INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/104

TURKEY

April 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR TURKEY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 25, 2016 consideration of the staff report that concluded the Article IV consultation with Turkey.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 25, 2016, following discussions that ended on February 1, 2016, 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 March 2, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Turkey.

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

Selected Issues

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International Monetary Fund
Washington, D.C.

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Press Release No. 16/182
FOR IMMEDIATE RELEASE
April 22, 2016

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

IMF Executive Board Concludes 2016 Article IV Consultation with Turkey

On March 25, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Background

Turkey's economic growth continues to show resilience despite several shocks. Growth remains based on domestic demand, in turn, supported by accommodative monetary and fiscal policies. Domestic consumption will receive an additional boost in 2016 after a 30 percent minimum wage increase and relaxation of macro prudential regulation. As a result, external imbalances continue to accumulate with large FX mismatches in the non bank corporate sector: despite a lower current account deficit on the back of lower oil prices, the NIIP remains heavily negative and increasing, with large financing needs.

The economy remains vulnerable to external shocks and the main risk for Turkey remains an acceleration of capital outflows. Hence, rebalancing of the economy, by increasing the structurally low domestic saving rate and reducing external vulnerabilities, remain priorities.

To this end, the government has announced an ambitious program of reforms aiming to increase potential growth and reduce external imbalances in the medium term. Priority should be given to those aimed at boosting domestic savings, productivity and female labor force participation.

Additionally, demand management policies in the form of tighter fiscal and monetary, should be implemented to contain domestic demand until structural reforms deliver results.

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

Executive Board Assessment[2]

Executive Directors welcomed the Turkish economy's resilient growth notwithstanding shocks in 2015. At the same time, they noted that inflation is high and that external imbalances and dependence on external financing pose vulnerabilities. They, therefore, underscored the need to rebalance the economy through macroeconomic policies and structural reforms aimed at increasing domestic savings and raising potential growth.

Directors noted that the fiscal stance this year aims to support growth. They considered that the authorities had been implementing prudent fiscal policy. Looking ahead, they emphasized that strengthening the fiscal position would contribute to reducing external imbalances, lowering inflation, and creating additional space to respond to shocks. Directors recommended prioritizing growth-enhancing spending and adopting a prudent wage policy. They also suggested improving risk management related to public-private partnerships.

Directors generally saw a need for a tighter monetary stance to bring down inflation. They agreed that normalizing the monetary policy framework would improve communication and enhance monetary transmission. Directors also recommended rebuilding international reserve buffers.

Directors took positive note that the banking sector remains well capitalized. They welcomed the gradual reduction in the use of non-core funding and the lengthening of maturities of banks' wholesale external financing. Nonetheless, indirect exposure to foreign exchange risk remains elevated and profitability has declined. Directors encouraged the authorities to consider additional steps to reduce incentives for the non-financial corporate sector to take on exchange rate risk.

Directors welcomed the authorities' comprehensive structural reform agenda and encouraged faster implementation to promote economic rebalancing. They supported funding the private pension and severance pay systems to raise saving, and highlighted the importance of improving labor market flexibility, female labor participation, and labor productivity to increase potential growth. Directors commended the authorities for hosting over 2.5 million Syrian refugees and for their efforts to integrate them into the labor market.

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

Turkey: Selected Economic Indicators, 2014–21

Population (2012): 74.9 million
Per capita GDP (2012): $10,527
Quota (2012): SDR 1,455.8 million

	2014	2015	2016	2017	2018	2019	2020	2021
		Projections						
				(Percent)				
Real sector								
Real GDP growth rate	2.9	3.8	3.8	3.4	3.5	3.5	3.5	3.5
Contributions to GDP growth								
Private domestic demand 1/	1.0	3.3	4.1	3.5	3.2	3.1	3.1	3.1
Public spending	0.1	0.4	0.6	0.2	0.4	0.5	0.5	0.5
Net exports	1.8	0.2	-0.9	-0.3	-0.1	-0.1	-0.1	-0.1
GDP deflator growth rate	8.3	10.2	11.5	8.6	7.2	6.6	6.3	6.1
Nominal GDP growth rate	11.5	14.4	15.7	12.4	10.9	10.3	10.0	9.8
CPI inflation (12-month; period-average)	8.9	7.7	9.8	8.8	7.3	6.9	6.6	6.5
PPI inflation (12-month; period-average)	10.2	5.3	7.9	9.7	7.9	7.4	6.7	6.5
Unemployment rate	9.9	10.2	10.8	10.5	10.5	10.5	10.5	10.5
Average nominal treasury bill interest rate 2/	9.3	9.5	...	...	...	...	...	...
Average real policy rate 2/	-0.2	0.0	...	...	...	...	...	...
				(Percent of GDP)				
Nonfinancial public sector								
Primary balance	0.9	1.2	0.6	1.3	1.2	1.3	1.4	1.4
Net interest payments	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Overall balance	-1.4	-1.0	-1.5	-0.9	-1.0	-0.8	-0.8	-0.8
Debt of the public sector								
General government gross debt (EU definition)	33.5	32.6	30.5	29.0	27.9	26.7	25.8	25.0
Nonfinancial public sector net debt	27.1	25.7	24.2	22.8	21.9	21.5	21.3	19.5
External sector								
Current account balance	-5.5	-4.4	-3.5	-4.1	-4.3	-4.4	-4.3	-4.4
o/w Nonfuel current account balance	0.7	0.1	-0.6	-0.4	0.1	0.2	0.1	0.0
Gross financing requirement	26.5	27.2	26.7	25.0	25.3	25.6	25.6	25.6
Foreign direct investment (net)	0.7	1.6	1.4	1.5	1.5	1.6	1.7	1.8
Gross external debt 3/	50.4	56.0	57.3	57.1	56.9	56.7	56.3	55.7
Net external debt	31.0	35.9	37.5	37.8	38.2	38.5	38.5	38.4
Short-term ext. debt (by remaining mat.)	21.0	23.6	22.0	22.2	22.4	22.4	22.3	21.8
Monetary aggregates								
Nominal growth of M2 broad money (percent)	11.9	19.4	20.7	17.4	15.9	15.3	15.0	14.8
GDP (billions of U.S. dollars) 4/	798.3	734.7	...	...	...	...	...	...
GDP (billions of Turkish lira)	1,747	1,999	2,313	2,599	2,883	3,181	3,499	3,843

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ Includes changes in stocks.
2/ Average to latest available.
3/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).
4/ GDP in U.S. dollars is derived using the average exchange rate (consolidated from daily data published by the CBRT).

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

March 2, 2016

KEY ISSUES

Context: Growth in 2015 was resilient to several shocks, supported by buoyant domestic demand. In 2016, a 30 percent minimum wage increase, relaxation of macro prudential regulations, and accommodative monetary and fiscal policies will continue fuelling domestic consumption, keeping growth at about 4 percent. The fiscal stance is projected to relax somewhat in 2016, with tightening delayed to 2017. The central bank has kept the policy rate unchanged, has postponed normalization of the monetary framework, and is using international reserves to offset pressures on the Lira. Inflation is set to exceed the target again by a wide margin. Macro prudential measures have successfully curbed consumer credit growth but some relaxation will occur in April. The current account deficit is declining thanks to lower oil prices. Nonetheless, the net international investment position remains heavily negative and external financing needs are substantial. The government has announced an ambitious program of reforms aiming at increasing potential growth and reducing external vulnerabilities over the medium term.

Policies: Growth is consumption-driven and dependent on external savings, making the economy vulnerable to external shocks. Rebalancing the economy and thus reducing these vulnerabilities remain a priority. Structural reforms should focus on increasing private savings, which are too low to sustain investment, and improving the labor market, which is marred by rapidly increasing labor costs, stagnant productivity, and a low employment rate, especially among women. While structural policies take time to yield fruits, domestic demand should be contained. Fiscal policy should be tightened by about 1½ percent of GDP by 2018 to increase domestic savings. The monetary policy framework should be normalized and the stance should be further tightened. The central bank should rebuild its depleted stock of international reserves. Macro prudential measures should be strengthened, while buffers in the banks should be maintained.

Approved By
Philip Gerson and Luis Cubeddu

Discussions for the 2016 consultation took place in Istanbul and Ankara between January 20 and February 1, 2016. The team comprised Messrs. Spilimbergo (Head), Chen, Impavido, Tieman (all EUR), Ms. Novikova (SPR), Mr. Flores (FAD), Messrs. Seshadri, Çeçen, and Ataş (Senior Resident Representative office). Mr. Gökçen (OED) joined the mission. The mission met with Deputy Prime Minister in charge of Economic and Financial Affairs Şimşek, Central Bank Governor Başçı, Acting Treasury Undersecretary Dağdaş, other senior officials, and representatives of the private sector. Mses. Chen and Mahadewa assisted in the preparation of the staff report.

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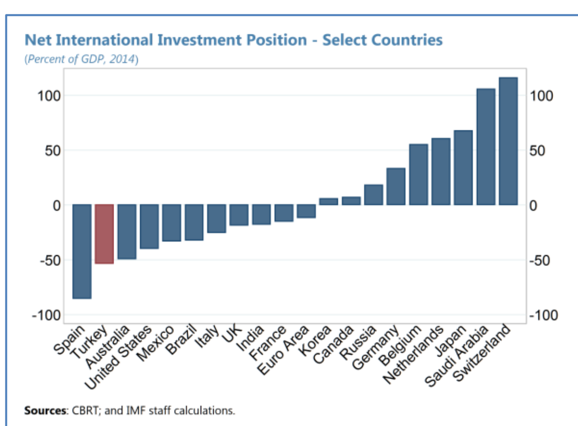
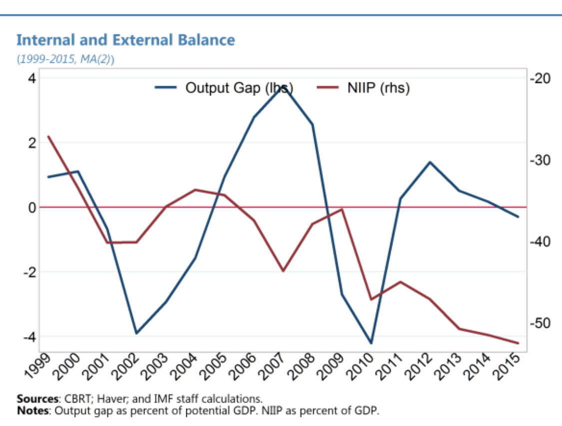
RESILIENT GROWTH BUT EXTERNAL IMBALANCES

A. Context

1. **The economy is broadly growing at potential but external imbalances keep accumulating**. With the economy projected to grow at 3.8 percent in 2015, output and unemployment gaps are practically closed. The current account deficit (CAD) is improving on the back of better terms of trade. However, at about -50 percent of GDP, the net international investment position (NIIP) is large by international standards and deteriorating under the baseline. Moreover, given the high share of short-term debt, the country's annual external financing needs are around 27 percent of GDP.



Net International Investment Position - Select Countries
(Percent of GDP, 2014)
Sources: CBRT; and IMF staff calculations.

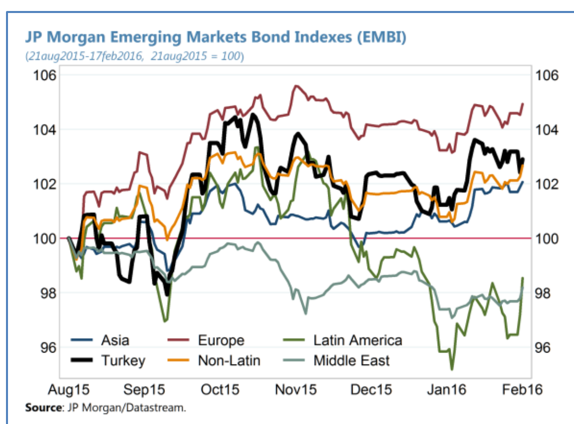


Internal and External Balance
(1999-2015, MA(2))
Sources: CBRT; Haver; and IMF staff calculations.
Notes: Output gap as percent of potential GDP. NIIP as percent of GDP.

B. Current Trends

2. **In 2015, growth displayed resilience despite several shocks with monetary policy insufficiently tight (see Section C below) and fiscal policy neutral (see Section D below).**

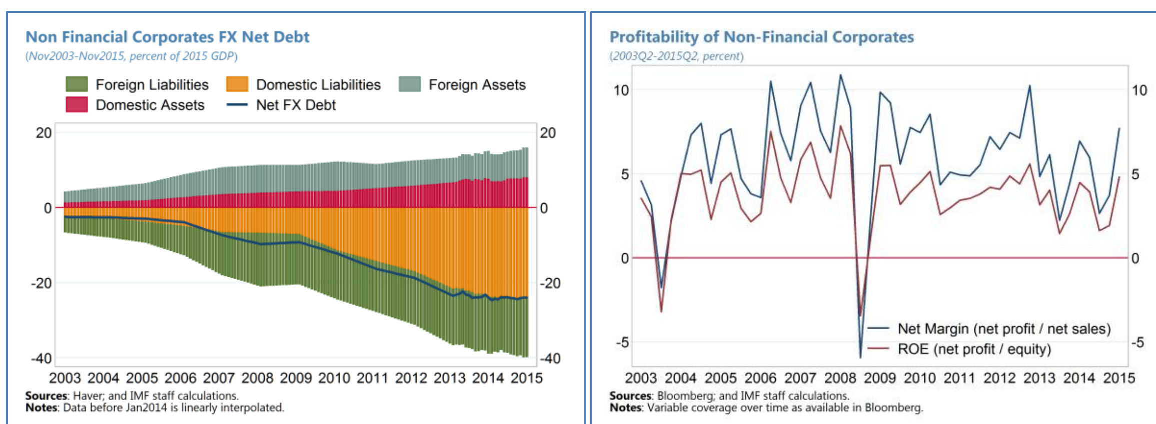
- *Political uncertainty.* Two parliamentary elections, the war in Syria, escalating tensions with Russia, resumption of the armed conflict in the South East, and terrorist attacks generated security and political uncertainty, undermining consumer confidence and investors' risk appetite.



JP Morgan Emerging Markets Bond Indexes (EMBI)
(21aug2015-17feb2016, 21aug2015 = 100)
Source: JP Morgan/Datastream.

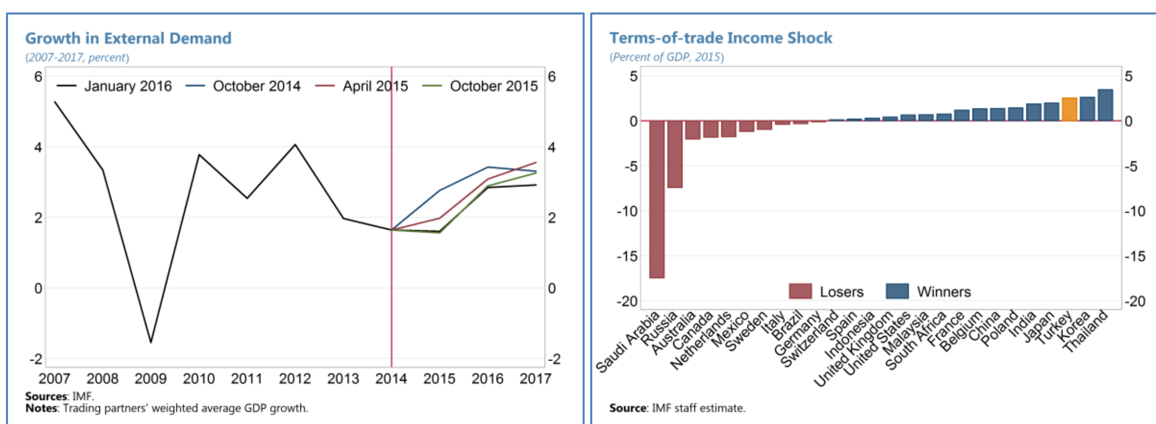
ISE National 100 Share Price Index
(02Sep2015-29Feb2016, 01Jan2013 = 100)
Source: Financial Times/Haver.
Notes: Events shown at first available BIST working day. Changes are relative to previous working day.

- *Weak investment and declining profitability*. In line with other emerging markets, investment has been lagging, even as investment was strong in 2015Q2. Moreover, the tighter external and domestic financing conditions, the increasing burden of corporate debt in foreign exchange (FX), and the consequent decreasing profitability compounded by increasing real unit labor costs (ULCs), have been taking a toll on investment.



- *Capital outflows have put pressure on the Lira.* The large Lira depreciation increased the burden of FX debt for the non financial corporate (NFC) market, now standing at a gross US$291 billion, or US$184 billion on a net basis. Non-exporting entities were particularly affected (see IMF 2016b) and this contributed to low private investment.

- *Depressed external demand*. While demand from the EU registered some marginal pick up, oil exporting trade partners were hit by a sharp fall of fuel prices. Hence, the contribution of net exports to real growth remained negative (see paragraph 8 below).

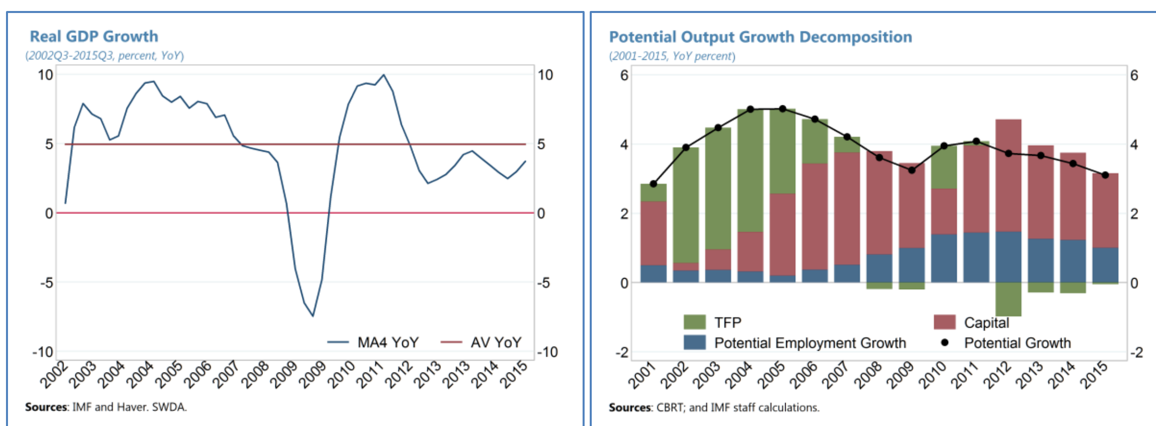


3. **Yet, several factors have made the economy more resilient to shocks**. Turkey has been one of the countries that benefitted the most from the low international oil prices in 2015. The lira depreciation increased the competitiveness of exporting firms. In addition, it improved households' net wealth, in lira terms, as households have net FX assets amounting to around 14 percent of GDP in September 2015. Corporate profit remains high, despite the long-term downward trend.

Moreover, companies have long FX positions over the short term, thanks to sizable FX deposits, and more than half of NFCs' external debt has maturity of more than 3 years.

4. **Still, growth is below both the historical average and the authorities' long-term target.** Economic growth is lower than the 5 percent 2002–15 average and authorities' announced 5 percent target due to ever decreasing contribution of investment and negative contribution of net exports.

5. **Potential growth is also slowing**. With both capital and labor growing strongly on average from 2006–14, the slowdown in potential output growth is due to stagnant total factor productivity (TFP) growth (Box 1 and IMF 2016b).



Box 1. Turkey: Potential Output in Turkey

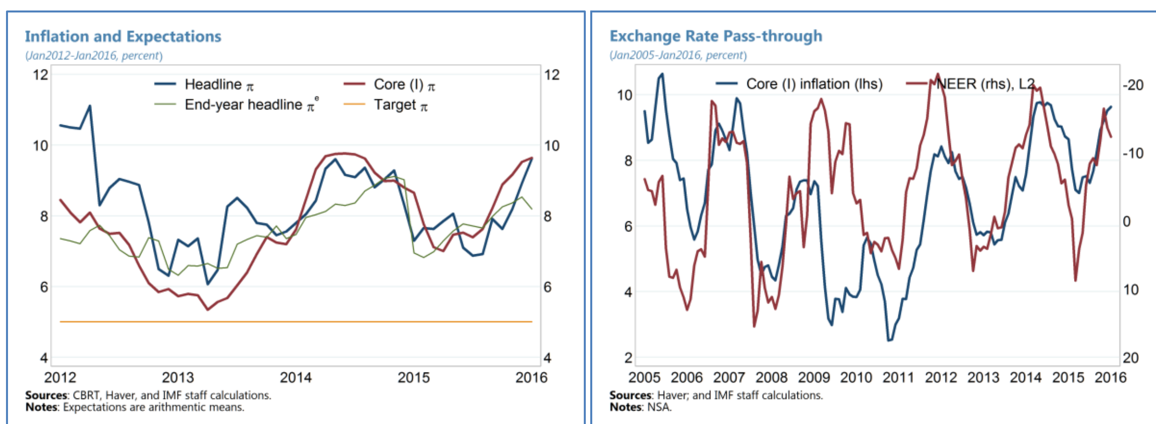
Potential output growth started to decline in 2006, dropped further going into the global financial crisis, and has since remained low—mainly as a result of lower potential TFP growth. The decline in TFP was partially offset by capital accumulation and an increase in labor force participation from 46 percent in 2007 to 50 percent in 2013, thanks to a 7 percentage point increase in female labor force participation and the female employment rate (IMF 2016b).

Potential output growth is expected to average 3–3½ percent from 2015–20 under current policies. Labor force growth is expected to contribute ½–1 percent to potential output growth. Capital stock growth is expected to contribute about 2 percent to potential output. With about 2½–3 percent contribution from capital and labor, potential TFP growth of ½–1 percent is necessary for Turkey to achieve a potential output growth of 3–3½ percent going forward. This is a significant increase from the negative growth rates after the global financial crisis but less than during the first half of the 2000s.

6. **The employment rate is low, especially among women**. The employment rate (at about 46 percent) remains much lower than the OECD average. The low female labor force participation and low retirement age are among the factors behind low employment levels. At an estimated 10.2 percent, the unemployment rate remains high, in part due to the rigid labor market rules (including a high labor tax wedge and high firing costs) and educational mismatches. Moreover,

absorbing the over 2.5 million refugees—who have been recently granted work permits—is a further challenge, as they may compete directly for employment with lower-skilled women.

