ratio (in percent)	184.0	201.7	218.5	216.9	199.2			192.4	185.7	179.8	173.3	165.8	157.2	
Gross external financing need (in billions of US dollars) 4/	214.9	204.0	198.0	213.1	206.7			174.8	191.2	201.5	210.4	217.6	221.9	
in percent of GDP	23.0	23.7	22.9	25.0	26.8			23.5	23.5	22.3	21.5	21.0	20.2	
Scenario with key variables at their historical averages 5/						10-Year Historical Average	10-Year Standard Deviation	**63.4**	**67.2**	**71.0**	**74.7**	**78.3**	**81.8**	**-0.8** For debt stabilization
Key Macroeconomic Assumptions Underlying Baseline														
Nominal GDP (US dollars)	934.1	859.4	863.4	852.6	771.3			743.7	813.8	904.6	978.8	1036.1	1099.5	
Real GDP growth (in percent)	5.2	6.1	3.2	7.5	2.8	5.3	4.4	0.2	3.0	3.0	3.0	3.5	3.5	
GDP deflator (change in domestic currency)	7.4	7.8	8.1	11.0	16.4	8.5	3.1	14.4	11.8	11.6	10.9	10.8	11.0	
GDP deflator in US dollars (change in percent)	-6.5	-13.3	-2.6	-8.1	-12.0	-4.6	7.3	-3.8	6.3	7.9	5.0	2.3	2.5	
Nominal external interest rate (in percent)	1.4	1.3	1.4	1.5	1.7	1.7	0.4	1.7	1.6	1.9	1.9	1.9	1.9	
Growth of exports (US dollar terms, in percent)	5.4	-10.0	-5.6	11.9	6.4	2.9	11.0	6.0	3.1	4.5	5.6	6.6	7.5	
Growth of imports (US dollar terms, in percent)	-3.1	-13.6	-4.2	16.7	-3.8	2.7	18.2	-5.1	5.7	6.6	7.3	7.1	7.5	
Current account balance, excluding interest payments	-4.1	-3.1	-3.2	-4.8	-2.5	-4.3	2.1	0.9	0.3	-0.3	-0.8	-0.9	-1.0	
Net non-debt creating capital inflows	0.9	1.4	1.3	1.4	1.1	1.4	0.3	0.8	0.9	0.7	0.8	0.8	0.8	

Source: IMF staff calculations.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP

3/ For projections, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex V. Implementation of Past Fund Advice

Recent Fund advice focused on the risks associated with an overheated economy. The 2018 Article IV staff report argued that the economy was, at the time, running above potential, with positive output and credit gaps, high inflation, and a large current account deficit. Against this backdrop, the Fund advised the authorities to rein in domestic demand to reduce imbalances, contain risks, and rebuild buffers to reduce vulnerabilities of the Turkish economy to downside risks. In the event, Turkey was hit by a large exchange rate shock in late 2018, which combined with the belated, but necessary, monetary policy rate hike, sharply curtailed domestic demand and reduced imbalances. Further action is needed now to contain risks and rebuild buffers while securing stronger and more resilient growth over the medium term.

Progress has been made on some of the 2017 FSAP recommendations (Table 1).

Table 1. Turkey: Progress in Implementation of FSAP Recommendations

Recommendations	Timing	Progress
Banking Supervision		
Revise legislation to further strengthen BRSA independence.	MT	Not done.
Deepen and broaden the risk assessment nature of banking inspection and follow up.	MT	The BRSA revised supervisory approaches, associated guidelines, and manuals in 2016 and implemented them in 2017. In addition, the BRSA strengthened risk assessments in bank examination reports as a forward-looking component of the CAMELS methodology and enhanced the coordination between on-site and off-site functions.
Strengthen corporate governance rules and enforcement.	MT	A revision of the internal system regulations reflecting the IOSCO and Basel principles is planned. The corporate governance assessment aspect of the supervisory process has been strengthened.
Evaluate and revise the definition of credit classifications and strengthen enforcement.	ST	In January 2018, and in conjunction with IFRS 9 implementation, the BRSA started developing new credit classification and provisioning rules. The new rules have come into force.
Insurance Supervision		
Improve independence, governance and accountability of supervisor; increase resources for internal control functions; integrate offsite, onsite and enforcement activities; develop risk-based, group supervision.	ST/MT	The supervisor has progressed with its revision of the regulation on internal systems of insurance, reinsurance and pension companies. Steps include establishing a compliance function requirement within insurance companies and strengthening their risk management. To better integrate offsite, onsite and enforcement, the supervisor has developed an early warning assessment tool – SEUS – that strengthens risk-based supervision. Also,

