INTERNATIONAL MONETARY FUND

IMF Country Report No.12/338

TURKEY

2012 ARTICLE IV CONSULTATION

December 2012

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 2012 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 26, 2012, 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 October 31, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its November 16, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Turkey.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

©2012 International Monetary Fund

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

October 31, 2012

KEY ISSUES

Context: The economy has slowed, driven by weakening domestic demand, but growth is expected to remain positive and more balanced this year. The current account deficit has adjusted at a significant pace and inflation has decelerated, although it remains above the central bank's target. Despite the reduction in imbalances and generally sound balance sheets in the economy, Turkey remains vulnerable to capital flow reversal due to its large external financing needs; should this occur, it could lead to a hard landing.

Challenges: In the short term, the priority is to reduce imbalances further and build buffers against possible adverse external developments. In the medium term, raising the economy's potential and breaking its boom-bust cycle requires enhanced coordination of macroeconomic policies, higher savings, and improved competitiveness.

Policy recommendations:

- The current fiscal stance is too loose, driven by rapid growth in primary expenditures. The 2013 budget envisages a tightening, which is appropriate.
- The medium-term fiscal plan should aim at a sizeable increase in the primary surplus. The back-loaded adjustment should be delivered through restraint in current spending.
- The central bank should normalize the monetary policy framework and focus more decisively on achieving its inflation target, which requires a positive real policy interest rate and improved communication with the markets.
- In the medium term, higher public savings should contribute to an increase in national savings, while broad structural reforms should be geared to improving competitiveness.

Approved By
Ajai Chopra and Martin Muhleisen

Discussions for the 2012 Article IV consultation were held in Ankara and Istanbul during September 13–25, 2012. The mission comprised Messrs. Ernesto Ramirez Rigo (head), Miniane, Tchaidze (all EUR), Hesse (MCM), Miao (SPR), Stanger (STA), Ms. Rial (FAD), and Mr. Lewis (Senior Resident Representative). Mr. Chopra (EUR) participated in some of the policy meetings. Mr. Yalvaç (Senior Advisor, OED) joined the meetings. The mission met with Deputy Prime Minister Babacan, Minister of Finance Şimşek, Central Bank Governor Başçı, Treasury Undersecretary Çanakcı, other senior public officials, and private sector representatives.

CONTENTS

CONTEXT 4

BACKGROUND 5

A. RECENT DEVELOPMENTS 5

B. OUTLOOK AND RISKS 8

TURKEY: RISK ASSESSMENT MATRIX 13

POLICY DISCUSSIONS 14

STAFF APPRAISAL 27

BOXES

1. Medium-Term Program, 2013–15 9
2. The Cyclical Position of the Turkish Economy in 2011 11
3. Linkages Between Turkey and Euro Area 12
4. The Conduct of Monetary Policy in Turkey 17
5. Macro-Prudential Policies in Turkey 19
6. Raising Savings In Turkey 23
7. Turkey's External Competitiveness 25

FIGURES

1. Economic Slowdown 35
2. High Frequency Indicators 36
3. Fiscal Stance 37
4. Monetary Policy 39
5. Financial Sectors 39
6. Households and Corporates 40
7. Turkey vs. Peers 41

TABLES

1. Selected Economic Indicators, 2007–13 ____ 29
2. Medium-Term Scenario, 2007–17 ____ 30
3. Summary of Balance of Payments, 2007–17 ____ 31
4. External Financing Requirements and Sources, 2007–17 ____ 32
5. Public Sector Finances, 2007–17 ____ 33
6. Banking System at a Glance, 2007–11 ____ **Error! Bookmark not defined.**

APPENDIXES

I. Debt Sustainability Analysis ____ 42

CONTEXT

1. Strong buffers and a prompt policy response to the 2008 global financial crisis helped Turkey recover quickly. Prior to the crisis, the Turkish authorities revamped the policy framework and gained policy space, used at the outset of the crisis. The policy response, the normalization of global financial conditions, and Turkey's fundamentals—low public sector debt, single-digit inflation, the banks' healthy balance sheets, and favorable medium-term prospects—resulted in a strong recovery, attracting sizeable capital inflows.

2. However, weak coordination of macroeconomic policies resulted in a slow reversal of the stimulus when the recovery materialized. The delay in implementing coordinated counter-cyclical policies allowed for a credit-fueled domestic demand boom to take hold. This pushed inflation to double digits and widened the current account deficit to 10 percent of GDP (the second largest in the world in dollar terms) in 2011, exposing Turkey to the risks of capital flow reversal at a time of continued global uncertainty.

3. After two years of rapid growth, the economy has slowed and imbalances are unwinding. Domestic demand started to decelerate decisively on the back of tighter macroeconomic policy from the summer of 2011 onwards, coinciding with the deterioration of the external environment. Exports have held up better than expected, with robust trade with the MENA region offsetting weak demand in the EU. The economic slowdown has allowed for a narrowing of the positive output gap and an improvement in the current account deficit and inflation.

- **The immediate challenge is to further reduce the risks presented by the external imbalance.** External financing needs will hover above 25 percent of GDP and continue to pose a significant vulnerability; in particular, due to the dependence of banks on short-term foreign borrowing, which in the face of an abrupt disruption to capital inflows could lead to a credit contraction and economic hard landing. At the same time, low interest rates in advanced economies could lead to strong capital inflows and the re-emergence of a domestic demand boom that would reverse the unwinding of imbalances. Such an environment requires navigating a very narrow policy path: maintaining the flexibility to respond in case domestic demand weakens further, while giving priority to reducing the current account deficit and inflation.

- **In the medium term, Turkey must address its low savings in order to reduce dependence on external financing.** Tackling the competitiveness gap and improving the policy mix to mitigate real cycles will be crucial toward this end. With a current account deficit norm of around 3 percent and the actual deficit 2–4 percentage points of GDP above what can be explained by fundamentals and desired policy settings, the real exchange rate appears overvalued by some 10–20 percent. The low savings rate, around 14 percent of GDP, results in a sharp pro-cyclicality of investment linked to the availability of external financing, with major consequences for the volatility of output. Better integrating monetary, fiscal, and macro-prudential frameworks would help smooth the cycles through future episodes of capital inflows and maintain financial stability.

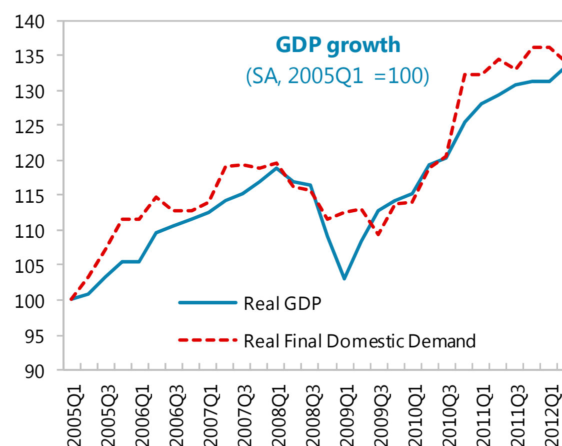
4. The Justice and Development (AK) Party continues to dominate the political landscape. It holds a comfortable majority in parliament, helpful in enabling the government to proceed with its legislative agenda. The adoption of a new constitution, possibly to include a strengthened

presidential system, is one of the major ongoing institutional issues. Foreign policy concerns loom large, notably the conflict in neighboring Syria. Turkey will enter an extended electoral period in 2013, with municipal elections expected in late 2013, a Presidential election in 2014, and parliamentary in 2015.

BACKGROUND

A. RECENT DEVELOPMENTS

5. The economy has cooled off considerably on the back of slower domestic demand. Real GDP growth decelerated to 2.9 percent in 2012Q2 (compared to 9.1 percent a year earlier). In the first half of 2012, real domestic demand contracted by 1.9 percent y-o-y after growing by 15.4 percent in 2011H1, with the deceleration led by private consumption and investment. Net exports became the main driver of growth as imports declined and exports held up despite weak demand in the traditional European markets due to diversification to Middle East and North Africa (MENA) countries.[1] Despite the deceleration in economic activity, unemployment fell below 9 percent, a ten-year low.



Sources: Haver and IMF staff estimates.

6. The deceleration is the result of both policy tightening and exogenous factors. Provisioning requirements and risk weights on general purpose loans were increased in June 2011, while the authorities used moral suasion to guide banks towards an implicit nominal credit growth target of 25 percent for end-year.[2] In the last quarter of 2011, euro area related turbulence and uncertainties over the domestic policy framework led to a reversal of capital flows, forcing the CBRT to tighten monetary policy considerably, increasing short-term market rates by 5 percentage points and selling 15 percent of its FX reserves to defend the lira. Tighter monetary policy and credit standards more than outweighed still-rapid public spending growth, seeding the deceleration in consumption and investment, with annual credit growth declining from 35 percent in 2011H1 to about 15 percent in early 2012.

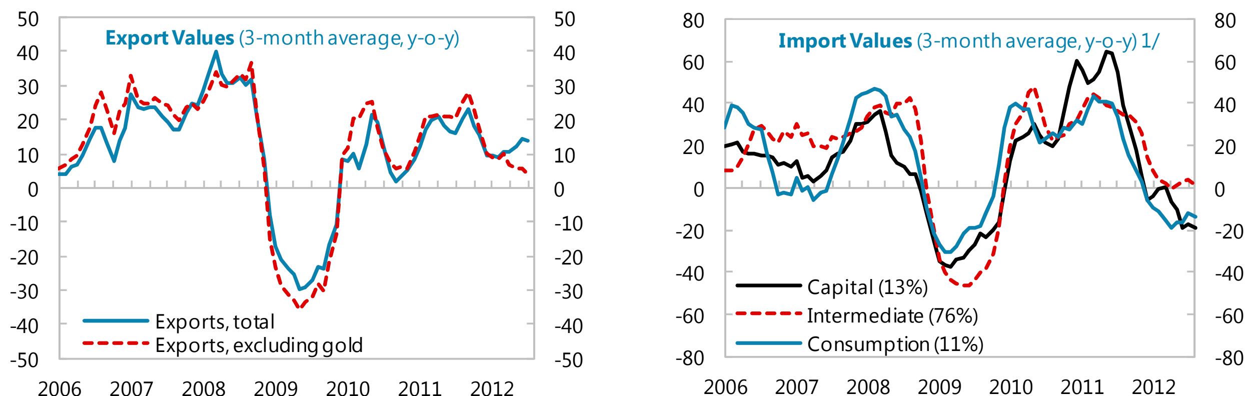
7. The improvement in the current account deficit is mainly the result of demand compression.[3] The 12-month rolling current account deficit has narrowed by 2 percentage points of GDP after peaking at 10.2 percent of GDP in October 2011. Imports have played the main role, falling

[1] The share of exports to MENA region rose to 31 percent in 2012H1 from 25 percent in 2011 while that of EU-27 declined to below 40 percent from 46 percent in 2011. Iran and Iraq became Turkey's second and third export destinations after Germany, although exports to Iran largely reflect exceptional gold exports.

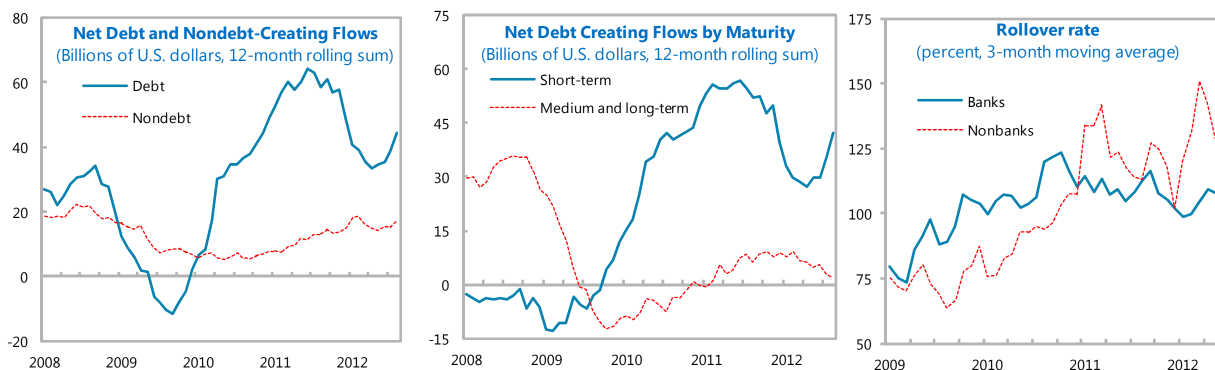
[2] See IMF Country Report No. 12/16.

[3] See Selected Issues Paper "Turkey's Current Account Rebalancing: Cyclical or Structural."

by 2 percent year-on-year through July. Exports have remained buoyant, increasing by 14 percent year-on-year, although non-gold exports grew more modestly by 5 percent.[4] The financing structure of the current account deficit has improved with the share of non-debt creating flows and long-term borrowing increasing to 45 percent of CAD in 2012H1, compared to 38 percent last year, and net FDI in line with last year. Finally, gross international reserves of the CBRT have risen to about $110 billion (about 75 percent of short-term external debt on a remaining maturity basis), as banks are using FX and gold to meet their lira reserve requirement obligations, but net reserves remain at around $50 billion.[5]



Sources: Turkstat and IMF staff estimates.
1/ Values in parentheses denote shares of total in June 2012.



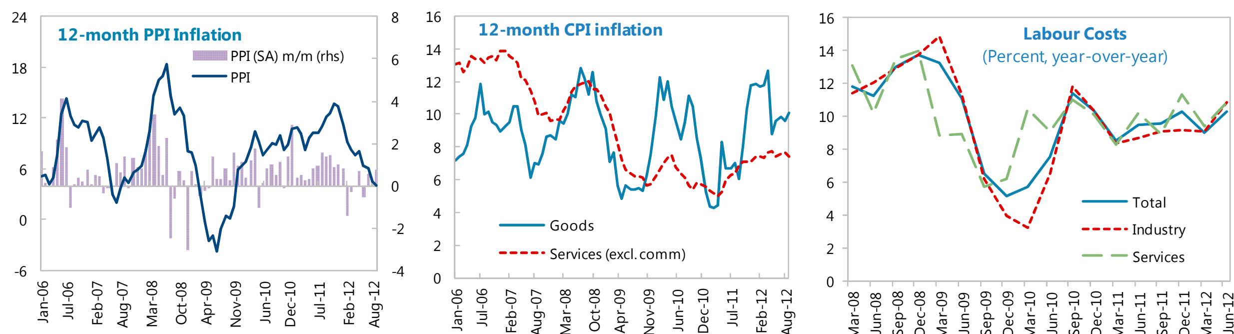
Sources: CBRT and IMF staff estimates.

8. Easing domestic demand pressures have helped reduce inflation, although it remains high. After peaking at 11.1 percent in April, inflation was 9.2 percent in September. Food prices, which represent just over a quarter of the CPI basket, have been benign, and the stable exchange rate has helped durable goods inflation. Despite these gains, core inflation, although declining,

[4] Gold exports, mostly to Iran, surged by 7 billion in the first 7 months of the year. Turkey is not a major gold-producing country and with some lag imports of gold have increased as well.

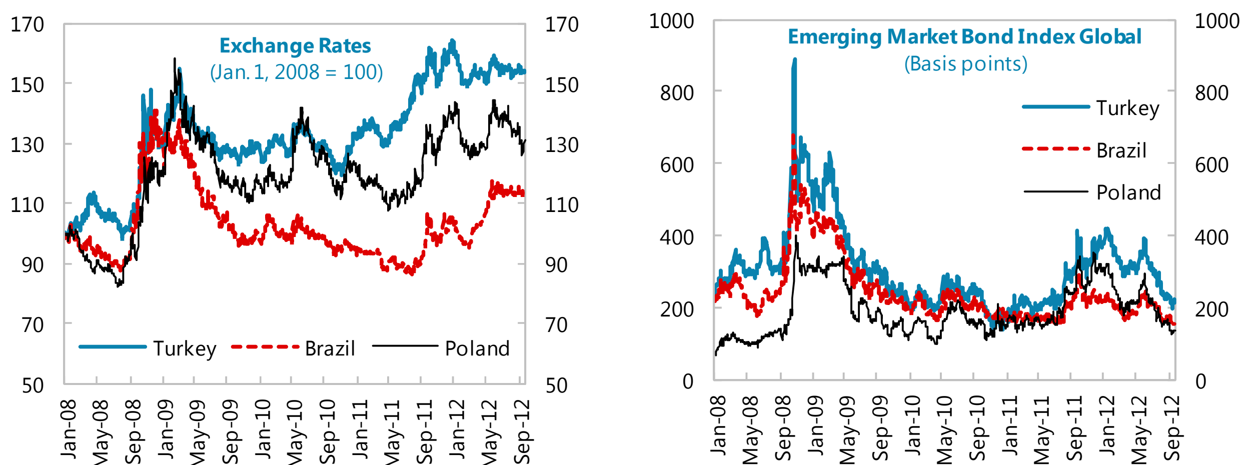
[5] The change in gross reserves in 2012 is likely to significantly exceed the overall BOP surplus, due to gold transactions between domestic banks and the central bank which are not recorded in the BOP.

remains around 7 percent; inflation in services remains around 7 percent; and labor costs increased by 10.3 percent in 2012Q2.



Sources: Turkstat and IMF staff calculations.

9. Overall, financial sector indicators remain robust and Turkish financial assets have performed well. Turkish banks, including subsidiaries of European banks, have maintained adequate capital buffers, with the CAR at 16.3 percent (above peer countries) even after moving to Basel II and II.5 in July 2012. Banking sector leverage remains comfortable at around 8 percent (Basel III definition) and external roll-over rates have been maintained above 100 percent despite global financial tensions. Profitability, although declining, remains high (return on equity at 16 percent), non-performing loans are at 2.8 percent of total assets, and provisioning remains comfortable at 80 percent. Capital inflows have helped lower the government benchmark yield to around 7.5 percent from 11.5 percent in early January, and contributed to the 30 percent increase in equity prices since the beginning of the year. The country's EMBIG spread is just above 200 basis points. Finally, in June Turkey received a one notch credit upgrade from Moody's to Ba1, just below investment grade.[6]



Source: Bloomberg.

[6] Fitch rates Turkey at BB+, one notch below investment grade, while S&P at BB, two notches below.

10. More recently, monetary policy has been eased. The CBRT, which allowed the effective interest rate[7] to increase to around 8 percent on average during the first half of 2012, has eased it by around 200 bps since July 2012, while cutting the overnight lending rate by 200 bps. Moreover, allowing banks to hold their Lira reserve requirements in foreign currency and in gold[8] has released lira liquidity and lowered banks' funding costs.

11. The authorities announced the medium-term fiscal plan (MTP) for 2013–15. Under the authorities' assumptions (Box 1), they aim to increase the primary surplus by 0.3 percent of GDP in 2013. The draft 2013 budget is consistent with the MTP target and hence, results in a tightening of the fiscal stance compared with 2012. However, the targeted primary surplus path to 2015 is lower than that specified in last year's MTP.

B. OUTLOOK AND RISKS

12. In staff's baseline scenario, growth will be below potential in 2012, rising gradually as domestic demand strengthens. High-frequency indicators, such as industrial production and credit, point to continued growth in 2012Q3, although at a slower pace than in 2012Q2. The conditions for a recovery in domestic demand appear to be in place, with record low unemployment, positive real wage growth, healthy private sector balance sheets, and low interest rates. Barring new external shocks, staff expects consumption to increase by an annualized 3¾ percent in the second half and investment to remain firm, growing by 4½ percent, altogether leading to real growth of around 3 percent in 2012. In 2013, real GDP and domestic demand are expected to increase by 3½ percent, with the contribution from net exports falling to zero as imports accelerate. In the medium term,

[7] The effective interest rate is the weighted average interest rate at which the CBRT provides liquidity to the market through its various open-market instruments on any given day.

[8] The CBRT allows up to 60 percent of lira-denominated reserves to be held in FX and up to 30 percent in gold, with a varying mark-up (Reserve Option Coefficient, ROC).

Box 1. Medium-Term Program, 2013–15

The macroeconomic assumptions underlying the medium-term plan (MTP)[9] are more optimistic than staff's, notably: (i) the economy is assumed to grow by 5 percent in 201415 versus 4–4¼ percent in the staff's scenario, possibly reflecting the effect of yet to be announced structural reforms; inflation is projected to fall rapidly over 2013 and converge close to the central bank's 5 percent target, whereas staff expect a significant deviation from the target next year, although expected to remain within the band (iii) the authorities see the current account deficit adjusting by some ¾ percentage point of GDP over the MTP horizon despite an acceleration in domestic demand, whereas staff expect the deficit to widen gradually. Taken individually, these gaps are within the margin of forecast error, but cumulatively the differences are non-trivial.

The new MTP envisages a less ambitious path for the public sector primary surplus than its predecessor. Relative to last year's MTP, the 0.8 percentage points (ppts) of GDP deterioration in the central government's surplus in 2012 (from 1.0 to 0.2 percent of GDP) is largely explained by spending overruns. This deterioration is fully carried over to the outer years despite higher revenues projected for 2013 and beyond—mainly due to recently introduced tax policy measures—driven by continued pressures on current spending, 1.3 ppts of GDP higher in the medium term relative to the previous MTP, despite assumptions of a compression in personnel spending from 2014 onwards. To compensate for this, the authorities envisage reducing capital spending in 2013 and beyond.

Staff project a less favorable medium-term fiscal outlook. While the authorities expect the central government's primary surplus to reach 0.7 percent of GDP by 2015, staff forecast a primary deficit of 0.1 percent of GDP. Discrepancies between staff's projections and the new MTP are centered on the spending side, with revenues relatively similar. In particular, staff assumes that current spending will not decline as a share of GDP, and sees risks to the assumed compression in capital spending.