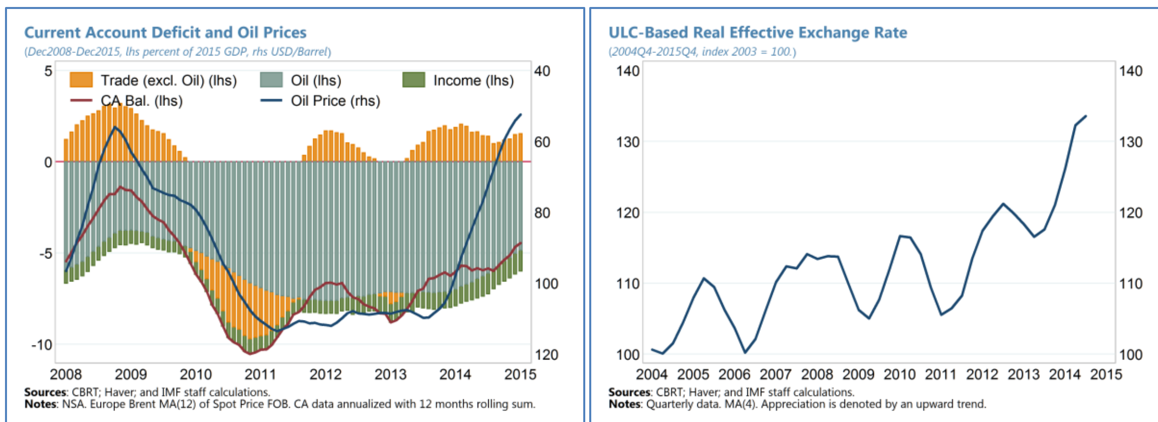
7. **Inflation remains high.** Both headline and core inflation[1] came out at 9.6 percent in January 2016, well-above the 5 percent target, partly due to exchange rate pass-through. Consequently, expectations remain poorly anchored; with end-year headline inflation expectations increasing from 7 to more than 8 percent in 2015.



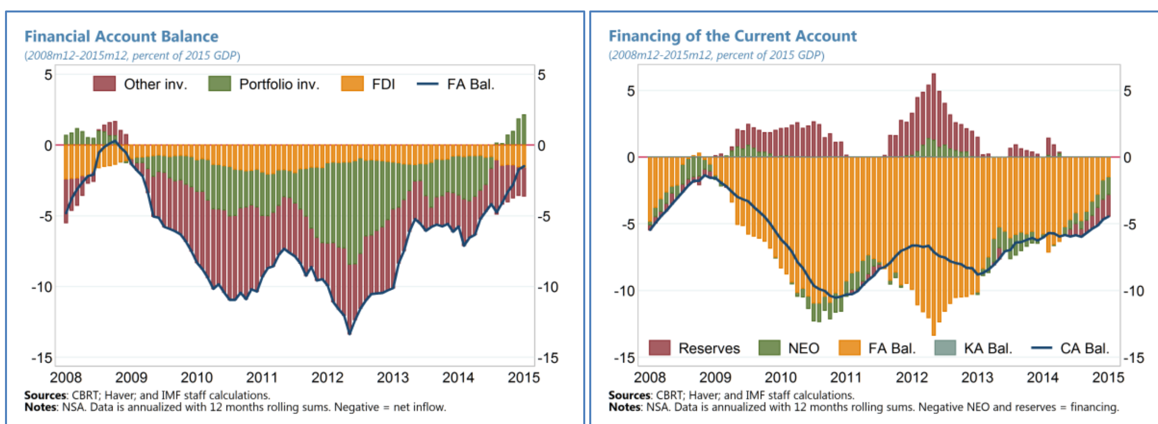
8. **At the same time, external vulnerabilities remain high**:

- *The current account deficit remains large despite lower fuel imports and the 2015 depreciation.* The 2015 CAD is estimated to have improved to 4.4 percent of GDP due to lower energy prices. However, the trade balance excluding gold and fuel deteriorated. Export revenues fell because of weak growth in trading partners and increasing ULCs. The real effective exchange rate (REER) depreciated by only 6.9 percent because high domestic inflation offset much off the nominal depreciation of the Lira. Overall, the economy's external position remains moderately weaker than the level consistent with medium-term fundamentals and desirable policies (Annex IV).

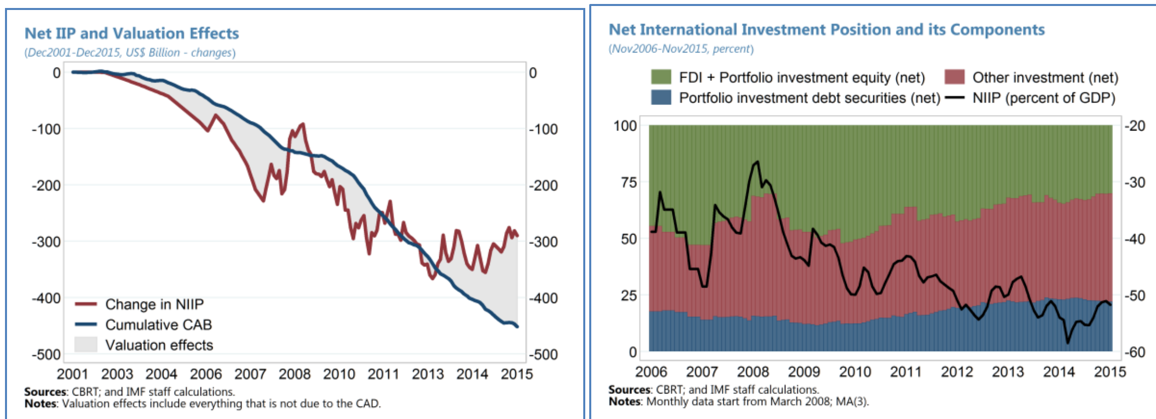
[1] Core-I inflation excludes energy, food, nonalcoholic beverages, alcoholic beverages, tobacco products, and gold.



- *The quality of external financing is a concern*. The maturity of bank loans increased after a change in reserve requirement rules (Section E below and Annex IV). However, the financial account balance (excluding reserves) shrunk to about 2 percent of GDP in 2015 with net portfolio flows turning negative. Net FDIs remain low, net errors and omissions are large and volatile, and the CBRT has used its international reserves to finance part of the CAD.



- *The large negative NIIP contributes to the CAD through increasing interest payments*. Turkey's NIIP reached -50 percent of GDP in 2015 supported by favorable valuation effects (Box 2) with FDI and equity portfolio shrinking while debt portfolio increasing. By 2021, the NIIP is projected to deteriorate to -60 percent of GDP. Debt service payments are large, simply due to the sheer size of the NIIP, and are projected to increase given the large share of debt with short maturities and variable interest rates, and increasing international rates.



Sources: CBRT; and IMF staff calculations.
Notes: Valuation effects include everything that is not due to the CAD.

Sources: CBRT; and IMF staff calculations.
Notes: Monthly data start from March 2008; MA(3).

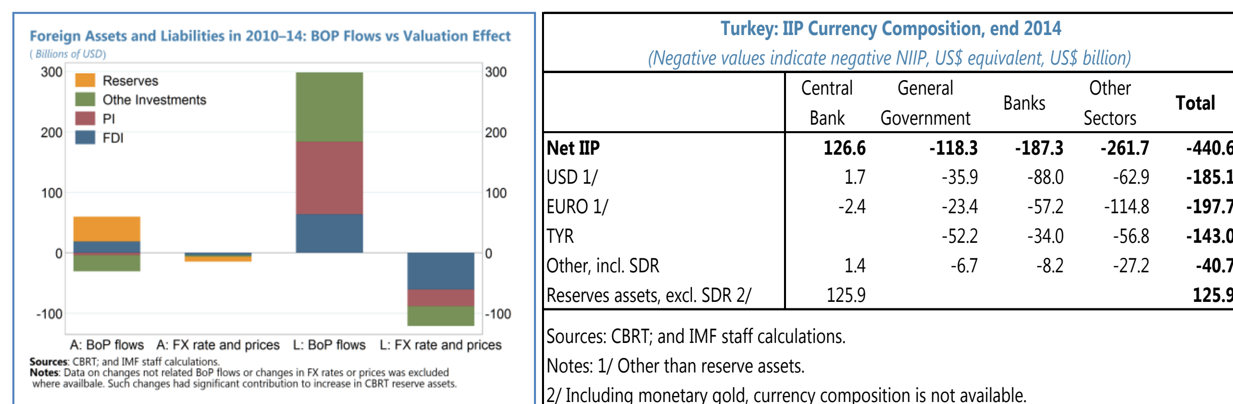
- *A large external debt with high external financing.* The external debt increased to 56 percent of GDP in 2015 with banks continuing to leverage up in wholesale FX financing. While the debt repayment profile over the next 12 months is broadly smooth, about one third of external debt is short-term, and financing needs remain above 25 percent of GDP over the projection horizon (Annex IV).

Box 2. Turkey: Net international Investment Position Valuation Effects

Turkey's persistent current account deficits led to the accumulation of one of the largest negative NIIP among emerging markets, in excess of about -50 percent of GDP. During 2000–15, foreign liabilities, consisting of mainly debt, at the expense of FDI and other equity investment, increased from 57 to 83 percent of GDP and exceeded US$600 billion. Over the same period, foreign assets grew from 20 to 33 percent of GDP (to about US$227 billion).

In the last few years, however, the total change in the NIIP fell short of the cumulative CAD by a large margin. In 2010–14 the difference between the sum of current account deficits and the change in the level of NIIP was US$109 billion. This means that absent favorable effects from valuation and other factors, NIIP would stand close -70 percent of GDP in 2015. Part of the difference was driven by introduction of the Reserve Option Mechanism (ROM) in 2011. Banks were allowed to meet their reserve requirements on lira-denominated liabilities by using foreign exchange and gold. By the end of 2014, the use of ROM in gold reached about US$16 billion. These gold holdings became part of the CBRT's gross reserves and were reflected in the countries' foreign assets. The remaining portion of the mismatch between the dynamic of the CAD and the NIIP is explained by an increasing role of net errors and omissions (NEO) and favorable valuation effects. In 2010–14 the net value of BoP transactions captured by the NEO term exceeded US$9.9 billion. While the nature of NEO is mixed, CBRT believes that this item, to a large extent, represents savings abroad. Finally, by 2010, the combined share of foreign equity investments and debt denominated in Turkish lira reached 57 percent of the total stock of liabilities. This helped to limit the growth of foreign liabilities during Lira depreciation. At the same time, FDI and portfolio flows, items that are most sensitive to price and FX changes, constitute a larger share of gross liabilities than assets. Hence, changes on the liabilities side dominate the dynamics of the NIIP for a given size of stock. The cumulative impact of the aggregated 'valuation' changes over 2010–14 is estimated at about 10 percent of 2014 GDP.

Valuation effects supported a modest NIIP improvement in 2015 to about -50 percent of GDP. Apart from the CBRT, in the beginning of 2015 Turkey was short in USD, euro, and Turkish Lira. In 2015, the Turkish Lira depreciated 21 percent against the US dollars and 6 percent against the EUR, improving the NIIP in USD terms. Overall, the effect of FX and other changes on the NIIP value in US dollars was in the order of US$90 billion, which is significantly larger than valuation effects registered in previous years.



Sources: CBRT; and IMF staff calculations.
Notes: Data on changes not related BoP flows or changes in FX rates or prices was excluded where availbale. Such changes had significant contribution to increase in CBRT reserve assets.

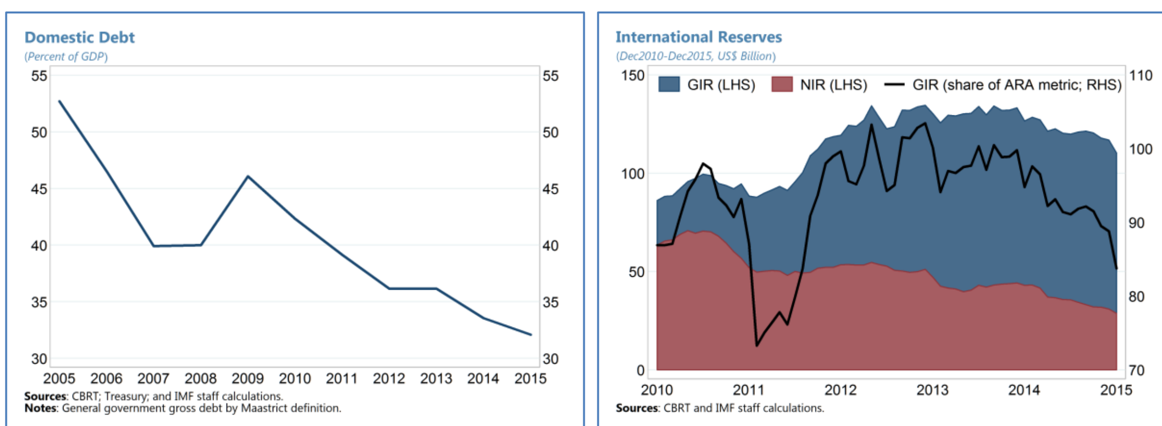
Turkey: IIP Currency Composition, end 2014
(Negative values indicate negative NIIP, US$ equivalent, US$ billion)

	Central Bank	General Government	Banks	Other Sectors	**Total**
Net IIP	**126.6**	**-118.3**	**-187.3**	**-261.7**	**-440.6**
USD 1/	1.7	-35.9	-88.0	-62.9	**-185.1**
EURO 1/	-2.4	-23.4	-57.2	-114.8	**-197.7**
TYR		-52.2	-34.0	-56.8	**-143.0**
Other, incl. SDR	1.4	-6.7	-8.2	-27.2	**-40.7**
Reserves assets, excl. SDR 2/	125.9				**125.9**

Sources: CBRT; and IMF staff calculations.
Notes: 1/ Other than reserve assets.
2/ Including monetary gold, currency composition is not available.

9. **A low private saving rate is the primary cause of external vulnerabilities**. Many factors contribute to the low private saving rate: (i) the expansion of safety nets and rapid urbanization, lowering precautionary savings; (ii) possibly financial deepening (which empirically typically has an ambiguous impact on saving); and (iii) low international real interest rates which are still providing cheap FX financing. For 2015, even the low (by peer country standard) private investment rate of 16 percent generates a private sector saving-investment gap of -3.8 percent of GDP. In contrast, the public saving-investment gap is around -0.5 percent, supported by an overall prudent fiscal policy.

10. **Buffers in the economy have decreased**. In the private sector, the profitability of non-bank corporates and the capital adequacy and profitability of banks have all decreased. In the public sector, fiscal buffers remain high as a primary surplus and trend real GDP growth above the real interest rate imply that the debt to GDP ratio continues to decline gradually (Annex III). Finally, the CBRT has been intervening in the market through auctions and direct sales of net reserves to importing SOEs. Therefore, Gross International Reserves (GIRs) have declined and fell below 90 percent of the IMF assessment of reserve adequacy (ARA) metric (Annex IV).



C. Medium Term Projections

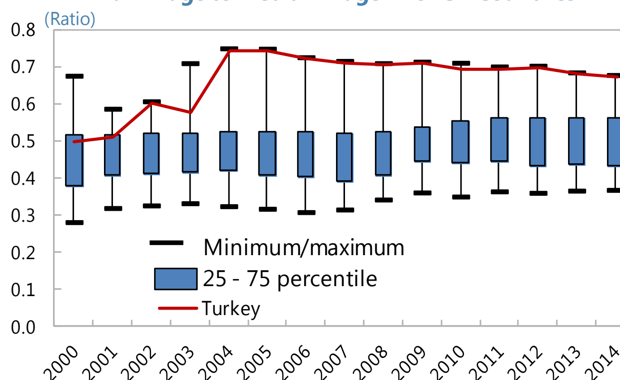
11. **The minimum wage increase will boost consumption**. In January 2016, the government raised the net minimum wage by 30 percent, fulfilling an electoral promise. This increase poses challenges for the labor markets, competitiveness, and the fiscal balance (Box 3). In addition, relaxation of macroprudential measures on consumer credit scheduled for April will provide further incentives for consumption.

12. **A loosening of the fiscal stance is envisaged for 2016.** The nonfinancial public sector primary surplus will decline by about 0.6 percent of GDP, in part due to the impact of the minimum wage increase and spending related to electoral promises (Table 5). For 2017–18, it is expected to recover to its 2015 level as the support related to the minimum wage increase is discontinued and other current spending is contained.

Box 3. Turkey: The Increase in the Minimum Wage

The minimum wage was increased by 30 percent in January. The increase—raising the net minimum wage to about TL1300 per month—is expected to directly impact more than 8 million workers in the formal sector. During the year, in order to ameliorate the impact on the labor market and the corporate sector, the government will provide support amounting TL100 per month for workers earning up to gross TL2,550 per month.

The minimum wage is relatively binding in Turkey. Ever since a similar sharp increase in 2004, the ratio of the statutory minimum wage to median wages has been the highest among OECD countries. The increase could reduce female labor participation, currently around 31½ percent.



Sources: OECD; and IMF staff calculations.

The increase in labor costs will amount to about 1.1 percent of GDP, although government support will reduce the cost for the private sector to about half that amount for the first year. If the impact on the labor market is small, consumption could increase by about 0.6 percent of GDP, boosting the economy and government revenues—reducing the net cost to the government to about 0.3 percent of GDP. However, a less benevolent scenario, with lower formal employment, will hinder growth while increasing the net fiscal costs.

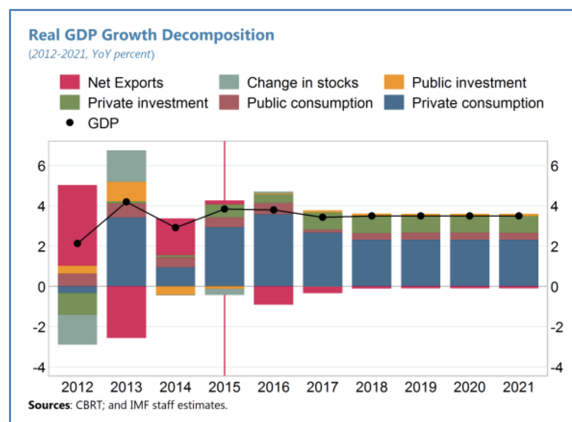
13. **Current policies will boost consumption in the near term…**.

- In 2016, growth is projected to be 3.8 percent, supported by domestic consumption thanks to minimum wage increase, by the relaxation of macroprudential policies, and accommodative fiscal and monetary policies. Exports are contained due to still lackluster growth in the EU and from oil exporting countries, and because of sanctions from Russia (Box 4 and Table 2).

- In 2017, growth is projected to decline slightly, reflecting slower real wage growth, recovering oil prices, and the envisaged fiscal consolidation.

- In the medium term, growth is projected to stabilize at around 3.5 percent, driven by domestic demand. The contribution from net exports is not expected to increase substantially unless reforms improve competitiveness.

14. **... but will hardly help rebalancing** (Table 3 and Table 4). In 2016, despite low external demand, the CAD would improve to 3.5 percent of GDP mainly because of low oil prices. For 2017–2018, staff assumes a gradual recovery in the EU and in the Middle East, and limited wage growth, helping to push the non-oil balance into a surplus and boosting the overall current account. Nevertheless, over the medium term the deficit is expected to climb again, with the moderately overvalued CPI-REER, higher energy prices and low competitiveness (as real earnings continue to grow more than productivity) returning the CAD to 4.4 percent of GDP.



15. **Consequently, external debt, financing requirements, and the NIIP would deteriorate.** The external debt and the NIIP would stabilize at around 56 and 60 percent of GDP, respectively (Annex II). External financing requirements would remain at around 26 percent of GDP as the progressive lengthening of external liabilities induced by the recently adopted macroprudential measures would compensate for the negative impact of higher international interest rates (Annex II).

16. **On balance, the risks to the medium term baseline are on the downside**, leaving Turkey exposed to a sudden stop (Annex I).

- On the positive side, the recent agreements to reopen EU accession chapters could serve as an anchor for reforms. The intensification of trade with Iran and a stronger than expected recovery in the EU and neighboring countries could further help reduce external imbalances. Finally, the prompt passage and implementation of reforms promised by the new government may yield results earlier than envisaged, with higher than expected productivity gains.

- On the negative side, the large annual financing needs, low and declining net international reserves (NIR), the short-term nature of capital inflows, and the ever larger negative NIIP are important risks. The US Federal Reserve could accelerate interest hikes and further increase the cost of external financing. Political pressure on the CBRT could re-merge, especially in the process of appointment of several board members. The recent increase in terrorist activity, the unrest in the South East, and any deterioration of the political situation could take a large toll on investors' confidence. The escalation of sanctions from Russia may further disrupt external demand. The 30 percent minimum wage increase could have a larger than estimated negative impact on formal employment, corporate profits and private investment.

On balance, the downward risks can affect the outlook in the short run while the positive risks will affect the scenario only in the medium term, so the balance of risks is negative in the short term.

Box 4. Turkey: Impact of Sanctions from Russia

Toward the end of 2015, Russia introduced restrictions on its economic relationships with Turkey. Sanctions concerned a wide range of food and manufacturing imports from Turkey, tourism and construction services, and included restrictions on hiring Turkish citizens. Visa-free travel to Russia was suspended starting from January 2016. Construction of a nuclear plant project in Turkey was put on hold. Later, restrictions were eased for selected manufacturing companies with production on Russian territory, and construction companies with long-term contracts. Turkey had launched an anti-dumping probe against Russian steel.

Before the collapse of the oil price, trade turnover between the two countries was approaching US$38.2 billion. Exports to Russia, including its share in the shuttle trade, constitute about 1.3 percent of Turkey's GDP. Russia is the second largest country by tourist arrivals, and an important consumer of Turkish food and industrial products. For some manufacturing businesses, about 60–80 percent of total sales were targeted to the Russian market. At the same time, Turkey receives over one half of its gas supply and about one fifths of its steel imports from Russia.

Sources: CBRT; and IMF staff estimates.

While the overall of effect of sanctions on the Turkish current account are likely to be moderate, the tourism sector could face a serious hit. In 2016, Turkish exports to Russia are estimated to fall short by some US$6–8 billion, including about US$3.5 billion losses in the tourism sector. The announcement of economic restrictions created disruptions in late 2015, and it will take time for the producers to redirect exports to other markets. Export revenues, however, were already shrinking as Russia was in recession and some large construction projects were finalized. Meanwhile further reduction of commodity prices will limit the increase in the deficit of Turkish trade with Russia.

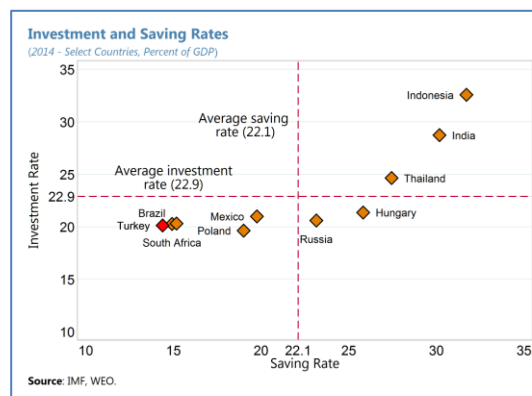
POLICY AGENDA: ACHIEVING EXTERNAL EQUILIBRIUM AND HIGHER GROWTH

A. Key Policy Dilemma

17. **Turkey faces a pressing need to reduce its sizable external imbalances**. On the supply side, structural reforms are necessary to boost the private saving rate, increase competitiveness and ultimately raise potential output. But reforms will deliver results only over the medium term. In the meantime, vulnerabilities should be reduced with demand policies, including monetary and fiscal policies, and some prudential measures in the financial sector.

18. **The staff's recommended mix of cyclical and structural policies would ultimately reduce the CAD and stabilize the NIIP**. The key items include the following:

- *Structural reforms*. Increasing funding of the private pension and the severance pay system would deliver the largest dividend to permanently increase the saving rate. In addition, labor market reforms aimed at increasing participation, in particular of women and refugees, and productivity would increase potential output (Section B below).



- *Tighter monetary policy*. A tighter monetary policy would help re-anchor expectations, contain NFC balance sheet effects, and is justifiable in the context of rapidly decreasing global liquidity (Section C below).