		related to offsite-onsite integration, the supervisor is developing stress testing approaches.
Systemic Risk Oversight		
Strengthen macro prudential measures to lower foreign exchange risk in the economy.	I	Through legislation that came into force in May 2018, the authorities restricted FX lending to borrowers with less than US$15 million of loan exposures through FX debt to FX income limits, and banned new FX-indexed corporate loans. Rules regarding FX borrowings are under development for exposures equal to or greater than US$15 million.
Strengthen FSC's governance and powers, provide explicit financial stability objective to all members, and limit Council of Minister's role.	ST	In January 2019, new legislation (law no. 4059) that restructures the FSC came into force. The Committee's name has changed to Financial Stability and Development Committee (FSDC). The law assigns the committee with more robust macro-prudential policy responsibilities, including for sustainable development.
Develop procedures for improved systemic risk assessment and coordination of macroprudential policies: agree to table policy proposals for ex ante FSC discussion and request formal responses to recommendations.	ST/MT	The FSDC secretariat duties are provided by the Ministry of Treasury and Finance. The Ministry is working on rules and procedures as required by law 4059 to improve systemic risk assessment and coordination of macroprudential policies. A systemic risk monitoring working group has also been established under the FSDC to identify systemic risks through stress testing tools.
Base choice of policy tools on integrated assessment of systemic risk and cost-benefit analysis of alternative options.	ST	The FSDC retains the previous working sub-groups established in 2017 under the systemic risk assessment group: (i) the systemic risk monitoring working group and (ii) the crisis and management and resolution working group. A heat map system has been put in place to facilitate a more integrated risk assessment system. The CBRT participates in the FSDC's assessment of systemic risk through ex-ante and ex-post impact analyses and presentation of findings. Furthermore, the Capital Markets Board has adopted a risk-based supervision program to address systemic risks arising from derivatives transactions that includes enhanced reporting and surveillance.
Strengthen transparency (including FSC publishing an Annual Report)	ST	This recommendation will be taken up by the FSDC.

Managing Systemic Liquidity		
Orient liquidity provision towards a single key policy rate.	I	The CBRT has shifted its main monetary policy instruments for liquidity provision from the late liquidity window (LLW) facility to the one-week repo auction rate.
Increase net reserves such that gross reserves are within the range of 100-150 percent of the Assessment of Reserves Adequacy (ARA) metric.	MT	According to the CBRT's calculations, gross reserves are at 76.2 percent of the ARA metric as of June 2019. The CBRT introduced auctions for non-deliverable forwards to operate in BIST derivatives market to manage the FX demand and help banks and corporates to manage their hedging. The auctions help to manage volatility without depleting CBRT's reserves during periods of volatility in November 2017 and August 2018. Rediscount credits also continue to contribute to net FX reserves by about USD 15 billion in 2018. This facility is projected to contribute to net reserves by USD 22.5 billion in 2019.
Improve ELA capacity; redefine CBRT FX lending facility as ELA and increase conditionality.	ST	The CBRT is conducting ongoing studies of amendments to central bank regulation and implementation instructions for ELA on provision of TL liquidity only.
Financial Crisis Management		
Strengthen recovery and resolution planning and enhance resolution powers by: (i) Strengthening the banking law; (ii) Developing guidance.	MT	Draft legislation has been prepared jointly by SDIF and BRSA, benefitting from technical assistance from the World Bank.
Strengthen domestic and cross-border coordination arrangements.	ST	A domestic crisis management and resolution working group operating under the FSC (now the FSDC) was established in 2017 under the systemic risk assessment group. The BRSA/SDIF report that cross border coordination arrangements are addressed by the forthcoming legislation.
Anti-money Laundering/Combating Financing of Terrorism (AML/CFT)		
Determine reason for low money laundering (ML) conviction rates and plan to address them.	MT	The Financial Crimes Investigation Board (MASAK) has increased its operational capacity through an increase in the number of staff of more than 10 percent, strengthened training programs, and improved several IT tools. In addition, staffing and training has been augmented at other AML/CFT agencies (e.g., police, customs, anti-narcotic agency). The authorities have completed Turkey's National