	Old MTP	New MTP	Staff	Old MTP	New MTP	Staff	Old MTP	New MTP	Staff	New MTP	Staff
In percent of GDP, unless noted	2012			2013			2014			2015	
GDP (percent change)	4.0	3.2	3.0	5.0	4.0	3.5	5.0	5.0	4.0	5.0	4.3
CPI (percent change, eop)	5.2	7.4	7.5	5.0	5.3	6.2	5.0	5.0	5.0	5.0	5.0
Current account balance	-8.0	-7.3	-7.5	-7.5	-7.1	-7.2	-7.0	-6.9	-7.3	-6.5	-7.5
Central government primary balance	1.0	0.2	0.1	1.2	0.5	0.5	1.4	0.6	0.1	0.7	-0.1
Central government primary revenues	22.1	22.0	22.2	22.0	22.8	22.7	21.8	22.5	22.5	22.1	22.3
Central government primary spending	21.1	21.9	22.1	20.9	22.3	22.3	20.4	21.9	22.4	21.4	22.4
of which current spending	19.1	19.5	19.7	18.9	20.2	20.1	18.4	19.8	20.2	19.2	20.2
of which capital spending	2.0	2.4	2.4	2.0	2.1	2.1	2.0	2.2	2.2	2.2	2.2

[9] This plan was announced on October 9th, after the mission's departure. The mission held discussions with the authorities on the broad contours of the MTP.

Turkey's favorable population dynamics, robust private sector, and increasing economic openness are supportive of GDP growth of close to 4¼ percent.

13. The staff considers that the output gap was large and positive in 2011 (Box 2), but it is projected to close following two years of below-potential growth. Together with weaker energy prices and positive base effects after last year's indirect tax hikes, this should bring inflation to 7.5 percent at end-2012 and 6.2 percent at end-2013, albeit still above the central bank's target. However, the current account deficit will continue to loom large: narrowing to 7½ percent of GDP in 2012 due to domestic demand compression and decreasing oil prices, but then widening back towards 8 percent in the medium term as growth again becomes domestic demand-led and the real exchange rate appreciates due to still high inflation.

14. Despite recent progress, the outlook is clouded by an uncertain external environment, with developments in Europe and global financial markets representing the main downside risk (Box 3). Turkey remains exposed to a sudden stop in capital inflows, as the 2011Q4 episode showed. Although it has so far not encountered significant difficulties securing external financing, Turkey's annual gross external financing needs are projected to exceed 25 percent of GDP in the years to come. The structure of bank liabilities has worsened with the loan-to-deposit ratio now at about 100 percent and the share of external funding (largely short-term) in banks' overall liabilities at 15 percent. The short FX position of the non-bank corporate sector has grown to $126 billion (although only $9 billion is short-term). Thus, were global liquidity to dry up or risk appetite for Turkey to turn sour, the economy would be forced into a sharp adjustment.

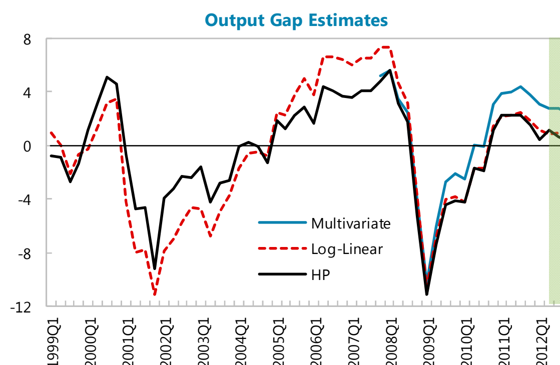
15. The risks could be exacerbated if the authorities try to stimulate the economy by relaxing macroeconomic policies at this time. If domestic demand were to accelerate significantly more than projected under the staff's base line scenario, the output gap would reopen thus reversing disinflation and resulting again in a widening of the current account deficit. This, in turn, would further raise the gross external financing needs, and increase the dangers posed by capital flow reversal.

16. The authorities have a more benign view of the cyclical position of the economy and the outlook. They believe that the output gap was close to zero in 2011 and that the acceleration in inflation and widening of the current account were driven mostly by one-off and exogenous factors. Inflation deviated from target due to excise tax increases, adverse developments in unprocessed food prices, and pass-through from the lira depreciation. The authorities point to moderate core and services inflation as evidence of no underlying price pressures. In their view, the current account was negatively impacted by the large deterioration in the terms of trade and a one-off adjustment to the economy's capital stock. Thus, they see the exchange rate as being close to equilibrium. Hence, relative to staff, they view imbalances to be smaller, vulnerabilities to be lower, and buffers to be larger, with the economy able to grow sustainably at close to 5 percent from 2013 onwards.

Box 2. The Cyclical Position of the Turkish Economy in 2011

The differences in the assessment of the macroeconomic stance between the authorities and staff are to a large degree driven by differences in views on the cyclical position. The authorities believe that the output gap was close to zero in 2011, while in staff's view it was positive with the estimates ranging between 2–4 percent of potential GDP.

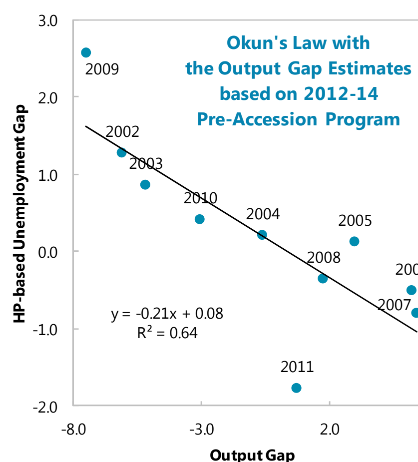
Assessments of the medium-term potential are not too different (about 4 percent in staff's view and 4½ percent according to the authorities) and so are the methodologies (univariate filters, the production function approach).[10] Hence, output gap differences are driven by differences in the forecasted paths for GDP. As the authorities forecast growth of 4–5 percent in 2012–13, filtering techniques attribute the recent high growth to potential, while the staff's forecast of lower growth in 2012–13 relocates it to the cyclical component.



Source: IMF staff estimates.

In staff's view, **a range of observations firmly point to a positive output gap in 2011**, given international experience:

- In 2010–11 GDP grew at a rate twice that of its potential, driven by domestic demand, while employment grew at 6.2 percent compared to 1.4 percent in 2006–09 or -0.2 percent in 1999–2009;
- CPI inflation accelerated from 4 percent in March 2011 (the lowest since 1969) to 11 percent in April 2012 (the highest since 2008);
- The growth rate of credit to the private sector peaked at above 40 percent in 2011;



Source: National authorities; IMF staff estimates.

- In 2009–11 the public sector balance improved by almost 5 percentage points of GDP, while the non-energy current account deteriorated by 6 percentage points of GDP.
- Lastly, the authorities' estimate of the 2011 output gap deviates significantly from the predictions of Okun's law, which otherwise holds well for the 2002–11 period (although 2009 is another exception).

The authorities, meanwhile, point to limited inflation in non-tradables and asset prices as evidence of no overheating and argue that sharp increases in the current account deficit and inflation are due to one-off factors.

[10] Additionally, staff makes use of the methodology developed in-house (Benes et al, "Estimating Potential Output with a Multivariate Filter," IMF Working Paper 10/285), while the authorities use a range of additional methods, such as sectoral gaps, supply-side surveys, structural models, etc.

Box 3. Linkages Between Turkey and The Euro Area

Developments in the Euro area impact Turkish economy by affecting **trade, FDI flows and availability of funding for local banks**, with the latter presenting the main risk in a sudden capital flow reversal.

According to BIS data, out of $218 billion of **consolidated foreign claims** (including equity ownership parents) of reporting banks on Turkey, $164 billion came from the European banks, with the main creditors being from the UK, Greece, Netherlands, Germany, and Spain. While about 18 percent of the banking sector has ownership links to Euro area banks under stress,[11] direct parent funding is low. Hence, an abrupt deleveraging of foreign parent banks presents less of a risk to their Turkish subsidiaries than via foreign banks' FX loans to Turkish banks and corporates. Also, as of January 2012, the BRSA applied amended minimum capital requirements for banks with foreign strategic shareholders.

The impact on trade is direct (via dampened price and volume of Turkish exports) and indirect (via decline in profits stemming from a weakening euro, in which a large share of exports is priced, against the US dollar, in which inputs are priced). So far in 2012H1, Turkish exports have been resilient (registering 15 percent increase), and profits do not show signs of weakening. Turkey's proximity to MENA and Asia proves a natural advantage in finding replacements for the European markets—especially for primary products such as apparel, textiles, and food—while maintaining relatively low shipment costs. Prior to the 2008 crisis, more than half of Turkish exports were destined for EU-27, with Germany leading the pack, but since then the share has declined to below 40 percent in 2012H1, while the share of MENA countries increased from less than 15 percent to 31 percent. Exports of gold, food, and building materials to Iran and Iraq have been particularly strong. Nevertheless, two thirds of Turkish exports to the EU-27 are those with medium to high technology components (motor vehicles, electrical equipment, and metals), which may prove harder to diversify. Given this sizeable share of European markets in absorbing the relatively more sophisticated Turkish exports, the impact can be non-trivial. In addition, Europe holds a dominant role in providing tourism and services receipts.

The EU represents around 72 percent of FDI. In 2007–11, FDI from the EU countries averaged US$9 billion per year, representing around 72 percent of total FDI flows to Turkey. Out of the FDI stock of US$134.5 billion at end-2011, EU investors account for 78 percent with the top three sources being Netherlands, Germany, and Austria (21 percent, 9 percent, and 8 percent respectively). FDI flows are in general more stable than other forms of flows and their concentration in the non-tradable sector (25 percent went into financial and insurance services, 21 percent into information and communication services, and 8 percent into wholesale and retail trade) serves as a stabilizing factor, since they rely more on Turkey's own fundamentals, such as growth potential and population dynamics, and thus, are less susceptible to external developments.

[11] This includes majority ownerships of Finansbank by the National Bank of Greece, TEB by BNP Paribas, non-majority ownerships of foreign banks, such as Spanish BBVA in Garanti and Italian UniCredit in Yapi Kredi, as well as foreign banks HSBC and ING. Denizbank, formerly of Franco-Belgian Dexia, has been sold to Russia's Sberbank.

TURKEY: RISK ASSESSMENT MATRIX[12]

Risk	Relative Likelihood	Impact if Realized	Policy response
1. Stagnation of euro area growth. With euro area the main destination for Turkish exports, the impact will be felt mainly via weaker exports.	High	Medium	- Fiscal automatic stabilizers should be allowed to operate fully. - Monetary policy should concentrate on achieving inflation target; FX interventions should only be considered during periods of excessive volatility in exchange rate. - Supervision should be intensified for subsidiaries of euro area banks.
2. Persistent external imbalance. Were domestic demand to bounce back strongly due to domestic policy loosening leading to excessive growth in credit, rebalancing would stop and unwinding of the current account deficit would reverse.	High	Medium	- Coordinated policy response should be put in place: reverse monetary policy easing, tighten fiscal policy to slow down domestic demand and facilitate work of the CBRT, use macro-prudential tools to guard against worsening of banks' balance sheets.
3. Strong intensification of the euro area crisis leading to capital flow reversal and a sudden stop. This will trigger an abrupt adjustment in output via a confidence shock, credit crunch, and demand compression; banks could face significant difficulties rolling over external debt; and lira depreciation will worsen balance sheets of banks and non-financial corporate.	Medium	High	- Exchange rate must be allowed to depreciate initially, but targeted FX interventions and reduction of FX RRs and the ROC can be used to avoid excessive overshooting to limit adverse balance sheets effects. Once overshooting is unwound, the focus should shift to supporting demand via loosening monetary policy. - Fiscal stimulus should be implemented at the outset. - Deposit insurance coverage could be temporarily increased; liquidity requirements, especially for FX, could be temporarily lowered; loan restructuring programs might be required to deal with NPLs.
4. Oil Price Hike. Geopolitical tensions in the Middle East could trigger an oil price shock. Given annual energy imports of 7 percent of GDP, the current account deficit and inflation would increase.	Low	Medium	- Monetary policy should ensure that the impact of higher energy prices does not lead to second round effects on inflation. - Fiscal automatic stabilizers should be allowed to operate fully.

[12] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is staff's subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

POLICY DISCUSSIONS

The Short-Term Challenge: Ensuring Prudent Policies

17. There has been some improvement in macroeconomic policies along the lines recommended in recent Article IV consultations. While in 2010–11, both monetary and fiscal policies were loose, contributing to the overheating of the economy and deterioration in the current account, the authorities tightened the stance starting in the middle of 2011 on. Initially, macro-prudential measures, such as increases in risk weights and provisioning were implemented in June 2011. Subsequently, the CBRT delivered much needed policy tightening in late 2011-early 2012, although this was not implemented within a normalized monetary framework as recommended. However, fiscal policy remained expansionary throughout 2012, but the authorities are aiming to tighten the stance for 2013–15[13] as there is a shared view on the need to reduce imbalances.

Fiscal Policy

18. In staff's view, the 2012 fiscal stance is pro-cyclical, when a neutral stance would have been appropriate. Fiscal performance has weakened in 2012, due to overruns in primary expenditures, the impact of lower growth on revenues, and fewer one-off proceeds from the tax restructuring implemented last year. While primary expenditures slowed in the second half of 2011, they reaccelerated in 2012, driven by wage increases granted in May that were above budget provisions and a rapid increase in public employment, mainly because of the recent education reform.[14] These have brought into doubt the budget spending ceilings. Additionally, overruns in health spending and higher than expected costs of the equalization schemes of public sector salaries could weigh on final outcomes. Thus, staff's current projections suggest that the authorities' primary surplus target of 1.1 percent of GDP could be missed by 1 percent of GDP, despite the introduction in September of a revenue package based on increases in fuel, alcohol, and automobile excises, worth 0.7 percent on an annual basis.

19. Staff support the authorities' fiscal objective for 2013 as it errs on the tighter side, given that the output gap will be closed next year. In particular, the draft budget target of a 0.5 percent of GDP primary surplus is appropriate as it contributes to the continued reduction of imbalances. However, staff recommended that the budget should aim to keep current spending unchanged as a share of GDP rather than increasing taxes yet again. Moreover, there are risks to the budget spending ceilings as they envision a significant compression in capital expenditure, which may be difficult to achieve. With debt-to-GDP having returned to pre-2008 levels, should the revenue outturns prove weaker than budgeted due to slower than expected growth, there would be room to allow for the operation of the automatic stabilizers.

[13] Based on staff's baseline projections, the fiscal impulse in 2012, measured as the change in the structural primary balance excluding one-off operations, is 0.5 percent of GDP.

[14] Among other objectives, the recent education reform aims to have children start school at 5 years of age rather than 6.

20. Staff underlined the importance of turning around the weakening trend in the primary balance. Despite the strong recovery since 2009, the primary surplus has declined as primary spending has continued to grow rapidly as share of GDP. In particular, the wage bill, pensions, and health spending, all difficult to reverse, have grown above the economy's potential and the pace of improvements in tax administration. Given these trends, staff pointed out that at unchanged policies the primary balance would be close to zero for much of the forecast period, bringing to an end a decade of significant declines in the debt-to-GDP ratio, a cornerstone of Turkey's success. Furthermore, the growing share of current spending in the budget has increased its rigidity and could come at the expense of much needed infrastructure investment. It also reduces the scope for fiscal policy to contribute to a more balanced macroeconomic policy mix as adjustments in current spending are slow to take place.

21. The authorities agreed that there is a need to maintain a sound fiscal stance. However, they believe fiscal policy in 2012 to be appropriate given the downside risks to growth, and argued that the package of fiscal measures implemented in September would make up for the expansion in current spending. The authorities concurred with staff that the 2013 budget should aim at controlling expenditure growth, while recognizing that this could be challenging given the projected growth of wages and pensions.

22. In addition, the authorities believe the deterioration in the budget performance is temporary and not structural. They argued that public debt has fallen to a comfortable level, allowing for lower primary surpluses than in the past. While acknowledging the fast growth of current spending, they pointed to the need to increase the provision of education and health services in order to raise the economy's potential. Moreover, their efforts to broaden the tax base, fight informality, and improve tax administration will in their view increase revenues in the medium term. Finally, they agreed that a better budgeting process would partly help contain spending overruns, such as through a more synchronized public sector wage bargaining process.

Monetary Policy

23. Staff underscored that despite recent declines, inflation remains high. The inflation outlook has improved somewhat, but there are clear risks to bringing inflation within the target band[15] by the end of 2013. Inflation expectations remain elevated relative to the target, wage increases outpace productivity gains, backward indexation of wages—notably in the public sector—leads to inflation inertia, and volatile food prices pose risks. The monetary easing since July may have been premature and, on balance, staff felt that the CBRT should be more forward-looking and cautious in light of the impact that the resumption in domestic demand-led growth may have on inflation and wage formation.

24. The CBRT's unconventional monetary framework attempts to achieve both price and financial stability in a difficult global environment. The mission is conscious that the CBRT faces a challenging environment of volatile capital flows and low interest rates in advanced economies. In

[15] The inflation target is 5 percent, ±2 percent.

response to these challenges, the central bank has, over time, introduced multiple new instruments aiming at gaining additional degrees of freedom in setting domestic interest rates, achieving a less volatile exchange rate, and safeguarding financial stability (Box 4). However, it is the ability to achieve the inflation target and anchor expectations that ultimately determines the success of monetary policy, and so far inflation has remained well above the target.

25. Staff argued that the CBRT would better serve its objectives within the context of a more standard inflation-targeting framework. Staff cautioned that while the new instruments may each seem appealing, as a whole, they are blurring policy signals and may be weakening the monetary transmission mechanism. With less traction, larger policy adjustments are needed to guide lending rates. Staff pointed to this year's slow and limited reaction of lending interest rates despite significant declines in the CBRT's effective rate since July and the cut in the overnight lending rate by 200 basis points. In addition, inflation expectations, which previously reacted to developments in inflation and the changes to the CBRT's target, have been broadly unchanged since October 2010, suggesting that the capacity to influence expectations has been weakened. Thus, staff recommended a normalization of the framework by returning to the use of the one-week repo rate as the main tool to manage the monetary stance. Given current inflation trends, this rate should be increased to positive levels in real terms. Should this stimulate capital inflows, staff advocated sterilized interventions for rebuilding net reserves, low by international standards, complemented by a more pro-active use of macro-prudential measures.

26. Staff encouraged the CBRT to strengthen its communication policy. The complicated framework, with its multiple tools and objectives—even though openly stated in the inflation reports—blurs the policy signaling, often giving the impression that other objectives take priority over inflation. The plethora of tools has proven challenging for market participants to understand. Clearer communication could help avoid the impression that objectives and tools are at times in conflict, and thus reduce costly uncertainty; in turn, this could help repair the monetary transmission channels.

27. The CBRT believes that its framework has been successful in dealing with multiple objectives. In their view, a standard inflation targeting framework cannot ensure financial stability in a world of volatile capital flows. They point to the declining inflation and current account deficit as proof that, by driving a wedge between domestic interest rates and the rates faced by speculative money, the framework can deliver lower inflation, more sustainable credit growth, and a less volatile exchange rate. The central bank agreed that there are upside risks to inflation, but argued that it has the capacity to adjust policy, seeing no evidence of a weakened transmission mechanism. The central bank concurred with staff that macro-prudential policies may be best suited to deal with some of the financial stability issues, but that in Turkey's case the CBRT is well positioned to deal with the financial risks. Finally, they agreed with staff that their framework of multiple instruments requires very careful communication, but felt they have made significant progress in this regard.

Box 4. The Conduct of Monetary Policy in Turkey[16]

Since late 2010, the CBRT has been implementing monetary policy in a manner referred to as unconventional, in response to a challenging external environment dominated by volatile capital flows. Instead of relying on one interest rate like inflation-targeting central banks generally do, the CBRT has resorted to utilizing a wide variety of instruments—such as reserve requirement (RR) ratios and a mix of various repo facilities—rather infrequently used by "traditional" central banks. In late 2010, the CBRT's view was that the exchange rate was overvalued, and the framework was supposed to bring about a correction via nominal depreciation while improving the structure of external financing by substituting debt with equity and short-term flows with long-term ones.

The new framework has, in fact, been implemented in two different ways. First, the CBRT changed the required reserve (RR) ratios, differentiating them by currency and maturity; purchased FX via regular daily auctions, changing the amounts in line with the perceived strength of capital inflows; and generated a lot of volatility in the interbank rates by varying the amount of liquidity it was providing to the market via *quantity* repo auctions. Altogether these operations led to a significant increase in liquidity, sharp nominal depreciation, and a surge in inflation. In late 2011-early 2012 the CBRT stopped changing the RR ratios, stopped intervening in the FX market, and started to vary *daily* the cost of liquidity it provides to the markets by changing the extent of using its *price* and *quantity* repo facilities. Since March it has allowed banks to hold their RR on lira-denominated liabilities in FX and gold, however, applying increasing penalties.

While **it is difficult to assess empirically the success of this framework** given the rather short time-span of its implementation, the following observations help form a view:

- It emerges that until the inception of the new framework, **inflationary expectations** were well approximated by an average of the inflation target and the latest inflation observation. Under the new framework, one-year ahead expectations have remained broadly flat at around 7 percent, suggesting that the link has been broken and survey participants simply report the numbers around the top of the target band.
- It also emerges that the new framework introduced **a non-trivial spread** between the cost of the CBRT-provided liquidity and the interbank rates. This spread seems to be affected by markets' perceptions of the strength of capital inflows.
- **Market participants perceive the monetary policy** as leaning towards stimulating growth, as long as the nominal exchange rate is not under pressure.
- **The role the framework played in reducing external imbalances is still unclear.** As nominal depreciation fed into inflation, attempts to turn things around led to a significant loss of reserves in the end of 2011. The 12-month current account deficit and its financing structure continued to deteriorate until early 2012. Whether the subsequent improvement is due to the way the monetary policy is conducted or a result of a slowdown in domestic demand—brought about by a range of factors including interest rate tightening *per se*—remains to be seen.

While headline inflation has started to decrease, **the core measures and inflationary expectations remain** above the target and **the CBRT's net reserves** are low. Were the risk appetite for Turkey to reverse, the ability of monetary policy to jump-start the economy or to defend the exchange rate will be constrained.

[16] See Selected Issues Paper "Turkey's New Monetary Framework."