- *Higher reserves*. The combination of higher reserves—currently at 86 percent of the IMF ARA (Section C below and Annex IV)—and other policies would contribute to a real effective depreciation of the Lira, which staff assesses as moderately over-appreciated (Annex IV). This would improve external competitiveness by adjusting relative prices, which is a much more desirable avenue than externally imposed income compression (Section C below).

- *Tighter fiscal policy*. A consolidation of 1.5 percent of GDP over 2016–18 would contribute to rebalancing by increasing aggregate savings (Section D below).

19. **The staff's policy recommendations would lower growth in the short term but increase potential output and stabilize the NIIP in the medium term**. Demand management policies recommended by staff would reduce growth by 1-2pps relative to the baseline in the short term. However, these policies would also decrease the probability of a disruptive sudden stop, and, crucially, would reverse the NIIP's negative trend, and would help bring down inflation to its target. Macro stability would favor savings and investment, Structural reforms promoting savings and productivity would support higher growth in the medium term. The combination of prudent macro policies and structural reforms would ensure sustainable growth with a contained current account deficit.

B. Structural Reforms

Background

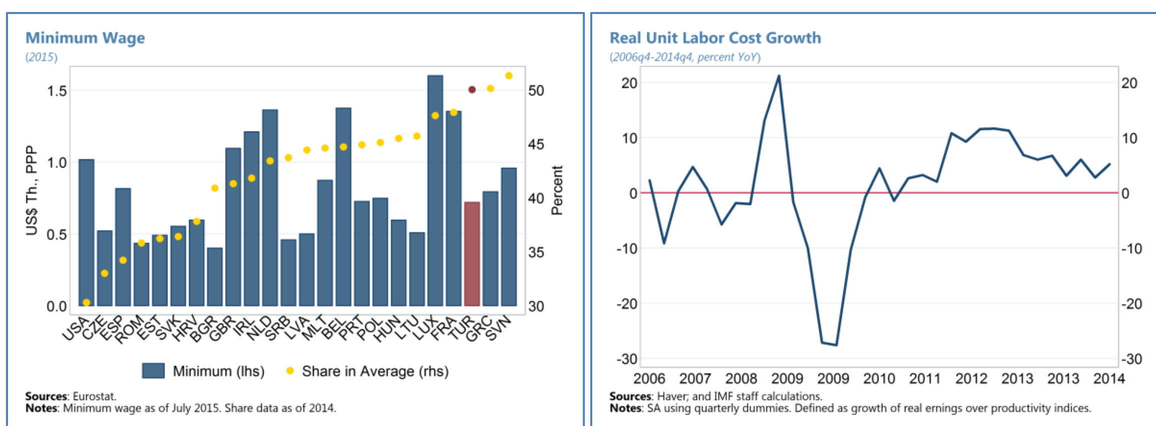
20. **Private savings are insufficient to finance long-term growth**. Current domestic savings are insufficient to finance domestic investment despite the fact that domestic investment, at around 20 percent of GDP, is also low by international standards (see paragraph 9 above).

21. **The employment rate is well below the OECD average, especially for women, and unemployment is high**. The reasons for this poor performance are rigid labor market rules

(including high hiring and firing costs) and educational mismatches. In addition, the over 2 million refugees, who have been recently granted working permits, add pressure.

22. **The authorities' reform program lacks prioritization and implementation thus far remains in progress**. Proposed reforms include modifying the private pension system to increase funding and participation, reforms in the education sector and labor market to boost competitiveness, boosting revenues by expanding some tax bases, and deepening capital markets to encourage corporates to borrow from domestic markets.

23. **The minimum wage is already high in comparison to other EMs in the region.** The minimum wage has been increasing in real terms in the last decade, standing over 50 percent of average wages in 2015, and is a key factor pushing up ULCs (paragraph 11 above and Box 3). More than 30 percent of employees are estimated to earn minimum wages or less.



Sources: Eurostat.
Notes: Minimum wage as of July 2015. Share data as of 2014.

Sources: Haver; and IMF staff calculations.
Notes: SA using quarterly dummies. Defined as growth of real ernings over productivity indices.

Staff position

24. **Priority should be given to reforms aimed at decreasing the saving-investment gap and increasing competitiveness.** Specifically, reforms aimed at increasing funding in the private pension and the severance pay systems (Box 5) while maintaining a tight fiscal stance, should be implemented swiftly. These reforms could raise the private saving rate (IMF 2016b), especially as the current pay-as-you-go pension system remains generous by international standards.

Box 5. Turkey: Boosting Private Savings

The authorities have put raising the private saving rate forward as an important policy goal to reduce the economy's external vulnerability. They have introduced a subsidized third pillar pension scheme, and, more recently, a savings subsidy for dowry and housing accounts. They have piloted an auto-enrollment funded pension scheme, and are committed to extend the auto-enrollment scheme nationwide. Lastly, proposals to reform the severance pay scheme by making it a funded and transferable benefit have been put forward. The authorities have also used macroprudential tools to limit credit growth, motivated by the aim of curbing excessive household borrowing.

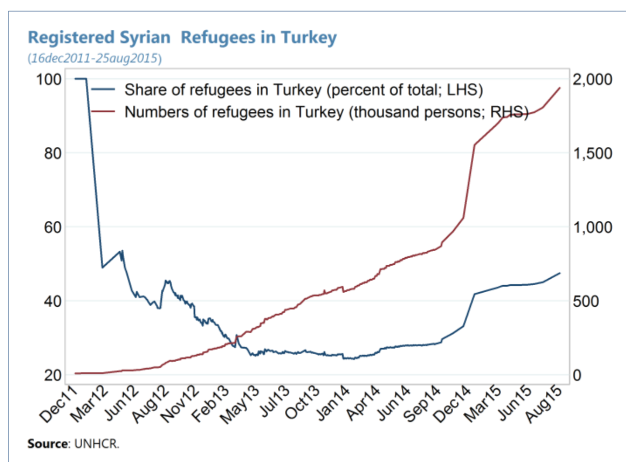
Going forward, full and swift implementation of the pension and severance pay reform plans is key. Given the urgency of reducing vulnerabilities and the time lag with which new policies will affect the saving rate, efforts should begin as soon as possible. In addition, Turkey's relatively young population and declining fertility rate imply the country is enjoying a demographic dividend. This provides a window of time to increase savings in anticipation of almost inevitable population ageing in the future. Macroprudential policies limiting credit growth should also remain part of the policy mix. IMF (2016b) provides more details on policy options.

These reforms will likely have other benefits besides increasing domestic savings and reducing external vulnerabilities. They include more labor market flexibility through severance pay portability; lowering of old age poverty rates through higher pension savings; and boosting domestic capital market development. They may hence provide an important contribution towards the authorities' stated goal of boosting the long term growth potential of the economy.

25. **The authorities should pursue a prudent minimum wage policy and help integrate refugees into the labor market**. Increasing the minimum wage faster than productivity is growing could hinder competitiveness and long-term growth prospects, and foster informality. For this year, the government support will ameliorate the impact on labor costs—although a more focused government support could have reduced the fiscal costs. For the future, it will be important to contain increases in the minimum wage at or below programmed inflation. Integration of the large number of refugees is a difficult economic and social challenge, and will require considerable fiscal effort (it is estimated that over 700000 children require schooling.) However, refugees could provide a boost to economic growth if integrated into the labor market (Box 6).

Box 6. Turkey: Refugees in Turkey

Turkey has one of the largest refugee populations in the world. Since the beginning of the Syrian crisis in March 2011, Turkey has received over 2.5 million refugees. According to the authorities, Turkey has spent over US$10 billion (including foreign contributions of US$0.4 billion) on refugees, since 2011.



Refugees have had an impact on informal labor markets. By end 2014, 86 percent of refugees had left the refugee camps and moved mostly to the provinces near the Turkish-Syrian border (45 percent) and to Istanbul (14 percent). Until January 2016, refugees were not allowed to work legally and worked only in the informal sector, with possibly some negative effect on the labor market of low-educated, female Turkish workers in informal agricultural jobs.

Authorities are working to integrate refugees in the labor market. In January 2016, and also in the context of collaboration with the EU, new legislation allows refugees to work with some restrictions to avoid disruptive effects on the labor market. The authorities are also working on an action plan to improve integration, especially in education (considering the large number of refugees of school age) and housing, also leveraging future grants from the EU.

Authorities' position

26. **The authorities agree that structural reforms are necessary to reduce external imbalances**. Their agenda builds on three blocks:

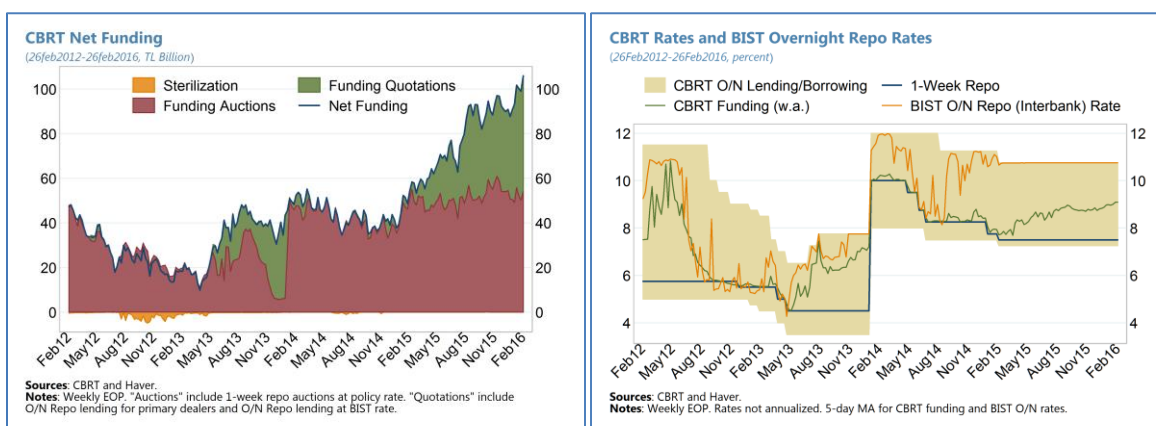
- their 10th development plan, which is in advanced stage of implementation and which they argue will deliver results this year, including more FDI to produce products currently imported, better commercialization of R&D, and the development of capital markets;
- critical structural reforms in the areas of the rule of law, education, private pensions, the labor market, income tax, and the judiciary, and aim at increasing competitiveness, labor market flexibility, savings, and in this way, potential output; and
- the enlargement of the custom union with the EU to services, public procurement, and possibly agriculture. Talks are likely to start in 2017H1.
- In 2016, the coverage of the private pension system will be increased by introducing automatic assignment of workers.

27. **The authorities shared the view that the raise in minimum wage would have an immediate boost to growth and inflation**. They also had concerns about the potential challenges of the wage increase for labor markets and competitiveness. Citing the strong fiscal position, they viewed the temporary labor subsidy as appropriate, because it would reduce the pressure on firms from higher wage bills and ameliorate possible negative consequences on employment and labor market formality.

C. Monetary Policy

Background

28. **In 2015, monetary tightening was insufficient to lower inflation**. The CBRT tightened the monetary stance moderately and in an opaque way by further limiting the share of liquidity at the one-week repo rate. However, inflation is still above target.



29. **The CBRT has not normalized its monetary framework**. By purposely confusing the signal on the stance, the unorthodox monetary policy framework has impaired monetary transmission and not delivered target inflation. After announcements in August 2015, the CBRT has taken only marginal steps to normalize the framework, eliminating the liquidity facility for primary dealers and simplifying the collateral framework. However full normalization has been postponed.

30. **Reserves are below the IMF ARA metric**. The CBRT has been intervening in the market through auctions and direct sales of net reserves to importing SOEs. Therefore GIRs have declined and remain well below the IMF assessment of reserve adequacy (ARA) metric.

Staff position

31. **The monetary stance should be tightened**. The one-week repo rate should be quickly increased into solidly positive real territory, and be sustained to bring inflation back towards the target. Macroprudential policies cannot be a substitute for such tightening. Given the CBRT's low credibility and the widespread de facto indexation combined with the recent large minimum wage increase, achieving disinflation solely through monetary tightening could entail high output losses. Instead, monetary policy should be supported by fiscal consolidation and structural reforms

(decreasing indexation), which would help contain the growth in ULCs, rebalance the economy, and re-anchor expectations.

32. **The monetary policy framework should be normalized and communication strengthened**. The CBRT should normalize its framework, by narrowing the interest rate band and providing all liquidity demanded by the market at a single policy rate. A normalized framework would facilitate effective CBRT communication and thus help rebuild credibility. In addition, the CBRT should provide clear guidance on how it intends to react to demand and supply shocks, including to the expected increase in inflation in 2016 stemming from the minimum wage hike.

33. **Net reserves should be increased to help weather shocks.** An increase in gross reserves of the order of US$14 billion in 2016 and another US$6 billion in 2017 would be needed to achieve the ARA metric. Thereafter, they would need to be allowed to grow at the same pace as GDP. The increase in GIR should be accompanied by a commensurate increase in NIR.[2] This could be partly achieved by halting off-market sales and daily FX auctions (while maintaining the option to conduct auctions), and refraining from interventions in the absence of disorderly market conditions. Tighter monetary policy will serve to alleviate pressure on the currency that may ensue, and, market conditions permitting, would allow for opportunistic FX purchases by the CBRT to further strengthen its reserve position.

Authorities' position

34. **The central bank felt that the current monetary framework has served the economy well and that the stance is appropriate.** It has allowed them to set a high marginal rate of funding, while at the same time relieving some of the pressure on banks through a lower average funding rate. They plan for a gradual return to the 5 percent inflation target over the next three years. In this regard, they see the high marginal funding rate as appropriately tight, and stressed that while headline inflation may still remain high until 2016Q2 due to the minimum wage increase and food inflation representing a large share of the CPI basket, other measures of core inflation have started to decline. In addition, they emphasized the role of macroprudential policies in containing financial stability risks associated with excessive consumer credit growth. Given the strong relationship of consumer credit growth and imports, they saw measures to contain the growth of credit as being more important than REER depreciation to reduce external imbalances, especially as they believed the exchange rate was already consistent with fundamentals. Finally, in February the government announced price caps on certain red meat products whose inflation has been particularly elevated. They assess the probability of a sudden stop as low, and do not see the need for additional monetary tightening as recommended by Staff.

35. **The monetary framework will be simplified when capital flow volatility is reduced**. Following the roadmap for simplification announced in August 2015, the CBRT had started to

[2] The main difference between gross and net international reserves is accounted for by banks' FX deposits in the CBRT, which stood at about US$80 billion in the end of 2015, including about US$25 billion of ROM in FX.

simplify its monetary framework. However, later the authorities considered that it is prudent to delay the simplification process given the recent global financial volatility. Simplification will resume once global volatility subsides.

36. **Gross international reserves are expected to stop decreasing after2016Q1**. The CBRT management expects off-market FX sales to the main state-owned energy company (Botaş) as well as on-market FX demand from the only refinery company in Turkey (Tupraş) to decrease in the coming months, driven by delayed effects of lower oil and gas prices. In addition, the amount and frequency of FX auctions may be reconsidered going forward. Taken together, the central bank expects GIRs to stabilize from end-March onward.

D. Fiscal Policy

Background

37. **The fiscal stance was broadly neutral in 2015 but the structure of the budget has worsened.** Above-target expenditure has been offset by stronger than envisaged tax revenues, particularly domestic VAT and some excises, as well as one-off contributions to social security from an amnesty. The fiscal tightening envisaged in the 2015–2017 medium term plan (MTP) did not materialize.

38. **The fiscal stance will loosen in 2016.** Consolidation is being delayed mostly to accommodate new spending related to election promises and a temporary labor subsidy to ameliorate the impact of the increase in the minimum wage (Box 7). Consolidation is resumed later on, albeit with less ambitious targets than in the 2015–2017 MTP. Enhancing long-term growth and strengthening domestic savings through structural reform remains the backbone of the MTP's ambitious structural reform agenda.

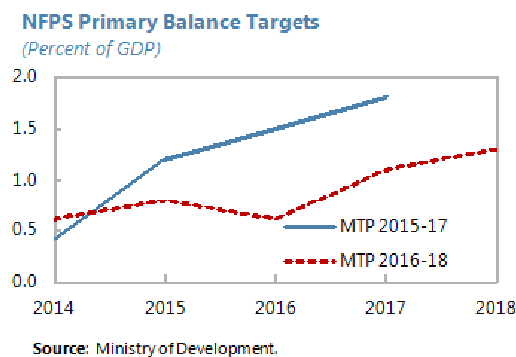
39. **Fiscal targets do not support rebalancing and face important risks**. With a modest consolidation of ½ percent of GDP in three years, fiscal policy targets fall short from a stance that would provide sufficient support for the rebalancing and the fight against inflation. They also face important risks. Growth targets for 2016–2017 are about 1 percentage point of GDP above consensus. In absence of such growth, the shortfall in central government revenues could amount to about ¼ percent of GDP. On the positive side, oil prices have declined and may lead to a stronger outturn for energy-related State-owned Enterprises.

Medium Term Program Targets
(Percent)

	2014	2015	2016	2017	2018
Growth	2.9	4.0	4.5	5.0	5.0
Inflation	8.2	8.8	7.5	6.0	5.0
CA (percent of GDP)	-5.8	-4.4	-3.9	-3.7	-3.5
Employment rate	45.5	46.1	46.5	46.9	47.4

Box 7. Turkey: The New MTP Targets Provide Less Support to Rebalance the Economy

The Medium Term Program (MTP) has ambitious targets and optimistic assumptions. It seeks to accelerate long-term growth through structural reforms and to raise domestic savings to rebalance the economy. It envisages strong growth, reaching 5 percent in 2017, and a current account balance that declines to 3½ percent of GDP. The MTP assumes that the effect of structural reforms will increase potential output growth to 5 percent in two years, with employment increasing quickly. It seeks to reach the 5 percent inflation target, but only in 2018. The non-financial primary surplus target accommodates the minimum wage and other election related spending in 2016, postponing consolidation until 2017.



40. **There is scope to improve risk management and enhance reporting, particularly at the fiscal "periphery."** A decade-long decline in debt to GDP, the extension of public debt maturities to reduce annual financing needs, and the adoption of IPSAS 32 accounting standards highlight the government's efforts to strengthen risk management and reporting. Nonetheless, public-private partnerships (PPP) have been increasing rapidly since 2009, which requires stronger central oversight, approval, disclosure, and anti-corruption measures. However, the government fiscal risk register, alternative macro-fiscal scenarios, and long-term fiscal projections—including on pensions—are not published.

Staff position

41. **Staff recommends a consolidation of 1½ percent of GDP by 2018**. While fiscal sustainability is not a concern, the stronger stance seeks to contribute to (i) support an increase in domestic savings; (ii) facilitate the CBRT's efforts to reach its inflation target; (iii) boost policy space given the increasing fiscal risks related to the use of PPPs and guarantees, and the leverage and indebtedness of private sector. The consolidation should focus on current expenditure and there is also scope to mobilize revenues—including through higher carbon taxes (Box 8)—and by lowering informality. Investment should not be further cut given still large infrastructure needs, as this would also generate incentives to use PPPs even if the risks outweigh the benefits.

42. **The authorities should further strengthen their risk management and reporting.** Staff stressed the need for central oversight, approval and disclosure of PPPs. It also highlighted that a fiscal risk statement can help to manage risks, improve economic efficiency and reduce borrowing costs.

Authorities' position

43. **The authorities assess that the slack in the economy calls for a stimulus in 2016, especially given the strong overall fiscal position**. The authorities estimate that output is about

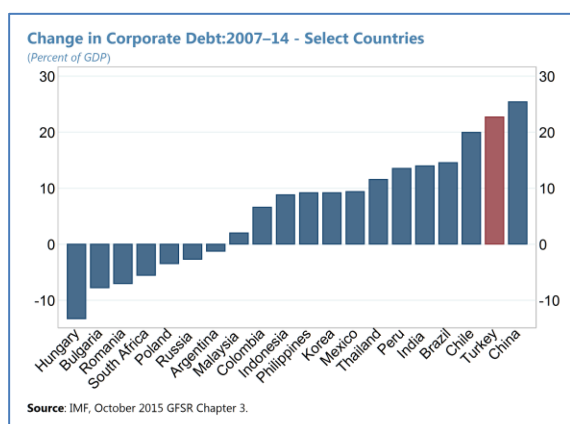
1 percent below potential and the fiscal impulse will put the economy closer to internal equilibrium, albeit generating some inflationary pressure, which is recognized in the new MTP. A looser fiscal stance is also necessary to accommodate electoral promises. The authorities recognize the need to strengthen the fiscal stance in the medium term to preserve fiscal buffers, to support price stability, and to increase domestic savings.

44. **The authorities agreed that the minimum wage increase might have some negative impact, and plan to use some of their fiscal space to ameliorate the effect on firms and the labor market.** They agree that the minimum wage will foster domestic consumption, working against the rebalancing of the economy. However, they consider this a temporary shock with consolidation efforts resumed in 2017.

E. Financial Sector

Background

45. **Bank buffers are above regulatory minima, but continue to deteriorate**. Banks had an average capital adequacy ratio of 15.6 percent (13.2 percent Tier-1) at the end 2015. Macroeconomic stress tests by the supervisor and the central bank show that banks are resilient to significant shocks, and prudential regulation prohibits providing household credit in FX.[3] However, return on average equity (ROAE) has declined to 11.3 percent, partly as a consequence of compressed net interest margins and fee rebates the banks had to pay their customers. This may restrict opportunities for banks to raise capital, at a time where capital increases may be needed for some banks to stay above the 12 percent level (at which more intense regulatory scrutiny starts to apply). Total debt of non-financial corporates has also increased rapidly in recent years.



Source: IMF, October 2015 GFSR Chapter 3.

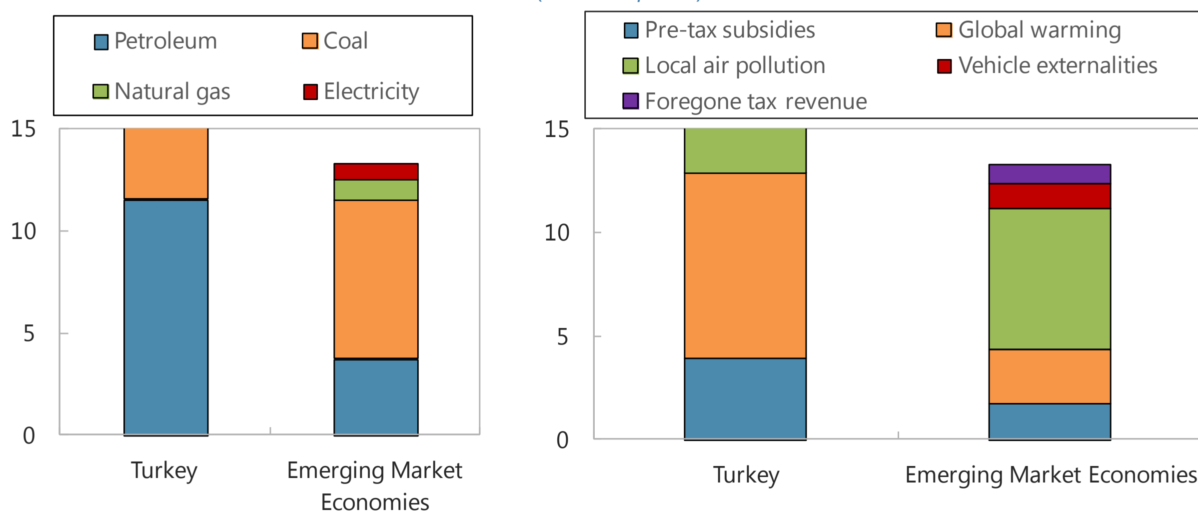
[3] The supervisor's stress testing models include assessments of credit, interest rate, and exchange rate risk. The upcoming FSAP will discuss these models and provide detailed assessments of capital adequacy and liquidity under stress.