		Risk Assessment as part of the FATF 4th round Mutual Evaluation in 2018.
Introduce customer due diligence requirements for politically exposed persons.	ST	Draft legislation has been prepared to cover the politically-exposed person concept more fully to be in line with the FATF recommendations.
Ensure compliance with requirements of the United Nations Security Council Resolution (UNSCRs), and strengthen border controls on currency transportation.	MT	Compliance with the UNSCR requirements remains incomplete. With respect to currency transportation, a circular on passenger accompanied outgoing cash movements has been prepared, and training of customs personnel has been increased. The Customs Agency is also working on further IT and operational capacity improvements.

INTERNATIONAL MONETARY FUND

TURKEY

November 21, 2019

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

CONTENTS

FUND RELATIONS

(Data as of November 4, 2019)

There is no outstanding Fund credit.

Membership Status:

Turkey became a member of the Fund on March 11, 1947.

General Resources Account

	SDR Million	Percent Quota
Quota	4,658.60	100.00
Fund holdings of currency	4,545.83	97.58
Reserve position in Fund	112.78	2.42

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	1,071.33	100.00
Holdings	965.33	90.11

Outstanding Purchases and Loans

None

Latest Financial Arrangements

	Approval Date	Expiration Date	Amount Approved	Amount Drawn
			In millions of SDRs	
Stand-By	05/11/05	05/10/08	6,662.04	6,662.04
Stand-By	02/04/02	02/03/05	12,821.20	11,914.00
Stand-By	12/22/99	02/04/02	15,038.40	11,738.96
Of Which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

Projected Payments to the Fund[1/]

(In millions of SDRs; based on existing use of resources and present holdings of SDRs).

	Forthcoming				
	2019	2020	2021	2022	2023
Principal	--	--	--	--	--
Charges/Interest	0.24	0.88	0.87	0.88	0.88
Total	0.24	0.88	0.87	0.88	0.88

[1/]When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Safeguard Assessments:

An assessment of the central bank's safeguards framework was conducted under the previous SBA and completed on June 29, 2005. While it uncovered no material weaknesses in the central bank's safeguard framework, a few recommendations were made to address some remaining vulnerabilities in the areas of internal audit and controls. Those recommendations have been implemented.

Exchange Rate Arrangement:

The currency of Turkey is the Turkish lira, which replaced the new Turkish lira on January 1, 2009. The *de jure* exchange rate arrangement is free floating; the *de facto* exchange rate arrangement is floating. Turkey accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement as of March 22, 1990 and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51).

Article IV Consultations:

Board discussion of the last Article IV staff report took place on March 30, 2018. The Article IV staff report (IMF Country Report No. 18/110) was published on April 30, 2018.

FSAP:

Financial stability assessments under the Financial Sector Assessment Program (FSAP) every five years are a mandatory part of Article IV surveillance. The last FSAP findings were summarized in the Financial System Stability Assessment (FSSA), which was issued on February 3, 2017 (IMF Country Report No. 17/35).

Resident Representative:

The IMF currently has a resident representative office in Ankara. Mr. Ben Kelmanson has been the senior resident representative since August 2018.

ROSCs

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 27, 2000	N/A
Corporate Governance	December 11, 2000	Prepared by the World Bank
Data ROSC [1/]	March 14, 2002	Country Report No. 02/55
Fiscal ROSC	November 25, 2003	Country Report No. 03/363
Fiscal ROSC	March 24, 2006	Country Report No. 06/126
FSSA and related ROSC	November 9, 2007	Country Report No. 07/361
Data ROSC	September 3, 2009	Country Report No. 09/286
FSSA and related ROSC	September 7, 2012	Country Report No. 12/261
BCP [2/]	March 7, 2014	N/A
IAIS [3/]	March 7, 2014	N/A
FSSA and related ROSC	February 3, 2017	Country Report No. 17/35

[1/] Report on Observance of Standards and Codes (ROSC).
[2/] Basel Core Principles for Effective Banking Supervision (BCP).
[3/] International Association of Insurance Supervisors (IAIS).