Financial Sector Policies

28. Staff noted the progress in implementing the 2011 FSAP update recommendations. The mission found that the BRSA has advanced in closing some of the supervisory and regulatory gaps, has expanded the coverage of consolidated supervision for banking groups, and has tightened the rules on asset classification and provisioning requirements. By successfully introducing Basel II in July 2012, some of the FSAP update recommendations in areas such as capital adequacy, risk management processes, and different types of bank risks were addressed as well. Based on results of the Basel Quantitative Impact Studies (QIS), banks seem well positioned for the introduction of Basel III by 2015, and thus, an accelerated time table could be considered. Staff underscored the instrumental role of the Financial Stability Committee (FSC) in coordinating the work of the involved institutions, as financial stability challenges and concerns will continue emerging.

29. Staff recommended expanding the macro-prudential tool-kit and applying it more proactively (Box 5). The authorities' prudent dividend payout rules have been very constructive in buttressing banks' balance sheets, but further efforts may be required to conserve existing capital buffers in times of rapid credit growth. Moreover, there is room to develop measures, within a well-articulated framework, to manage key risks. In particular, staff suggested the following macro and micro-prudential measures: (i) formalizing a consumer debt-to-income limit (DTI), already applied by banks for their internal risk management and credit scoring; (ii) phasing in Basel III liquidity ratios to help address the banks' structural maturity and currency mismatches; and (iii) applying targeted increases in FX required reserves at shorter maturities to slow down banks' short-term external borrowing. The BRSA draft regulation on credit risk management should be finalized, as it could improve banks' risk management and help supervisory examination of banks' FX lending practices. This in turn would allow tighter conditions on FX borrowing for non-FX earning corporates.

30. The authorities highlighted the strength of the financial system and regulatory framework, but concurred that continued vigilance is needed to maintain financial stability. They consider that the financial performance of the banking system has remained very strong, with sufficient buffers and no difficulty in accessing external funding. They believe that the banking system is in a good position to transition to Basel III sooner than 2015. The BRSA plans to finish drafts of the Basel III regulation by end-2012, and with over 90 percent of regulatory capital constituting core tier 1 capital, it believes a long phase-in period won't be needed. Moreover, the authorities are of the view that they have already implemented a number of important macro-prudential measures such as loan-to-value limits, minimum payment levels for credit cards, as well as increases in risk weights and provisioning for consumer loans, the latter resulting in a significant decline in credit growth. Thus, they think it would be premature to consider new measures at the current juncture, but see room to examine possible new macro-prudential tools should particular areas in the banking system become a policy concern in the future.

Box 5. Macro-Prudential Policies in Turkey[17]

Turkey faces the typical emerging market challenge of maintaining financial stability while dealing with capital flows and the economic cycle. The 2007/8 crisis underscored the need for countries to develop a strong MPP framework as well as enhanced prudential regulation and supervision. Also, in Turkey, macro-prudential measures (MPP) could help relieve some pressures from the central bank in dealing with financial stability issues.

At the outset of the 2008–09 crises, the authorities implemented a number of MPP measures to safeguard the domestic financial sector. These measures were successful in mitigating the impact of the downturn in the banking sector. Additional steps were taken, albeit belated, in the summer of 2011 to deal with the credit boom: increased risk weights and provisioning requirements on consumer loans contributed to the significant slowdown in credit growth.

Turkey made progress on the organizational aspects of its MPP framework. The Financial Stability Committee (FSC) was created in June 2011 to improve coordinating of all the agencies involved in safeguarding financial stability while maintaining operational autonomy of the participating agencies. The 2011 FSAP Update also recommended an increased emphasis on communication, an enhanced interagency coordination, as well as a leading role of the CBRT on the macroprudential committee to harness the central bank's expertise in risk assessment.

The macro-prudential tool kit could be expanded, but sequencing and calibration of new measures will be important. New measures could be considered in the following areas:

- **Prevent household overleveraging.** Household debt, although lower than in many peer countries, has increased to around 50 percent of disposable income during the recent boom phase. Setting a consumer debt-to-income limit (DTI) across the banking system could help maintain household balances' resilience. Banks already apply such DTI requirements for their internal risk management and credit scoring.
- **Contain short-term FX borrowing by banks.** Turkish banks, partly due to improved external sentiment and limited local funding (loan-to-deposit ratio at 103 percent), make extensive use of this source of funding. Introducing a minimum FX liquidity ratio at the 3-month and longer horizons and phasing in Basel III liquidity ratios could help address banks' structural maturity and currency mismatch. As in the existing liquidity regulation framework in Turkey, the Basel III liquidity rules could be differentiated by currencies. Finally, the application of FX RR increases at shorter maturities could also be considered to slow down banks' short-term external borrowing.
- **Limit nonfinancial corporate FX exposure.** FX corporate loans comprise 26 percent of banks' total loan portfolio and 40 percent of corporate loans. The BRSA draft regulation on credit risk management should be finalized to improve banks' risk management and help supervisory examination of banks' FX lending practices. But there is scant information on corporate FX hedging, and filling this data gap would be important. It would be also possible to tighten the conditions by which non-FX earning corporates could borrow FX in Turkey. Also, higher risk weights and provisioning on unhedged FX lending to corporates could be introduced if growth in this lending segment would become excessive. Data availability would be an important prior condition for such a measure.

[17] See Selected Issues Paper "Macroprudential Framework and Policies in Turkey."

31. The mission and authorities agreed on the importance of addressing the AML/CFT deficiencies identified by the Financial Action Task Force (FATF). Since June 2011, Turkey has been included on a list of jurisdictions with strategic AML/CFT deficiencies that have not made sufficient progress in addressing them. Moreover, on October 19 the FATF decided to suspend Turkey's membership by February 2013, unless the country adopts legislation to address identified AML/CFT deficiencies by then. This development could lead to heightened due diligence from foreign financial institutions regarding transactions with Turkey. The authorities have submitted draft legislation to parliament which has not been enacted yet, but which they expect to meet the standards necessary to deal with the identified deficiencies.

Overall Short-Term Policy Mix

32. Staff argued that policies need to become tighter. Given the external vulnerabilities, high inflation, and buffers smaller than at the start of the 2008 crisis, policies should remain geared towards reducing imbalances. Thus, staff believes that fast growing public spending together with the monetary easing could have been premature. The tightening of the fiscal stance proposed in the draft 2013 budget is therefore appropriate, as further policy loosening to achieve higher growth rates could end disinflation and leave Turkey with a high and growing current account deficit. Accordingly, a period of below potential growth is needed. Staff also suggested that there is much to be gained through better coordination to assure a more balanced overall stance.

33. The authorities agreed that additional reductions in imbalances should be the priority. However, given their assessment of the policy stance, which differs from that of staff in some key areas, they believe that achieving disinflation and a further reduction in the current account deficit does not require growth below 4 percent, as they see potential growth closer to 5 percent. Moreover, they point to the slowdown in domestic demand as an indication that the overall policy mix was sufficiently tight and consistent with their objective of reducing vulnerabilities. However, the authorities agreed with staff that, should the unwinding of imbalances start to reverse, some policy tightening would be required, noting that it would be more appropriate to be done via monetary policy.

Medium-Term Challenge: Rebalancing the Policy Framework and Reducing Dependence on External Funding

34. Staff pointed out that, due to its low savings, Turkey remains prone to boom-bust cycles driven by capital flows. The national saving rate has fallen dramatically over the last fifteen years, reflecting in part improved macroeconomic conditions that reduced the need for precautionary savings, and a cleaned-up banking system able to rapidly expand credit (Box 6). However, the savings rate of around 15 percent of GDP is too low, leaving the country highly dependent on volatile foreign capital and resulting in boom-bust cycles in investment and output. In addition, full realization of the potential offered by the country's young population and strategic location requires higher investment rates than at present, which could not be sustained given current savings levels.

35. Staff argued that fiscal policy had a role to play in raising national savings and mitigating the economy's excessive cyclical swings. The decline in national savings over the

recent decade happened despite increases in public savings. However, this need not reflect Ricardian equivalence, and indeed, estimates find only a partial Ricardian offset.[18] Moreover, since there is no single item that could increase private sector savings quickly and significantly, the public sector would have to lead the way. Increasing the primary balance to its pre-crisis levels (around 2 percent of GDP) could have two important effects. First, it would help boost national savings, perhaps by 1 percentage point of GDP. Second, it would relieve pressure on monetary policy, allowing for a more depreciated real exchange (REER overvaluation—see Box 7—has been an important factor in the savings decline).

36. Staff recommended that the fiscal medium-term plan should anchor the broad guidelines of the adjustment in public savings. The new 2013–15 Medium-Term Program should have targeted a sizable increase in the structural primary surplus, although the adjustment path could be back-loaded. To achieve this, the mission recommended a structure of adjustment that could have helped reduce the budget rigidities. Specifically, staff advocated containing real primary spending growth below the potential growth rate of 4 percent in the next three years and changing the public pension system; in particular, by increasing contribution rates without raising benefits commensurately. Also, public spending on health programs, which has grown significantly in recent years, could be reexamined; and the tax base should be broadened by eliminating tax exemptions and improving tax administration.

37. Staff commended the authorities for their efforts to boost private savings. The mission welcomed the authorities' recent reform of private pensions, which replaced previous tax incentives with direct government contributions. The new system has wider coverage, including people who are not on formal payrolls, and tilts incentives towards poorer contributors. The reform should help boost private pension contributions, which have much room to grow.

38. Staff also argued that boosting competitiveness more broadly would support domestic savings and rebalancing. The recently introduced Commercial Code helps improve corporate governance and encourages FDI. The recent package of investment incentives could, if properly administered, help stimulate investment in advanced technology sectors and lower the import content of production. Yet, staff pointed out that past experience with similar schemes, depending on tax exemptions, showed mixed results. Thus, expectations should be modest and higher priority should be given to maintaining broad VAT and income tax bases. Staff also asserted that reforms should advance in other key areas:

- **Efforts to address the large informal sector, which have had some success in recent years, need to be sustained.**[19] There is much evidence that firms in the informal sector are more liquidity constrained, invest less, are less profitable, and grow more slowly. Informal workers also save less than their counterparts in the formal sector.

---

[18] See Selected Issues Paper "Boosting Savings in Turkey."

[19] The informal sector in Turkey is quite large—according to the World Bank, more than 40 percent of the labor force works in the informal sector.

- **The labor market needs to become more competitive** via greater use of part-time and temporary labor, reform of the severance pay system, and slowing the growth of the high minimum wage, while ensuring an adequate safety net. Turkey needs to continue improving the quality of its workforce by bolstering the education system and training programs. Lastly, measures should be targeted at boosting the female participation rate, which at about 30 percent remains well below that of most middle-income countries.

- **Regulatory constraints in some product and service markets are obstacles** in what is otherwise a generally vibrant domestic market. Tax policy and administration are complicated and costly for business, routinely cited in surveys as key weaknesses in Turkey's business climate.

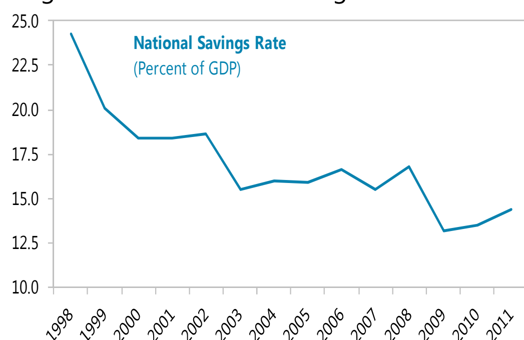
- **Despite impressive efforts to improve infrastructure and reduce energy dependence, more is needed.** Efforts to relieve transport sector bottlenecks, important to reducing costs in the economy, are underway. Steps to raise domestic energy production are welcome, but should be paired with further efforts to improve efficiency in energy production and distribution, notably by continued involvement of the private sector.

39. The authorities concurred with the need to increase national savings as the key medium-term goal. They pointed to the steps taken earlier in the year, such as the private pension reform, as likely to deliver significant gains in savings. Moreover, they agreed that public policies have a role to play in boosting savings, but mainly by improving the targeting of some social programs to reduce disincentives to private sector savings. Finally, they outlined policies in the medium-term fiscal plan that would promote higher savings, but felt that a primary surplus of 1 percent on average over the cycle was adequate given the low and still declining debt. In addition they argued that returning the primary surplus to the pre-crises level would be difficult to achieve given current spending needs.

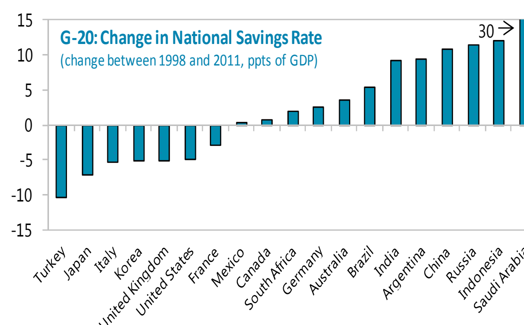
40. The authorities believe that they are undertaking substantial efforts to promote competitiveness. They highlighted the importance of the new package of investment incentives, which, by promoting investment in high technology and lowering labor costs, should boost export potential as well as increase local content, reducing the import dependence of domestic production. Through their significant efforts in improving tax administration—and in time, changes to tax policy—they expect further reductions in informality, which hampers the competitiveness of the formal sector by keeping labor taxes high. Finally, they believe that their education reform will increase educational attainment over the medium term, and produce a better alignment of educational training with the needs of the economy.

Box 6. Raising Savings In Turkey

Turkey's national saving rate has fallen dramatically over the last 15 years, from some 25 percent of GDP in the late 1990s to less than 15 percent of GDP now. This decline has been larger than in any G-20 country over this period and stands in stark contrast to the experience in peer emerging economies, even if some of these have enjoyed better terms of trade than Turkey. On the positive side, the national savings rate has increased over the last two years, but these modest gains have yet to fully make up for the loss in savings in the aftermath of the global financial crisis.

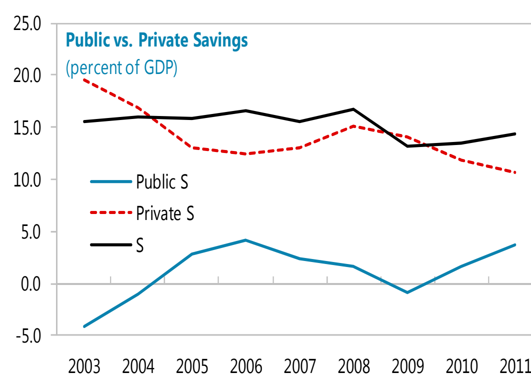


Source: Ministry of Development.



Source: WEO, and IMF staff calculations.

The decline in national savings happened despite large increases in public savings. Fiscal consolidation efforts led to an 8.5 percentage points of GDP increase in public savings over the last ten years.[20] However, this was more than offset by a 9 percentage point decline in the private saving rate. Independent studies attribute most of this decline to households rather than corporates, and point to a significantly more stable macroeconomic and political environment that reduced the need for precautionary savings, as well as to the rapid expansion in credit via a cleaned-up banking sector. Other factors, such as demographics and appreciation of the real exchange rate, also seem to have played a role. As for the striking public-private offset, it stemmed from a combination of partial Ricardian equivalence (with estimates of the Ricardian offset in the 0.4–0.8 range) and exogenous factors that affected public and private savings simultaneously but in opposite directions, such as the global recovery and normalization of financial conditions post-2008.



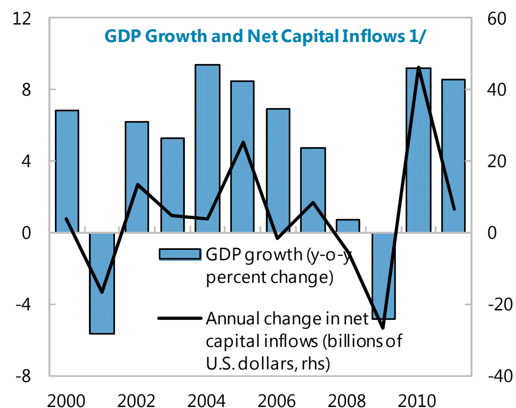
Source: Ministry of Development.

National savings are too low, and this has been a key reason behind Turkey's boom-and-bust cycles. At some 15 percent of GDP for much of the last decade, the national saving rate has been well below the investment rate, leaving the economy highly dependent on volatile foreign savings to fill the gap.

[20] High inflation complicates the disaggregation of total savings between public and private savings before 2003.

Box 6. Raising Savings In Turkey (Continued)

As a result, when capital flows are ample, investment expands rapidly and the current account deteriorates;[21] in reverse, when external financing becomes scarce, investment retracts rapidly and the current account deficit adjusts. The volatility of investment, closely tied to the capital flow cycle, has been significantly greater than in comparable countries like Brazil or Poland. In turn, investment volatility has been a key reason for booms and busts in economic activity. Looking into the medium term, studies suggest that Turkey will need to invest 25–30 percent of GDP in order to fulfill the potential offered by its young population, strategic location, and low female labor participation rate. Such investment rates will be impossible to sustain at current savings rates.



Sources: Central Bank of Turkey; and IMF staff calculations.
1/ Includes errors and omissions.

Increasing savings is thus a key objective. The government has recently replaced tax incentives for private pensions with direct government contributions, widening the coverage of the system to the many who are not on payroll, and making it more progressive. The vesting period in the system was also lengthened. These changes go in the right direction and are in line with World Bank recommendations; with private pension assets accounting for only 1½ percent of GDP at present, the gains could be non-trivial. Still, the savings gap is too wide to be bridged through these measures alone, hence other avenues should be considered:

- *Raising the structural primary fiscal balance back to pre-crisis levels:* given only partial Ricardian equivalence, fiscal policy can play a role in raising national savings. Tighter fiscal policy would also relieve pressure from the central bank and allow, ceteris paribus, for a more depreciated real exchange rate.
- *Increasing mandatory savings through the pay-as-you-go pension system:* this could be achieved by increasing current contribution rates with no increase in benefits. The difficulty of such a reform is political, given that the last decade has already seen major changes to the pension system.
- *Tackling informality:* efforts to address the large informal sector, which accounts for about 40 percent of the labor force, need to be sustained. There is much evidence that informal workers save less than their counterparts in the formal labor market, after controlling for other variables.

Still, difficulties in raising national savings should not be underestimated. The fact that the national saving rate has been relatively stable over the last ten years despite large underlying changes in public and private savings should caution about the difficulty of the task at hand.

[21] Strong consumption (including of durables) contributed to the large deterioration in private savings over the last three years, and in this sense it contributed to the widening of the current account deficit. However, higher public savings compensated for the decline in private savings over this period, so viewed from an S-I perspective the rise in investment fully explains the deterioration in the current account.

Box 7. Turkey's External Competitiveness

Turkey still faces a competitiveness gap despite the ongoing reduction of the current account deficit. Rising unit labor costs and inflation differentials with trading partners in 2012 have erased almost half of Turkey's gain in external competitiveness derived from the large nominal depreciation in 2010–11.

Real effective exchange rates, based on consumer and producer prices, rose by around 10 percent in 2012 on the back of inflation differentials, clawing back almost half of the real depreciation accumulated between October 2010 and August 2011. Rising by a similar amount but starting from a higher base, the ULC-based REER remains elevated as real wages increased, labor productivity growth weakened with the increasing participation of low-skilled labor force, and unit labor costs grew with inflation. As a result, some REER indicators are now comparable to the levels prevailing during the crisis, and higher than the levels of the early-2000s.

The **US dollar-euro exchange rate** is also an important determinant of the competitiveness of Turkey's exports, especially in view of the high import content—and hence relatively low domestic valued added—of Turkish production. Many raw materials and intermediate inputs are priced in US dollars or currencies that move closely with the US dollar, while many of Turkey's final products are sold in Europe and priced in euros. Thus, a continued depreciation of euro would further strain the bottom line of exporting industries and the overall current account adjustment process.

Export diversification to the MENA region has allowed Turkish exports to grow despite weak demand in the EU, its main traditional trading partner. Exports to MENA countries following the crisis have increased by around 10 percentage points to 31 percent of total exports in 2012H1, compensating for the loss of market share to the EU. Moreover, in recent months non-monetary gold exports to Iran have picked up significantly. However, penetration by Turkish exporters of emerging and fuel exporters' markets has declined since the onset of the global crisis, reversing in part the significant market-share gains of earlier years, suggesting that competitiveness remains an issue to be addressed.

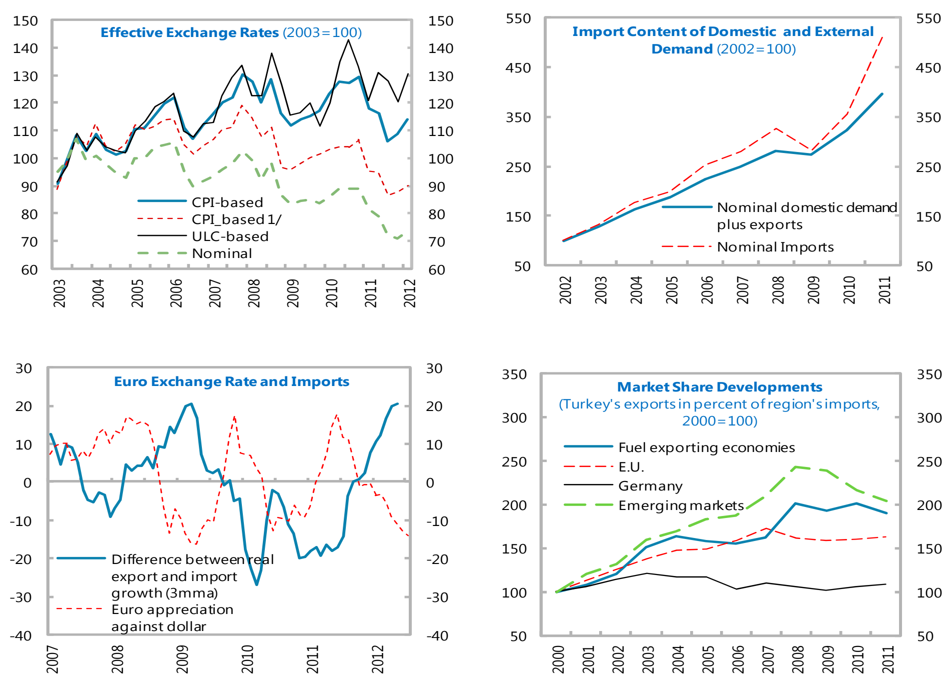
The EBA assessments show the current account deficit is 2–4 percentage points of GDP larger than the level that can be explained by fundamentals and desired policy settings, and that the real exchange rate is 10–20 percent higher. This is a similar assessment to the one contained in the 2011 Article IV Consulation Staff Report. It should be noted that these current account assessments rely in part on end-2011 data: since then, the current account has adjusted significantly, leading staff to project a fall in the deficit of some 2½ percentage points of GDP in 2012. However, even if some of this adjustment is structural, the residual current account deficit continues to point to a siginificant competitiveness gap.