Box 8. Turkey: Environmental Taxes

Turkey is ahead of other emerging markets in addressing the challenge of pricing energy consumption at a level that reflects its true costs, including environmental and health costs (carbon emissions and hence global warming, the impact of air pollution on health, and the bearing on traffic congestion, accidents and road damage.) Faced with the need for fiscal consolidation after the 2001 crisis, the authorities raised excises on fuels and reformed the energy sector, which not only strengthened public finances but also helped the environment and reduced negative externalities.

Post-tax Subsidy by Product and Component, 2013

(Percent of GDP)



Source: IMF staff calculations.

Nonetheless, there is still ample room to further reduce post-tax subsidies, particularly for coal, which has a significant impact on local air quality. Moreover, the specific excise taxes on gasoline and diesel have not changed for the last three years, which implies a decline in the real value of the tax.

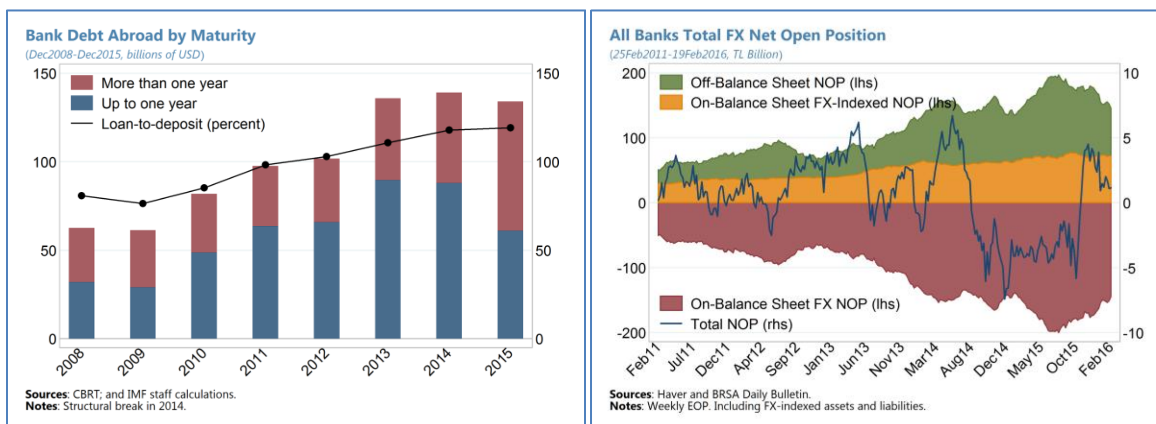
46. **Macroprudential measures and low growth have curbed credit growth and slowed the pace at which leverage is increasing** (Appendix E). FX-adjusted credit growth has decreased to 14 percent on an annual basis. FX deposits have increased in reaction to the Lira depreciation, generating lower demand for FX wholesale funding. Although growth in FX deposits stopped in 2015H2, the switch from non-core to core FX liabilities continues as overall credit growth is lower. In addition, recent macro prudential measures discouraging short term wholesale FX funding are starting to have an effect, lengthening the maturity of FX funding.[4] However, macroprudential measures have yet to meaningfully reduce (indirectly, by containing systemic risk) external

[4] Since October 2015, reserve requirement ratios for short-term FX liabilities were further increased, but only for new liabilities emerging after August 2015. Remuneration of TL reserves has increased by 200 bps. The full impact of these measures is expected to be felt only in 2018.

imbalances: credit growth (while decreasing) continues to be high and banks continue to intermediate a large share of Turkey's external debt.

47. **Still, banks' wholesale external foreign exchange funding has risen rapidly.** The sector's loan-to-deposit (LtD) ratio stands at 119 percent, with the ratio at 89 and 142 percent for foreign (FX) and local currency respectively. Wholesale external funding in FX is, on the margin, financing the expansion of local currency lending. Driven by the interest rate differential, this exposure has risen from US$61 billion in 2009 to US$135 billion in October 2015. The exposure at short maturity has decreased marginally over the last two years, to US$78 billion (Figure 4a). Banks hedge the FX risk associated with this funding, mainly off-balance sheet, and hence the net open FX position of the sector is small at 1 percent of regulatory capital.

48. **Rollover risk and indirect credit risk associated with FX lending have increased.** The rollover risk and hence FX liquidity risk associated with the gross exposure is significant. Should these risks materialize, banks' deposits with the CBRT under the reserve option mechanism (ROM), and possibly FX reserve requirement deposits could be used to partially cover the FX liquidity needs. In addition, banks face indirect credit risk stemming from their FX and FX-indexed loans to NFCs. The NFC sector's net open foreign exchange position has increased from US$67 billion at end-2009 to US$174 billion at end-October 2015. Anecdotal evidence suggests part of this net open position is hedged or covered by FX collateral, but data gaps prevent quantification.



49. **In addition, the gradual introduction of Basel III may increase the need for banks to raise capital.** New risk weights and countercyclical and systemic capital buffers will be phased in, starting this year. First, risk weights on banks' FX-denominated required reserves and ROM deposits at the CBRT will increase in April 2016. At the same time, risk weights on consumer and mortgage lending will be lowered, in anticipation of introducing debt-to-income ratios. Second, certain subordinated loans will no longer be counted as Tier 2 capital. Taken together, these measures are expected to lower the average CAR in the banking system by about 0.6 percentage points. The BRSA has also announced the detailed schedule of the introduction of additional capital buffers. While the schedule foresees a gradual phase in of these buffers over the period 2016–19, the required minimum CAR will increase by a total of 4.5–7 percentage points. Taken together, these developments may put many banks CAR close to or even below the required minimum, thus

necessitating capital increases. Without such increases banks' capacity to lend may be curtailed. Over the medium term, the move toward IRB risk weighting may increase the capital ratio, providing some relief. The upcoming FSAP will review these issues in detail.

Required Capital Increase Schedule for Basel III Compliance

(Percent)

	2015	2016E	2017E	2018E	2019E
Minimum CAR	8.0	8.0	8.0	8.0	8.0
Minimum Tier I Ratio	6.0	6.0	6.0	6.0	6.0
Capital Conservation Buffer	0.0	0.6	1.3	1.9	2.5
Systemic Risk Buffer 1/	0.0	0.25-0.5	0.5-1.0	0.75-1.5	1.0-2.0
Countercyclical Capital Buffer	0.0	0.0	0-2.5	0-2.5	0-2.5
Required CAR	**8.0**	**8.85 - 9.1**	**9.8-12.8**	**10.65-13.9**	**11.5-15.0**
Required Tier I Ratio	**6.0**	**6.85-7.1**	**7.8-10.8**	**8.65-11.9**	**9.5-13.0**

Source: BRSA.

Note: 1/ Buffer for the systemically most important banks.

Staff position

50. **Macroprudential policies should be strengthened, targeting banks' wholesale FX external financing.** Specifically, current reserve requirement measures aimed at lengthening the maturity of banks' external financing as well as the net stable funding ratio could be phased in more quickly, while increasing the remuneration differential between FX and Lira reserves could slow overall FX wholesale borrowing. To increase buffers and incorporate the increased indirect credit risk associated with FX lending, higher capital charges should be considered and provisioning on FX loans increased as a prudential measures. Related to this, the prudential treatment of FX-indexed lending should be brought into line with that of FX lending, as it materially pertains to the same risk. Data gaps needs to be closed to better assess risks from FX exposures by NFCs. Finally, the relaxation of risk weights on consumer lending should have awaited the introduction of debt-to-income ratios.

Authorities' position

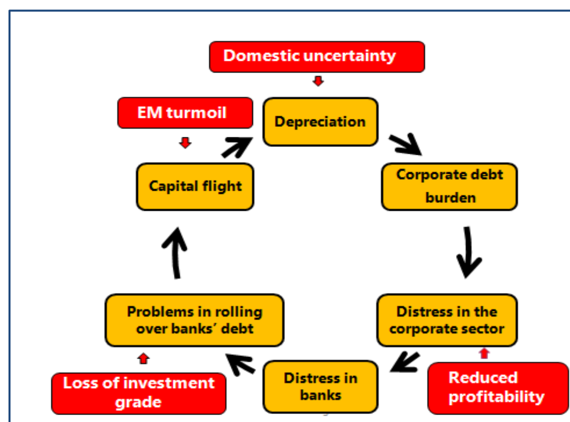
51. **The BRSA felt that the sharp slowdown in consumer credit growth allowed for a relaxation of macroprudential measures**. Thus, they announced a decrease of risk weights on consumer loans from April. The resulting increase in the banks' capital ratio is seen as supporting banks at the time they will see pressure on capital adequacy from an increased risk weight on FX deposits at the CBRT. BRSA management explained that they will maintain the maximum maturity restriction on consumer loans, which they see as the more binding constraint.

52. **The regulator does not see a need for new measures targeting FX risk**. Banks have a negligible net open FX position, and their stock of wholesale external financing has decreased over the last year. In addition, the BRSA feels that FX risk is better managed through the supervisory review process. In the longer term, once income data are available, the regulator plans to move to a

regulatory regime for consumer lending based on debt-to-income ratios. Finally, while the overall foreign exchange risk in the economy remains substantial, the BRSA remains confident that its vigilant supervision and broad powers to address problems in banks as they occur suffice. In this regard, they see no need to accelerate the schedule for the introduction of the net stable funding ratio.

F. Contingency Planning

Background



53. **A sudden capital flow reversal remains the main risk in the short term**. Shocks in international capital markets could result in accelerated capital outflows or, in extremis, a sudden stop. In such an environment, banks and corporates will find it difficult to roll over their external debt, and banks may also find it prohibitively expensive to renew their FX hedges. Banks will likely react by not rolling over corporates' domestic FX loans, precisely at the time when corporates will be strained to repay them. Staff estimates that a 20 percent depreciation shock would lead NFCs' leverage to worsen by about 45 percentage points (Box 9). Hence the banks would see a large credit risk materializing. The economy would likely enter a recession.

Staff position

54. **In such disorderly market conditions, the authorities should react by employing both monetary and fiscal policies.** While a modest nominal depreciation is warranted, a sharp depreciation may become a shock amplifier and hence increase financial and macroeconomic disruption. A sharp increase in the policy rate will be needed to support the exchange rate and facilitate an orderly deleveraging process. Direct FX intervention may be warranted, but reserves are low, and thus the scope for any credible intervention is limited. In the likely event of a recession (and only in such a case), the authorities should consider loosening fiscal policy to support the real economy. Preemptively publishing an explicit fiscal risk statement may facilitate such a fiscal reaction. Still, corporate liquidity or solvency problems may occur, requiring swift and appropriate action.

Authorities' position

55. **The authorities do not assess the risk of sudden capital flow reversal as high**. In the current juncture, Turkey is faring much better than its emerging market peers. In addition, the current asynchronous monetary policy of major central banks does not raise concerns about major liquidity gluts. Finally, the strong trade and financial linkages with a recovering EU suggest that even in moment of crisis, rollover ratios will not decrease drastically.

56. **In addition, the economy has sufficient buffers to withstand severe shocks**. Policy buffers are high as the fiscal stance is prudent and the public debt to GDP ratio is low and continues to decrease. In addition, the private sector has shown its resilience. Households cannot borrow in FX, are not highly indebted, and have plenty of cash buffers. Banks have no open FX position, are well managed, and have high loss-absorbing levels of capital. The industrial structure of the economy is flexible enough to withstand external shocks and Turkey has proven to be able to diversify its exports. Non-bank corporates have a sizeable net open FX position, but no signs of distress have been observed after the recent large depreciation. This suggests that corporates are largely hedged.

57. **Finally, the authorities argue they have a wide set of instruments to manage any pressures that might occur**. For mild shocks, the CBRT can influence the cost of lira, as well as on-shore euro and dollar funding separately, through its remuneration regime of required reserves and its liquidity provision framework. This has been made even more flexible with the recent inclusion of FX assets in the basket of eligible collateral for CBRT Lira liquidity, which would provide support should the FX swap market temporarily close. Should a more severe shock occur, they would first let the automatic stabilizers work. Fiscal policy would be used in case of a recession. In case banks need to draw down the ROM, they have sufficient Lira assets that the CBRT could accept as collateral under the emergency liquidity assistance framework to provide Lira liquidity. In addition, unrecorded Turkish assets abroad would come back as necessary. In this respect, the authorities mentioned that net errors and omissions in the BOP are countercyclical (see paragraph 8 above.)

Box 9. Turkey: Balance Sheet Effects

Following the financial crisis, banks have become the main channel through which external funding is intermediated. Banks' total external debt has increased from about 8 percent of GDP in 2008 to about 29 percent in September 2015. These external liabilities are mainly in FX and are mostly matched by FX denominated loans to the non-financial corporate and FX deposits with the central bank. In addition, household deposits are another important source of FX funding to the banks.

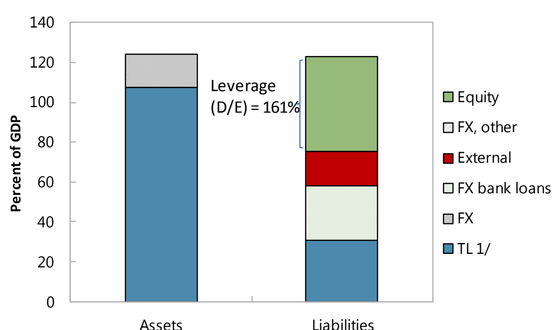
Non-financial corporates have large FX exposures owing to borrowing from the domestic banking system and directly from abroad. While external borrowing has declined, there has been an increase in the overall FX exposure of the sector as the increase in FX borrowing from the domestic banking system is larger than the decline in external borrowing. The result is an overall net FX open position in the sector of about 27 percent of GDP by September 2015. This consists of 17 percent of GDP in external borrowing, 25 percent in domestic FX borrowing, 2 percent of GDP in other FX liabilities, and 17 percent of GDP in FX assets.

Households have significant FX deposits and limited external liabilities as FX borrowing is restricted. While some households continue to have some outstanding FX indexed debt, the amount is a small in comparison to their FX deposits, which amounted to about 14 percent of GDP in September 2015.

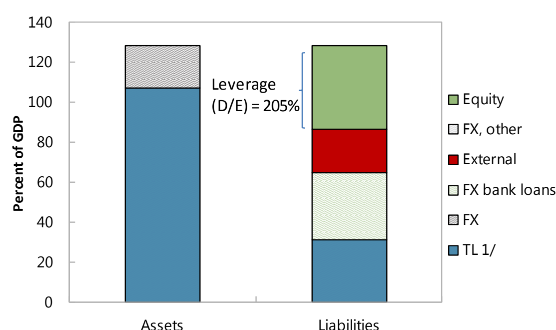
Reflecting the FX open positions, a scenario involving depreciation of the lira would significantly worsen the NFCs balance sheet yet improve households' net wealth. A 20 percent depreciation would result in an increase in the NFCs leverage (debt-to-equity ratio) by about 44 percentage points, to about 205 percent. This reflects the large FX liabilities in the corporate sector—which account for about 50 percent of total NFCs liabilities—amplified by the depreciation shock. Households' assets would improve (in lira terms) from their holding of FX deposits. Other sectors in the economy tend to be less affected, with banks' capital ratios (measured by equity-to-total assets) deteriorating by about 2 percentage points.

The Impact of a 20 Percent Depreciation Shock Scenario on NFCs and Bank Balance Sheets

NFCs balance sheet: before the shock …



… after the shock, leverage ratio increased significantly



1/ Includes non-financial assets.
Sources: CBRT, IFS, and Fund staff calculations.

STAFF APPRAISAL

58. **Strong growth is set to continue in 2016, but with higher inflation**. The 30 percent increase in the minimum wage, a planned relaxation in macro prudential regulation, a moderate

loosening of fiscal policy, and the insufficiently tight monetary stance will support domestic demand and GDP growth. Inflation is well above the authorities' 5 percent target and on the rise.

59. **Underlying external imbalances persist.** The improvement in the current account is due to lower oil prices, and the non-energy balance has barely changed. The economy's external position remains moderately weaker than the level consistent with medium-term fundamentals. The current domestic demand-based growth does not help rebalancing and the low private saving rate, if unaddressed, will perpetuate accumulation of external imbalances. Moreover, financing of the deficit remains a concern, with some of it coming from reserves.

60. **The economy has shown resilience in the face of external shocks but buffers have decreased.** The large foreign currency debt of the nonfinancial corporate sector and the dependence of banks on foreign financing expose Turkey to the risk of accelerating capital outflows. International reserves have declined and the international investment position remains highly negative. The fiscal stance has been loosened.

61. **The main challenges are to reduce external imbalances and to boost the potential growth rate of the economy.** In the short run, a reduction of external imbalances can be achieved through tighter fiscal and monetary stances. Macroprudential policies may also have a further role to play, but are not a substitute for these macroeconomic policies. If such policies are implemented, slower domestic demand growth and increased savings would lower external imbalances. This would provide a window of opportunity to implement far-reaching structural reforms to raise the private sector saving rate and potential output, delivering stronger and more sustainable long-term growth.

62. **A tighter fiscal stance would contribute to reducing external imbalances and lowering inflation, creating additional space to react to shocks**. With public debt at 32 percent of GDP, debt sustainability is not a concern. Yet, fiscal policy consolidation could be more ambitious than envisaged in the MTP. A stronger public sector budget position would create additional policy space to react to shocks. The increasing use of guarantees and PPPs to finance investment entails contingent liabilities that could materialize during a downturn.

63. **A tighter monetary policy stance is needed to bring inflation back to the 5-percent target in the medium term**. Inflation remains well-above target and has increased recently. Inflation expectations have remained unanchored. The real policy rate should be increased into decisively positive territory. This would also alleviate depreciation pressure on the lira.

64. **The framework for monetary policy needs to be improved to strengthen its effectiveness.** Narrowing the interest rate band and providing all liquidity demanded by the market at a single policy rate will provide a clear signal on the policy stance and strengthen the monetary transmission mechanism.

65. **Reserves should also be boosted.** Given the improvement in the current account balance, the CBRT should increase its net reserves. Interventions should be restricted to periods of disorderly

market conditions. Tighter monetary policy would help to support, market conditions permitting, FX purchases.

66. **Buffers in the banks should be maintained as risks persist.** The external macro imbalances bring risks that are reflected in the banks' balance sheets. As intermediaries of foreign savings, banks remain reliant on external wholesale funding and have large FX exposures to the domestic corporate sector. Banks have been resilient so far. Capital adequacy ratios remain above regulatory minima and are mostly based on high-quality capital. Nonperforming loans are low and well provisioned. Macroprudential policies have lengthened the maturities of banks' wholesale FX external financing, adding some resilience. Looking forward, prudential policies should be adjusted to reflect increased risks associated with FX lending. The recent adjustment of consumer loan risk weights that will take effect in April should be reviewed if consumer credit growth rebounds too sharply. Other macroprudential measures focused on overall indebtedness would also be useful.

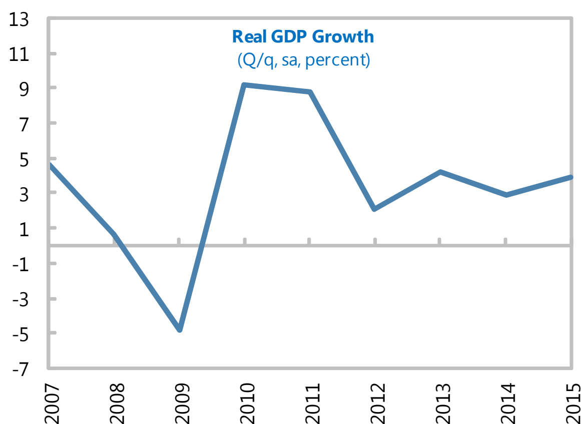
67. **The authorities' appropriately ambitious structural reform agenda is central to the goal of successful economic rebalancing.** Specifically, reforms aimed at increasing funding of the private pension and the severance pay systems could significantly raise the private saving rate. Addressing the lack of flexibility in the labor market and further developing local capital markets would boost growth and improve competitiveness. The authorities' reform plans should be implemented swiftly and fully.

68. **The increase in the minimum wage will pose challenges to the labor market, competitiveness and fiscal balance,** although higher wage may improve income distribution and provide a short-term economic boost. In the context of rigid labor markets, efforts to improve labor market flexibility would help avoid a surge in informal sector employment, and would diminish the negative consequences of higher wages for competitiveness.

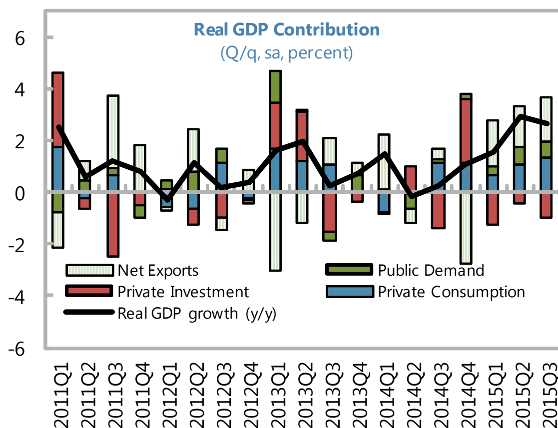
69. **It is recommended that the next Article IV consultation be held again on the usual 12-month cycle.**

Figure 1. Turkey: Recent Developments

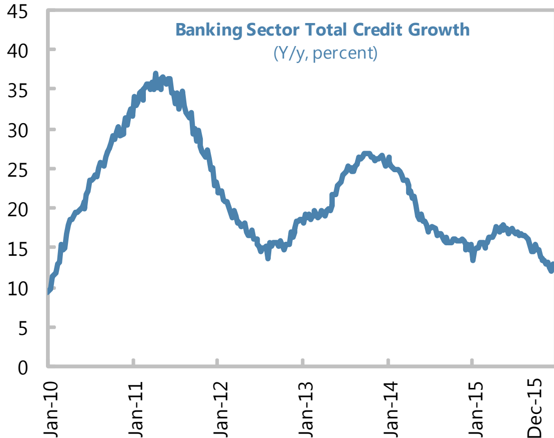
Growth has weakened...



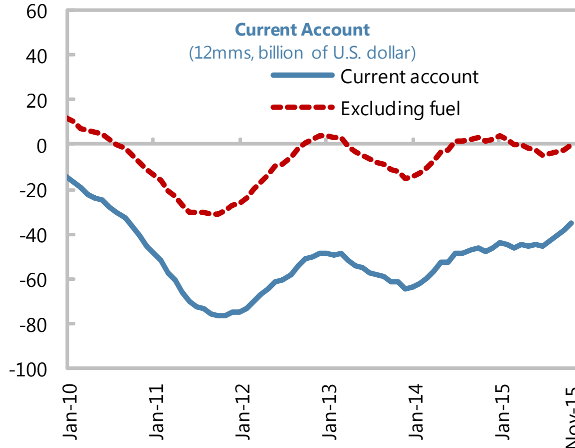
...and the composition has shifted from public demand and net exports to private demand ...