Recent Technical Assistance

Dept.	Timing	Purpose
MCM	February 2012	Stress testing framework for the financial sector supervisor
FAD	September 2012	G–20 budget institutions
MCM	October 2012	Early warning system and stress testing
FAD	November 2012	Measurement of structural fiscal balances
STA	January 2013	National account statistics
MCM	December 2013	Stress testing
STA	December 2013	Monetary and financial statistics
STA	March 2014	Government finance statistics
STA	March 2014	National accounts statistics
FAD	April 2014	Performance-based budgeting
FAD	May 2014	Tax revenue modeling
STA	May 2014	Financial sector accounts
STA	July 2014	Government finance statistics—public sector debt statistics
STA	April 2015	National accounts statistics
FAD	June 2015	Fiscal transparency evaluation
STA	January 2016	Compilation system for independent annual estimates of GDP
STA	April 2016	Government finance statistics—GFSM2014 and ESA10
FAD	December 2017	Public-Private Partnerships (PPP)
FAD	January 2018	VAT Policy Issues
MCM	September 2018	Stress testing (follow up)

WORLD BANK RELATIONS

A. International Bank for Reconstruction and Development (IBRD)

1. The Performance and Learning Review (PLR) of the Country Partnership Framework (CPF, FY18–21) is under preparation for Board discussion in January 2020. To date, all planned IBRD lending in the CPF pipeline has been fully delivered, totaling US$3.7 billion. There are now 13 IBRD operations, two Global Environment Facility (GEF)-financed projects and six trust-funded (recipient-executed trust funds, RETFs) projects in the portfolio for a combined total of US$4.77 billion. Portfolio indicators were consistently strong with a low-level of risk, high disbursements, satisfactory closing of seven lending operations (including RETFs), and no disconnect with Independent Evaluation Group reviews

2. Turkey's 11th National Development Plan, released in July 2019, has reaffirmed that the three major CPF focus areas remain relevant—Growth, Inclusion, and Sustainability. The strategic orientation is still valid although some adjustments to CPF objectives and revision of indicators will be needed to reflect evolutions in government demand for World Bank Group (WBG) support. Because the CPF is designed as a flexible program, the WBG team and the government are currently discussing how to support Turkey to face the evolving development challenges and to deliver on the goals of the 11th Plan. At the same time, the WBG program continues to maintain a long-term focus, maximizing opportunities to support Turkey's progression to high-income country status.

3. Turkey still has space in the IBRD lending envelope of the CPF to deliver new operations in FY20–21. The CPF proposed IBRD financing for the FY17–21 period at US$5-7.5 billion. To date, US$3.9 billion of this envelope has been used and demand for additional lending in FY20 is strong at about US$1.13 billion and indicative lending for FY21 is US$1.1 billion.

4. As part of the EU's response to the Syrian refugee crisis, the WBG was entrusted with managing a total of €205 million of the EU funded Facility for Refugees in Turkey (FRiT). In the first tranche agreed in 2016, this was targeted towards three projects (i) €150 million for "Education Infrastructure for Resilience Activities" to help Turkey respond to the growing demand for access to education among Syrian refugee children; (ii) €50 million to cover socio-economic support for refugees and host communities that will finance employment services and active labor market programs; and (iii) €5 million to support the creation of entrepreneurship and employment opportunities for refugees and host communities. The second tranche of the EU FRiT was agreed in June 2019 and has allocated approximately US$283 million going to the WBG for socio-economic projects and a further US$150 million for municipal services.

5. The Trust Fund portfolio has increased to US$250 million with 8 active operations, most notably the Clean Technology Fund (CTF), EU Instrument for Pre-Accession Assistance (IPA) funds, Global Environmental Facility (GEF) funds, and Swedish International Development Cooperation Agency (SIDA) Gender Funds, and the Grant Facility for Disaster Risk Reduction (GFDRR).

B. International Finance Corporation

6. **IFC portfolio implementation continued to perform satisfactorily.** The CPF expected IFC's own-account investment program has reaching a total of US$3,250 million (FY17: US$1,348m, FY18: US$1,127m, FY19: US$275m, FY20 to date: US$500m) delivery since the beginning of the CPF. IFC also committed US$938 million to Turkish banks under its Global Trade Finance Program (GTFP), broadening access to finance for companies. However, FY19 saw a significantly reduced program of US$275 million, reflecting IFC's current level of exposure to Turkey (2nd largest exposure globally), elevated economic and political risks, and increased global risk aversion.