In the context of still **large capital inflows**, however, standard REER assessments may overstate the extent of overvaluation. There is little evidence that industry's share in GDP is falling (a good proxy for the tradable sector) and investment in industry has grown strongly in the past 5 years (something that is difficult to square with a very uncompetitive exchange rate). Moreover, the recent surge of capital inflows to Turkey has not only financed the current account deficit in an accounting sense but may have also caused it in a behavioral sense, at least partially: by relaxing consumers' budget constraints to facilitate import demand.

Box 7. Turkey's External Competitiveness (Continued)

When the inflows abate, as they are beginning to, both the near- and medium-term current account projections would improve which, in turn, would imply smaller misalignment. This is consistent with the notion of "capital account dominance" in Emerging Markets. Alternatively, if the flows—though mostly of a short-term duration—turn out to be more persistent, then the equilibrium exchange rate itself would appreciate accordingly reflecting the changed fundamentals, and hence leading to a smaller estimated misalignment, other things being equal.[22]

It is essential for Turkey to close the competitiveness gap so as to attract more FDI flows into the tradable sector. That would help to get more closely integrated into the global supply chain and move up the value-added ladder. However, at around 2.0 percent of GDP, FDI inflows are still below the G–20 EM average of around 2.5 percent of GDP, with flows tilted toward non-tradable sectors such as banking and real estate. The government has recently launched an investment incentive scheme aimed at tackling the current account deficit by lowering the import content of production. However, significant barriers remain in the efficiency of the labor market and the general business environment.



1/ Against developing countries.

Sources: Central Bank of Turkey; Bloomberg; Turkstat; IMF, *Direction of Trade Statistics*; and IMF staff estimates.

[22] It is very difficult, if not impossible, to tell in practice whether a surge in inflows is temporary or portends a persistent trend. A rule of thumb, offered by Ostry et al. (2010), is that flows that push the real exchange rate toward equilibrium are more likely to be persistent than flows that contribute to overshooting since flows would presumably be subject to reversal in the future as overshooting eventually unwinds. This suggests that current inflows into Turkey are more likely to be temporary.

STAFF APPRAISAL

41. After two years of rapid growth, the economy has slowed significantly, unwinding imbalances. The tighter macroeconomic policies have started to deliver disinflation and a reduction in the current account deficit, while maintaining a more measured pace of growth. The conditions for continued growth this year are in place. Beyond 2012 the economy is in a good position to return to its long-term growth rate of around 4 percent.

42. The Turkish financial system remains sound. Banks' profitability is high by international standards, while leverage and the level of non-performing loans are low. Introduction of Basel II and II.5 standards has resulted in only marginal reductions in the system's still-high capital adequacy ratio. Tighter macro-prudential measures have eased concerns over excessive credit growth, and the rising dependence of the system on external financing observed over the last few years appears to be leveling off.

43. However, Turkey continues to face considerable risks given the large current account deficit and uncertain external environment. Priority should be given to fully achieving the orderly rebalancing of the economy. Macroeconomic policies helped engineer the soft landing of the economy, but the authorities must stand ready to adjust their stance if the trends in disinflation and the external deficit reduction start to unwind. In the absence of further efforts, annual gross external financing needs will remain high and the unstable global financial environment will remain a major risk, with a possible reversal in capital flows forcing the economy into a sharp adjustment.

44. Staff support the authorities' fiscal objective for 2013 as it errs on the tighter side. The 2012 budget deficit target will be missed, mainly as a result of primary expenditure overruns, leading to a pro-cyclical fiscal stance at a time when a neutral stance would have been more appropriate. The 2013 budget should aim to ensure current expenditure does not grow as share of GDP rather than rely on tax measures to meet the target.

45. The medium-term fiscal plan for 2013–15 is a step in the right direction, but a more ambitious effort is needed to set the basis for increasing budget flexibility and resilience to the cycle. Turkey's budget has structural weaknesses: excessive dependence of revenues on buoyant domestic demand and increasingly rigid expenditures. The public sector wage bill and pensions have grown faster than the economy's potential and the pace of improvements in tax administration. This could come at the expense of much needed infrastructure investment and reduces the scope for fiscal policy to help establish a more balanced macroeconomic policy mix and respond to shocks. In addition to ongoing efforts to broaden the tax base and improve tax administration, reforms on the spending side—significantly restraining growth in real current expenditure—are needed as well. The authorities' broad guidelines for the MTP would need to be fleshed out with concrete expenditure proposals and it would be important that more effort be placed in reducing current spending than envisaged now.

46. The monetary policy stance needs to be tighter given upside risks to inflation, and the impact that the resumption in domestic demand-led growth may have on inflation expectations and wage formation. Turkey's growth outlook, still-high inflation, and a history of deviations from the

target call for a positive real policy interest rate. Were capital inflows to accelerate, the CBRT should rebuild net reserves for precautionary reasons through sterilized interventions.

47. The merits of the CBRT's policy framework have not been fully established. The new framework, relying on a battery of novel instruments to gain degrees of freedom in segmenting domestic and international interest rates, has not yet proved its superiority. A return to a more conventional framework is warranted, and even more so should the inflation target remain elusive or inflation expectations stay high. In the meantime, the CBRT should strengthen its communications, which have at times been confusing to market participants.

48. In the medium term, it is essential to improve the macroeconomic policy mix. Tighter fiscal policy would relieve pressure on monetary policy to achieve its inflation target and deliver an environment less prone to real exchange rate appreciation. This would help deal with Turkey's competitiveness challenges and support efforts to reorient the economy from import dependence toward export growth. Moreover, it would allow for lower nominal interest rates, reducing exposure to volatile and destabilizing short-term capital inflows.

49. There has been progress in financial sector supervision and regulation, and there is scope to expand the macro-prudential tool kit. Some of the gaps in the regulatory and supervisory framework have been closed; and banks seem well positioned for the introduction of Basel III by 2015. Despite this, the macro-prudential tool kit needs to be used in a more targeted and active manner to ensure financial stability. There is room to expand the macro-prudential measures, within a well articulated framework, to manage key risks.

50. Turkey needs to address its low domestic savings which make it heavily dependent on capital inflows. High investment needs and the current low level of savings leave the Turkish economy exposed to volatile capital inflows. The authorities have correctly identified increasing savings as the key medium-term priority and have recently undertaken several reforms in this area. However, further efforts by the public sector are needed. In particular, the authorities should aim to deliver a sizeable increase in the primary surplus, which would boost national savings. The forthcoming medium-term fiscal plan, based on prudent macroeconomic assumptions, should anchor the broad guidelines of the adjustment, complementing policies to improve the structure of the budget.

51. Boosting competitiveness requires a broad, multi-pronged approach. The new Commercial Code should improve corporate governance and encourage FDI. The package of investment incentives could stimulate investment in advanced technology sectors and lower the import content of production; however, such schemes tend to deliver mixed results and only in the long run. Thus, additional efforts should be considered to improve the functioning of the labor market, reduce informality, increase labor market participation, eliminate red-tape in product and service markets, and improve the capacity and efficiency of the domestic energy sector.

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

Table 1. Turkey: Selected Economic Indicators, 2007–13

Population (2011): 74.7 million
Per capita GDP (2011): $10,469
Quota (2012): SDR 1,455.8 million

	2007	2008	2009	2010	2011	2012	2013
						Proj.	
				(Percent)			
Real sector							
Real GDP growth rate	4.7	0.7	-4.8	9.2	8.5	3.0	3.5
Private consumption growth rate	5.5	-0.3	-2.3	6.7	7.8	0.0	2.8
Private gross fixed investment growth rate	2.6	-9.0	-22.5	33.6	23.1	-2.3	2.9
Contributions to GDP growth							
Private domestic demand	5.0	-1.8	-8.3	12.6	9.7	-1.0	3.1
Public spending	0.8	0.6	0.8	0.9	0.3	0.5	0.6
Net exports	-1.2	1.9	2.7	-4.4	-1.5	3.5	-0.1
GDP deflator growth rate	6.2	12.0	5.3	5.7	8.9	6.2	7.9
Nominal GDP growth rate	11.2	12.7	0.2	15.4	18.1	9.3	11.7
CPI inflation (12-month; end-of period)	8.4	10.1	6.5	6.4	10.4	7.5	6.2
PPI inflation (12-month; end-of-period)	5.9	8.1	5.9	8.9	13.3	3.2	6.2
Unemployment rate	10.3	11.0	14.0	11.9	9.8	...	...
Average nominal treasury bill interest rate	18.4	19.2	11.6	8.1	8.5	...	...
Average ex-ante real interest rate	6.9	12.2	2.6	1.8	1.1	...	...
				(Percent of GDP)			
Nonfinancial public sector							
Primary balance	3.2	1.6	-1.0	0.8	2.0	0.1	0.4
Net interest payments	4.9	4.4	4.6	3.7	2.6	3.0	2.9
Overall balance	-1.8	-2.8	-5.6	-2.9	-0.6	-2.8	-2.5
General government structural primary balance 1/	0.8	0.5	2.5	1.3	-0.6	-1.1	-0.7
Debt of the public sector							
General government gross debt (EU definition)	39.9	40.0	46.1	42.4	39.3	38.4	36.9
Nonfinancial public sector net debt	34.4	34.5	39.5	36.8	33.4	32.3	31.4
External sector							
Current account balance	-5.9	-5.7	-2.2	-6.4	-10.0	-7.5	-7.2
Nonfuel current account balance	-1.5	-0.1	2.1	-2.0	-3.8	-1.4	-1.3
Gross financing requirement	17.6	17.1	18.6	19.3	25.1	23.0	25.9
Foreign direct investment (net)	3.1	2.3	1.1	1.0	1.7	1.8	2.1
Gross external debt 2/	38.4	38.4	43.7	39.7	39.6	45.0	45.7
Net external debt	21.0	21.5	24.7	24.1	24.2	27.5	29.7
Short-term external debt (by remaining maturity)	11.7	16.0	15.2	16.7	17.9	20.4	20.3
Monetary aggregates							
Nominal growth of M2 broad money (percent)	15.7	26.7	13.0	19.1	14.8	...	...
GDP (billions of U.S. dollars) 3/	649	730	614	731	774	...	...
GDP (billions of Turkish lira)	843	951	953	1,099	1,298	1,419	1,585

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

1/ The structural balance is estimated using the absorption gap method and excludes one-off operations.
2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).
3/ GDP in U.S. dollars is derived using the average exchange rate (consolidated from daily data published by the CBRT).

Table 2. Turkey: Medium-Term Scenario, 2007–17

(Percent change, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2003–11	2012–17
						Proj.						Average	Average
Real GDP	4.7	0.7	-4.8	9.2	8.5	3.0	3.5	4.0	4.3	4.4	4.5	5.3	3.9
Real domestic demand	5.7	-1.2	-7.4	13.5	9.6	-0.5	3.6	4.0	4.6	4.8	4.8	6.4	3.5
Private consumption	5.5	-0.3	-2.3	6.7	7.8	0.0	2.8	4.0	4.5	4.8	4.8	5.7	3.5
Private investment	2.6	-9.0	-22.5	33.6	23.1	-2.3	2.9	5.0	6.0	6.0	6.0	13.2	3.9
Public spending	6.5	4.5	5.5	5.9	2.3	3.6	3.9	2.6	2.8	2.8	5.7	4.0	3.6
Exports	7.3	2.7	-5.0	3.4	6.4	16.7	7.6	4.0	4.5	4.5	4.5	5.3	7.0
Imports	10.7	-4.1	-14.3	20.7	10.9	1.7	7.6	4.0	5.6	5.7	5.7	9.7	5.0
Contributions to GDP growth (percent)													
Real domestic demand	5.9	-1.2	-7.6	13.5	10.0	-0.5	3.6	4.1	4.6	4.8	4.9	6.4	3.6
Private consumption	3.8	-0.2	-1.6	4.7	5.4	0.0	1.9	2.6	3.0	3.2	3.2	3.9	2.3
Private investment	0.6	-2.0	-4.4	5.4	4.5	-0.5	0.6	1.1	1.3	1.3	1.3	2.1	0.8
Public spending	0.8	0.6	0.8	0.9	0.3	0.5	0.6	0.4	0.4	0.4	0.4	0.5	0.4
Net exports	-1.2	1.9	2.7	-4.4	-1.5	3.5	-0.1	-0.1	-0.4	-0.4	-0.5	-1.1	0.3
Exports	1.8	0.7	-1.3	0.9	1.6	4.0	2.0	1.1	1.3	1.3	1.3	1.3	1.8
Imports	-3.0	1.2	4.0	-5.2	-3.0	-0.5	-2.1	-1.2	-1.6	-1.7	-1.7	-2.4	-1.5
Saving-investment balance (percent of GDP)													
Public saving-investment balance	-1.5	-2.6	-5.3	-2.5	-0.4	-1.6	-2.6	-2.4	-2.2	-2.2	-2.0	-3.1	-2.1
Private saving-investment balance	-4.4	-3.1	3.1	-3.9	-9.6	-5.9	-4.6	-4.9	-5.2	-5.5	-5.9	-2.1	-5.3
Employment rate	41.5	41.7	41.2	43.0	45.0	...	...	...	...	...	...	42.1	...
Unemployment rate (percent)	10.3	11.0	14.0	11.9	9.8	...	...	...	...	...	...	11.0	...
GDP deflator	6.2	12.0	5.3	5.7	8.9	6.2	7.9	5.7	5.0	5.0	5.0	10.0	5.8
Consumer prices													
Period average	8.8	10.4	6.3	8.6	6.5	9.0	7.9	5.6	5.0	5.0	5.0	10.2	6.2
End-period	8.4	10.1	6.5	6.4	10.4	7.5	6.2	5.0	5.0	5.0	5.0	9.7	5.6
Output gap (percent of potential GDP)	4.1	1.2	-6.6	-1.6	2.1	0.6	-0.1	-0.3	-0.2	0.0	0.4	0.2	0.1
Nonfinancial public sector (percent of GDP)													
Primary balance	3.2	1.6	-1.0	0.8	2.0	0.1	0.4	0.1	0.1	0.1	0.1	2.9	0.1
Overall balance	-1.8	-2.8	-5.6	-2.9	-0.6	-2.8	-2.5	-2.6	-2.5	-2.5	-2.4	-2.8	-2.6
Primary revenue of central government	21.0	20.4	21.0	21.9	22.2	22.2	22.7	22.5	22.3	22.3	22.3	21.4	22.4
Primary expenditure of central government	18.4	18.5	22.5	22.3	20.9	22.1	22.3	22.4	22.4	22.4	22.4	19.2	22.3
Rest of the public sector, primary balance	0.6	-0.3	0.5	1.3	0.7	0.0	-0.1	0.0	0.2	0.2	0.2	0.7	0.1
Net interest expenditure	4.9	4.4	4.6	3.7	2.6	3.0	2.9	2.7	2.6	2.6	2.5	5.7	2.7
General government structural primary balance (percent of GDP) 1/	0.8	0.5	2.5	1.3	-0.6	-1.1	-0.7	-0.5	-0.5	-0.5	-0.5	2.4	-0.6
General government gross debt (percent of GDP, EU definition)	39.9	40.0	46.1	42.4	39.3	38.4	36.9	36.2	35.8	35.4	35.0	48.3	36.3
External indicators													
Current account (percent of GDP)	-5.9	-5.7	-2.2	-6.4	-10.0	-7.5	-7.2	-7.3	-7.5	-7.7	-7.9	-5.2	-7.5
Gross external debt (percent of GDP) 2/	38.4	38.4	43.7	39.7	39.6	45.0	45.7	46.5	46.4	46.9	47.9	40.3	46.4
Real effective exchange rate (CPI-based, levels, EOP)	131.7	114.9	116.8	125.7	109.5	122.9	121.6	124.9	128.5	132.2	136.0	115.3	127.7

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

1/ The structural primary balance is estimated using the absorption gap method and excludes one-off operations.

2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).

Table 3. Turkey: Summary of Balance of Payments, 2007–17

(Billions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
								Proj.			
Current account balance	-38.4	-41.5	-13.4	-46.6	-77.1	-59.5	-61.3	-66.9	-75.0	-85.0	-95.8
Trade balance	-46.9	-53.0	-24.9	-56.4	-89.1	-76.3	-82.2	-89.0	-98.2	-108.0	-119.4
Exports (f.o.b.)	115.4	140.8	109.6	120.9	143.4	158.7	166.5	171.0	178.6	186.8	195.9
Imports (f.o.b.)	-162.2	-193.8	-134.5	-177.3	-232.5	-235.0	-248.7	-260.0	-276.8	-294.8	-315.3
of which Fuel imports (c.i.f.)	-33.9	-48.3	-29.9	-38.5	-54.1	-56.2	-58.5	-61.6	-66.1	-72.3	-79.1
Services and Income (net)	6.2	9.4	9.1	8.4	10.2	14.5	18.0	18.8	19.3	18.8	18.4
Services and Income (credit)	35.4	42.5	39.1	39.2	42.5	45.4	49.0	50.7	52.5	54.4	56.7
of which Tourism receipts	18.5	22.0	21.3	20.8	23.0	23.1	24.0	25.8	27.6	29.5	31.6
Services and Income (debit)	-29.2	-33.1	-30.0	-30.9	-32.3	-30.9	-31.0	-31.9	-33.2	-35.6	-38.2
Private transfers (net)	1.4	1.4	1.2	0.9	0.9	1.2	1.7	2.0	2.5	2.8	3.6
Official transfers (net)	0.8	0.7	1.2	0.6	0.8	1.0	1.2	1.3	1.4	1.5	1.5
Capital and Financial account balance	44.7	36.3	9.3	56.7	63.7	65.5	61.3	66.9	75.0	85.0	95.8
Direct investment, net 1/	19.9	17.0	6.9	7.6	13.4	13.9	18.1	19.9	22.1	24.0	25.4
Inward	22.0	19.5	8.4	9.0	15.9	17.3	19.9	21.9	24.3	26.3	27.7
Outward	-2.1	-2.5	-1.6	-1.5	-2.5	-3.4	-1.9	-2.0	-2.2	-2.3	-2.3
Portfolio investment in securities	-0.1	-5.6	-1.6	12.0	19.5	13.3	14.1	15.4	16.0	17.1	17.6
Public sector (central and local governments and EBFs)	1.0	2.3	3.4	7.7	4.5	5.6	5.3	5.6	5.6	5.6	6.8
Central Bank of Turkey (excl. reserve assets, liabilities)	-1.1	-1.4	-0.5	-0.1	-1.5	-0.7	-0.3	-0.3	-0.3	-0.3	-0.3
Deposit money banks (net)	0.3	-4.3	12.9	36.7	25.1	24.4	12.8	11.1	13.1	16.4	18.8
FX deposits abroad (- denotes accumulation)	-3.5	-13.3	12.7	8.7	12.8	4.7	4.1	3.4	2.7	2.2	1.8
Other (net)	3.9	9.0	0.2	28.0	12.3	19.7	8.6	7.7	10.4	14.2	17.0
Medium and long-term (net)	7.3	0.9	-1.7	2.0	8.5	1.1	2.7	2.9	5.7	8.3	10.8
Short-term (net)	-3.4	8.1	1.9	25.9	3.8	18.6	5.9	4.8	4.7	5.9	6.2
Other private sector (net)	28.7	26.7	-12.6	-3.8	8.5	12.7	12.3	15.2	18.5	22.0	27.4
Medium and long term (net)	25.8	23.1	-9.4	-6.0	4.0	3.1	6.0	7.3	9.1	11.3	15.6
Short term (net)	2.9	3.6	-3.1	2.2	4.5	9.6	6.3	7.9	9.4	10.7	11.7
Errors and omissions	1.8	4.1	4.1	2.7	11.6	3.1	0.0	0.0	0.0	0.0	0.0
Overall balance	8.0	-1.1	0.1	12.8	-1.8	9.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Percent of GDP											
Current account balance (incl. shuttle trade)	-5.9	-5.7	-2.2	-6.4	-10.0	-7.5	-7.2	-7.3	-7.5	-7.7	-7.9
Nonfuel current account balance	-1.5	-0.1	2.1	-2.0	-3.8	-1.4	-1.3	-1.5	-1.8	-2.0	-2.2
Trade account balance (incl. shuttle trade)	-7.2	-7.3	-4.0	-7.7	-11.5	-9.7	-9.6	-9.7	-9.8	-9.8	-9.9
Capital and financial account balance	6.9	5.0	1.5	7.8	8.2	8.3	7.2	7.3	7.5	7.7	7.9
Overall balance	1.2	-0.1	0.0	1.8	-0.2	1.2	0.0	0.0	0.0	0.0	0.0
Percent change											
Volume growth in exports of goods and services	7.3	2.7	-5.0	3.4	6.4	16.7	7.6	4.0	4.5	4.5	4.5
Volume growth in imports of goods and services	10.7	-4.1	-14.3	20.7	10.9	1.7	7.6	4.0	5.6	5.7	5.7
Terms of trade	1.9	-3.1	2.1	-3.1	-4.4	-4.9	1.3	-2.5	-0.7	-0.2	-1.0
Gross foreign reserves (CBRT) 2/											
In billions of U.S. dollars	76.2	74.0	74.8	86.1	88.4	110.0	110.0	110.0	110.0	110.0	110.0
In months of goods and nonfactor service imports	4.9	4.0	5.6	5.1	4.1	5.1	4.8	4.6	4.3	4.1	3.8
Reserves to short-term debt ratio (residual maturity) 3/	90.4	73.6	78.0	72.3	71.9	68.8	64.9	60.5	56.1	51.6	48.2
Net international reserves (CBRT)	56.1	57.1	57.3	63.4	51.9	51.8	51.8	51.8	51.8	51.8	51.8
Debt service ratio 4/	32.0	32.0	37.6	30.4	25.2	21.3	19.2	19.6	20.0	20.7	19.9

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

1/ Including privatization receipts.