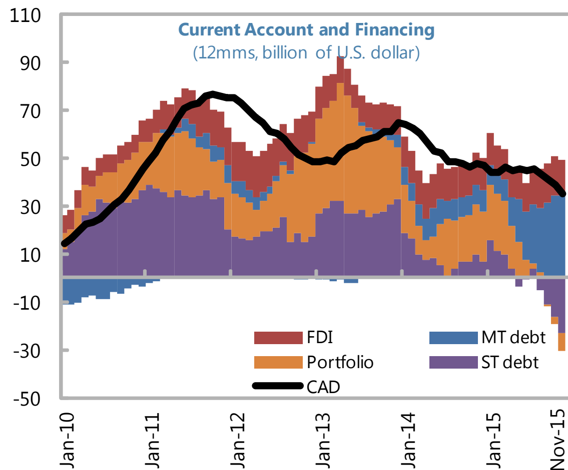
...as credit growth is also slowing.



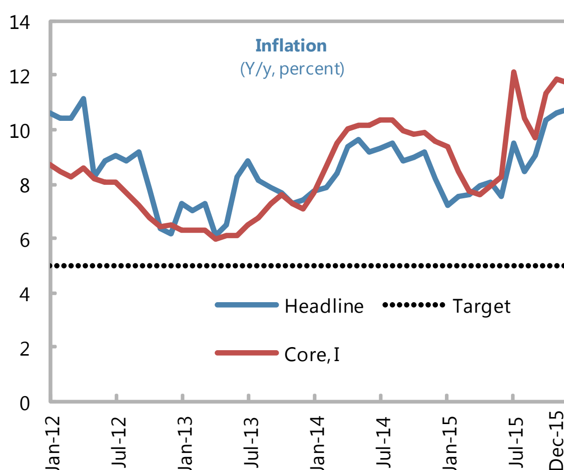
External imbalances remain high...



...but the financing of the current account deficit remains tilted towards portfolio and debt creating flows.



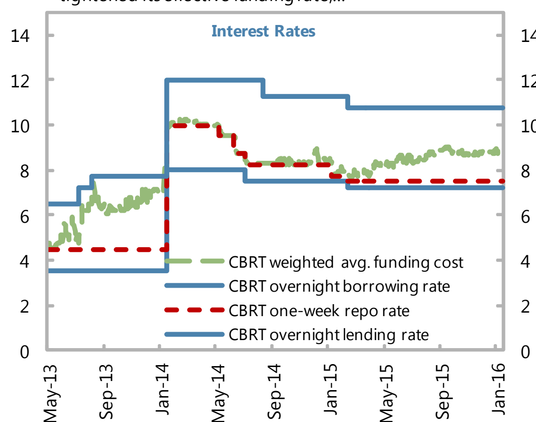
Headline and core inflation remain well-above target.



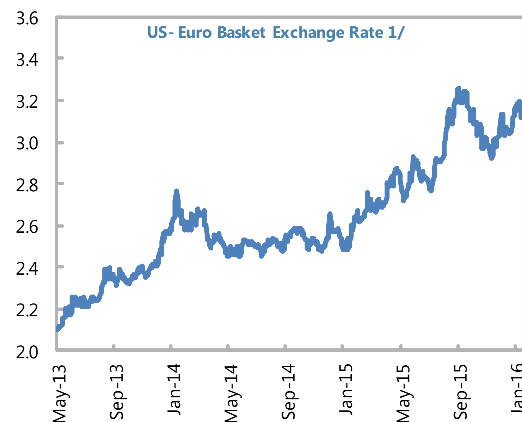
Sources: Bank for International Settlements (BIS); Central Bank of the Republic of Turkey (CBRT); Haver Analytics; Turkstat; and IMF staff calculations.

Figure 2. Turkey: Monetary Policy and Financial Markets

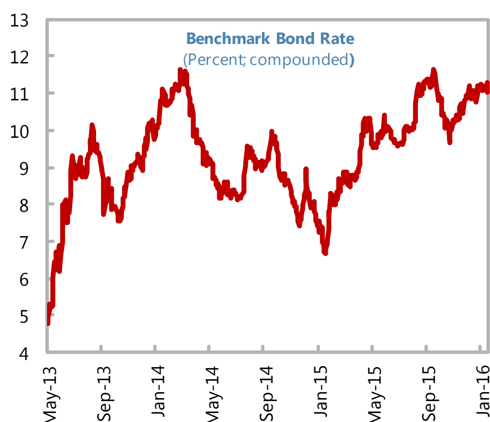
The CBT loosened headline rates throughout the year, but tightened its effective funding rate,...



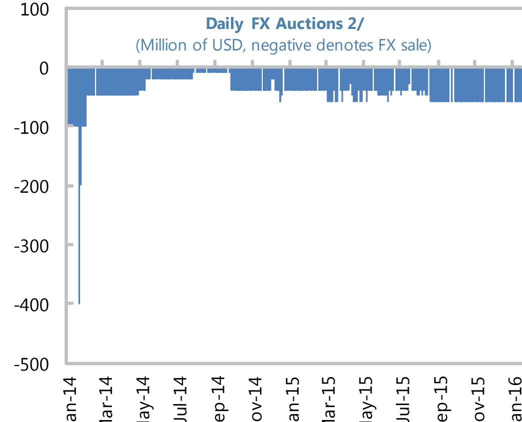
...while the exchange rate depreciated ...



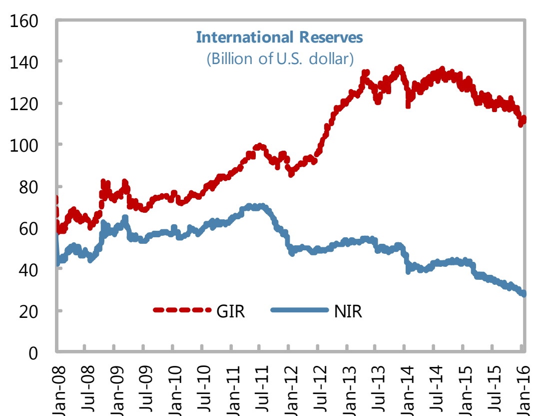
...and bond yields rose.



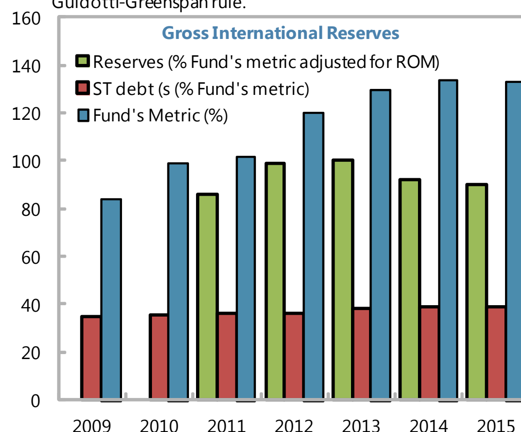
The CBRT has been selling FX reserves instead of rebuilding buffers.



Reserves are declining and net reserves are low....



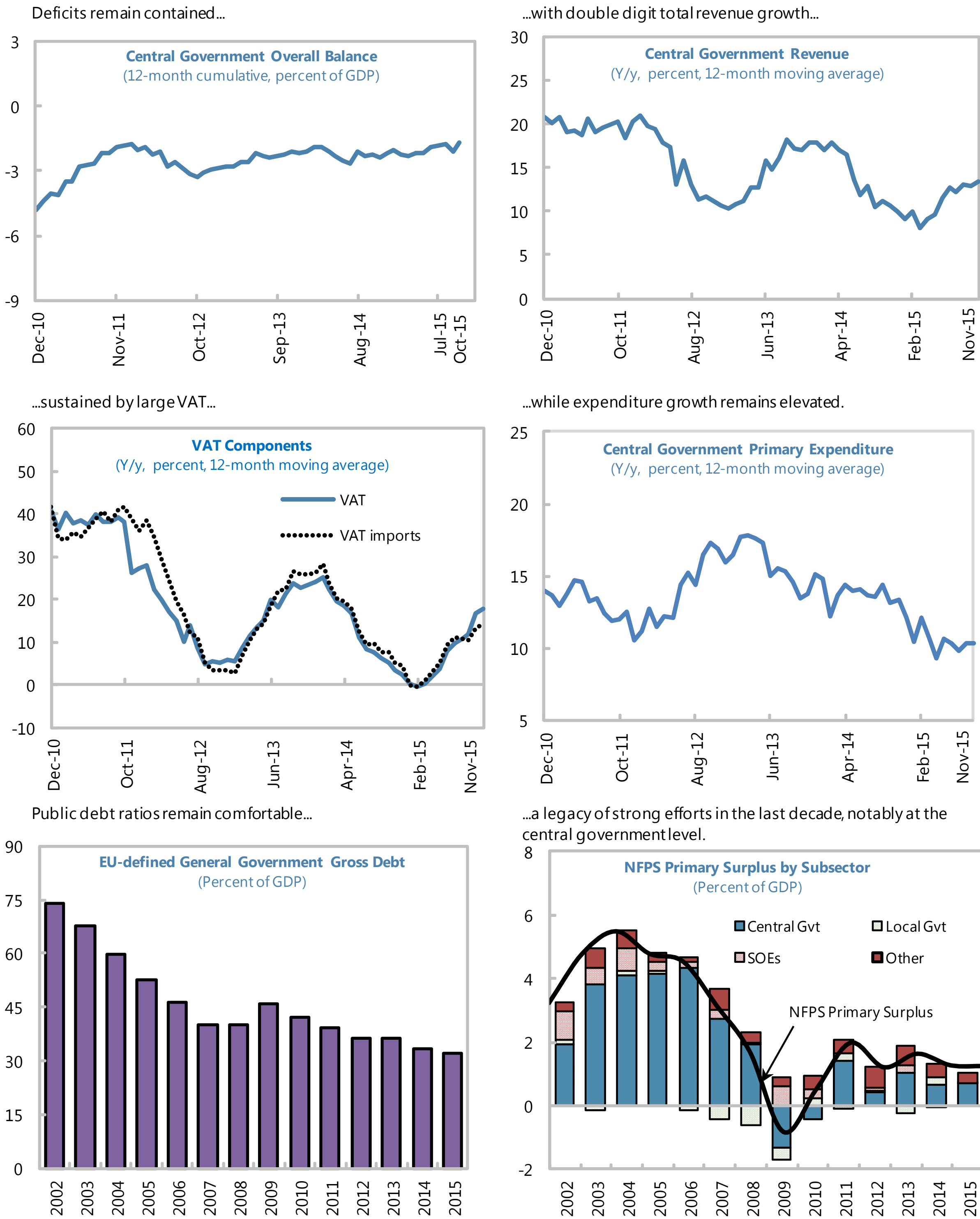
...but reserves fall short of the Fund's benchmark metric (when corrected corrected for ROM deposits) and the Guidotti-Greenspan rule.



Sources: Banking Regulation and Supervision Agency (BRSA); CBRT; Haver Analytics; and IMF staff estimates.

1/ Lira per equal-weight euro/dollar basket.

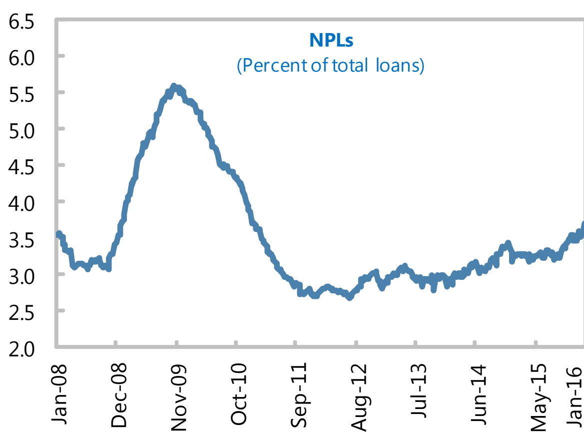
2/ Does not include the CBRT intervention of US$3.1 bn in January 2014.



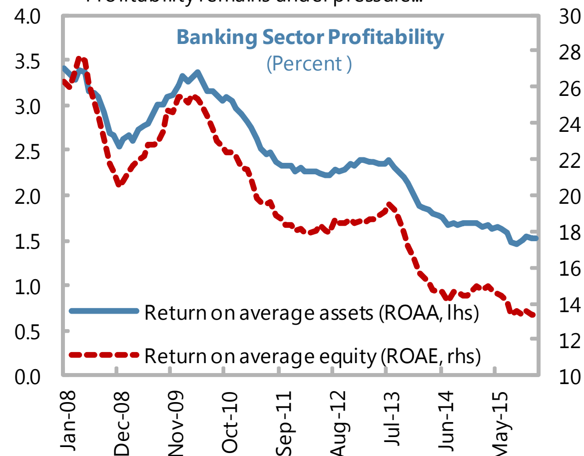
Sources: Minister of Finance; Haver Analytics; Treasury; and IMF staff calculations.

Figure 4. Turkey: Financial Sector Trends

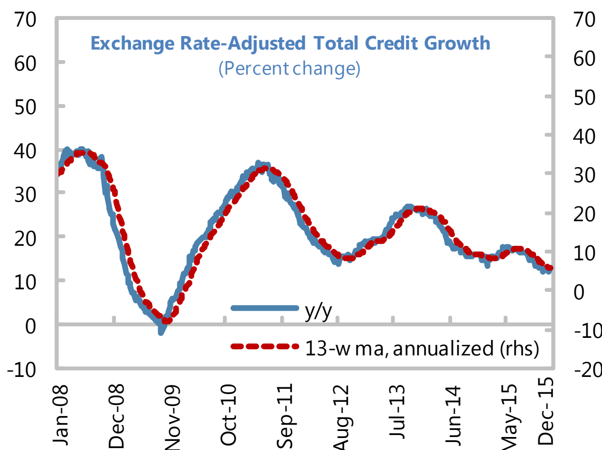
NPL ratios remain near historic lows.



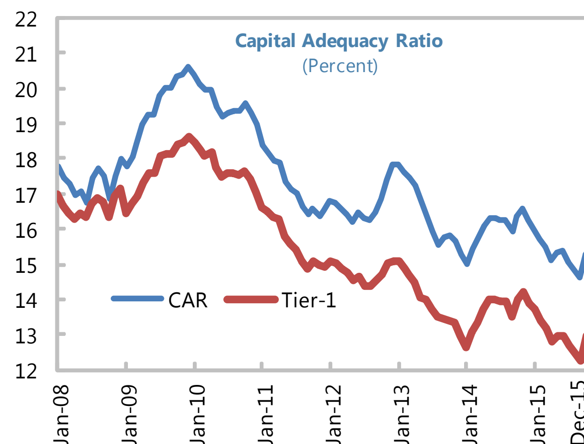
Profitability remains under pressure...



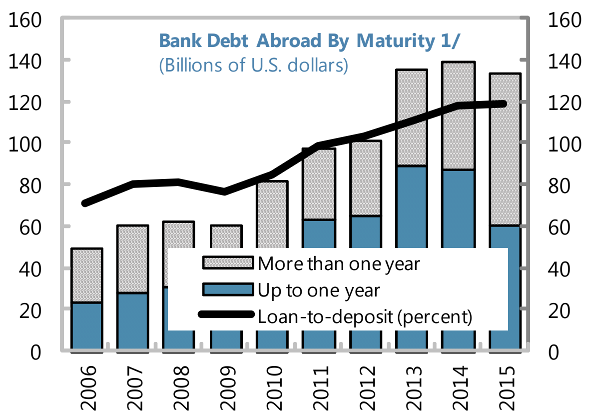
...while credit growth has started to decrease...



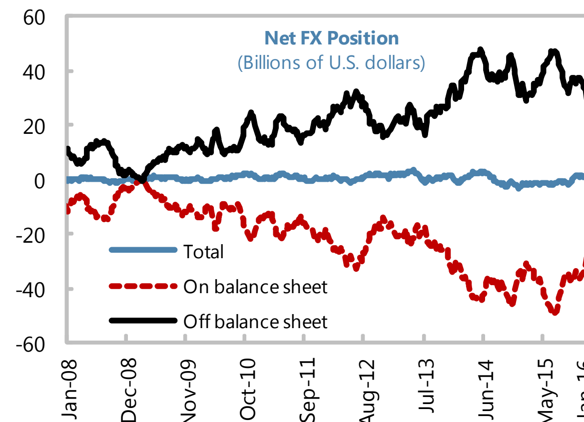
...and capital ratios are declining, but remain well-above regulatory minima.



The loan-to-deposit ratio is increasing with lending financed from abroad.



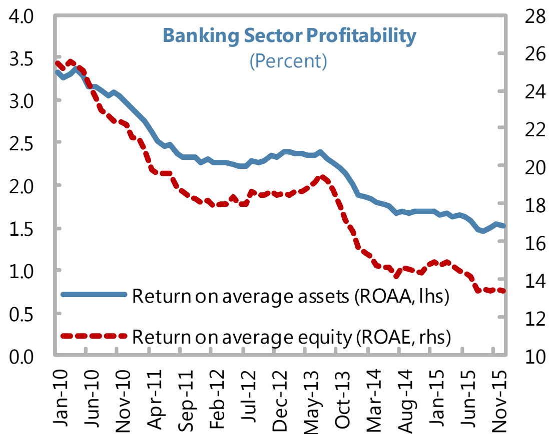
Banks are leveraging in FX to maintain profitability, albeit positions are fully hedged.



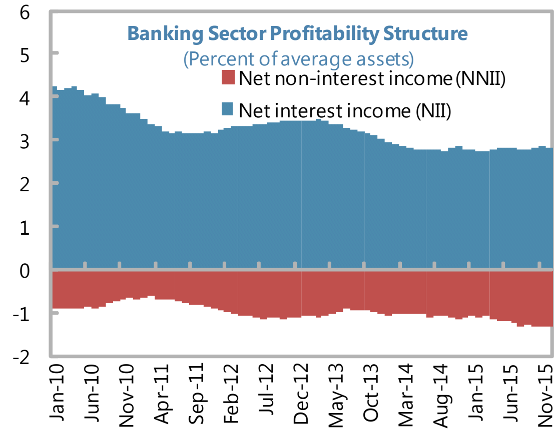
Sources: BRSA; CBRT; Haver Analytics; and IMF staff calculations.
Note: 1/ Structural break in 2014.

Figure 5. Turkey: Financial Sector Profitability Trends

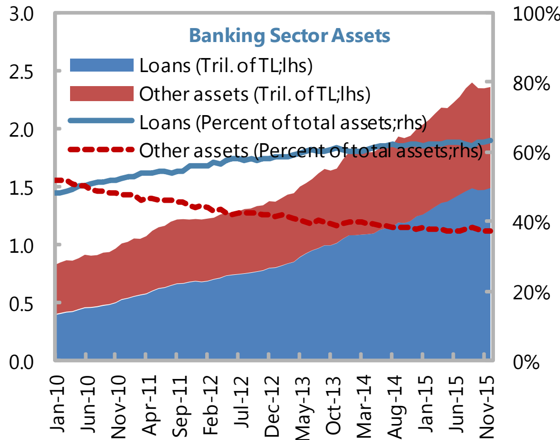
Profitability has steadily decreased...



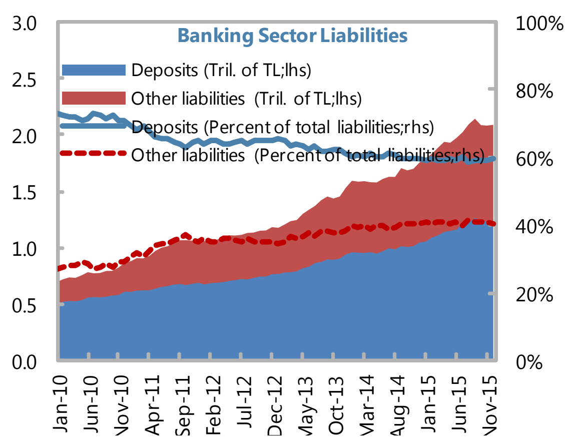
...driven by both lower interest margins and higher non-interest expense.



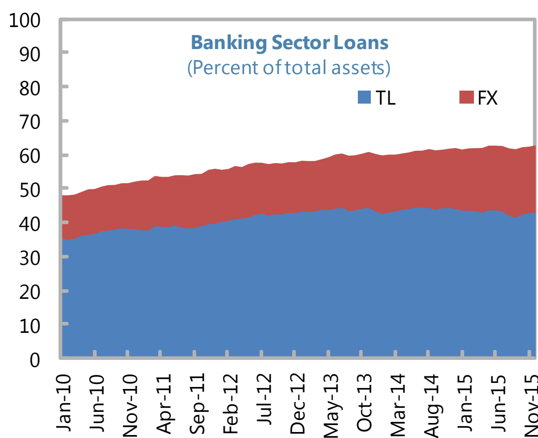
The loan book continues to grow....



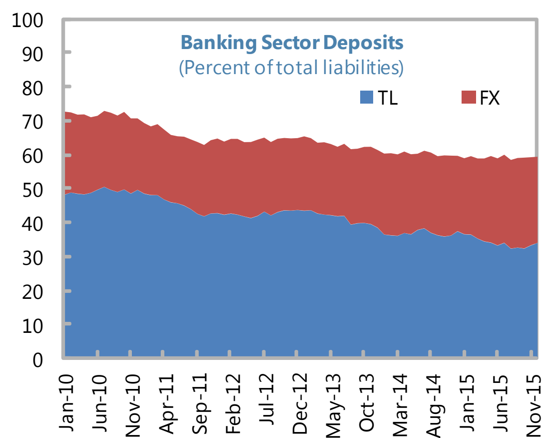
...while deposits fund an ever smaller share.



Both TL and FX loans have increased....



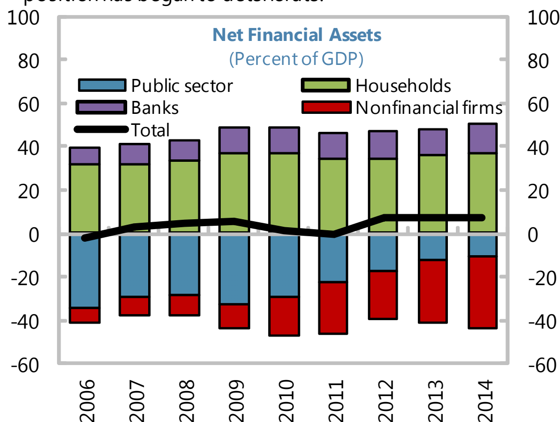
...while FX deposits increased at the expense of TL deposits.



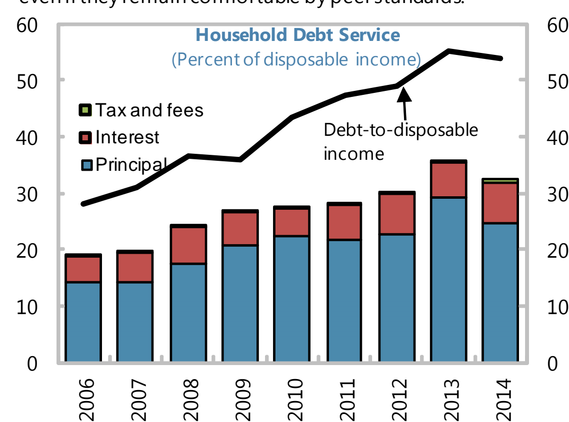
Sources: BRSA; Haver Analytics; and IMF staff calculations.