C. Multilateral Investment Guarantee Agency

7. **Turkey continued to be Multilateral Investment Guarantee Agency's (MIGA) largest country by gross exposure, representing about 13 percent of MIGA's gross portfolio.** As of end-FY19, MIGA's gross exposure in Turkey totaled about US$3 billion across 15 projects (five in the infrastructure sector, four in the financial sector, and six in the services sector). Two-thirds of the portfolio stems from MIGA non-honoring guarantees: state-owned enterprises and sub-sovereigns, with the remainder being political risk insurance guarantees (largely in support of PPPs in the healthcare sector). Over the past fiscal year, MIGA underwrote new guarantees of US$618 million in the financial sector and conducted a Project Evaluation Report, validated by the IEG, on the non-honoring transaction with TurkExim I, guarantees issued in 2015, which achieved a Satisfactory development outcome.

STATISTICAL ISSUES

(As of November 4, 2019)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is broadly adequate for surveillance purposes, despite some shortcomings especially in national accounts and government finance statistics.
National Accounts: Published data for 1998 onwards adheres to the standards of the *System of National Accounts 2008 (2008 SNA)/ European System of Accounts 2010 (ESA 2010).* The Turkish Statistical Institute (TURKSTAT) compiles and disseminates a comprehensive set of national accounts series, including quarterly Gross Domestic Product (GDP) at current prices and in chain-linked volume terms (production approach and expenditure approach); quarterly and annual GDP at current prices (income approach); financial and non-financial sectoral accounts; government accounts regional accounts; and supply and use tables. In December 2016, TURKSTAT published a new series of national accounts, with reference year 2009 and benchmark year 2012. Quarterly national accounts are published within 2 months after the reference period. Since the end-2016 revision, annual GDP is estimated independently from the quarterly estimates and is published within 9 months after the reference period. The end-2016 dissemination of rebased national accounts led to a significant upward revision of GDP, with many changes introduced, including improvements in methodology, the adoption of the *2008 SNA/ESA 2010*, and the use of new data sources.
Price Statistics: The consumer price index (CPI) and the producer price index (PPI) generally conform to international standards. The CPI has 2003 as base year and the weights are based in the Household Budget Survey conducted yearly by TURKSTAT. The PPI is compiled for mining, manufacturing, and utilities. A separate PPI is disseminated for agriculture.
Government Finance Statistics: Coverage of the budget is largely complete. Data for some fiscal operations conducted through extra budgetary funds are available only with some lags. Fiscal analysis is further complicated by some quasi-fiscal operations carried out by state banks, state economic enterprises (SEEs), and other public entities; and technical problems associated with consolidating the cash-based accounts of governmental entities with the accrual-based accounting of SEEs. It is difficult to reconcile fiscal data with monetary and BOP data, especially in the accounting of external debt flows and central government deposits. Data available for publication in the *Government Finance Statistics Yearbook* cover the general government sector and its subsectors with coverage of both stocks and flows, including a full general government balance sheet. Quarterly general government data on an accrual basis, including revenue, expenditure, financing, and balance sheet data, are reported for publication in *International Financial Statistics (IFS)*.

Monetary and Financial Statistics: The Central Bank of Turkey (CBRT) reports monetary statistics for the central bank, other depository corporations, and other financial corporations, using the standardized report forms (SRFs), which accord with the concepts and definitions set out in the IMF's *Monetary and Financial Statistics Manual*.	
Financial Sector Surveillance: The Banking Regulatory and Supervision Agency (BRSA) reports all 12 core FSIs and nearly all the encouraged FSIs on a quarterly basis. Turkey reports data on some key series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).	
External Sector Statistics: The CBRT compiles and disseminates balance of payments and international investment positions (IIP) statistics on monthly basis in broad conformity with the conceptual framework of the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*). The CBRT participates in the IMF's surveys on direct and portfolio investments, and reports data template on international reserves and foreign currency liquidity regularly. In addition, the CBRT started reporting the currency composition of IIP (beginning with 2016 data) to STA recently.	
II. Data Standards and Quality	
Turkey has subscribed to the Special Data Dissemination Standard (SDDS) since 1996.	The latest Data ROSC was published in September 2009.