2/ The change in gross reserves in 2012 is likely to significantly exceed the overall BOP surplus, due to gold transactions between domestic banks and the central bank which are not recorded in the BOP.

3/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).

4/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).

Table 4. Turkey: External Financing Requirements and Sources, 2007-17

(Billions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
								Proj.			
Gross external financing requirements	114.4	124.6	114.5	140.9	194.2	181.5	221.5	237.7	258.1	282.6	310.4
Current account deficit (excluding official transfers)	39.2	42.3	14.6	47.2	77.9	60.6	62.5	68.2	76.4	86.4	97.3
Amortization on debt securities	3.7	3.4	1.9	2.6	1.8	2.4	1.5	1.2	1.2	1.2	0.0
Medium- and long-term debt amortization	28.8	35.8	44.9	41.3	35.9	34.7	32.5	34.7	37.4	40.8	45.4
Public sector 1/	3.3	3.5	3.2	3.2	2.9	3.8	4.4	4.4	4.4	4.4	4.4
Private non-bank sector	22.4	25.1	34.0	31.4	26.1	23.3	22.7	24.5	26.5	28.9	32.0
Banks	3.1	7.2	7.6	6.7	6.9	7.5	5.4	5.9	6.5	7.5	9.0
Short-term debt amortization	42.6	43.1	53.1	49.7	78.6	83.8	125.0	133.6	143.1	154.1	167.6
Public sector (net) 1/	4.3	4.4	5.1	5.4	5.9	8.3	7.0	7.0	7.0	7.0	7.0
Trade credits 2/	16.4	21.1	22.0	21.1	22.8	25.4	29.3	29.9	32.0	35.1	38.9
Banks	20.7	16.6	24.5	22.6	48.8	48.0	80.3	86.7	92.0	97.2	103.7
Other private	1.2	1.0	1.5	0.7	1.2	2.2	8.3	10.0	12.2	14.8	18.0
Available financing	114.4	124.6	114.5	140.9	194.2	181.5	221.5	237.7	258.1	282.6	310.4
Sales of portfolio and other investment assets	-6.9	-13.3	8.3	3.5	14.0	5.9	7.0	5.7	5.0	4.5	3.9
Foreign direct investment (net)	19.9	17.0	6.9	7.6	13.4	13.9	18.1	19.9	22.1	24.0	25.4
Portfolio flows	6.5	-0.4	4.9	20.9	18.1	18.9	20.4	21.7	22.3	23.6	24.1
Government Eurobonds	4.6	4.0	3.8	6.7	4.3	7.3	5.5	5.5	5.5	5.5	5.5
Banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private non-bank sector (net) 3/	1.9	-4.4	1.1	14.2	13.8	11.6	14.9	16.2	16.8	18.1	18.6
Medium and long-term debt financing	61.1	56.5	37.3	35.8	44.7	32.2	41.8	45.8	53.1	61.4	72.8
Public sector 1/	2.5	3.8	4.0	6.3	3.2	3.8	5.4	5.4	5.4	5.4	5.4
Private non-bank sector	48.2	44.6	27.3	21.9	29.1	21.5	28.3	31.6	35.5	40.1	47.6
Banks	10.4	8.1	6.0	7.6	12.5	6.9	8.1	8.8	12.2	15.8	19.8
Short-term financing	38.9	59.2	51.2	82.8	90.1	116.4	134.3	144.5	155.6	169.1	184.1
Public sector 1/	4.4	5.1	5.4	5.9	8.3	7.0	7.0	7.0	7.0	7.0	7.0
Trade credits	21.1	22.0	21.1	22.8	25.4	29.3	29.9	32.0	35.1	38.9	43.0
Banks and other private	13.4	32.0	24.7	54.1	56.4	80.1	97.4	105.6	113.4	123.2	134.1
Other 4/	2.1	4.5	6.1	3.2	12.1	3.3	0.0	0.0	0.0	0.0	0.0
GIR change (- denotes increase)	-8.0	1.1	-0.1	-12.8	1.8	-9.1	0.0	0.0	0.0	0.0	0.0
of which IMF (net)	-4.0	1.7	-0.7	-2.2	-2.8	-2.0	-0.8	0.0	0.0	0.0	0.0
Purchases	1.1	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-5.1	-1.9	-0.7	-2.2	-2.8	-2.0	-0.8	0.0	0.0	0.0	0.0
of which SDR allocation	0.0	0.0	-1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Net public sector financing (incl. IMF, excl. reserves)	1.3	8.4	8.5	11.5	9.1	10.9	12.3	13.6	13.7	13.8	15.1
Government debt rollover rate (in percent) 5/	62	150	150	213	169	119	130	130	130	130	130
Bank debt rollover rate (in percent)	163	120	72	201	143	125	114	111	113	119	124
Corporate debt rollover rate (in percent)	160	188	71	85	125	123	124	127	131	134	137
Gross external financing requirements (percent of GDP)	17.6	17.1	18.6	19.3	25.1	23.0	25.9	25.9	25.7	25.7	25.7
International Investment Position (percent of GDP)	-48.5	-27.6	-45.4	-49.1	-41.8	...	...	...	...	...	...

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

1/ Includes Central Bank of the Republic of Turkey (excludes IMF purchases and repurchases).
2/ Series reflects stock of short term trade credits at end of previous year.
3/ Portfolio equity and domestic government debt (net).
4/ Errors and omissions and other liabilities.
5/ For 2007, excluding IMF financing.

Table 5. Turkey: Public Sector Finances, 2007–17

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
								Proj.			
Nonfinancial public sector primary balance	3.2	1.6	-1.0	0.8	2.0	0.1	0.4	0.1	0.1	0.1	0.1
Central government	2.6	1.8	-1.5	-0.5	1.3	0.1	0.5	0.1	-0.1	-0.1	-0.1
Primary revenue	21.0	20.4	21.0	21.9	22.2	22.2	22.7	22.5	22.3	22.3	22.3
Tax revenue	18.1	17.7	18.1	19.2	19.5	19.6	20.1	19.9	19.7	19.7	19.7
Personal income taxes	4.1	4.0	4.0	3.7	3.8	3.8	3.8	3.8	3.8	3.9	3.9
Corporate income taxes	1.6	1.8	1.9	1.9	2.1	1.9	1.8	1.8	1.8	1.8	1.8
VAT	5.1	4.9	4.9	5.7	6.1	6.2	6.4	6.3	6.2	6.2	6.2
SCT	4.6	4.4	4.6	5.2	4.9	5.0	5.3	5.2	5.2	5.2	5.1
Other	2.6	2.6	2.7	2.7	2.7	2.7	2.8	2.7	2.7	2.7	2.7
Nontax revenue 1/	2.8	2.7	2.9	2.7	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Primary expenditure	18.4	18.5	22.5	22.3	20.9	22.1	22.3	22.4	22.4	22.4	22.4
Personnel	5.9	5.8	6.6	6.7	6.6	7.2	7.3	7.4	7.4	7.4	7.3
Goods and services, *of which* :	2.6	2.6	3.1	2.6	2.5	2.4	2.1	2.1	2.1	2.1	2.1
Transfers, *of which* :	8.4	8.2	10.7	10.7	9.4	10.0	10.7	10.8	10.7	10.8	10.8
Social security institutions	3.9	3.7	5.5	5.0	4.1	4.8	5.1	5.3	5.4	5.4	5.4
Agricultural subsidies	0.7	0.6	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Transfers of revenue shares	2.0	2.1	2.2	2.4	2.4	2.1	2.3	2.3	2.2	2.2	2.2
Capital transfers	0.4	0.3	0.5	0.6	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditure	1.5	1.9	2.1	2.4	2.4	2.4	2.1	2.2	2.2	2.2	2.2
Rest of the public sector	0.6	-0.3	0.5	1.3	0.7	0.0	-0.1	0.0	0.2	0.2	0.2
Extrabudgetary funds	0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1
Revolving funds 2/	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.4	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Local governments 2/	-0.4	-0.6	-0.4	0.2	0.2	-0.1	-0.2	-0.1	0.0	0.0	0.0
State economic enterprises 3/	0.4	0.0	0.6	0.7	0.1	-0.2	-0.1	0.0	0.0	0.0	0.0
Nonfinancial public sector overall balance	-1.8	-2.8	-5.6	-2.9	-0.6	-2.8	-2.5	-2.6	-2.5	-2.5	-2.4
Interest expenditure (net)	4.9	4.4	4.6	3.7	2.6	3.0	2.9	2.7	2.6	2.6	2.5
Memorandum items:											
General government primary revenue	30.6	30.6	31.3	32.3	33.8	33.8	34.1	33.9	33.8	33.9	33.9
General government primary expenditure	27.9	29.1	32.9	32.2	31.8	33.5	33.6	33.8	33.8	33.8	33.8
General government primary balance	2.8	1.5	-1.6	0.1	1.9	0.3	0.5	0.1	0.1	0.0	0.1
General government overall balance	-2.1	-2.9	-6.2	-3.5	-0.6	-2.7	-2.5	-2.6	-2.4	-2.5	-2.4
General government structural primary balance 5/	0.8	0.5	2.5	1.3	-0.6	-1.1	-0.7	-0.5	-0.5	-0.5	-0.5
General government gross debt	39.9	40.0	46.1	42.4	39.3	38.4	36.9	36.2	35.8	35.4	35.0
Nominal GDP (billions of Turkish lira)	843	951	953	1,099	1,298	1,419	1,585	1,743	1,908	2,092	2,295

Sources: Turkish authorities; and IMF staff estimates.

1/ Excluding privatization proceeds, transfers from CBRT, and interest receipts.
2/ Excluded from consolidated government sector.
3/ Excluding severance payments for retirees.
4/ IMF deficit definition excludes profit transfers of the CBRT, proceeds from the sale of assets of the central government, and dividend payments from Ziraat Bank from revenue.
5/ The structural primary balance is estimated using the absorption gap method and excludes one-off operations.

Table 6. Banking System at a Glance, 2007–11

(Percent, unless otherwise indicated)

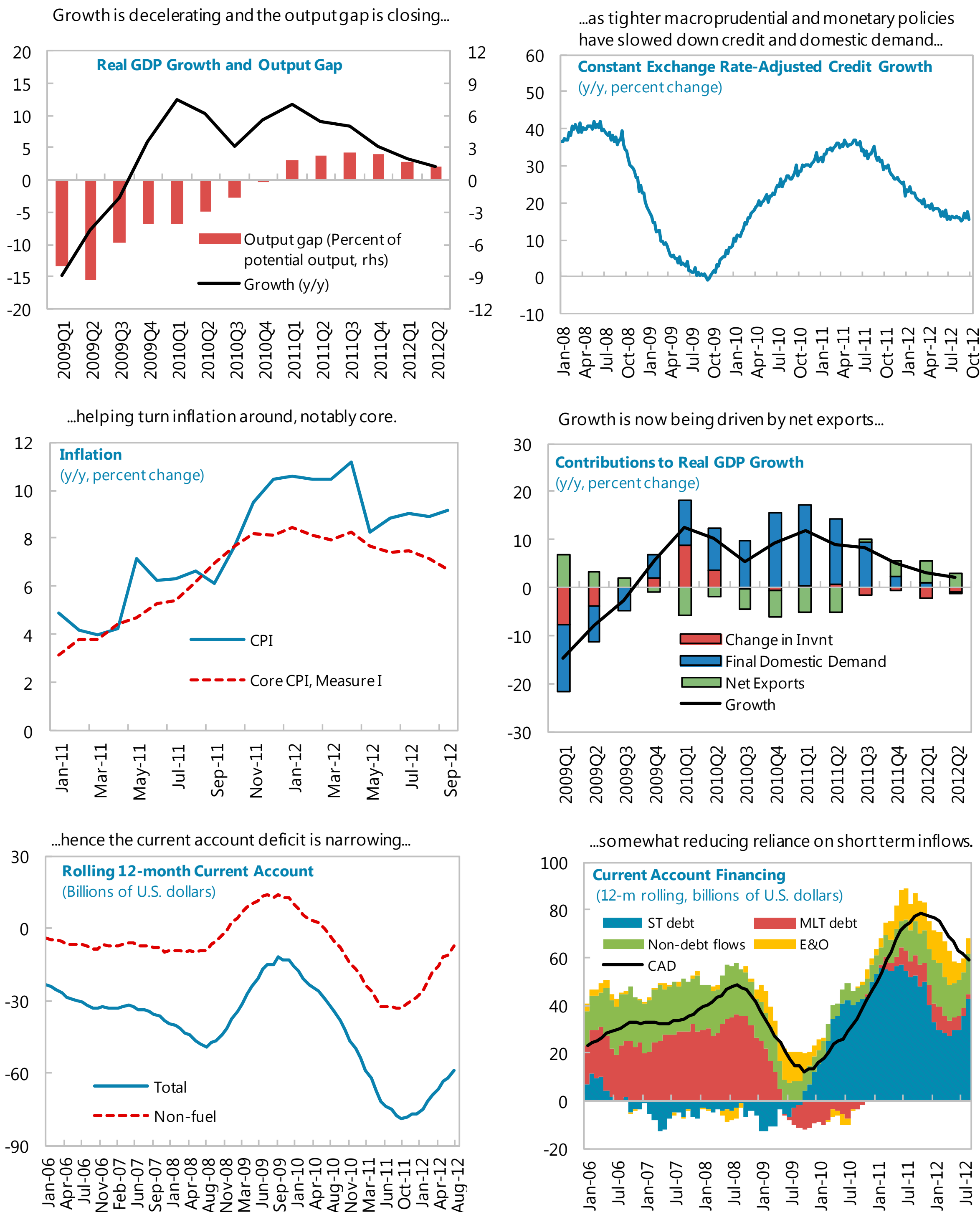
	2007	2008	2009	2010	2011
Balance sheet and loan quality					
Assets (percent of GDP)	69.0	77.1	87.6	91.6	93.8
Loans / total assets	49.1	50.2	47.1	52.2	56.1
Government securities / total assets	28.3	26.5	31.5	28.6	23.4
Loan-to-deposit ratio	80.0	80.8	76.3	85.2	98.2
Year-on-year loan growth	30.4	28.6	6.9	33.9	29.9
NPLs (gross, percent of total loans)	3.6	3.8	5.6	3.8	2.8
Provisioning ratio (percent of NPLs)	86.8	79.8	83.6	83.8	79.4
FX exposure					
FX assets / FX liabilities (on-balance sheet only)	84.6	86.9	84.7	84.0	83.7
FX loans / total loans	24.0	28.7	26.6	27.0	29.0
FX deposits / total deposits	35.4	35.3	33.7	29.7	33.9
Capital ratios					
Capital adequacy ratio	18.9	18.0	20.6	19.0	16.5
Shareholders' equity / total assets	13.0	11.8	13.3	13.4	11.9
Profitability and liquidity ratios					
Return on assets	2.8	2.1	2.6	2.5	1.7
Return on equity	24.5	18.7	22.9	20.1	15.5
Liquid assets / total assets 2/	31.7	23.7	29.4	27.7	24.7

Sources: BRSA; and IMF staff calculations.

1/ Based on data through June 2012. Return on assets/equity is annualized.

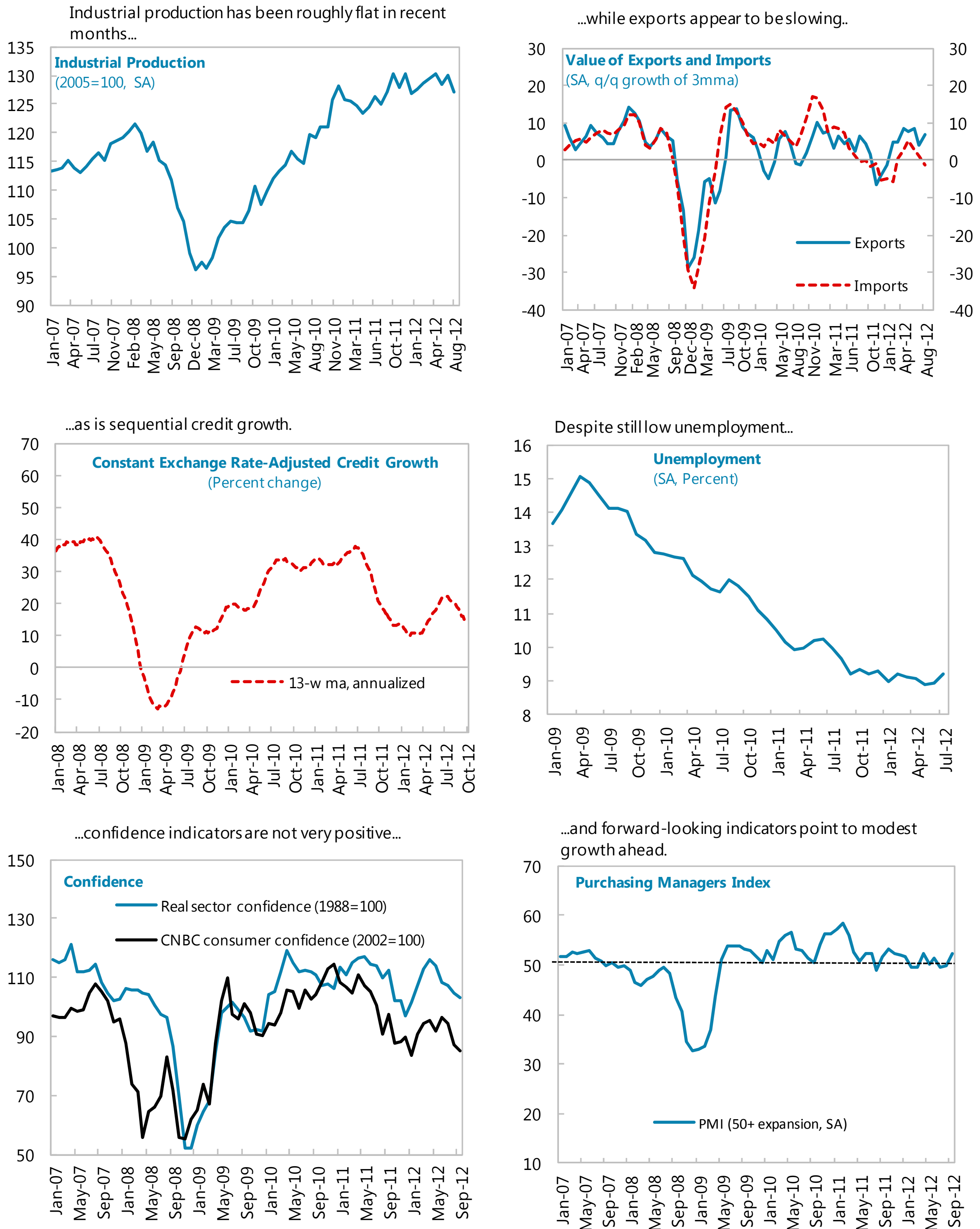
2/ Liquid assets include cash, receivables from the CBRT, money markets, and banks, and securities held for trading and sale.

Figure 1. Turkey: Economic Slowdown



Source: Haver; CBRT.

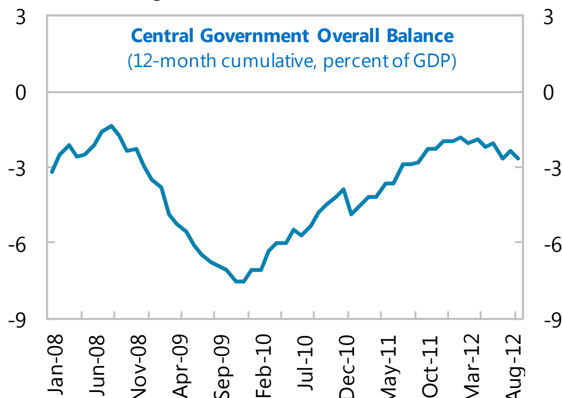
Figure 2. Turkey: High-Frequency Indicators



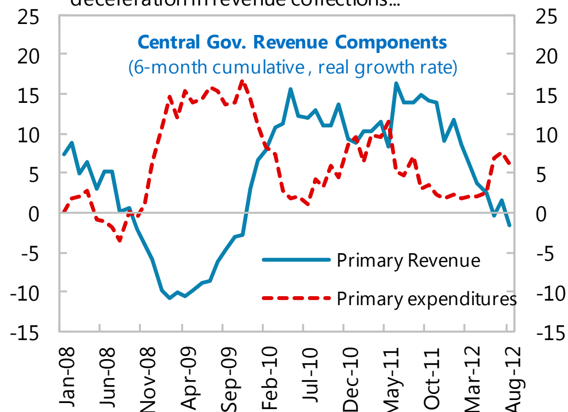
Source: Haver; CBRT; Turkstat.

Figure 3. Turkey: Fiscal Stance

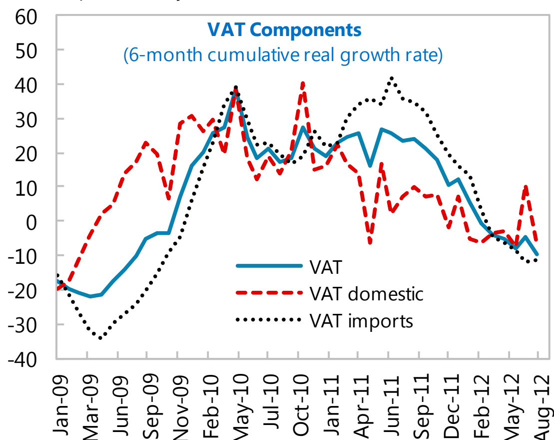
Deficits remain contained but have been worsening in 2012...



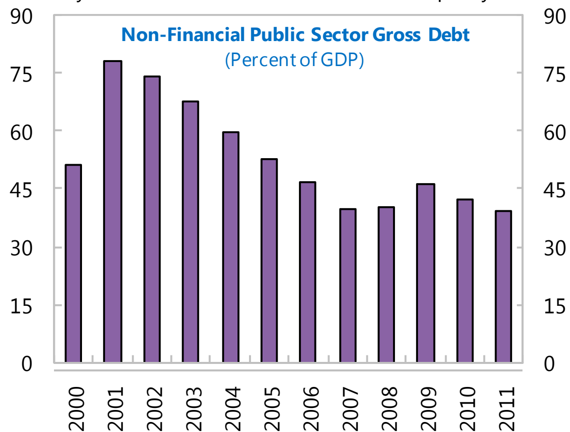
...as increases in current spending add to the deceleration in revenue collections...