Figure 6. Turkey: Households and Corporate

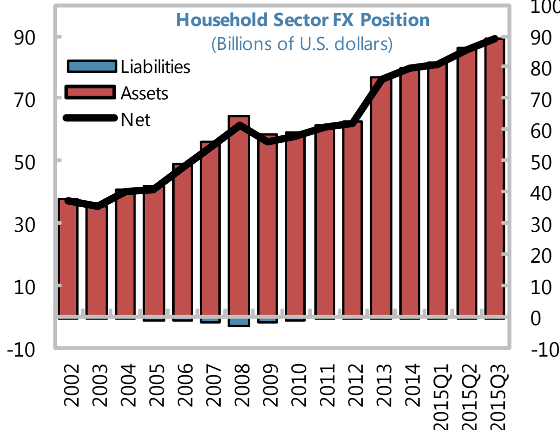
On aggregate across sectors, the net financial asset position has begun to deteriorate.



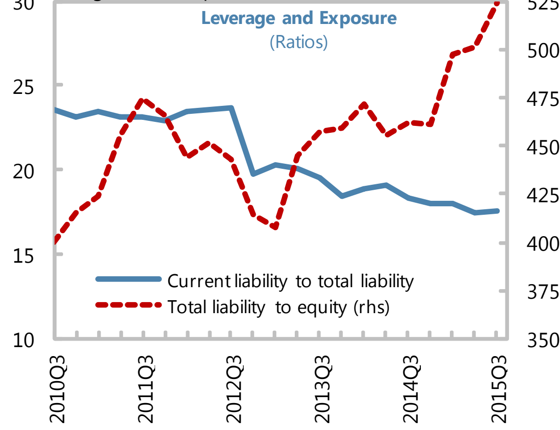
Within sectors, household debt ratios continue to increase, even if they remain comfortable by peer standards.



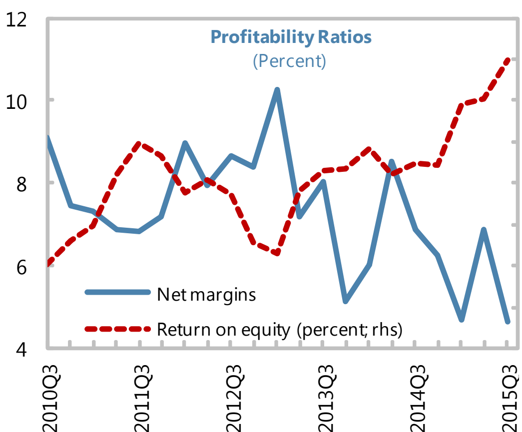
Turkish households have no FX debt.



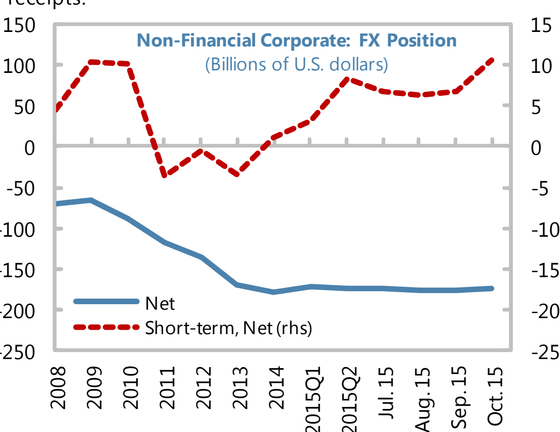
Leverage in the corporate sector has increased....



...and although the sector remains profitable...



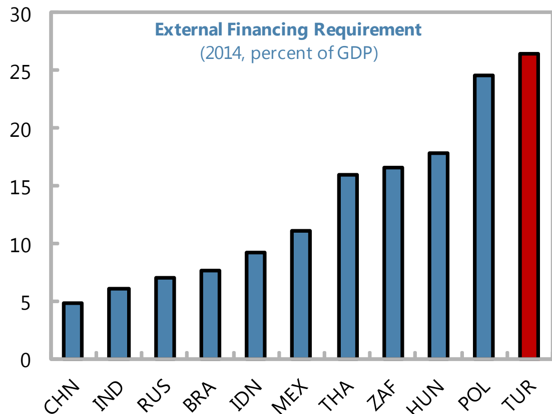
...the net FX position is negative, large and growing, albeit mostly long-term and partially hedged via swaps or export receipts.



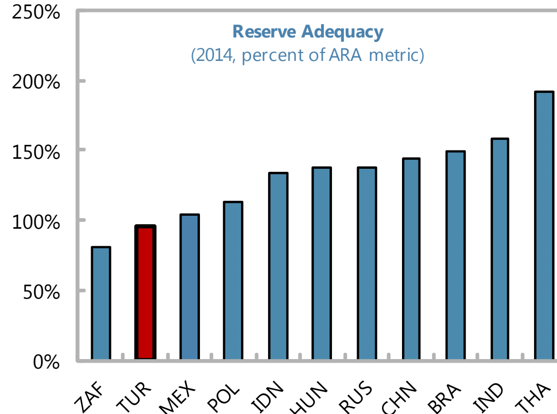
Sources: Bloomberg; BRSA; CBRT; The Bank Association of Turkey (TBA); Undersecretariat of Treasury; and IMF staff estimates.

Figure 7. Turkey: Turkey vs. Peers

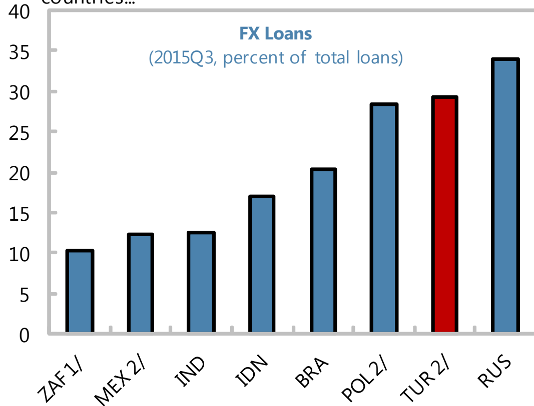
Turkey has large gross financing requirements...



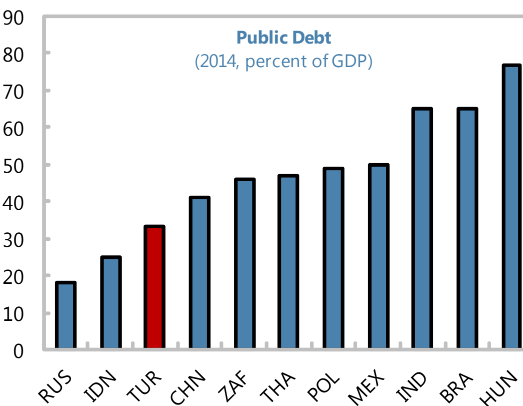
...and lower foreign exchange reserves than peers



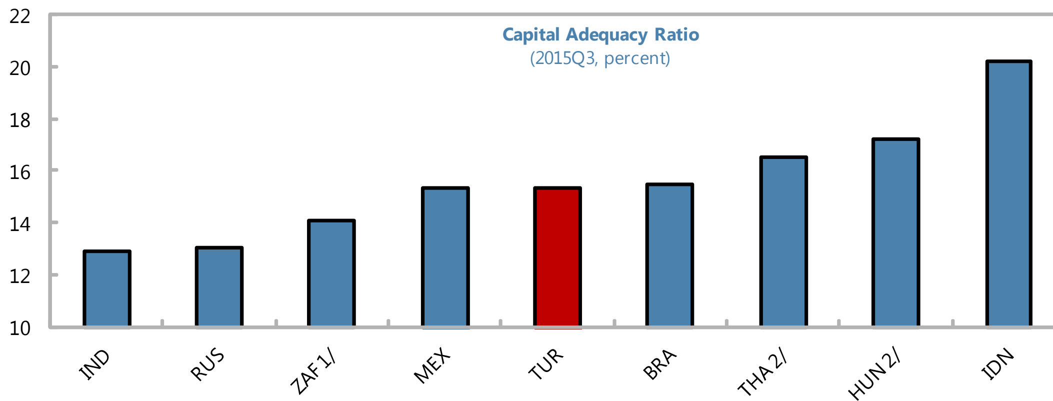
Exposure to FX risk is also larger than in most peer countries...



...but there is ample fiscal space.



The financial system has buffers.



Notes: BRA = Brazil; CHN = China; HUN = Hungary; IND = India; IDN = Indonesia; MEX = Mexico; POL = Poland; RUS = Russia; ZAF = South Africa; THA = Thailand; and TUR = Turkey.
1/ 2015Q1.
2/ 2015Q2.

Table 1. Turkey: Selected Economic Indicators, 2014–21

Population (2014): 78.1 million
Per capita GDP (2014): $10,222
Quota (2015): SDR 1,455.8 million

	2014	2015	2016	2017	2018	2019	2020	2021
		Proj.						
	(Percent)							
Real sector								
Real GDP growth rate	2.9	3.8	3.8	3.4	3.5	3.5	3.5	3.5
Contributions to GDP growth								
Private domestic demand 1/	1.0	3.3	4.1	3.5	3.2	3.1	3.1	3.1
Public spending	0.1	0.4	0.6	0.2	0.4	0.5	0.5	0.5
Net exports	1.8	0.2	-0.9	-0.3	-0.1	-0.1	-0.1	-0.1
GDP deflator growth rate	8.3	10.2	11.5	8.6	7.2	6.6	6.3	6.1
Nominal GDP growth rate	11.5	14.4	15.7	12.4	10.9	10.3	10.0	9.8
CPI inflation (12-month; period-average)	8.9	7.7	9.8	8.8	7.3	6.9	6.6	6.5
PPI inflation (12-month; period-average)	10.2	5.3	7.9	9.7	7.9	7.4	6.7	6.5
Unemployment rate	9.9	10.2	10.8	10.5	10.5	10.5	10.5	10.5
Average nominal treasury bill interest rate 2/	9.3	9.5	...	...	...	...	...	...
Average real policy rate 2/	-0.2	0.0	...	...	...	...	...	...
	(Percent of GDP)							
Nonfinancial public sector								
Primary balance	0.9	1.2	0.6	1.3	1.2	1.3	1.4	1.4
Net interest payments	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Overall balance	-1.4	-1.0	-1.5	-0.9	-1.0	-0.8	-0.8	-0.8
Debt of the public sector								
General government gross debt (EU definition)	33.5	32.6	30.5	29.0	27.9	26.7	25.8	25.0
Nonfinancial public sector net debt	27.1	25.7	24.2	22.8	21.9	21.5	21.3	19.5
External sector								
Current account balance	-5.5	-4.4	-3.5	-4.1	-4.3	-4.4	-4.3	-4.4
o/w Nonfuel current account balance	0.7	0.1	-0.6	-0.4	0.1	0.2	0.1	0.0
Gross financing requirement	26.5	27.2	26.7	25.0	25.3	25.6	25.6	25.6
Foreign direct investment (net)	0.7	1.6	1.4	1.5	1.5	1.6	1.7	1.8
Gross external debt 3/	50.4	56.0	57.3	57.1	56.9	56.7	56.3	55.7
Net external debt	30.8	35.7	37.5	37.8	38.2	38.5	38.5	38.4
Short-term external debt (by remaining maturity)	21.0	23.6	22.0	22.2	22.4	22.4	22.3	21.8
Monetary aggregates								
Nominal growth of M2 broad money (percent)	11.9	19.4	20.7	17.4	15.9	15.3	15.0	14.8
GDP (billions of U.S. dollars) 4/	798.3	734.7	...	...	...	...	...	...
GDP (billions of Turkish lira)	1,747	1,999	2,313	2,599	2,883	3,181	3,499	3,843

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

1/ includes changes in stocks.
2/ Average to latest available.
3/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).
4/ 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, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
		Proj.						
(Percent)								
Real Growth								
Real GDP	2.9	3.8	3.8	3.4	3.5	3.5	3.5	3.5
Real domestic demand	1.1	3.6	4.7	3.7	3.5	3.5	3.5	3.5
Private consumption	1.4	4.4	5.4	3.9	3.4	3.4	3.4	3.4
Private investment	0.4	3.4	2.2	4.5	4.5	4.2	4.2	4.2
Public spending	0.6	2.3	4.0	1.6	2.9	3.2	3.2	3.2
Exports	6.8	-0.1	0.1	2.0	3.0	3.4	3.4	3.4
Imports	-0.2	-0.8	3.5	3.1	3.2	3.5	3.5	3.5
Output gap (percent of potential GDP)	-0.3	-0.3	0.0	0.2	0.1	0.0	0.0	0.0
Contributions to real GDP growth								
Real domestic demand	1.1	3.6	4.7	3.7	3.6	3.6	3.6	3.6
Private consumption	0.9	2.9	3.6	2.7	2.3	2.3	2.3	2.3
Private investment	0.1	0.7	0.4	0.9	0.9	0.8	0.8	0.8
Public spending	0.1	0.4	0.6	0.2	0.4	0.5	0.5	0.5
Net exports	1.8	0.2	-0.9	-0.3	-0.1	-0.1	-0.1	-0.1
Exports	1.8	0.0	0.0	0.5	0.7	0.8	0.8	0.8
Imports	0.0	-0.2	0.9	0.8	0.9	0.9	0.9	0.9
(Percent of GDP)								
Shares (percent of GDP)								
Private Consumption	68.9	67.7	67.7	68.2	68.2	68.3	68.4	68.6
Public Consumption	12.0	15.1	15.0	14.7	14.7	14.7	14.7	14.7
Private Investment	15.9	16.0	15.6	15.8	15.9	16.0	16.1	16.1
Public Investment	4.4	4.0	3.9	3.9	3.8	3.8	3.8	3.8
Net Exports	-4.4	-2.8	-2.2	-2.5	-2.6	-2.8	-2.9	-3.2
Exports	27.7	27.5	25.2	25.3	25.5	25.4	25.1	24.9
Imports	32.2	30.2	27.4	27.9	28.1	28.2	28.1	28.0
Nonfinancial public sector (percent of GDP)								
Primary balance	0.9	1.2	0.6	1.3	1.2	1.3	1.4	1.4
Overall balance	-1.4	-1.0	-1.5	-0.9	-1.0	-0.8	-0.8	-0.8
Primary revenue of central gov.	23.3	23.1	22.7	22.6	22.5	22.5	22.5	22.5
Primary expenditure of central gov.	22.6	22.4	22.6	21.9	21.8	21.7	21.6	21.6
Rest of the public sector, primary balance	0.2	0.5	0.5	0.6	0.4	0.5	0.5	0.5
Net interest expenditure	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Gen. gov. structural primary balance 1/	0.7	0.9	0.2	0.8	0.9	1.2	1.2	1.2
Gen. gov. gross debt (EU def.)	33.5	32.6	30.5	29.0	27.9	26.7	25.8	25.0
External indicators (percent of GDP)								
Current account	-5.5	-4.4	-3.5	-4.1	-4.3	-4.4	-4.3	-4.4
Gross external debt 2/	50.4	56.0	57.3	57.1	56.9	56.7	56.3	55.7
NIIP (percent of GDP)	-55.2	-51.1	-53.5	-54.9	-56.3	-57.6	-58.8	-60.1
REER (CPI-based, level, average)	102.3	99.8	97.5	97.5	97.5	97.5	97.5	97.5
Public saving-investment balance	-0.8	-0.5	-1.7	-0.9	-0.8	-0.7	-0.7	-0.9
Private saving-investment balance	-5.1	-3.8	-1.6	-3.0	-3.4	-3.7	-3.7	-3.7
Memo Items								
Employment rate (percent)	45.5	...	...	...	...	...	...	...
Unemployment rate (percent)	9.9	10.2	10.8	10.5	10.5	10.5	10.5	10.5
Headline Inflation (Period average)	8.9	7.7	9.8	8.8	7.3	6.9	6.6	6.5
Headline Inflation (End of Period)	8.2	8.8	10.5	7.4	7.3	6.5	6.7	6.4
Nominal GDP (billions of Turkish lira)	1747	1999	2313	2599	2883	3181	3499	3843
Nominal GDP (billions of U.S. dollars)	798.3	734.7	...	...	...	...	...	...

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 by GDP in U.S. dollars calculated by staff (consolidated from daily data published by the CBRT).

Table 3. Turkey: Summary of Balance of Payments, 2014–21
(Billions of US$)

	2014	2015	2016	2017	2018	2019	2020	2021
					Proj.			
Current account balance	-43.6	-32.2	-26.3	-32.6	-35.4	-38.3	-40.3	-42.8
Balance on goods and services	-36.8	-23.9	-16.4	-20.1	-22.0	-24.7	-27.5	-31.3
Goods, net	-63.6	-47.8	-38.9	-44.4	-47.7	-51.5	-55.0	-59.0
Exports of goods	168.9	152.1	144.9	153.3	162.5	171.4	179.0	187.3
Imports of goods	232.5	199.9	183.9	197.7	210.2	222.9	234.0	246.3
of which Fuel imports	-55.0	-38.2	-27.5	-35.6	-42.8	-46.9	-48.5	-50.2
Services, net	26.8	24.0	22.5	24.3	25.8	26.8	27.5	27.8
Credit	51.7	46.2	44.3	46.9	49.7	52.4	54.7	56.5
Debit	24.9	22.3	21.8	22.6	23.9	25.6	27.2	28.8
Primary income, net	-8.1	-9.5	-11.0	-13.7	-14.6	-14.7	-14.0	-12.7
of which interest expenditure	5.6	5.2	10.4	14.2	17.7	20.0	21.3	22.6
Secondary income net	1.4	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Capital account	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance, excl. reserves	41.6	10.7	26.3	32.6	35.4	38.3	40.3	42.8
Direct investment, net 1/	5.5	11.5	10.7	11.7	12.9	14.2	15.7	17.8
Portfolio investment, net	20.1	15.4	-2.2	-8.5	-9.4	-8.9	-11.1	-12.6
of which government eurobonds, net	4.2	0.3	0.3	0.1	0.6	-0.1	1.4	1.4
Other investment, net	16.0	14.6	13.4	12.3	13.2	15.1	13.5	12.4
of which short-term borrowings	4.1	-21.3	-1.0	0.0	0.0	-0.4	-0.4	-0.8
of which banks (loans)	3.8	-21.4	-1.0	0.0	0.0	-0.4	-0.4	-0.8
of which other sector (loans)	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.6	9.7	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance, excl. reserves	-0.4	-11.8	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)							
Current account balance	-5.5	-4.4	-3.5	-4.1	-4.3	-4.4	-4.3	-4.4
Nonfuel current account balance	0.7	0.1	-0.6	-0.4	0.1	0.2	0.1	0.0
Trade account balance (incl. shuttle trade)	-4.6	-3.3	-2.2	-2.5	-2.6	-2.8	-3.0	-3.2
Capital and financial account balance	-5.3	-3.1	-3.5	-4.1	-4.3	-4.4	-4.3	-4.4
Overall balance	0.0	-1.6	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent year-on-year)							
Export of goods and services, volume growth	7.1	-0.4	1.4	2.0	3.0	3.4	3.4	3.4
Export value growth	5.3	-10.1	-5.0	5.8	6.0	5.5	4.4	4.3
Import of goods and servcies, volume growth	-0.1	-0.7	3.1	3.1	3.3	3.5	3.5	3.5
Import value growth	-3.1	-13.7	-7.7	7.1	6.3	6.1	5.1	5.3
Change in terms of trade	1.1	4.7	4.7	-0.2	0.0	-0.6	-0.6	-0.9
Gross foreign reserves (CBRT) 2/								
In billions of U.S. dollars	127.3	110.5	110.5	110.5	110.5	110.5	110.5	110.5
Net international reserves	42.9	28.7	28.7	28.7	28.7	28.7	28.7	28.7
Net international reserves (exl. govt. FX deposits)	39.9	27.4	27.4	27.4	27.4	27.4	27.4	27.4
Debt service ratio 3/	19.7	20.8	35.2	32.1	33.7	34.6	34.8	35.4

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 financing surplus, due to gold transactions between domestic banks and the central bank which are not recorded in the BOP.

3/ Interest and amortization payment of medium- and long-term debt in percent of export receipts.

Table 4. Turkey: External Financing Requirements and Sources, 2014–21
(Billions of US$)

	2014	2015	2016	2017	2018	2019	2020	2021
		Proj.						
Gross external financing requirements	211.8	199.9	199.9	197.5	210.9	225.1	237.7	250.6
Current account deficit	43.6	32.2	26.3	32.6	35.4	38.3	40.3	42.8
Amortization of government eurobonds	3.1	2.8	2.8	3.9	4.3	4.4	3.1	3.1
Medium- and long-term debt amortization	34.7	33.2	53.4	46.1	49.4	53.0	56.8	60.6
Government 1/	3.1	2.8	2.5	2.5	2.5	2.5	2.5	2.4
Banks	9.2	11.6	28.5	19.2	20.7	22.3	24.2	26.0
Other sectors	22.5	18.8	22.4	24.4	26.2	28.2	30.2	32.1
Short-term debt amortization	130.4	131.7	117.4	114.8	121.7	129.5	137.5	144.1
Government 1/	0.8	0.3	0.2	0.5	1.0	1.5	1.9	2.4
Banks	92.3	94.8	79.2	80.6	82.8	85.5	88.3	89.8
Other sectors	37.3	36.6	38.0	33.7	37.9	42.5	47.3	51.9
Available financing	211.8	199.9	199.9	197.5	210.9	225.1	237.7	250.6
Sale of assets 2/	-2.4	-20.9	-4.7	-8.2	-9.2	-9.6	-10.1	-9.6
Foreign direct investment (net)	-5.5	-11.5	-10.7	-11.7	-12.9	-14.2	-15.7	-17.8
Portfolio flows	20.9	-7.5	4.1	10.5	11.4	11.1	13.4	15.0
Government eurobonds	7.3	3.0	3.1	4.0	4.9	4.3	4.5	4.5
Domestically-issued government bonds(net)	0.4	-7.7	0.4	0.5	0.5	0.5	0.5	0.5
Banks' bonds (net)	10.4	-0.7	1.0	7.4	7.6	7.7	8.4	9.7
Other sectors' equity and bonds (net)	4.9	1.5	1.7	1.7	1.9	2.1	2.3	2.5
Medium and long-term debt financing	45.8	68.3	74.4	60.1	64.2	69.8	73.7	76.2
Government 1/	0.3	0.8	2.1	2.1	2.1	2.1	2.0	2.0
Banks	17.3	37.8	40.6	25.8	27.5	30.4	32.5	33.8
Other sectors	28.3	29.7	31.7	32.2	34.6	37.3	39.1	40.4
Short-term debt financing 3/	150.0	149.3	136.4	146.4	156.9	167.6	176.1	186.4
Government 1/	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Banks	94.8	79.2	80.6	82.8	85.5	88.3	89.8	90.7
Other sectors	55.7	70.2	55.8	63.6	71.4	79.3	86.3	95.7
Official transfers	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other 4/	2.0	9.9	0.0	0.0	0.0	0.0	0.0	0.0
GIR change (- denotes increase)	0.5	11.8	0.0	0.0	0.0	0.0	0.0	0.0
of which IMF (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	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)	1.5	-1.4	0.3	0.1	0.6	0.0	1.4	1.4
Government's loan rollover rate (in percent)	-3	22	77	68	59	52	46	41
Banks' loan rollover rate (in percent)	110	110	113	109	109	110	109	107
Other sectors' loan rollover rate (in percent)	140	180	145	165	165	165	162	162
Gross external financing requirements (percent of GDP)	26.5	27.2	26.7	25.0	25.3	25.6	25.6	25.6
International Investment Position (percent of GDP)	-55.2	-51.1	-53.5	-54.9	-56.3	-57.6	-58.8	-60.1

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

1/ Incl. general government and the Central Bank of the Republic of Turkey; excludes eurobonds and IMF purchases and repurchases.
2/ Incl. sale of portfolio assets by the govt., banks, and other private sectors; and sale of assets classified under Other Investments.
3/ Includes currency and deposits of non-residents.
4/ Includes errors and omissions and other liabilities.