Turkey: Table of Common Indicators Required for Surveillance
(As of November 4, 2019)

	Date of latest observation	Date received	Frequency of data[7/]	Frequency of reporting[7/]	Frequency of publication[7/]	Memo Items: Data Quality – Methodological soundness[8/]	Memo Items: Data Quality Accuracy and reliability[9/]
Exchange Rates	Sep. 2019	10/11/2019	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1/]	Aug. 2019	10/07/2019	W	W	W		
Reserve/Base Money (narrow definition)	Aug. 2019	10/07/2019	W and M	W and M	W and M	O, O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Aug. 2019	10/04/2019	W and M	W and M	W and M		
Broad Money	Aug. 2019	10/04/2019	W and M	W and M	W and M		
Central Bank Balance Sheet	Aug. 2019	10/07/2019	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Aug. 2019	10/04/2019	W and M	W and M	W and M		
Interest Rates[2/]	Sep. 2019	10/04/2019	D/W/M	D/W/M	W/M		
Consumer Price Index	Sep. 2019	10/03/2019	M	M	M	O, LO, O, LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3/] – General Government[4/]	2019Q2	Oct. 2019	Q	Q	Q	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3/] – Central Government	Jan. 2018	Feb. 2018	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5/]	Jan. 2018	Feb. 2018	M	M	M		
External Current Account Balance	2019Q2	10/11/2019	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Aug. 2018	10/11/2019	M	M	M		
GDP/GNP	2019Q2	09/02/2019	Q	Q	Q	O, LO, O, O	LO, O, LO, O, LO
Gross External Debt	2017Q3	2017Q4	Q	Q	Q		
International Investment Position[6/]	2019Q2	9/26/2019	Q	Q	Q		

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.

4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
8/ These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
9/ This reflects the assessment provided in the data ROSC or the Substantive Update (published on September 3, 2009 and based on the findings of the mission that took place during October 2016) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

Statement by Mr. Raci Kaya, Executive Director for Turkey and Mr. Omer Ethem Bayar, Advisor to the Executive Director

December 9, 2019

On behalf of the Turkish authorities, we would like to thank Mr. McGettigan and his team for the comprehensive set of reports which reflect the depth and candor of the discussions in Ankara and Istanbul.

Macroeconomic Context

A deterioration in the sentiment toward emerging market economies as well as a number of adverse geopolitical developments have triggered a major bout of stress for the Turkish economy and financial markets in the second half of 2018. Reflecting the run on Turkish assets, the Lira depreciated sharply and market valuations suffered. The adverse developments in the monetary and financial markets led to a temporary spike in inflation, while also undermining broad confidence to hamper private consumption and investment. The authorities responded to these shocks with a host of policy measures - including a significant monetary tightening by the Central Bank of Republic of Turkey (CBRT), a judicious use of the fiscal policy to introduce targeted incentives, and the restructuring of the Financial Stability and Development Committee with a stronger mandate - to (i) reinstate monetary and financial stability, (ii) facilitate the rebalancing of the economy, and (iii) avoid a sharp and protracted downturn in economic activity.

Buoyed by the authorities' supportive policies as well as a more favorable external backdrop, the Turkish economy has embarked on a recovery path starting from Q1/2019 and y-o-y growth returned to positive territory as of Q3/2019 after having registered negative rates for three quarters. The Lira gained strength which was accompanied by more favorable market valuations as well as a gradual improvement in broad confidence indicators. Inflation, after reaching its peak (25.2 percent) in October 2018, has retreated significantly to 10.56 percent (y-o-y, end-November 2019) reflecting the tight monetary policy stance, supportive demand conditions, favorable base effects, as well as a stronger Lira. The current account has registered a remarkable correction—in the order of US$ 63.8 bn (i.e. around 8.3 percent of GDP)—to return to surplus after many years. The current account adjustment came on the back of resilient exports, decreasing import demand, and a strong tourism performance. Unemployment, on the other hand, has risen to 14 percent reflecting a broad-based slowdown in economic activity as well as the ongoing sectoral rebalancing, particularly affecting the construction sector.