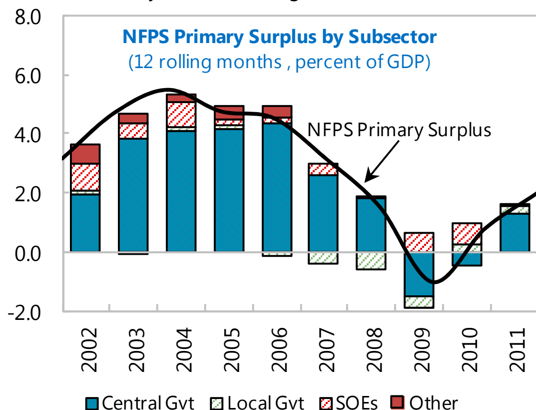
...particularly VAT.



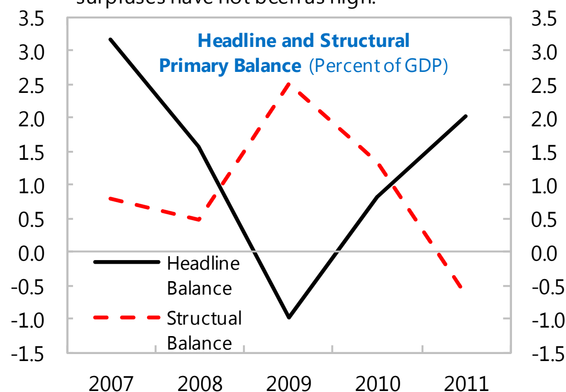
Debt has fallen substantially over the last ten years on the back of conservative fiscal policy...



...notably at the central government level...



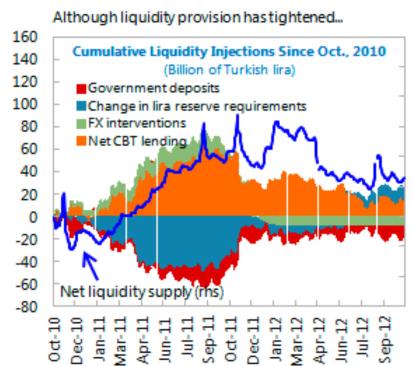
...even if, on a cyclically-adjusted basis, primary surpluses have not been as high.



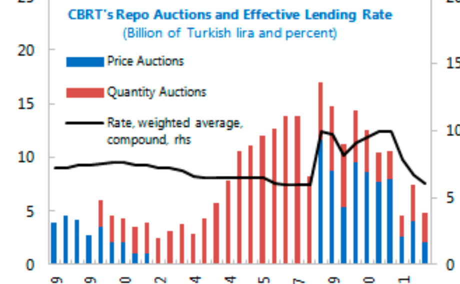
Source: Fund's estimates based on official data.

Figure 4. Turkey: Monetary Policy

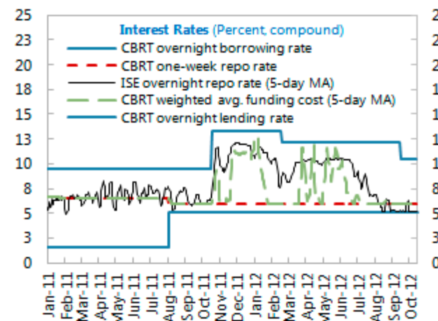
Although liquidity provision has tightened...



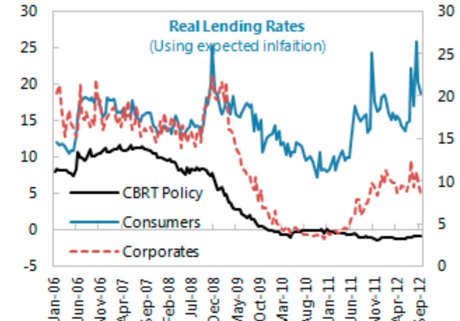
...and the central bank has switched to price auctions, the cost of liquidity has come down...



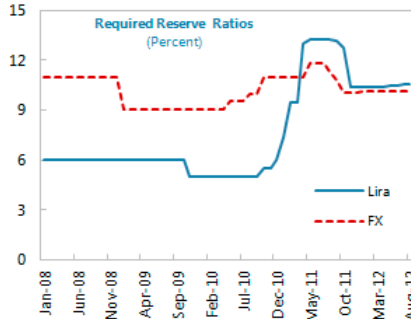
... and so did market rates, thanks to renewed inflows.



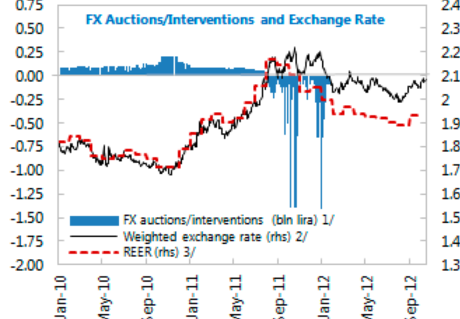
Real lending rates, however, have yet to respond.



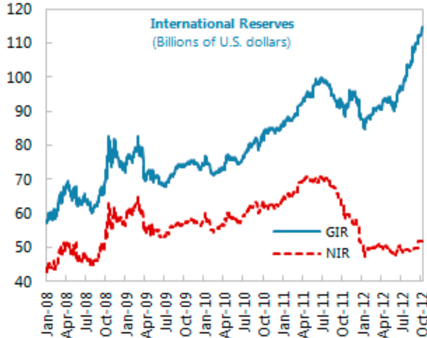
The CBRT no longer relies on reserve requirement ratios...



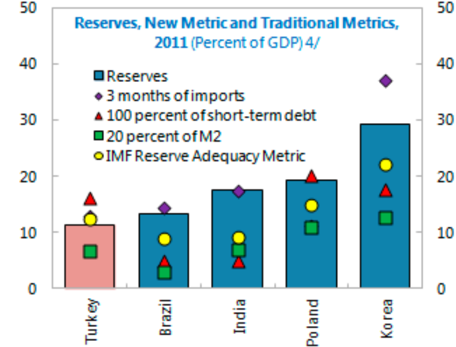
...and it no longer auctions or intervenes in the FX markets as pressures on the lira have abated.



Despite the recent sharp increase in gross reserves, net reserves remain low...



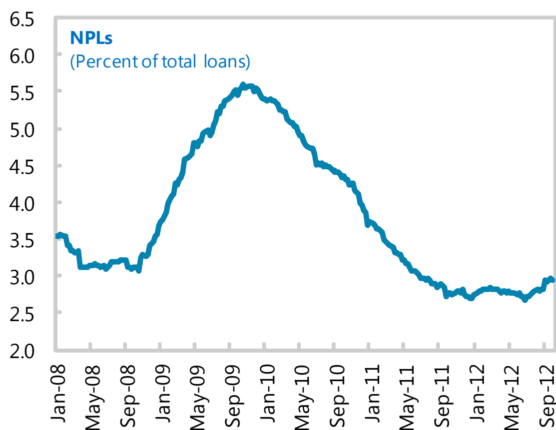
... particularly if compared to the peer countries.



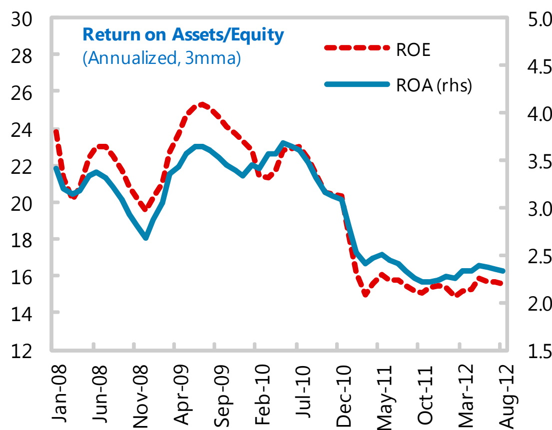
1/ A positive number indicates FX purchases.
2/ Lira per equal-weight euro/dollar basket.
3/ Inverted, renormalized, up means depreciation.
4/ Based on end-2011 numbers due to data availability. Thus, it does not incorporate the significant increase in gross reserves in Turkey in 2012.
Source: Haver; CBRT; BRSA; and IMF staff estimates.

Figure 5. Turkey: Financial Sector

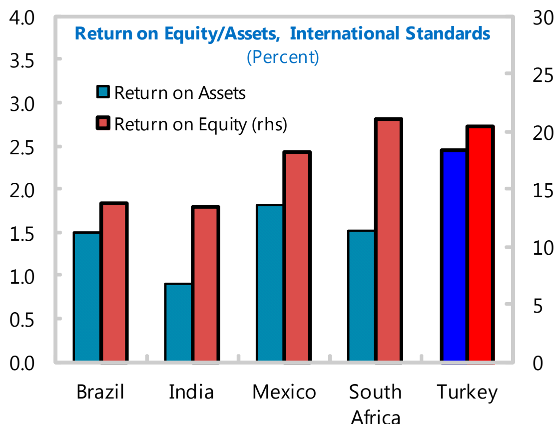
NPL ratios remain near historic lows despite a recent uptick.



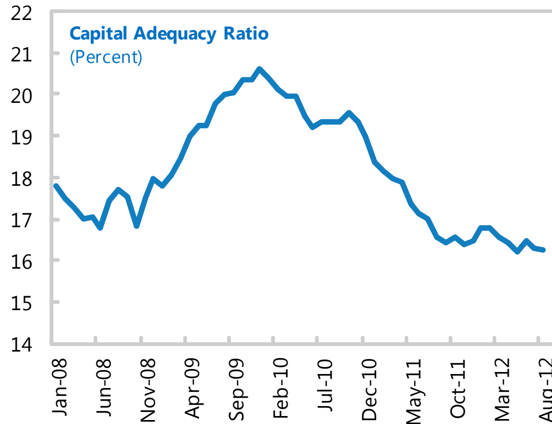
Profitability has fallen from its 2009-10 peak....



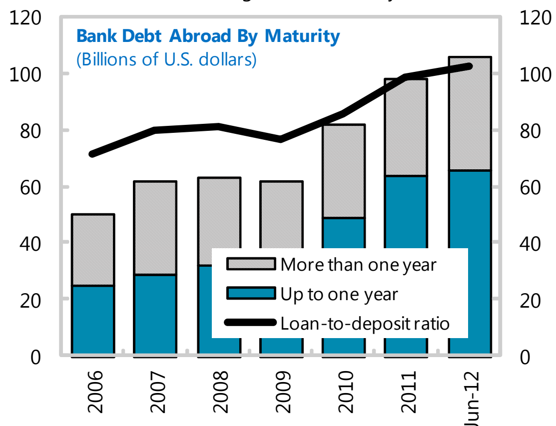
...but remains comfortable by international standards...



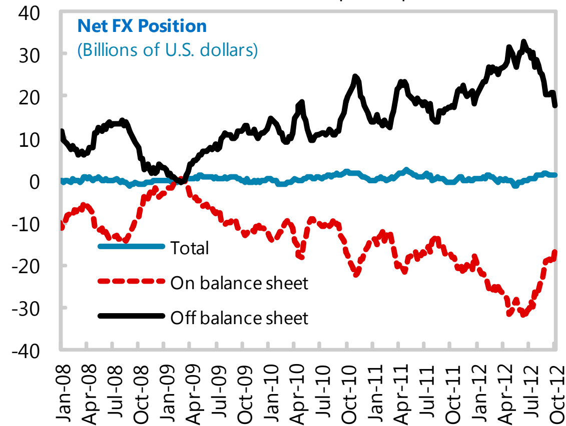
...while prudential ratios are well above regulatory minima.



However, loan-to-deposit ratios have increased sharply and external funding is dominated by short-term debt.



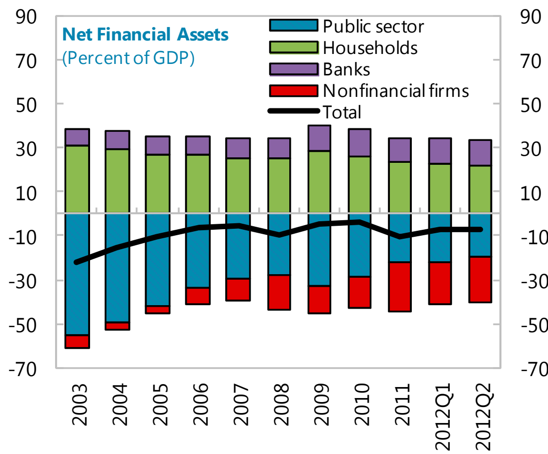
New CBRT policies on required reserves are helping banks close their on-balanche sheet open FX positions.



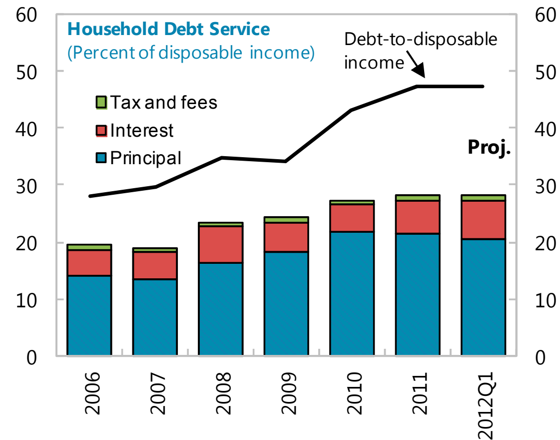
Sources: Haver; CBRT; BRSA.

Figure 6. Turkey: Households and Corporates

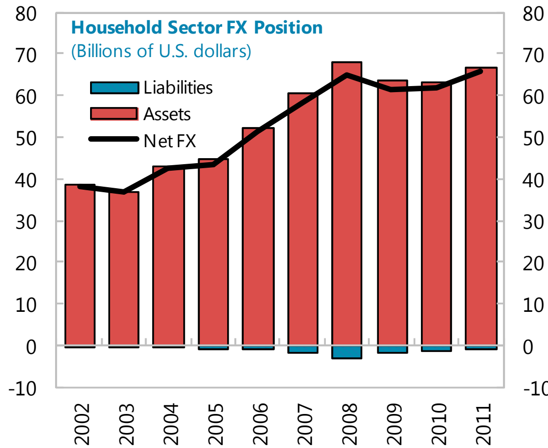
Improvement in the public sector's balance sheet was matched by a deterioration in other sectors...



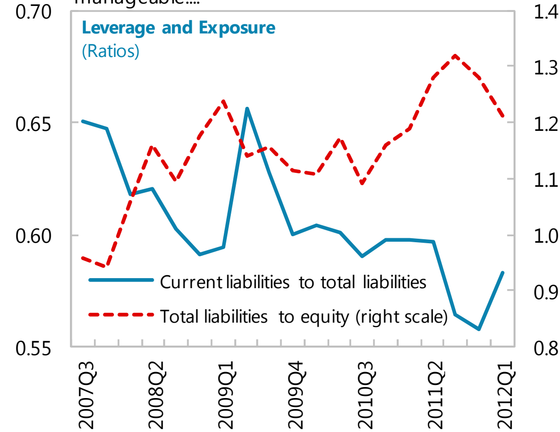
...such as households, where debt ratios have increased even if they remain comfortable by peer standards.



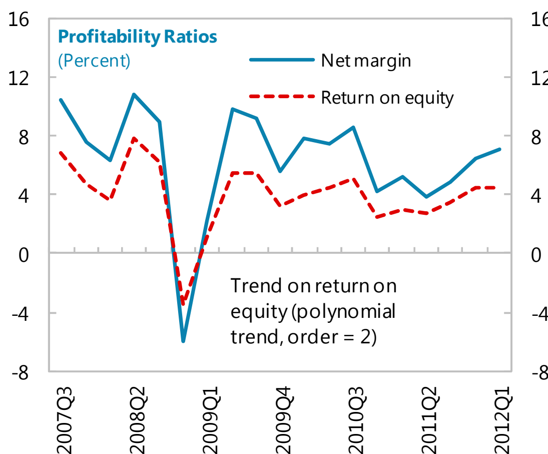
Moreover, Turkish households have no FX debt.



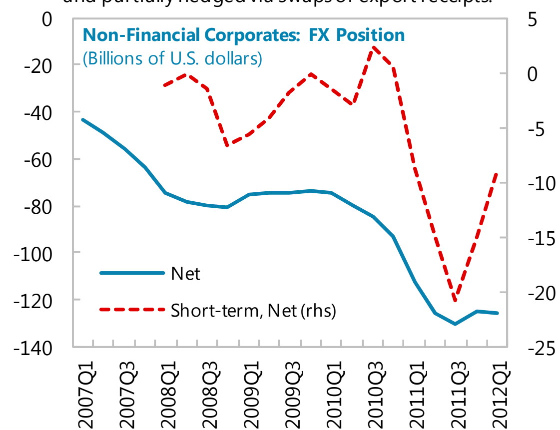
Leverage in the corporate sector has risen but remains manageable....



...and profitability is strong...

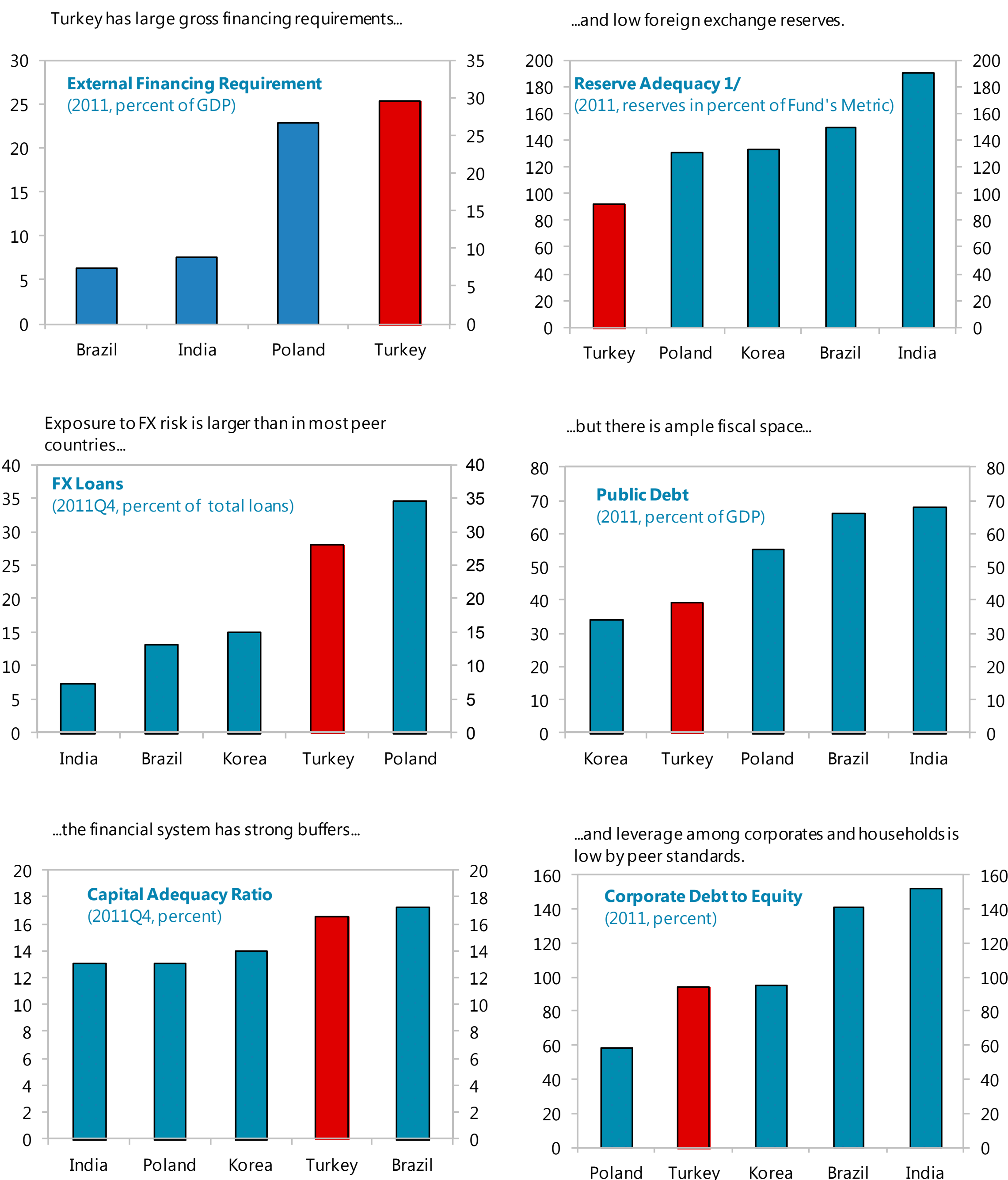


...but the open FX position is large, albeit mostly long-term and partially hedged via swaps or export receipts.



Sources: CBRT; Treasury; BRSA; TBA; and IMF staff estimates.

Figure 7. Turkey vs. Peers



1/ Based on end-2011 numbers due to data availability. Thus, it does not incorporate the significant increase in gross reserves in Turkey in 2012.
Source: World Economic Outlook; IMF Financial Soundness Indicators and Corporate Vulnerability databases.

APPENDIX I—DEBT SUSTAINABILITY ANALYSIS

Public Debt

Under staff's baseline scenario public debt-to-GDP ratio is projected to continue declining, although marginally. The nonfinancial public sector primary surplus is expected to deteriorate to 0.1 percent of GDP in 2012 and be broadly balanced in the outer years. As a result, both the general government debt (EU definition) and nonfinancial public sector net debt ratio fall slightly over the projection period to 35 and 30 percent of GDP respectively (Table A1).