Table 5. Turkey: Public Sector Finances, 2014–21

(Percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021
		Proj.						
Nonfinancial public sector primary balance	0.9	1.2	0.6	1.3	1.2	1.3	1.4	1.4
Central government	0.7	0.7	0.1	0.7	0.7	0.8	0.9	0.9
Primary revenue	23.3	23.1	22.7	22.6	22.5	22.5	22.5	22.5
Tax revenue	20.2	20.4	20.1	20.0	19.9	20.0	19.9	20.0
Personal income taxes	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Corporate income taxes	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6
VAT	5.9	6.0	5.9	5.8	5.8	5.8	5.8	5.8
SCT	5.2	5.3	5.3	5.3	5.3	5.3	5.2	5.2
Other	3.0	3.1	3.0	3.0	3.0	3.0	3.0	3.0
Nontax revenue 1/	3.2	2.7	2.7	2.6	2.6	2.6	2.5	2.6
Primary expenditure	22.6	22.4	22.6	21.9	21.8	21.7	21.6	21.6
Personnel	7.4	7.3	7.5	7.4	7.3	7.2	7.1	7.0
Goods and services, *of which*:	2.3	2.3	2.2	2.1	2.1	2.1	2.1	2.1
Transfers, *of which*:	10.2	10.0	10.6	9.9	9.8	9.8	9.8	9.9
Social security institutions	4.4	4.0	4.7	4.2	4.3	4.3	4.4	4.4
Agricultural subsidies	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Transfers of revenue shares	2.7	2.8	2.9	2.9	2.9	2.9	2.9	2.9
Capital transfers	0.4	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditure	2.8	2.8	2.4	2.6	2.6	2.6	2.6	2.6
Rest of the public sector	0.2	0.5	0.5	0.6	0.4	0.5	0.5	0.5
Extrabudgetary funds	-0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Revolving funds 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Local governments 2/	0.1	0.2	-0.1	0.0	0.1	0.2	0.2	0.2
State owned enterprises	0.0	0.0	0.3	0.3	0.2	0.1	0.1	0.1
Nonfinancial public sector overall balance 3/	-1.4	-1.0	-1.5	-0.9	-1.0	-0.8	-0.8	-0.8
Interest expenditure (net)	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Memorandum items:								
General government structural primary balance 4/	0.7	0.9	0.2	0.8	0.9	1.2	1.2	1.2
General government cyclical adjusted balance	-0.4	-0.9	-1.8	-1.3	-1.2	-1.1	-1.1	-1.3
General government gross debt	33.5	32.6	30.5	29.0	27.9	26.7	25.8	25.0
Nominal GDP (billions of Turkish lira)	1,747	1,999	2,313	2,599	2,883	3,181	3,499	3,843

Sources: Turkish authorities; and IMF staff estimates.

1/ Excluding privatization proceeds, transfers from

2/ Excluded from consolidated government sector.

3/ IMF deficit definition excludes profit transfers of the CBRT, proceeds from the sale of assets of the central government, and

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

Table 6. Turkey: Banking System at a Glance, 2010–15
(Percent)

	2010	2011	2012	2013	2014	2015
Balance Sheet			Percent of GDP			
Total Assets	91.6	93.8	96.7	110.5	114.1	118.1
o/w Gross Loans	47.9	52.6	56.1	66.8	71.0	74.4
Liabilities	79.4	82.7	83.9	98.2	100.9	105.0
o/w Deposits	56.2	53.6	54.5	60.3	60.2	62.4
Shareholders' Equity	12.2	11.1	12.8	12.4	13.3	13.1
Off-Balance Sheet						
o/w Commitments	79.6	109.7	121.4	103.8	97.9	104.0
o/w Contingencies	14.9	16.8	17.0	21.3	22.0	23.0
Asset Quality			Percent			
NPLs / Gross Loans	3.7	2.7	2.9	2.8	2.9	3.1
Provisions / Gross NPLs	83.8	79.4	75.2	76.3	73.9	74.6
Credit Growth (YoY) 6/	33.9	29.9	16.4	31.8	18.5	19.7
Profitability						
Total Int. Income / Int. Bearing Assets (av) 1/ 2/ 7/	9.2	8.2	9.1	7.6	7.9	7.8
Cost / Income (Efficiency) 8/	67.8	74.4	72.6	71.2	74.5	76.3
ROAA 1/ 7/ 9/	2.5	1.7	1.8	1.6	1.3	1.2
ROAE 1/ 7/ 9/	20.1	15.5	15.7	14.2	12.3	11.3
Funding and Liquidity						
Loan-to-Deposit ratio	85.2	98.2	102.9	110.7	117.9	119.2
Loan-to-Deposit ratio (TL)	88.5	105.4	113.1	126.7	133.2	141.6
Loan-to-Deposit ratio (FX)	77.4	84.1	82.0	83.8	91.9	89.0
Non-Core / Core Liabilities 3/	33.9	44.9	43.7	52.0	55.2	56.4
Non-Core / Core Liabilities (TL) 3/	23.3	28.5	26.4	29.0	29.7	31.8
Non-Core / Core Liabilities (FX) 3/	66.8	87.2	90.8	103.4	112.9	101.4
Leverage Ratio 1/ 4/	6.2	5.3	5.0	5.2	5.7	5.3
Liquid Assets / Assets	28.2	26.2	26.0	24.3	23.3	21.6
Assets / Liabilities (3 months, int. sensitive)	72.5	71.7	81.9	79.5	75.4	74.1
Capital Adequacy						
CAR	19.0	16.6	17.9	15.3	16.3	15.6
CT1R	17.0	14.9	15.1	13.0	13.9	13.2
RWA / Assets	72.0	78.4	80.2	84.3	83.4	83.5
FX Risk						
FX Assets / FX Liabilities (on-balance sheet) 5/	92.9	92.2	94.0	91.0	90.4	91.2
NOP / Regulatory Capital	0.1	0.4	2.0	-0.6	-2.2	1.3
NOP before hedging / Regulatory Capital	-15.6	-21.2	-14.0	-28.9	-28.5	-30.0
Miscellaneous						
Nominal GDP (TL billion) 0/	1098.8	1297.7	1416.8	1567.3	1747.4	1996.3
Deposit Interest Rate (Percent)	7.9	10.6	7.6	8.0	9.5	11.0
Loan Interest Rate (Percent)	10.6	17.1	11.9	12.6	13.1	16.4
TL/US$, EOP	1.5	1.9	1.8	2.1	2.3	2.9

Sources: IMF staff calculation based on Table 7 if not noted otherwise.
0/ WEO and estimated for current year. 1/ Current year data are annualized using 12 months rolling sums. 2/ Net of NPL provisions. 3/ Core liabilities include deposits and shareholders' equity. 4/ Proxied by T1 Capital over last 2 months average balance sheet assets and average off-balance sheets exposures (> 3 percent). 5/ Including FX-indexed assets and liabilities. 6/ Non-FX adjusted. 7/ As provided by BRSA. 8/ Other non-interest income added to expenses when <0. 9/ Net income as a share of average assets or equity.

Table 7. Turkey: Banking System Detailed Data, 2010–15
(Billions of Turkish Lira)

		2010	2011	2012	2013	2014	2015
Balance Sheet							
Total Assets		1,006.7	1,217.7	1,370.7	1,732.4	1,994.3	2,357.5
o/w Total Assets (FX)		257.8	369.0	415.9	590.6	693.1	903.9
o/w Assets (FX-indexed)		27.2	37.1	39.6	60.8	63.9	71.3
o/w Gross Loans		525.9	682.9	794.8	1,047.4	1,240.7	1,484.9
o/w Gross Loans (FX)		142.1	198.1	206.4	294.7	359.7	471.5
o/w Liquid Assets		284.2	318.9	356.0	421.1	465.1	509.3
Liabilities		872.1	1,073.0	1,188.7	1,538.7	1,762.3	2,095.2
o/w Libilities (FX)		306.7	440.7	484.3	716.1	837.1	1,069.8
o/w Liabilities (FX-indexed)		0.0	0.0	0.0	0.0	0.0	0.0
o/w Deposits		617.0	695.5	772.2	945.8	1,052.7	1,245.4
o/w Deposits (FX)		183.5	235.5	251.8	351.7	391.4	530.0
Shareholders' Equity		134.5	144.6	181.9	193.7	232.0	262.2
o/w Sahreholders' Equity (FX)		1.0	-0.2	4.3	0.7	3.6	2.2
Income Statement Annualized 1/							
(a)	Interest Income	77.4	88.2	109.9	110.6	138.7	164.2
(b)	Interest Expenses	38.7	48.8	57.6	53.3	73.1	86.8
(c = a - b)	Net Interest Income	38.7	39.3	52.3	57.3	65.6	77.3
(d)	NPL Provisions	5.4	4.1	7.9	10.5	13.5	15.8
(e = c - d)	Net Interest Income (after NPL provisions)	33.3	35.2	44.4	46.8	52.1	61.5
(f)	Non-Interest Income	23.9	26.6	27.0	33.5	37.6	42.1
(g)	Non-Interest Expenses	30.2	36.2	42.8	50.0	55.6	64.3
(h)	Other non-interest income	0.3	-0.3	1.6	0.8	-2.6	-6.3
(I = f - g + h)	Net Non-Interest Income	-6.0	-10.0	-14.3	-15.7	-20.6	-28.4
(j = e + i)	Gross Profits	27.3	25.2	30.1	31.1	31.5	33.1
(k)	Net Income	22.1	19.8	23.5	24.7	24.6	26.1
Off-Balance Sheet							
Total Off Balance Sheet Transactions		1,038.3	1,642.5	1,961.3	1,960.6	2,094.6	2,534.7
o/w Commitments		874.7	1,424.0	1,720.3	1,626.7	1,710.9	2,076.2
o/w Contingencies		163.6	218.5	241.0	334.0	383.7	458.5
Capital							
Regulatory Capital		137.6	157.9	196.3	223.3	270.8	306.3
T1 Capital		123.6	142.6	165.8	189.6	231.2	259.3
Risk Weighted assets		725.1	954.2	1,099.3	1,461.2	1,662.7	1,967.9
FX Risk							
NOP		0.1	0.6	3.9	-1.2	-6.0	3.9
NOP before hedging		-21.5	-33.5	-27.6	-64.4	-77.0	-91.9
Memo							
Nominal GDP (TL billion) 0/		1,098.8	1,297.7	1,416.8	1,567.3	1,747.4	1,999.3
Deposit Interest Rate (Percent)		7.9	10.6	7.6	8.0	9.5	11.0
Loan Interest Rate (Percent)		10.6	17.1	11.9	12.6	13.1	16.4
TL/US$, EOP		1.5	1.9	1.8	2.1	2.3	2.9

Sources: Banking Regulation and Supervison Agency as available in Haver if not otherwise noted.
0/ WEO and estimated for current year. 1/ Current year data are annualized using 12 months rolling sums.

Annex I. Risk Assessment Matrix

Source of Risks	Likelihood	Impact	Policy Response
Tighter or more volatile global financial conditions: • **Sharp asset price decline and decompression of credit spreads** sharply deteriorating Turkey's external financing outlook, as investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, the Fed policy rate path, and increases in U.S. term premia, with poor market liquidity amplifying volatility • **Surge in the US dollar exchange rate:** a further dollar surge creates balance sheet strain for Turkey, where many corporates are dollar debtors, but dollar exports are limited.	Medium High	High Medium	• Tighten monetary policy to bring it in line with the inflation target. • To the extent the NIR level allows, use FX reserves to smooth volatility in disorderly market conditions. • In case a recession ensues, consider loosening the fiscal stance. Publish a fiscal risk statement to guide policies.
Structurally weak growth in Europe: • Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances in the Euro area, hurting demand for Turkish exports.	High	Medium	• Medium term: Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports.
Loose domestic policies leading to: • High inflation and a deteriorating fiscal position, eroding confidence and leading to re-dollarization. This could occur if the government tries to spur growth through demand management, rather than long-term structural reform.	Medium	High	• Short-run: Tighten monetary policy and normalize the framework. Tightening above and beyond what was originally called for might be necessary. • Medium term: Tighten fiscal policy to bring it back into line with the medium-term program. Prioritize expenditure compression.
Geopolitical uncertainties: • **Russia**: the conflict between Turkey and Russia escalates, leading to further trade sanctions, possibly including energy supplies. • **Heightened risk of fragmentation/state failure/security dislocation in the Middle East,** leading to migrant flows, with negative global spillovers.	Medium High	Medium Medium	• Preemptively increase FX reserves through sterilized intervention. • Medium term: Improve competitiveness through structural reform. • Reduce energy dependence by developing additional domestic generation capacity. • Clarify the CFT framework.

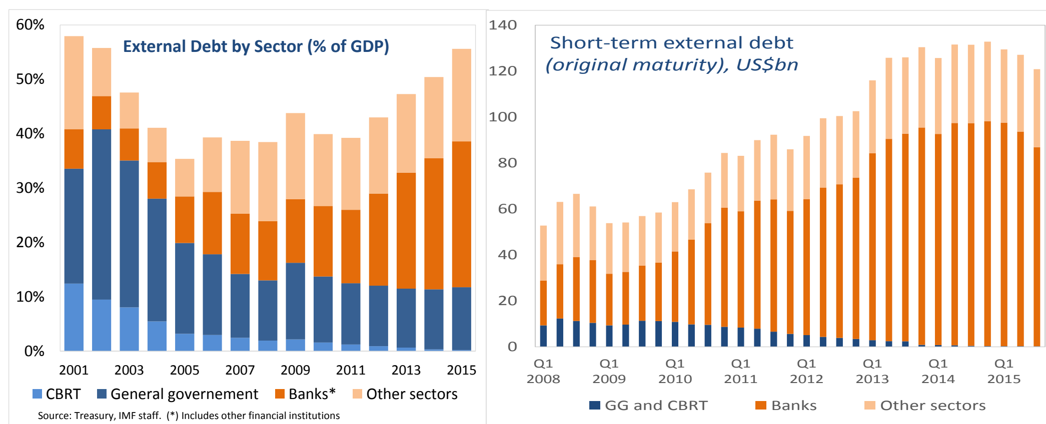
[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex II. External Debt Sustainability

Turkey's external debt continued to increase and is estimated to exceed 50 percent of GDP in 2015.[1] *The debt path is sustainable and robust to most stress tests. Under the baseline debt is forecast to increase slightly over the medium term. However, it is susceptible to a large Lira depreciation. In addition, annual external financing needs in excess of 25 of GDP expose the economy to high liquidity and rollover risks.*

Background and assumptions

1. **Turkey has relied on debt-creating flows, mainly short term, to finance its large and persistent current account deficit.** As a result, Turkey's external debt exceeded 50 percent of GDP in 2014. Private creditors, including bondholders, hold close to 90 percent of debt. Most of external debt resides with banks that intermediate capital inflows into domestic loans, mostly in Lira but also in FX. About one third of the total external debt stock, or about 16 percent of GDP, was short term in 2015.[2]



2. **Under the baseline, the current account deficit would continue to add to the debt stock over the medium term, while the structure of external financing would slightly improve.** Staff forecast the current account deficit to increase to about 4.5 percent of GDP over the medium term. This in part reflects slow recovery of the oil price and a gradual increase in global interest rates leading to a deterioration of the investment income balance. Amid a low global interest rate environment, the effective interest rate paid by Turkey on its external debt fell to 1.5 percent in 2014–15, this rate is projected to increase to 4.3 percent over the medium term. Debt-creating flows would remain the main source of financing, despite some increase in the share of foreign direct investments. Assuming that the recent trend in lengthening of new debt maturities would continue,

[1] The debt sustainability analysis is based on the definition of external debt used by Undersecretary of Treasury, covering liabilities arising from loans obtained from the residents abroad and liabilities arising out of bonds issued in international capital markets. Government securities issued in Turkish lira are excluded.

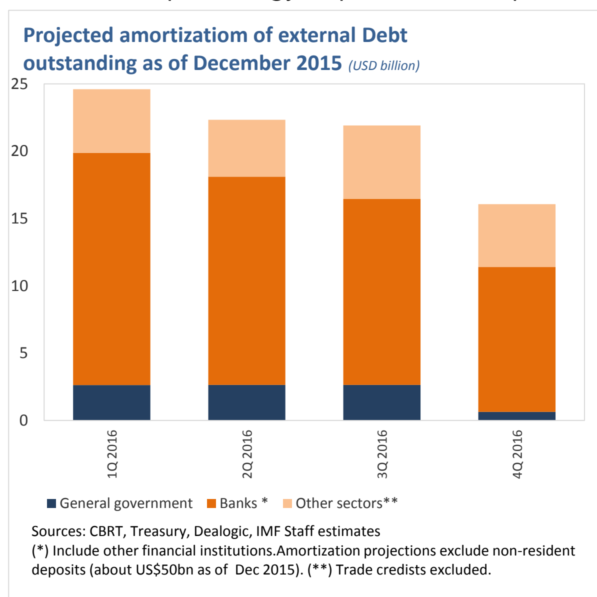
[2] This includes 'nonresidents' deposits in Turkish banks and trade credits with the original maturity of less than 12 month.

the share of short-term external debt (by original maturity) in the total debt stock would decline slightly over the medium term and would stay at about 30 percent of the total debt stock.

Assessment

3. **High level of Turkey's external debt, while sustainable, is vulnerable to valuation shocks. The** debt path stabilizes at just above 56 percent of GDP by 2020 under the baseline scenario. A steeper recovery of fuel prices, leading to current account of about 5 percent would push the debt ratio above 60 percent over the medium term. The debt path remains robust to standardized growth and current account shocks. However, more than 90 percent of Turkish external debt is denominated in foreign currency. Hence, the debt path is susceptible to exchange rate movements. A permanent Lira depreciation by 30 percent would push the external debt stock to 83 percent of GDP by 2020.[3] This analysis however does not take into account the potential contraction of the current account deficit associated with such a sharp currency movements.

4. **External financing requirements in excess of 25 percent of GDP and a large share of debt with adjustable rates make the economy vulnerable to shifts in global liquidity and international investor's appetite**. In 2016 Turkey is expected to repay over US$170 billion of debt to external investors. Combined with the interest rate bill and trade deficits this adds up to total gross financing needs of over 26 percent of GDP. A relatively smooth quarterly debt repayment profile over the next 12 months is a mitigating factor, and cheaper energy imports will compensate for increased debt service. However, about three quarters of total external debt, including debt with short maturities, is indexed to global interest rates. Normalization of monetary by advanced economics or rising spreads for emerging markets could quickly translate into higher borrowing costs. According to DSA simulation results, an increase in interest rates by 1 s.d. compared to the baseline would increase the debt level by additional 2 percentage points to 58 percent of GDP.[4] Moreover, a sudden stop in capital flows may trigger a simultaneous rise in both borrowing costs and exchange rate pressure.



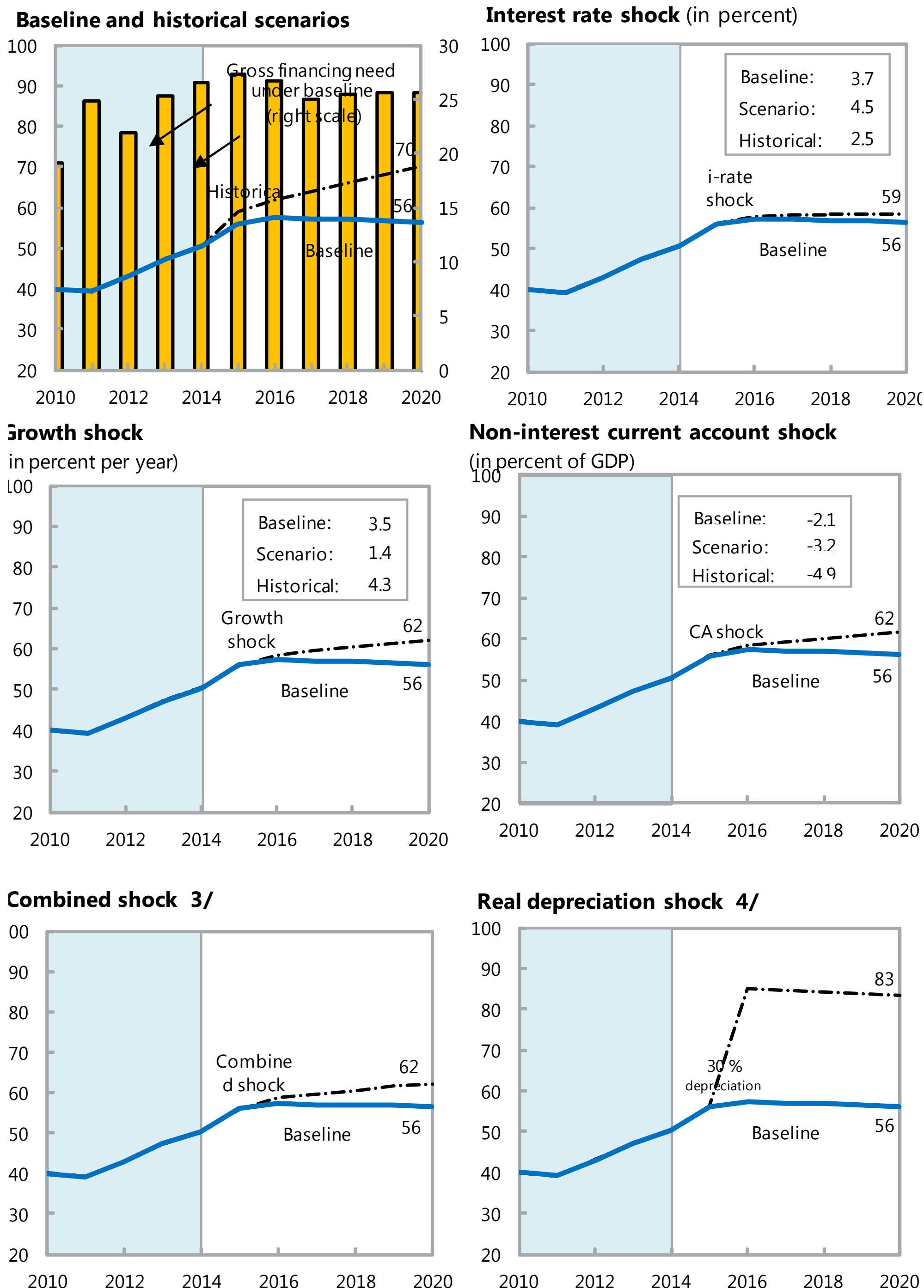
Sources: CBRT, Treasury, Dealogic, IMF Staff estimates
(*) Include other financial institutions.Amortization projections exclude non-resident deposits (about US$50bn as of Dec 2015). (**) Trade credists excluded.