The authorities have used the available fiscal room to avoid an excessive slowdown, and to aid the ongoing rebalancing of the economy. The recently announced New Economy Program has set the year-end central government budget deficit target at 2.9 percent of GDP, implying a 0.9 percentage point widening in the fiscal deficit relative to 2018. The headline figures reflect both the deliberate fiscal stimulus provided via targeted transfers and temporary tax breaks, as well as the role of automatic stabilizers (e.g. weaker indirect tax revenues). The authorities also took some steps to compensate for the weak tax revenues by non-tax revenues. Beyond the central government, the authorities do not envisage a deterioration in the balances of the rest of the public sector, including local governments. Consequently, the EU-defined general government debt stock is forecast to be at 32.8 percent of GDP as of end-2019.

Outlook and Policies

The New Economy Program[1] 2020–2022 (NEP), released in September 2019, is prepared in line with the key themes of *Balance*, *Discipline*, and *Transformation* and aims to uplift economic growth back to its historical averages while enhancing price and financial stability and consolidating gains on external balances.

The authorities are more sanguine on the growth outlook as they expect 5 percent real growth over the planning horizon. Following the weak performance in 2018 and 2019, the authorities believe that the slack in the economy will enable a convergence of economic activity toward its long-run trend under a moderate growth momentum without necessarily jeopardizing the price stability and external balance objectives. This `U-shaped` recovery hinges on the assumption of a benign external environment which would enable a continued improvement in financial conditions for the Emerging Market Economies. Policies will continue to be geared towards supporting the tradable sectors, increasing R&D expenditures, improving the energy and logistical infrastructure, as well as upgrading the human capital. With the gradual dissipation of sectoral drags on employment (i.e. mostly from the construction sector), the authorities expect employment generation to gain pace and the unemployment rate to decline to 9.8 percent by the end of 2022.

Monetary Policy

Inflation is projected to decline to low single-digit levels. The CBRT, while retaining the medium-term inflation target at 5 percent, has set interim targets to better anchor expectations in the short term. As such, the headline CPI, which is forecast to be at 12 percent as of end-2019, is projected to decline gradually to 8.2 percent in 2020, 5.4 percent in 2021, and stabilize around the target by 2022.

The authorities concur that managing inflation expectations is critical for a sustained disinflation process. Currently, 12 and 24-month ahead expectations hover above the CBRT's forecasts while there is a gradual convergence of expectations toward the authorities' interim targets. On that note, the authorities believe that the CBRT's improved forecast accuracy since October 2018 has significantly supported the credibility of the monetary policies and help anchor expectations. With medium-term expectations still lying outside the uncertainty band around the inflation target, the authorities agree that all

[1] New Economy Programs are flagship policy documents of the Turkish economy, providing a macro framework and setting out the policy objectives for a period of three years.

macroeconomic policies should be coordinated to bring the inflation down.

The authorities consider the current monetary policy stance consistent with the projected disinflation path. The CBRT has cut the interest rates by a cumulative of 1000 bps since July 2019, in view of the improving inflation outlook amid upbeat indicators for underlying inflation, supply-side factors, and favorable import prices. Additionally, the authorities take the global monetary conditions into consideration in their decision processes as well.

The recent rate cuts by the CBRT led to a downward shift in the yield curves of bond and swap markets confirming a more favorable inflation outlook, the improvement in expectations, and a decline in the risk premium.

The authorities concur with the staff on the need to accumulate international reserves as economic and financial conditions permit. They also underscore that the international reserve data is compiled and published in a timely, comprehensive, and transparent manner, consistent with international standards.

Fiscal Policy

Fiscal policy will be growth-friendly and fiscal prudence - the long-standing anchor of the Turkish economy's resilience - will be preserved. The overall fiscal policy stance, which was recalibrated in 2018-19 to buttress economic activity, will be broadly kept unchanged in 2020. On a similar note, the budget deficit-to-GDP ratio is targeted to remain below 3 percent in the outer years of the planning period as well. The authorities believe that stronger economic activity as well as improvements to the revenue administration will help reverse the relatively weak tax performance in 2019. Currently, the authorities do not intend to introduce new tax policy measures in addition to what was already enacted in 2019. Efforts to restrain expenditure growth as well as to improve the composition of the spending envelope will continue. Consequently, public debt is set to remain broadly flat between 32–34 percent of GDP throughout the NEP period.