However, public sector sustainability could deteriorate under alternative scenarios in the absence of fiscal consolidation. Different policy path or growth scenarios would significantly affect debt outcomes (Figure A1). In particular, medium term public debt dynamics are highly sensitive to different growth scenarios. If medium-term growth rates are persistently lower than anticipated, stabilizing the debt ratio would require further fiscal consolidation. Assuming expenditure plans remain unchanged, the debt-to-GDP ratio could reach 45 percent of GDP by 2017 should growth be 2.2 percentage points (½ a standard deviation) lower each year than in the baseline scenario. To a lesser extent, public debt ratios remain sensitive to large and permanent exchange rate, contingency liabilities, and interest rate shocks despite the increasing share of debt denominated in domestic currency and fixed interest rate. Under a one-off 30 percent real depreciation of the exchange rate, the public debt ratio would increase by about 7 percentage points above the baseline projections. Similarly, a contingent liability shock of 10 percent of GDP would increase public debt by a similar amount over the medium-term.

External Debt

Under the baseline, gross external debt, while sustainable, is increasing and vulnerable to a large exchange rate shock (Table A2). External debt is expected to rise to 48 percent of GDP by 2017 on account of still large current account deficit, slower GDP growth than prior to the crisis, and an increase in debt-creating inflows. In 2011, the significant drawdown of assets held abroad and the high growth helped keep external debt in check despite the double digit current account deficit. Going forward, the buffer will be much smaller and external debt as a percent of GDP could be much higher, were it not for favorable GDP deflators. The external debt is robust to the standardized growth and current account shocks (one-half standard deviation) and a customized interest rate shock to the level seen in 2008. External debt will remain below 60 percent of GDP under individual shocks or a combination of the three standardized shocks. However, an additional real depreciation of 30 percent in 2012 would cause gross external debt to rise to over 70 percent of GDP (Figure A2). Nevertheless, a real exchange rate shock of this size would likely further precipitate adjustment in the current account and other second-round effects that would mitigate the impact on external debt, but which are not captured in a static debt sustainability exercise.

The more prominent risk to external debt sustainability in both the near and the medium term, however, is liquidity and roll-over risk. Annual gross external financing needs, after a small drop in 2012, are forecast to revert back to above 25 percent and remain elevated in the medium term. The still-high current account deficit and the heavy reliance of short term borrowing in its financing are the main factors behind the persistently large external financing need. Were the global risk appetite to reverse, Turkey would be subject again to financing difficulties as seen in end-2011 and early 2012, which were only relived following the ECB's LTRO operation. Given the relatively low FX reserve coverage by international standards, Turkey's debt sustainability remains susceptible to international investors' shifting risk appetite as the latter could trigger a simultaneous rise in both borrowing cost and exchange rate pressure.

Turkey's decreasing exposure to the Fund and moderate external debt levels should ensure adequate capacity to repay the Fund. Under the baseline scenario, the exposure to Turkey would decline from SDR 1.9 billion at end-2011 to only SDR 0.6 billion at end-2012 (39 percent of Turkey's quota, 0.1 percent of GDP, or 1 percent of reserves). The outstanding exposure will be all repurchased by 2013Q2.

Table A1. Turkey: Public Sector Debt Sustainability Framework, 2007-2017
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	**Debt-stabilizing primary balance 9/**
General Government gross debt 1/	39.9	40.0	46.1	42.4	39.3	38.4	36.9	36.2	35.8	35.4	35.0	
Baseline: Nonfinancial public sector net debt 1/	34.4	34.5	39.5	36.8	33.4	**32.3**	**31.4**	**31.0**	**30.8**	**30.5**	**30.2**	**-0.2**
o/w foreign-currency denominated	12.6	13.9	14.0	12.0	12.3	12.0	12.4	12.4	12.1	11.0	10.4	
Change in public sector debt	-5.7	0.1	4.9	-2.7	-3.4	-1.1	-0.9	-0.5	-0.2	-0.3	-0.3	
Identified debt-creating flows (4+7+12)	-7.3	1.9	4.2	-3.6	-2.9	-0.4	-1.0	-0.3	-0.3	-0.3	-0.3	
Primary deficit	-3.2	-1.6	1.0	-0.8	-2.0	-0.1	-0.4	-0.1	-0.1	-0.1	-0.1	
Revenue and grants	30.6	30.6	31.3	32.3	33.8	33.8	34.1	33.9	33.8	33.9	33.9	
Primary (noninterest) expenditure	27.5	29.0	32.2	31.5	31.7	33.7	33.7	33.9	33.7	33.8	33.8	
Automatic debt dynamics 2/	-2.6	5.2	4.4	-1.3	-0.5	0.1	-0.5	-0.1	-0.1	-0.1	-0.2	
Contribution from interest rate/growth differential 3/	0.9	0.5	4.5	-1.5	-3.0	0.1	-0.5	-0.1	-0.1	-0.1	-0.2	
Of which contribution from real interest rate	2.6	0.7	2.8	1.6	-0.4	1.0	0.5	1.0	1.1	1.1	1.0	
Of which contribution from real GDP growth	-1.7	-0.2	1.7	-3.1	-2.6	-0.9	-1.0	-1.1	-1.2	-1.2	-1.2	
Contribution from exchange rate depreciation 4/	-3.6	4.7	-0.1	0.3	2.5	...	...	...	...	...	...	
Other identified debt-creating flows	-1.5	-1.8	-1.2	-1.5	-0.4	-0.4	-0.1	-0.1	-0.1	-0.1	0.0	
Privatization receipts (negative)	-0.8	-1.0	-0.3	-0.4	-0.4	-0.4	-0.1	-0.1	-0.1	-0.1	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	-0.7	-0.7	-1.2	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.7	-1.8	0.7	0.9	-0.5	-0.7	0.1	-0.2	0.1	0.0	-0.1	
Public sector debt-to-revenue ratio 1/	112.3	112.9	126.2	113.8	98.9	95.4	92.3	91.3	90.9	90.1	89.1	
Gross financing need 6/	18.2	15.5	20.3	20.0	10.6	10.5	11.1	12.8	8.8	11.9	11.8	
in billions of U.S. dollars	118.3	113.5	125.0	146.3	82.0	83.0	94.5	117.0	88.5	130.4	142.3	
Scenario with key variables at their historical averages 7/						**32.3**	**28.4**	**24.4**	**20.8**	**17.2**	**13.7**	**-0.4**
Scenario with no policy change (constant primary balance) in 2012-2017						**32.3**	**31.7**	**31.1**	**30.9**	**30.5**	**30.1**	**-0.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.7	0.7	-4.8	9.2	8.5	3.0	3.5	4.0	4.3	4.4	4.5	
Average nominal interest rate on public debt (in percent) 8/	13.7	14.4	13.2	10.9	8.4	9.7	10.0	9.4	9.1	9.1	9.0	
Average real interest rate (nominal rate minus change in GDP deflator, in p	7.5	2.4	8.0	5.2	-0.5	3.5	2.1	3.7	4.1	4.1	4.0	
Nominal appreciation (increase in US dollar value of local currency, in perc	21.3	-23.0	0.4	-2.1	-18.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.2	12.0	5.3	5.7	8.9	6.2	7.9	5.7	5.0	5.0	5.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.9	6.4	5.7	6.6	9.4	9.4	3.4	4.7	3.8	4.6	4.5	
Primary deficit	-3.2	-1.6	1.0	-0.8	-2.0	-0.1	-0.4	-0.1	-0.1	-0.1	-0.1	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

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.

Table A2. Turkey: External Debt Sustainability Framework, 2007–17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 7/
1 Baseline: external debt 1/	38.4	38.4	43.7	39.7	39.6	45.0	45.7	46.5	46.4	46.9	47.9	-6.3
2 Change in external debt	-0.8	0.0	5.3	-4.0	-0.1	5.5	0.6	0.8	-0.1	0.5	0.9	
3 Identified external debt-creating flows (4+8+9)	-5.2	-1.0	7.8	-2.1	6.2	4.4	3.4	2.8	2.6	3.1	3.5	
4 Current account deficit, excluding interest payments	4.8	4.1	0.5	5.2	8.9	6.4	6.5	6.7	7.0	7.3	7.5	
5 Deficit in balance of goods and services	7.2	7.3	4.0	7.7	11.5	9.7	9.6	9.7	9.8	9.8	9.9	
6 Exports	17.8	19.3	17.8	16.5	18.5	20.1	19.5	18.7	17.8	17.0	16.2	
7 Imports	25.0	26.5	21.9	24.3	30.0	29.8	29.1	28.4	27.6	26.8	26.1	
8 Net non-debt creating capital inflows (negative)	-3.9	-2.4	-1.6	-1.5	-1.6	-2.0	-2.3	-2.8	-3.0	-2.7	-2.5	
9 Automatic debt dynamics 2/	-6.1	-2.7	8.9	-5.8	-1.2	0.0	-0.8	-1.1	-1.3	-1.4	-1.4	
10 Contribution from nominal interest rate	1.2	1.6	1.7	1.2	1.0	1.1	0.7	0.6	0.5	0.5	0.5	
11 Contribution from real GDP growth	-1.5	-0.2	2.2	-3.4	-3.2	-1.2	-1.5	-1.7	-1.8	-1.9	-1.9	
12 Contribution from price and exchange rate changes 3/	-5.8	-4.0	5.0	-3.6	1.0	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 4/	4.4	1.0	-2.5	-1.9	-6.3	1.0	-2.8	-2.0	-2.7	-2.6	-2.5	
External debt-to-exports ratio (percent)	216.2	199.2	245.1	240.2	213.8	223.9	234.2	249.1	260.7	276.4	294.8	
Gross external financing need (billions of U.S. dollars) 5/	118.7	125.8	114.0	142.5	196.3	182.4	221.2	236.4	256.7	281.1	308.8	
Percent of GDP	18.3	17.2	18.5	19.5	25.3	23.1	25.9	25.8	25.6	25.6	25.6	
Scenario with key variables at their historical averages 6/						45.0	41.0	37.7	34.8	32.3	30.2	-5.1
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	4.7	0.7	-4.8	9.2	8.5	3.0	3.5	4.0	4.3	4.4	4.5	
GDP deflator in U.S. dollars (percent change)	17.2	11.8	-11.6	9.0	-2.4	-1.1	4.6	3.2	5.0	5.0	5.0	
Nominal external interest rate (percent)	3.6	4.6	3.7	3.1	2.8	2.9	1.6	1.3	1.1	1.1	1.1	
Growth of exports (U.S. dollar terms, percent)	23.2	22.1	-22.1	10.3	18.6	10.7	4.9	2.7	4.5	4.6	4.9	
Growth of imports (U.S. dollar terms, percent)	20.5	19.5	-30.6	31.9	31.1	1.1	5.8	4.5	6.5	6.5	6.9	
Current account balance, excluding interest payments	-4.8	-4.1	-0.5	-5.2	-8.9	-6.4	-6.5	-6.7	-7.0	-7.3	-7.5	
Net non-debt creating capital inflows	3.9	2.4	1.6	1.5	1.6	2.0	2.3	2.8	3.0	2.7	2.5	

1/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBT).

2/ 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 U.S. dollar terms, g = real GNP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ 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 deflator).

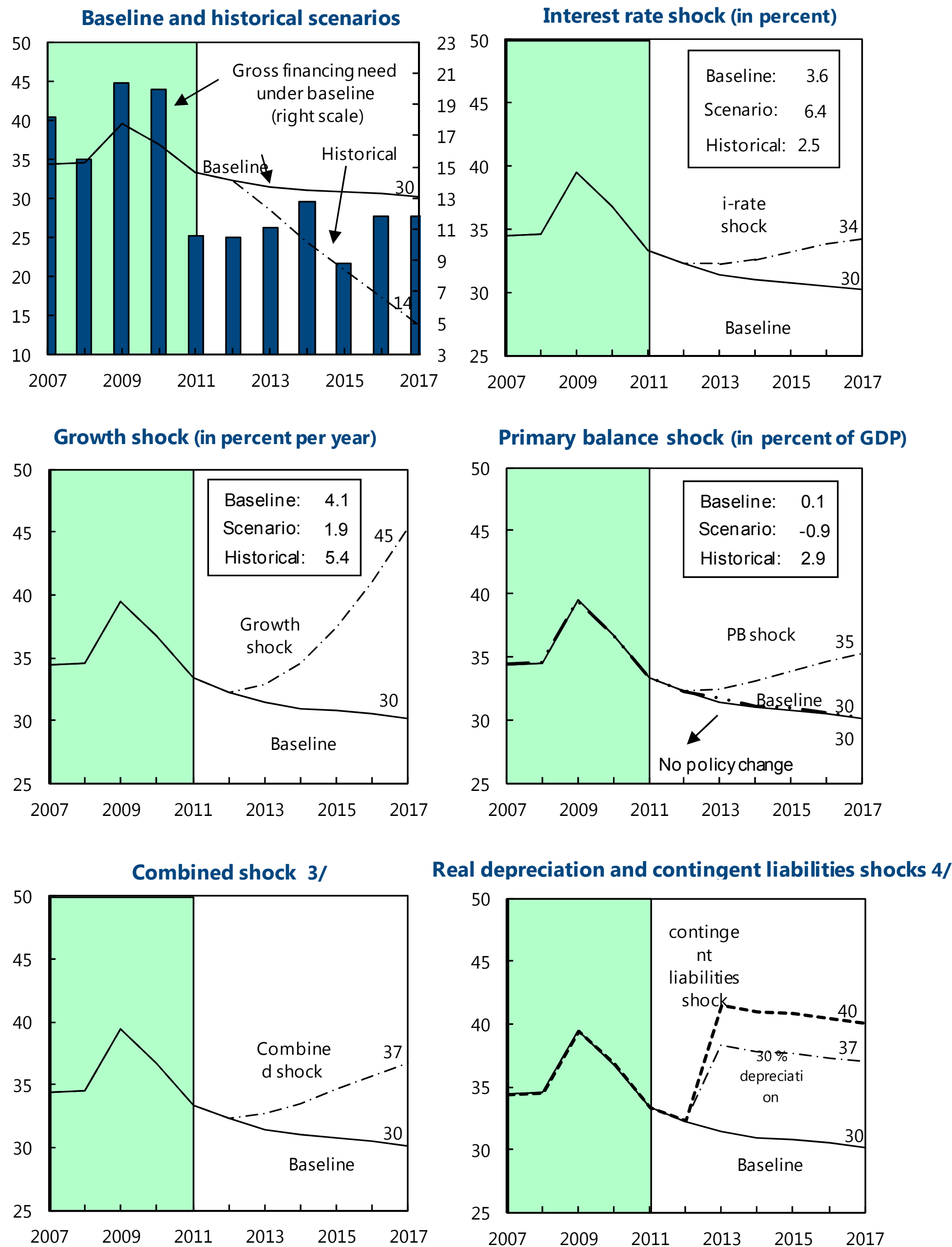
4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. Differs slightly from external financing requirement in Staff Report because includes official transfers and IMF repurchases but excludes increase in portfolio and other investment assets.

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

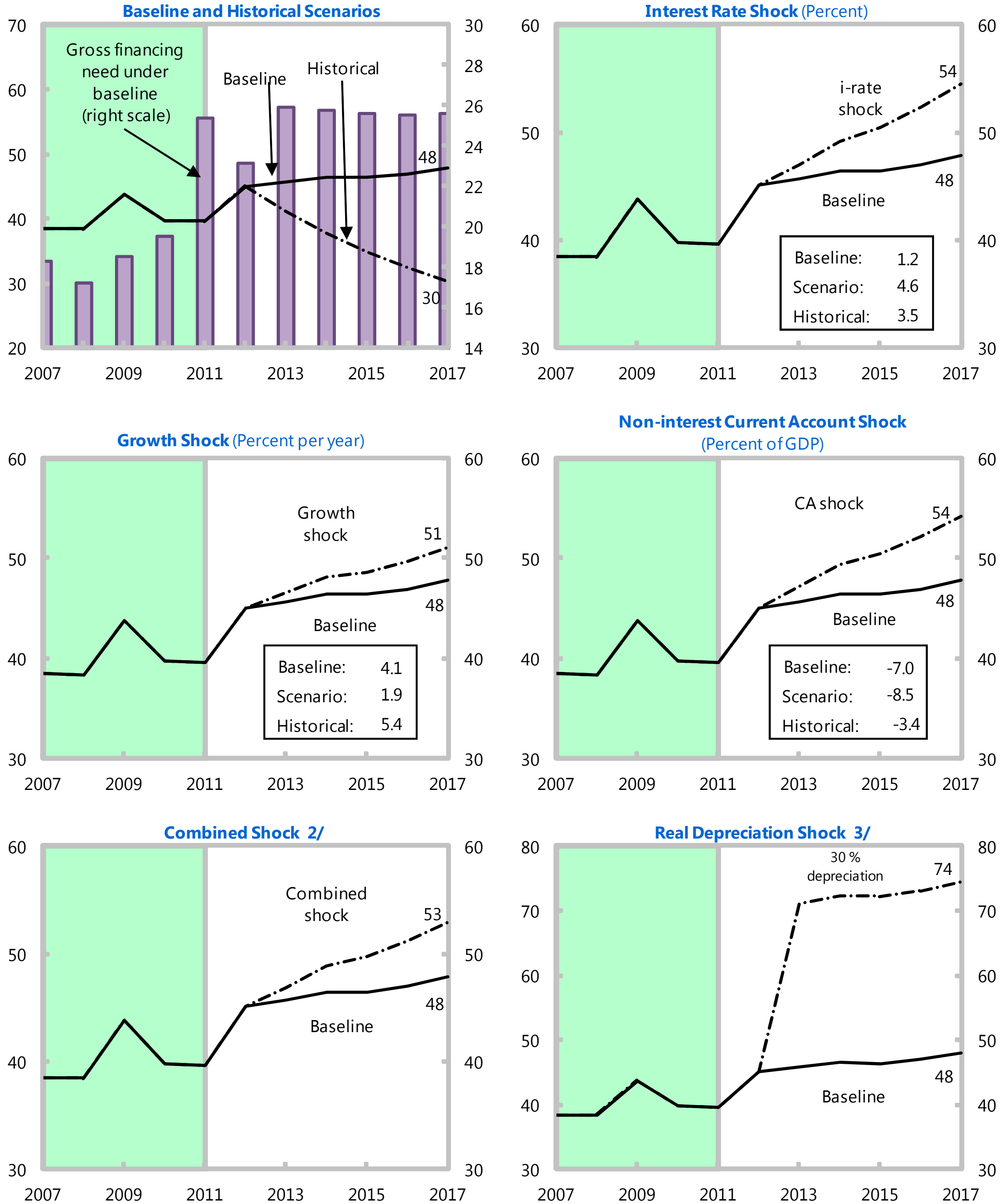
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A1. Turkey: Public Debt Sustainability: Bound Tests 1/ 2/
(Net Nonfinancial Public Sector debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. 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 primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure A2. Turkey: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks except for the interest rate shock where the 2008 average of 4.6 percent is applied. 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 31, 2012

Prepared By European Department

CONTENTS

FUND RELATIONS 2

WORLD BANK RELATIONS 5

STATISTICAL ISSUES 6

FUND RELATIONS

(Data as of September 30, 2012)

A three-year SDR 6.7 billion (559 percent of quota) **Stand-By Arrangement** was approved in May 2005 and expired on May 10, 2008. Cumulative purchases amounted to SDR 6.7 billion.

The Board concluded an **Ex-Post Assessment of Longer-Term Program Engagement and Ex-Post Evaluation of Exceptional Access** for Turkey on August 1, 2008 (SM/08/248).

In September 2008, the Fund initiated **Post-Program Monitoring**, which concluded in September 2011.

Outstanding Fund credit amounted to SDR 0.8 billion (58 percent of quota) as of September 30, 2012.

1. Membership Status:

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

2. General Resources Account

	SDR Million	Percent Quota
Quota	1,455.80	100.00
Fund holdings of currency	2,186.19	150.17
Reserve position in Fund	112.78	7.75

3. SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	1,071.33	100.00
Holdings	971.21	90.65

4. Outstanding Purchases and Loans

	SDR Million	Percent Allocation
Stand-By Arrangements	843.16	57.92

5. 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	12/20/01	15,038.40	11,738.96
Of Which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

6. Projected Payments to the Fund[1/]

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	281.05	562.11	--	--	--
Charges/Interest	2.41	2.68	0.09	0.09	0.09
Total	283.47	564.79	0.09	0.09	0.09

[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.

7. 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.

8. 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.

9. Article IV Consultations:

The last Article IV staff report (SM/11/305) was issued on January 27, 2012. Board discussion took place on November 30, 2011.

10. ROSCs

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 26, 2000	N/A
Corporate Governance	December 11, 2000	Prepared by the World Bank
Data ROSC	March 14, 2002	Country Report No. 02/55
Fiscal ROSC	November 25, 2003	Country Report No. 03/353
Fiscal ROSC	March 24, 2006	Country Report No. 06/126
FSSA and Related ROSC	May 7, 2007	Country Report No. 07/361
Data ROSC	September 3, 2009	Country Report No. 09/286
BCP	*Forthcoming*	*Forthcoming*
IAIS	*Forthcoming*	*Forthcoming*

11. Recent Technical Assistance

Dept.	Timing	Purpose
FAD/MFD	February 2005	Treasury cash management and state bank reform
MFD	2005–06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May 2005	Investor relations office
FAD	July 2005	Income tax reform
FAD	2005–08 (numerous missions)	Revenue administration reforms
FAD	February 2007	Health spending
STA	June 2007, November 2007	Revision of national accounts statistics and communication strategy
STA	November 3–17, 2008	DATA ROSC
FAD	June 2009	Tax administration
MCM	February 2012	Stress testing framework for the financial sector supervisor
MCM	September 2012	Early warning system and stress testing

WORLD BANK RELATIONS

1. **Turkey and the World Bank Group have a strong partnership, which continuously deepened over the last twelve years.** Country Partnership Strategies (CPSs) form the basis of the partnership between Turkey and the World Bank. In the implementation of the CPS for FY08-11, IBRD provided financing of US$7.6 billion, IFC financing was US$ 2.0 billion, and MIGA's gross exposure grew by 42 percent. The new Country Partnership Strategy FY12-15 envisages financing levels of up to US$ 4.45 billion; the increased provision of analytical and advisory services as well as new services and instruments – including fee-based services. The CPS has three main strategic objectives and pillars: (i) enhanced competitiveness and employment; (ii) improved equity and public services; and, (iii) deepened sustainable development. Turkey's development success and a number of its economic and social reforms have attracted international interest and recognition. Together, Turkey and the World Bank are exploring avenues to collaborate in sharing Turkey's experiences abroad.

2. **Turkey is IBRD's third largest borrower in terms of debt outstanding**. The active portfolio of investment projects with World Bank financing includes 14 projects with total net commitments of US$5.566 billion (as of March 2012). The investment portfolio supports financial and private sector development (38 percent), urban development (23 percent), the energy sector (33 percent), transport (3 percent) and health and education (3 percent).

3. **IFC's own-account investment program in Turkey is expected to remain in the range of USD425-500 million/year, or USD 1.7-2.0 billion for the CPS FY12-15 period**. Although IFC's investment volume is not expected to increase, its strategy is flexible and constituent with the WBG's approach to MIC's. IFC aims to adjust its areas of intervention, products and instruments to the country's needs. IFC expects to target under-served sectors of the economy, providing financing in areas including Micro, Small and Medium Enterprises; energy efficiency and renewable energy; municipalities; and, poorer regions in the country. IFC intends to continue promoting South-South investments and supporting Turkish companies to invest in the region and further abroad.

4. **The World Bank Group is engaged in Turkey with its full range of financing as well as analytic, knowledge, and advisory services.** Recent analytic, knowledge, and advisory activities have included assessments of the economic and social impact of the crisis and policies and programs to mitigate it and promote growth recovery, Country Economic Memorandum on savings and sustainable growth, a roadmap for the development of a corporate bond market, a Transport Public Expenditure Review, studies on female labor force participation, the inequality of opportunities, the quality of education, early childhood development, an investment climate assessment, and technical assistance on food safety, sustainable development, watershed management and promoting gender equity in the private sector and entrepreneurship. Much analytic and advisory work is carried out together with the Turkish authorities, the private sector, academia, or civil society stakeholders. The World Bank Group engages with civil society in the preparation and implementation of projects and collaborates closely with other development partners such as the IMF, EU, United Nations organizations, and key bilateral partners.

STATISTICAL ISSUES

1. **Data provision to the Fund is broadly adequate for surveillance purposes, despite certain shortcomings.** Turkey subscribes to the Special Data Dissemination Standard (SDDS).

Real Sector Statistics

2. **Data on producer and consumer prices are published monthly, with a short lag. Monthly data on industrial production are published with a lag of five to six weeks**. The CPI and the PPI generally conform to international standards. The methodology of the CPI was improved with the introduction of a 2003-based index, and this new CPI was effective as of 2005. The methodology of the CPI was further improved in 2009 regarding the collection of telecommunication services prices. The new CPI does not cover owner-occupied housing, commodities produced by households for own consumption, and expenditures on commodities obtained through in-kind payments. The PPI is compiled only by product (and not by economic activity).

3. **Quarterly national accounts are published with a 2-3 month lag**. The Turkish Statistical Institute (Turkstat) publishes national accounts in current and constant prices for the production and expenditure approaches to gross domestic product (GDP) and in current prices for the income approach. Only quarterly GDP data are presented on a seasonally adjusted basis.

4. **In March 2008, revised annual and quarterly estimates were released for 1998 onwards following the introduction of *ESA 1995* in Turkish National Accounts**. However, GDP time series have not been constructed for years prior to 1998. Work is underway aiming at incorporation of data from annual collections, the development of independent estimates of household consumption, and further enhancement of estimates for the non-observed economy. A project recently initiated aims at extending the scope of the accounts to a full sequence of accounts for the total economy, annual supply and use tables, and institutional sector accounts.

5. **There is a wide range of data on labor market developments, with the biannual Household Labor Force Survey (HLFS) replaced with a monthly survey at the beginning of 2000**. These new data are published quarterly with a three month lag. Coverage of wage developments in the private sector has improved through the use of quarterly surveys of the manufacturing sector.

Government Finance Statistics

6. **Budgetary data are published monthly, with a lag of some 2–3 weeks**. Coverage of the budget is incomplete, with some fiscal operations conducted through extra budgetary funds, for which data are available only with long lags. Fiscal analysis is further complicated by the omission of certain transactions from the fiscal accounts, 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.

7. Turkey reports fiscal data for publication in the *Government Finance Statistics Yearbook*. The latest data available are for 2010 and cover the general government sector and its subsectors. Monthly data are reported on an irregular basis for publication in *International Financial Statistics*, starting from September 2009.

Monetary and Financial Statistics

8. Data on the central bank balance sheet, and provisional data on the main monetary aggregates and total domestic credit, are published weekly, with a one- and two-week lag, respectively. Data on the monetary survey and deposit interest rates are published monthly, with a one month lag, except for year-end data, where the lag is two months. The CBRT reports to STA the Standardized Report Form (SRF) 1SR for the Central Bank on a monthly basis with a one month lag and SRF 2SR for the Other Depository Corporations with a one month lag, except for year-end data, where the lag is two months.

9. Public data on banks' external funding could be improved. The CBRT reports data on banks foreign assets and liabilities, however, this includes data on transactions with banks' branches abroad that are classified as non-residents from the BOP perspective. The BRSA maintains data on the consolidated banking sector with more accurate information on the true foreign assets and liabilities; however, this data is not currently disseminated in a public report.

External Sector Statistics

10. The central bank reports quarterly BOP data to STA with about two months lag; in May 2012, it started reporting quarterly IIP data from 2006 onwards. The CBRT participates in the Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct investment Survey (CDIS). External sector statistics are compiled in broad conformity with the conceptual framework of the fifth edition of the *Balance of Payments Manual* (*BPM5).*

Turkey: Table of Common Indicators Required for Surveillance
(As of September 5, 2012)

	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]	Data Quality Accuracy and reliability[9]
Exchange Rates	Jul. 2012	8/2/2012	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jul. 2012	8/28/2012	W	W	W		
Reserve/Base Money (narrow definition)	Jun. 2012	8/6/2012	W and M	W and M	W and M	O,O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Jun. 2012	8/6/2012	W and M	W and M	W and M		
Broad Money	Jun. 2012	8/6/2012	W and M	W and M	W and M		
Central Bank Balance Sheet	Jun. 2012	8/6/2012	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Jun. 2012	8/6/2012	W and M	W and M	W and M		
Interest Rates[2]	Jul. 2012	8/6/2012	D/W/M	D/W/M	W/M		
Consumer Price Index	Jul. 2012	8/9/2012	M	M	M	O,LO,O,LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep, 2011	10/18/2011	M	M	M	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Dec. 2011	6/19/2012	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug. 2011	09/20/2011	M	M	M		
External Current Account Balance	Q1 2012	7/19/2012	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2012	7/19/2012	M	M	M		
GDP/GNP	Q1 2012	7/19/2012	Q	Q	Q	O, LO,O, O	LO, O, LO, O, LO
Gross External Debt	Aug. 2011	08/18/2011	Q	Q	Q		
International Investment Position[6]	Q1 2012	5/29/2012	M	M	M		

[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 assets and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC published in September 2009 and based on the findings of the mission that took place during November 3-17, 2008. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and valid.

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/130
FOR IMMEDIATE RELEASE
November 20, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Turkey

On November 16, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Background

After growing well above trend in 2010 and 2011, the Turkish economy has slowed to a more sustainable 3 percent growth rate this year. Growth has also become more balanced, as domestic demand and imports decelerated on the back of tighter monetary and macro-prudential policies implemented in 2011, while exports continue to perform well thanks to successful diversification towards new markets. In November, Turkey was upgraded to investment grade by one credit rating agency.

Slower and more balanced growth is helping to unwind imbalances. The current account deficit has shrunk significantly, by 33 percent year-on-year in the year to August. Inflation, both headline and core, is also coming down from its peak in early 2012, though recent increases in indirect taxes and administered prices have boosted it temporarily and could further undermine competitiveness.

[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. 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.

The primary budget surplus so far in 2012 has fallen significantly relative to the same period last year. The budget target for the year is expected to be missed, notably because of spending overruns in the areas of personnel, health, and capital spending. The banking system remains well capitalized, with capital ratios at more than 16 percent and well above regulatory minima, and not materially impacted by the introduction of Basel II and II.5. Profitability is strong, and Non-Performing Loans (NPLs) remain near historic lows despite a minor uptick in recent months.

Executive Board Assessment

Executive Directors commended the Turkish authorities for setting the stage for more sustainable and balanced growth in 2012, accompanied by declines in the current account deficit and inflation. Directors noted that the outlook is clouded by external uncertainties, and that Turkey remains vulnerable to shifts in market sentiment, given the country's still large external financing needs. Policy priorities thus need to remain geared toward a continued unwinding of imbalances. Raising domestic savings and enhancing the economy's potential are important objectives over the medium term.

Directors welcomed the tighter fiscal policy stance proposed in the 2013 budget, turning around the pro-cyclical stance of this year and contributing to a more balanced policy mix. They underlined the importance of containing growth in current spending, including the wage bill, while protecting priority infrastructure investment. Directors welcomed ongoing measures to broaden the tax base, enhance tax administration, and improve budget flexibility. Further efforts, particularly on spending reforms, would be needed to achieve the desirable level of the primary surplus. Directors viewed the medium-term fiscal program for 2013-15 as a welcome step in the right direction.

Noting that inflation remains above the target band and inflation expectations stay elevated, Directors recommended that the central bank adopt a more forward-looking monetary policy stance and closely monitor developments in domestic demand, wages, and capital flows. They recognized the challenging environment in which the monetary policy framework operates, with its objectives of both price and financial stability. Many Directors saw merit in returning to a positive real policy rate under a conventional inflation-targeting framework, supported by a strengthened communication policy. A number of Directors considered that, in the current environment of volatile capital flows, the more flexible policy framework has served the Turkish economy well. In order to manage risks from excessive short-term capital inflows, many Directors saw scope for greater use of sterilized intervention, given the relatively low level of international reserves, complemented with macro-prudential measures.

Directors commended the authorities for progress in improving the health of the financial system and the supervisory and regulatory framework, along the lines of the 2011 FSAP Update. They

noted that banks appear well-positioned for the introduction of Basel III, ahead of schedule. Directors encouraged continued vigilance and a broadening of macro-prudential tools to mitigate risks to banks' balance sheets. They looked forward to swift action to address deficiencies in the AML/CFT legal framework.

Directors observed that the savings rate had fallen significantly over the past decade. While welcoming the recent reform of private pensions, they noted that fiscal policy also has an important role to play. Most Directors were of the view that a significant increase in the primary surplus could raise national savings, thus reducing the country's vulnerabilities to volatile capital flows and boom-bust cycles.

Directors emphasized the need to improve competitiveness and the business climate. Efforts should continue to reduce the large informal sector, improve the functioning of the labor market, and streamline regulations in the product and service markets. Directors also encouraged steps to diversify energy sources and improve efficiency in energy production and distribution.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Turkey: Selected Economic Indicators, 2007–13

Population (2011): 74.7 million
Per capita GDP (2011): $10,362
Quota (2012): SDR 1,455.8 million

	2007	2008	2009	2010	2011	2012	2013 Proj.
				(Percent)			
Real sector							
Real GDP growth rate	4.7	0.7	-4.8	9.2	8.5	3.0	3.5
Private consumption growth rate	5.5	-0.3	-2.3	6.7	7.8	0.0	2.8
Private gross fixed investment growth rate	2.6	-9.0	-22.5	33.6	23.1	-2.3	2.9
Contributions to GDP growth							
Private domestic demand	5.0	-1.8	-8.3	12.6	9.7	-1.0	3.1
Public spending	0.8	0.6	0.8	0.9	0.3	0.5	0.6
Net exports	-1.2	1.9	2.7	-4.4	-1.5	3.5	-0.1
GDP deflator growth rate	6.2	12.0	5.3	5.7	8.9	6.2	7.9
Nominal GDP growth rate	11.2	12.7	0.2	15.4	18.1	9.3	11.7
CPI inflation (12-month; end-of period)	8.4	10.1	6.5	6.4	10.4	7.5	6.2
PPI inflation (12-month; end-of-period)	5.9	8.1	5.9	8.9	13.3	3.2	6.2
Unemployment rate	10.3	11.0	14.1	12.0	9.8	...	...
Average nominal treasury bill interest rate	18.1	19.3	11.4	8.4	9.1	...	...
Average ex-ante real interest rate	6.9	12.2	2.6	1.8	1.1	...	...
				(Percent of GDP)			
Nonfinancial public sector							
Primary balance	3.2	1.6	-1.0	0.8	2.0	0.1	0.4
Net interest payments	4.9	4.4	4.6	3.7	2.6	3.0	2.9
Overall balance	-1.8	-2.8	-5.6	-2.9	-0.6	-2.8	-2.5
General government structural primary balance 1/	0.8	0.5	2.5	1.3	-0.6	-1.1	-0.7
Debt of the public sector							
General government gross debt (EU definition)	39.9	40.0	46.1	42.4	39.3	38.5	36.9
Nonfinancial public sector net debt	34.4	34.5	39.5	36.8	33.4	32.3	31.4
External sector							
Current account balance	-5.9	-5.7	-2.2	-6.4	-10.0	-7.5	-7.2
Nonfuel current account balance	-1.5	-0.1	2.1	-2.0	-3.8	-1.4	-1.3
Gross financing requirement	17.6	17.1	18.6	19.3	25.1	23.0	25.9
Foreign direct investment (net)	3.1	2.3	1.1	1.0	1.7	1.8	2.1
Gross external debt 2/	38.4	38.4	43.7	39.7	39.6	45.0	45.7
Net external debt	21.0	21.5	24.7	24.1	24.2	27.5	29.7
Short-term external debt (by remaining maturity)	11.7	16.0	15.2	16.7	17.9	20.4	20.3
Monetary aggregates							
Nominal growth of M2 broad money (percent)	15.7	26.7	13.0	19.1	14.8	...	...
GDP (billions of U.S. dollars) 3/	649	730	614	731	774	...	...
GDP (billions of Turkish lira)	843	951	953	1,099	1,298	1,419	1,585

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ The structural balance is estimated using the absorption gap method and excludes one-off operations.
2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).
3/ GDP in U.S. dollars is derived using the average exchange rate (consolidated from daily data published by the CBRT).

Statement by Mr. Prader and Mr. Yalvac on Turkey - 2012 Article IV Consultation November 16, 2012

We thank staff for the comprehensive set of papers. Our authorities appreciate the dialogue with staff.

After the strong growth performance in 2010 and 2011, the authorities targeted a rebalancing of the economy in 2012. With prudent monetary, fiscal and macro prudential policies, Turkey has managed to slow down the economy and reduce imbalances without risking the favorable medium term outlook. In addition to the positive reaction in the equity markets, CDS levels and spreads, the latest rating upgrade by Fitch to investment grade reflects the authorities' success in rebalancing the economy.

As an important policy anchor, the Medium-Term Program (MTP) for the period 2013—2015 was announced on October 9, 2012. The program was prepared under a gloomy global economic and financial outlook despite all the commendable measures taken by the major key players in the world economy. The authorities have continued their cautious stance for this program period, taking the downside risks for the global economy into consideration.

The MTP aims at gradually converging to potential output growth, further reducing the current account deficit, achieving inflation targets, maintaining a strong fiscal balance, and strengthening financial stability. In addition to the favorable fiscal position, a strong financial sector, household and corporate sector balance sheets will be critical to achieve the targets put forward in the MTP.

Growth Outlook

Following the high growth of 9.2 percent in 2010 and 8.5 percent in 2011, the authorities decided on a policy induced economic slowdown to contain the imbalances which could jeopardize macroeconomic and financial stability. Since strong private sector consumption and the appreciation of the Turkish Lira (TL) were the underlying reasons for imbalances, the authorities designed a framework that would curb private credit growth and reverse the real appreciation trend of the TL. However, the weaker than expected global growth outlook and higher than forecasted energy prices have negatively affected the planned growth path. The Turkish economy is expected to grow by 3.2 percent in 2012. Towards the end of the MTP period, the economy is expected to gradually reach the medium-term growth target of 5 percent, which is higher than staff's estimates.

The economy has adequate resources to reach the targeted growth levels. Since 2009, 4.2 million jobs have been created and the unemployment rate has declined to its lowest level in the last decade. The young population with positive employment prospects and a strong banking sector will be critical for achieving sustainable growth targets in the medium term. Additionally, a favorable fiscal stance in terms of a low debt-to-GDP ratio and budget deficit is important to eliminate the bottlenecks in infrastructure, human capital and public administration.

Monetary Policy

Faced with excessive cross-border capital inflows, rapid credit growth, and a deterioration in the current account deficit in the second half of 2010, the Central Bank has enhanced the conventional inflation targeting regime. They adopted financial stability as a complementary objective and added a set of policy instruments with a particular emphasis on credit growth. Accordingly, since the end of 2010, the Central Bank has been implementing a new framework supported by a mix of credit, liquidity and interest rate policies.

The new framework has supported a healthier outlook in the composition of growth as well as improvements in the current account balance. The annual rate of credit growth has declined from 35 percent to around 14 percent. The current account deficit to GDP ratio is expected to come down from 10 percent in 2011 to 7.3 percent at the end of 2012. More importantly, this adjustment has been achieved without a contraction in the aggregate demand, thanks to a marked improvement in the contribution of net exports. Despite the slower growth in the Euro area, exports have increased with the support of a successful market and product diversification.

Although the adjustments in energy prices in September have led to a revision of headline inflation forecasts for end-2012 from 6.2 percent to 7.4 percent, inflation has recently been on a declining trend. Core inflation has been easing since the beginning of the year and is expected at around 6 percent at the end of the year. The risks are on the downside due to the favorable outlook of unprocessed food prices. Moreover, existing output gap and the tapering-off of last year's exchange rate pass- through effects are expected to bring inflation down to the target of around 5 percent at the end of 2013.

So far, the new policy framework has been successful in rebalancing the economy without hampering the price stability objective. Moreover, exchange rate volatility in Turkey has been lower than in peer emerging economies with current account deficits. Overall, the last two years have illustrated well the importance of establishing a flexible policy framework with a broad range of instruments in order to cope with the variety of shocks arising from global factors. The asymmetric interest rate corridor and the reserve option mechanism, which are important tools developed by the Central Bank, are likely to support the flexibility of the policy framework going ahead. Should the new framework continue to function well, it could be a good alternative to the standard inflation-targeting framework with sterilized interventions under a floating exchange rate regime. Nevertheless, the authorities are thankful for staff's valuable contribution to the policy discussion and they will closely follow the developments under the new framework.

Fiscal Policy

The fiscal outlook remains strong. The ratio of public debt to GDP in 2012 is expected to decline from 39.2 percent in 2011 to 36.5 percent in 2012. The central government budget deficit is forecast to be around 2.3 percent, which is higher than last year's target of 1.5 percent. As is well illustrated in the staff paper, the difference derives from primary expenditure overruns in 2012. The two main factors for the increase in primary expenditure are public spending which should improve the economy's growth capacity, as well as uncertainties in the global and domestic growth outlook.

The latest episode of strong growth, which resulted in the high level of the current account deficit, has once again highlighted the need for measures to eliminate the bottlenecks in the economy and to improve the economic growth capacity. In this vein, the government has increased the resources for education, infrastructure, research and development, and better public administration. According to the latest budget figures, investment expenditures in education as well as in infrastructure, including energy and transportation, were significantly increased.

The uncertainties in the global and domestic economy have also resulted in a cautious stance in tightening the fiscal targets. The latest policy framework for curbing credit growth and limiting an appreciation of the TL has initiated a successful soft landing in private domestic demand, which has been the driving force of growth. Therefore, the authorities' fiscal stance has been cautious, to avoid a hard landing in a highly uncertain global environment.

Having said that, the authorities are aware of the delicate balance between public expenditure needs and fiscal stability for long-term sustainable growth. In order to achieve the budget targets, in September 2012, the authorities announced a package of fiscal measures, including tax increases and adjustments in energy prices. The latest measures have been a strong signal of commitment to fiscal discipline.

On the other hand, the authorities are also attentive to the need for changing the tax structure from indirect to direct taxes and broadening the tax base. The size of the informal economy is seen to be the most important obstacle. Therefore, the authorities have been working on the "Strategy of Action to Fight the Informal Economy". Part of this strategy is for example to increase the number of social security inspectors from 700 to 1500 by the end of 2012.

Financial and Corporate Sectors

The strength of the financial sector has supported strong growth during the global financial crisis. Although the banking sector has started to implement the Basel II and II.5 standards, the capital adequacy ratio has broadly preserved its already high level. The NPL ratio has also maintained its low levels. According to the Basel Quantitative Impact Studies, banks also seem to be well-positioned for the introduction of Basel III.

The authorities are closely following best practices in supervision in line with the FSAP recommendations. The Banking Regulation and Supervision Authority signed a

"consolidated supervision protocol" with the Undersecretariat of Treasury, Capital Markets Board, Savings Deposit Insurance Fund, and the Central Bank to expand the coverage of consolidated supervision for banking groups. The authorities are keen on strengthening the financial stability with the support of macro-prudential tools. The developments in household, corporate and bank balance sheets have been closely evaluated in the Financial Sector Committee.

Regarding the corporate sector, the authorities closely follow the short FX position of the non-bank corporate sector, which has reached USD 126 billion. However, there are two comforting aspects; the short-term portion of the liabilities is very small (only USD 9 billion) and the rollover ratios are very strong. As it is well depicted in the graph on the rollover rates (page 6), the non-bank financial sector has been able to rollover over 100 percent during times of high financial stress. This reminds of the fact that most of these loans could be used against cash collateral. The authorities are working to obtain more data to understand the risks stemming from this.

The authorities are aware of the importance of improvements in AML/CFT. The draft legislation, which is expected to improve the framework, is submitted to parliament.

Structural Policies

The authorities agree that one of the most crucial structural policies is improving the savings to GDP ratio. The past episodes have shown that public savings did not automatically improve national savings. Therefore, more efforts will be directed to improving private savings. The private pension system has been revised to increase the number of the participants and the amount of funds under these schemes.

A simple and predictable tax policy is key to enhancing the competitiveness of the economy and reducing the informal sector. The authorities will continue to take steps to increase tax compliance and broaden the tax base.

Turkey's dependence on energy imports necessitates more efforts in diversifying energy sources and improving energy efficiency. The authorities have been allocating more resources to decrease Turkey's energy bill.