Even though debt sustainability is not a source of concern, fiscal discipline will be used as a policy tool to complement the monetary policy efforts to tame inflation. In this regard, the 2020 central government budget aims to strike a delicate balance between buttressing economic activity and consolidating the gains of rebalancing. Furthermore, the authorities will continue to set public wages through a rules-based methodology and in line with the projected inflation path.

On Public-Private-Partnership (PPP) projects, building on the assessments and recommendations of the very productive technical assistance mission conducted in late 2017, a framework arrangement will be prepared to ensure efficiency, productivity, affordability, and integrity in PPP applications. On the Sovereign Wealth Fund (SWF), the authorities assured staff that they will adhere to international best practices in accounting of its activities.

Current Account

The current account will be kept at sustainable levels. The rapid and sizable adjustment in the current account is a defining feature of the rebalancing story of the Turkish economy. In view of the volatile external environment, the authorities are keen to keep the current account in close check and avoid any undue expansion of the deficit that would expose the economy to the swings in the global sentiment. In that vein, the current account is expected to post a deficit of 1.2 percent of GDP in 2020 - a level that is in broad conformity with the Fund's norm current account assessments and will keep the external financing needs at a reasonable level. The authorities will also give prominence to structural policies that aim to increase exports of high value-added products, reduce import dependence on key sectors, and bolster the tourism potential.

Financial Sector

The Turkish banking system has proven its resilience in the face of severe adverse shocks. Turkish banks are well capitalized with a system-wide capital adequacy ratio above 18 percent (latest data as of October 2019) which is well above the regulatory minimum. The total non-performing loan ratio, notwithstanding a modest increase, remains at manageable levels (i.e. 5.15 percent). By regulation, banks are not allowed to carry net open FX positions beyond a certain limit (i.e. 20 percent of regulatory capital) and therefore, the balance sheet of the banking system is effectively immune to the direct effects of currency valuation, including through appropriate use of off-balance sheet hedging instruments. The authorities do not agree with staff's assessment of a continued positive credit gap and believe that although the latest credit developments indicate a revival of loan growth, the credit gap is still in negative territory. Furthermore, both the banking regulator as well as the analysts from the banking sector concurred that the weakness in loan growth is primarily driven by sluggish credit demand rather than supply side constraints. The authorities, while acknowledging the possible confidence effects of a third-party asset quality review, consider the current supervisory framework robust—aided by regular, detailed on-site examinations as well as an effective stress test framework.

The authorities agree that an effective insolvency regime and an out-of-court restructuring system will be crucial to resolve remaining balance sheet issues in the non-financial corporate sector. Therefore, the authorities are working on a new legislation that will modernize the legal framework as well as address identified stretches in the current system, including those pertaining to debtor-creditor rights. The authorities also encourage private-sector driven initiatives to facilitate voluntary restructuring of debt contracts.

Structural Reforms

The current political landscape gives a window of opportunity to implement comprehensive structural reforms in an effort to improve the Turkish economy's competitiveness, strengthen its resilience to external shocks, and address impediments to job creation and investments. Policies are already underway to improve the efficiency of *inter alia* the labor market, business environment, public financial management, capital markets, and judicial and education systems. Targeted incentives will continue to support the renewable energy as well as other critical and technology-intensive sectors. With a stronger focus on social inclusion, poverty alleviation, and providing equal opportunity to all, the authorities are also intensifying their efforts to improve social outcomes in Turkey. These efforts are bearing fruit as the rank of Turkey in World Bank Doing Business Indicators has improved to 33 in 2019, from 60 in 2017. The authorities acknowledge the need for better prioritization of the reform agenda and appreciate the thematic analysis by staff which has provided valuable insights.

International Development Efforts and Refugees

Turkey, despite recent economic challenges, continues to expand its global humanitarian outreach in support of the UN Sustainable Development Goals, with its total development assistance reaching USD 9.3 billion just in 2017 - affirming its position as one of the most generous countries globally.

With more than 4 million refugees, Turkey continues to host the largest population of displaced people globally. Significant efforts and funding were mobilized to provide essential public services, including education and health for these people. The authorities continue to take measures to integrate refugees to social and economic life in Turkey, while also spearheading international efforts to secure a safe and voluntary return of these people to their home countries.

Final Remarks

The Turkish authorities are grateful for the analytical depth and rigor of the Article IV consultations and associated policy advice, which will carefully be assessed. The authorities will continue to work closely with the Fund.