[3] The baseline projections already take into account a combined negative valuation effect coming from lira and euro depreciation vis-à–vis dollar in 2015. For the projections, the valuation effect is assumed to be zero.

[4] The stress test was modified to account for potential increase in Turkey's risk premium.

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

(External 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. Shock to interets rate was increased to 1 standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance. 4/ One-time real depreciation of 30 percent occurs in 2015.

Table 1. Turkey: External Debt Sustainability Framework, 2010–20
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014			2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
Baseline: External debt	39.9	39.2	43.0	47.3	50.4			**56.0**	**57.3**	**57.1**	**56.9**	**56.7**	**56.3**	**-2.8**
Change in external debt	-3.9	-0.7	3.8	4.3	3.1			5.5	1.4	-0.2	-0.2	-0.2	-0.4	
Identified external debt-creating flows (4+8+9)	-2.3	5.4	3.2	4.6	5.5			0.8	-0.2	0.6	0.6	0.7	0.6	
Current account deficit, excluding interest payments	5.3	8.9	5.3	7.0	4.7			3.7	2.1	2.3	2.1	2.1	2.0	
Deficit in balance of goods and services	5.4	8.9	5.4	6.8	4.6			3.3	2.2	2.5	2.6	2.8	3.0	
Exports	21.5	23.7	26.0	25.5	27.6			27.0	25.3	25.4	25.5	25.5	25.2	
Imports	-26.9	-32.5	-31.4	-32.3	-32.2			-30.3	-27.5	-27.9	-28.2	-28.3	-28.1	
Net non-debt creating capital inflows (negative)	-1.5	-1.7	-2.0	-1.2	-1.0			-1.5	-1.6	-1.7	-1.8	-1.8	-1.9	
Automatic debt dynamics 1/	-6.2	-1.8	-0.1	-1.3	1.7			-1.4	-0.7	-0.1	0.2	0.4	0.4	
Contribution from nominal interest rate	0.8	0.7	0.7	0.7	0.7			0.7	1.4	1.8	2.1	2.3	2.3	
Contribution from real GDP growth	-3.4	-3.3	-0.8	-1.7	-1.4			-2.1	-2.1	-1.9	-1.9	-1.9	-1.9	
Contribution from price and exchange rate changes 2/	-3.6	0.8	-0.1	-0.2	2.4			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-1.5	-6.1	0.5	-0.3	-2.3			4.8	1.6	-0.8	-0.8	-0.9	-1.0	
External debt-to-exports ratio (in percent)	185.8	165.9	165.2	185.7	182.5			207.0	226.8	224.9	223.0	222.5	223.7	
Gross external financing need (in billions of US dollars) 4/	139.8	192.7	172.2	208.6	211.8			199.9	199.9	197.5	210.9	225.1	237.7	
in percent of GDP	19.1	24.9	21.8	25.3	26.5	10-Year	10-Year	27.2	26.7	25.0	25.3	25.6	25.6	
Scenario with key variables at their historical averages 5/								**59.1**	**61.8**	**64.0**	**66.2**	**68.2**	**70.1**	**-3.4**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	9.2	8.8	2.1	4.2	2.9	4.3	4.4	3.8	3.8	3.4	3.5	3.5	3.5	
Exchange rate appreciation (US dollar value of local currency, chang	3.2	-10.3	-6.8	-5.7	-13.0	-3.9	8.5	-19.6	-11.8	-6.3	-4.9	-4.3	-3.9	
GDP deflator (change in domestic currency)	5.7	8.6	6.9	6.2	8.3	7.6	2.0	10.2	11.5	8.6	7.2	6.6	6.3	
GDP deflator in US dollars (change in percent)	9.1	-2.6	-0.3	0.2	-5.7	3.4	9.2	-11.4	-1.7	1.8	1.9	2.1	2.2	
Nominal external interest rate (in percent)	2.0	1.8	1.9	1.7	1.5	2.5	0.9	1.3	2.5	3.3	3.9	4.2	4.3	
Growth of exports (US dollar terms, in percent)	8.1	16.6	12.0	2.1	5.3	9.8	11.8	-10.1	-4.6	5.8	6.0	5.5	4.4	
Growth of imports (US dollar terms, in percent)	30.0	28.1	-1.7	7.2	-3.1	11.3	18.0	-13.7	-7.4	7.1	6.3	6.1	5.1	
Current account balance, excluding interest payments	-5.3	-8.9	-5.3	-7.0	-4.7	-4.9	2.2	-3.7	-2.1	-2.3	-2.1	-2.1	-2.0	
Net non-debt creating capital inflows	1.5	1.7	2.0	1.2	1.0	-0.2	1.9	1.5	1.6	1.7	1.8	1.8	1.9	

Sources: Staff calculations.

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

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

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

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

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

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

Annex III. Public Debt Sustainability

At about 32 percent of GDP (measured as general government gross debt according to Maastricht criteria), Turkey's public debt ratio is well below its historical ten-year average. Gross public sector financing needs have decline significantly and will remain low over the medium term. The DSA suggests that Turkey's government debt is sustainable even under different shock scenarios. Given the debt structure (average maturity of 6.4 years, 67percent of total debt at fixed interest rates, and only 35 percent of the debt in foreign exchange) the direct interest and exchange rate pass-through to the budget is relatively slow. Only the impact of lower GDP growth rates represents a significant threat to debt dynamic. While all public debt profile indicators are below early warning benchmarks, the high external financing requirements point to risks arising from the external debt position.

Baseline and Realism of Projections[1]

1. **Debt-levels.** Turkey's favorable debt dynamics are underpinned by a primary surplus and trend GDP growth above the real interest rate. Despite the impact of a weaker currency, debt to GDP ratio continues to gradually decline. Staff forecast that the ratio will continue its declining path from already moderate levels reaching 26 percent in 2020—down by 7.4 pp since end-2014. At 5.1 percent of GDP in 2015, gross public financing needs have decline from 15 percent on average for 2005–13—a significant accomplishment.

2. **Growth.** Past projections of growth outcomes show high forecast errors, possibly due to high volatility of GDP in Turkey, but don't seem to have a systematic bias that undermine the assessment of sustainability. The current growth projections are similar to the levels for 2014–15, which lessens their positive impact in reducing the level of debt. The output gap is roughly closed in 2015, and is projected to remain closed over the medium term. Turkey's debt is highly sensitive to big swings in GDP growth, highlighting the relevance of growth shocks in the stress tests.

3. **Sovereign yields.** Turkey's yields remain quite volatile, albeit they remain below the levels in the first quarter of 2014. The spreads against the US bonds in the last three months remained on average at 283 bps, higher than its lowest value of 118 bps observed in May 2013. The effective interest rate is forecast to decline from 9.1 percent in 2015 to 8.2 percent in 2016. However, in the medium term—despite lower inflation—the effective rates are expected to increase due to the push from international rates.

4. **Fiscal adjustment.** In the baseline the structural primary balance improves slightly, albeit the change in the headline number is smaller as it compensates some one-off social security revenues. The maximum projected 3-year adjustment of the cyclically-adjusted primary balance is slightly positive.

[1] The new DSA framework is described in (http://www.imf.org/external/np/pp/eng/2013/050913.pdf).

5. **Maturity and rollover**. Given current debt structure (average maturity of 6.4 years, 67 percent share of fixed interest debt to total debt, and only 35 percent denominated in foreign currency), the direct interest and exchange rate pass-through to the budget are small.

Shocks and Stress Tests

6. **Primary balance shock**. A deterioration of 1.0pp of GDP in the primary balance for 2 years slows down the downward trend of debt-to-GDP ratio relative to the baseline. Sovereign borrowing costs are pushed up (25 bps for each 1 percent of GDP worsening in the primary balance). The impact on the debt-to-GDP ratio and gross financing needs levels by 2021 is modest.

7. **Growth shock**. Real output growth rates are lowered by 1 standard deviation, or 4.2 percentage points, for 2 years starting in 2017. The decline in growth leads to lower inflation (0.25 percentage points per 1 percentage point decrease in GDP growth). The nominal primary balance deteriorates significantly compared to the baseline as nominal revenues fall against unchanged expenditure plans, reaching -2.6 percent of GDP by 2016. The deterioration in primary balance leads to higher sovereign borrowing costs. The debt-to-GDP ratio increases to about 37 percent during the growth shock and then gradually trends down. By the end of the period, gross public financing needs climb toward 8.5 percent of GDP.

8. **Interest rate shock**. The real effective rate reaches similar levels as in 2009, which implies a permanent increase in spreads by about 400bps. The government's interest bill climbs reaching an implicit average interest rate of 14.1 percent by 2021. The debt-to-GDP ratio remains at low levels below 30 percent, and while gross public financing needs increase, they remain below 8 percent of GDP by 2021.

9. **Contingent liability shock**. A one-time bail out of the financial sector is assumed to increase non-interest expenditures by 10 percent of banking sector assets.[2] This is combined with real GDP growth shock (1 standard deviation for 2 years). Sovereign borrowing costs are pushed up (25 bps for each 1 percent of GDP worsening in the primary balance) while inflation declines (0.25 percentage points per 1 percentage point decrease in GDP growth). Debt rises to 36 percent of GDP in 2018 and then gradually declines. Gross public financing needs increase to about 8 percent of GDP in the medium term.

10. **Combined shock**. A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). In the case of Turkey, a combined shock would increase debt to around 41 percent of GDP, still below the average debt level between 2004 and 2012.

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[2] This shock is equivalent to 4.8 percent of GDP. The shock could also be seen to cover (a combination of) other contingencies, part of which could be a bailout of PPP projects or loan guarantees. PPP projects with treasury investment guarantees amount to 0.9 percent of GDP, treasury guaranteed loans (outside the general government) amount to 1.4 percent of GDP, and loan subject to debt assumption amount to 1.1 percent of GDP.

Turkey: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

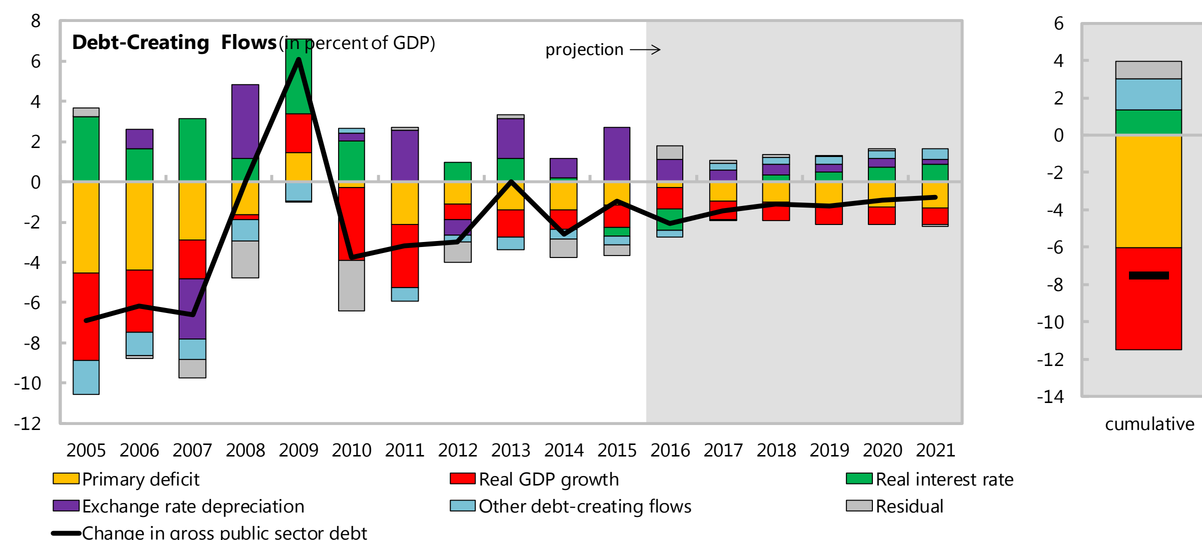
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	42.1	33.5	32.6	30.5	29.0	27.9	26.7	25.8	25.0
Public gross financing needs	15.1	8.3	5.1	5.1	3.9	4.8	5.1	5.0	5.5
Real GDP growth (in percent)	4.4	2.9	3.9	3.8	3.4	3.5	3.5	3.5	3.5
Inflation (GDP deflator, in percent)	7.5	8.3	10.2	11.5	8.6	7.2	6.6	6.3	6.1
Nominal GDP growth (in percent)	12.3	11.5	14.4	15.7	12.3	10.9	10.3	10.0	9.8
Effective interest rate (in percent) [4/]	12.4	9.2	9.1	8.2	8.7	8.7	8.7	9.5	10.1

As of February 05, 2015		
Sovereign Spreads		
Spread (bp) 3/		313
CDS (bp)		301
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BB+	BBB
Fitch	BBB-	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.6	-2.6	-1.0	-2.1	-1.4	-1.1	-1.2	-0.9	-0.8	-7.5	
Identified debt-creating flows	-2.0	-1.7	-0.4	-2.7	-1.0	-0.7	-0.8	-0.5	-0.5	-6.3	
Primary deficit	-1.9	-1.4	-1.2	-0.3	-0.9	-1.0	-1.2	-1.3	-1.3	-6.0	0.8
Primary (noninterest) revenue and gra	32.5	35.7	35.4	34.8	35.4	35.4	35.5	35.6	35.8	212.6	
Primary (noninterest) expenditure	30.6	34.3	34.2	34.5	34.5	34.4	34.3	34.4	34.5	206.6	
Automatic debt dynamics [5/]	0.7	0.2	1.1	-2.1	-1.0	-0.6	-0.4	-0.1	0.1	-4.1	
Interest rate/growth differential [6/]	0.1	-0.8	-1.6	-2.1	-1.0	-0.6	-0.4	-0.1	0.1	-4.1	
Of which: real GDP growth	-1.8	-0.9	-1.1	-1.1	-0.9	-0.9	-0.9	-0.8	-0.8	-5.5	
Exchange rate depreciation [7/]	0.6	1.0	2.7	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.8	-0.5	-0.4	-0.3	0.3	0.3	0.4	0.4	0.5	1.7	
Public Sector: Privatization Proceeds	-0.8	-0.6	-0.6	-0.4	-0.3	-0.2	-0.2	-0.1	0.0	-1.2	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Deposit build-up	0.0	0.1	0.2	0.1	0.6	0.6	0.5	0.5	0.5	2.8	
Residual, including asset changes [8/]	-0.6	-0.9	-0.6	0.7	0.2	0.1	0.0	0.1	-0.1	1.0	



Source: IMF staff.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

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

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

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

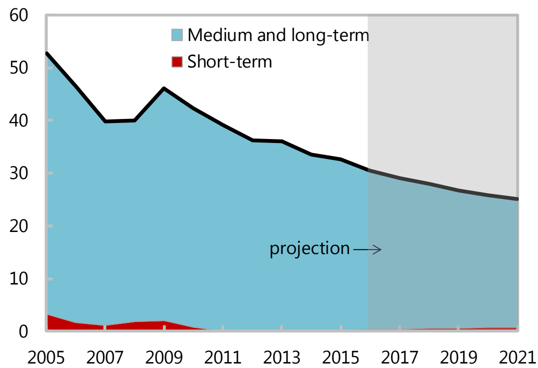
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

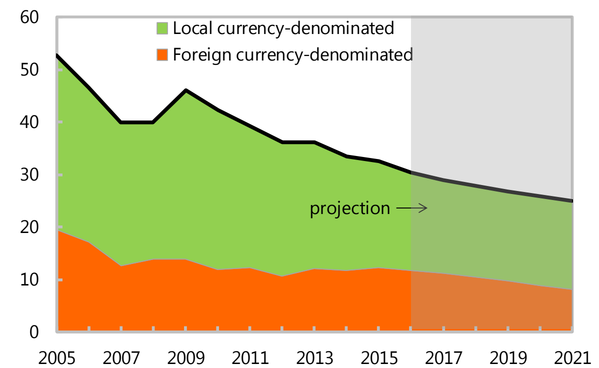
8/ For projections, this line includes exchange rate changes during the projection period.

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

Turkey: Public DSA - Composition of Public Debt and Alternative Scenarios

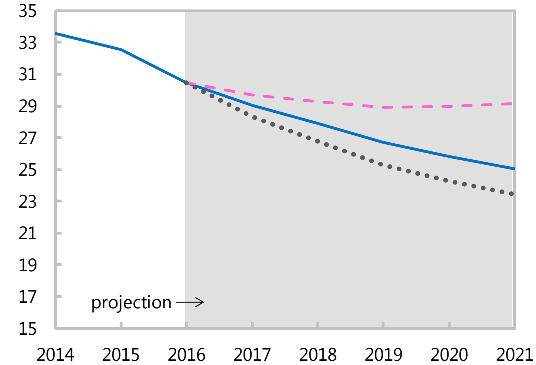
Composition of Public Debt

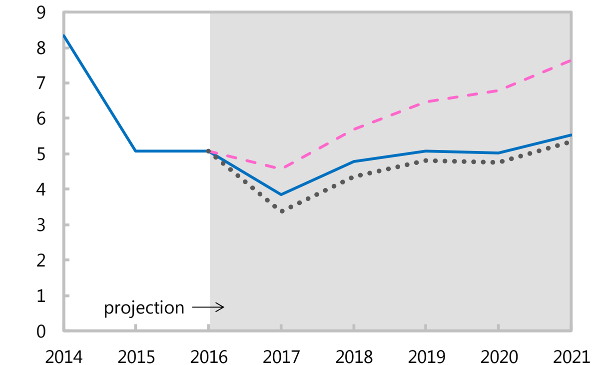




Alternative Scenarios

Baseline Historical Constant Primary Balance





Underlying Assumptions

(in percent)

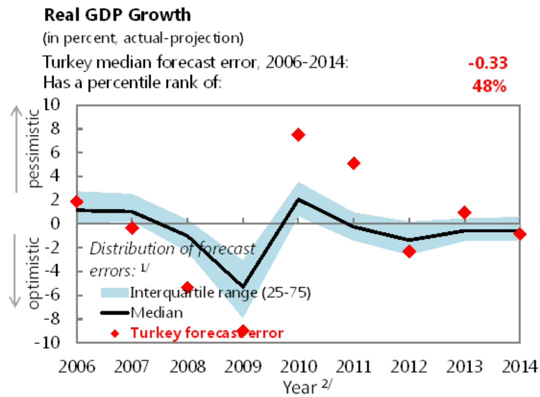
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	3.8	3.4	3.5	3.5	3.5	3.5
Inflation	11.5	8.6	7.2	6.6	6.3	6.1
Primary Balance	0.3	0.9	1.0	1.2	1.3	1.3
Effective interest rate	8.2	8.7	8.7	8.7	9.5	10.1
Constant Primary Balance Scenario						
Real GDP growth	3.8	3.4	3.5	3.5	3.5	3.5
Inflation	11.5	8.6	7.2	6.6	6.3	6.1
Primary Balance	0.3	0.3	0.3	0.3	0.3	0.3
Effective interest rate	8.2	8.7	8.7	8.6	9.4	9.9

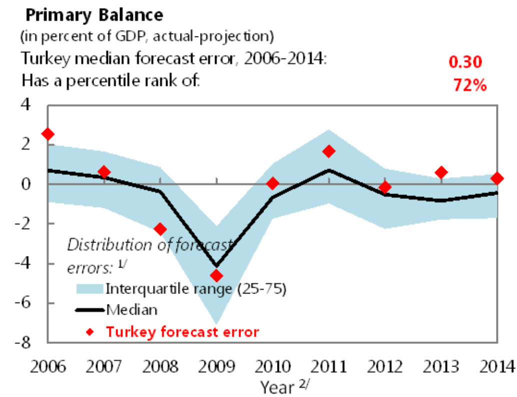
Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	3.8	3.8	3.8	3.8	3.8	3.8
Inflation	11.5	8.6	7.2	6.6	6.3	6.1
Primary Balance	0.3	1.5	1.5	1.5	1.5	1.5
Effective interest rate	8.2	8.7	9.0	9.2	10.4	11.2

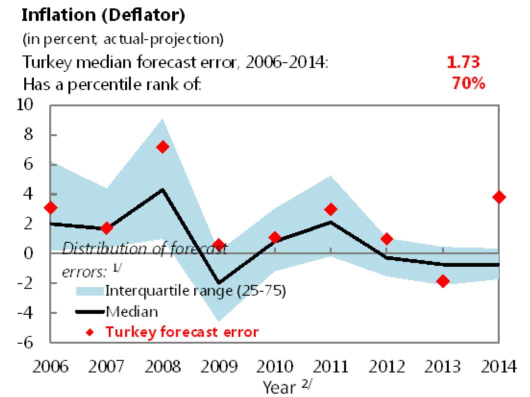
Source: IMF staff.

Turkey Public DSA – Realism of Baseline Assumptions

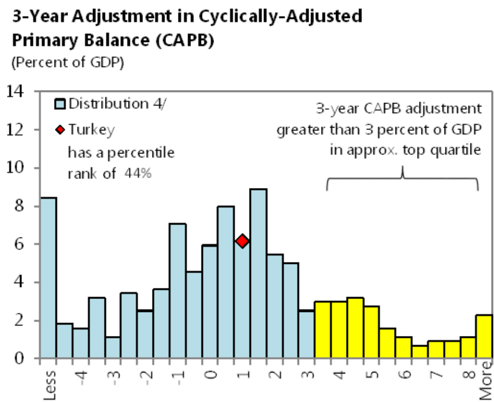
Forecast Track Record, versus all countries

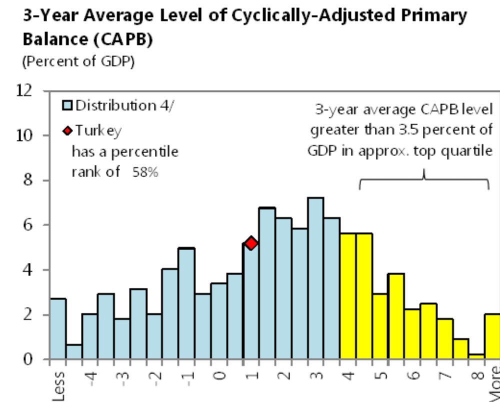




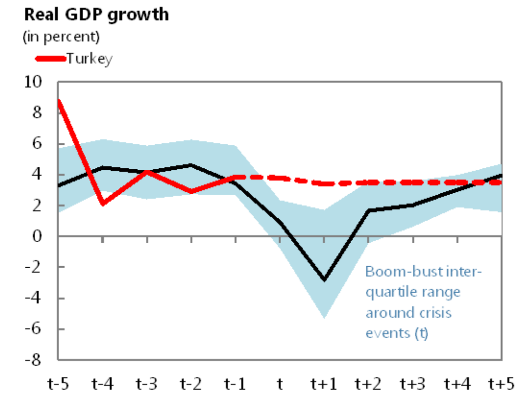


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

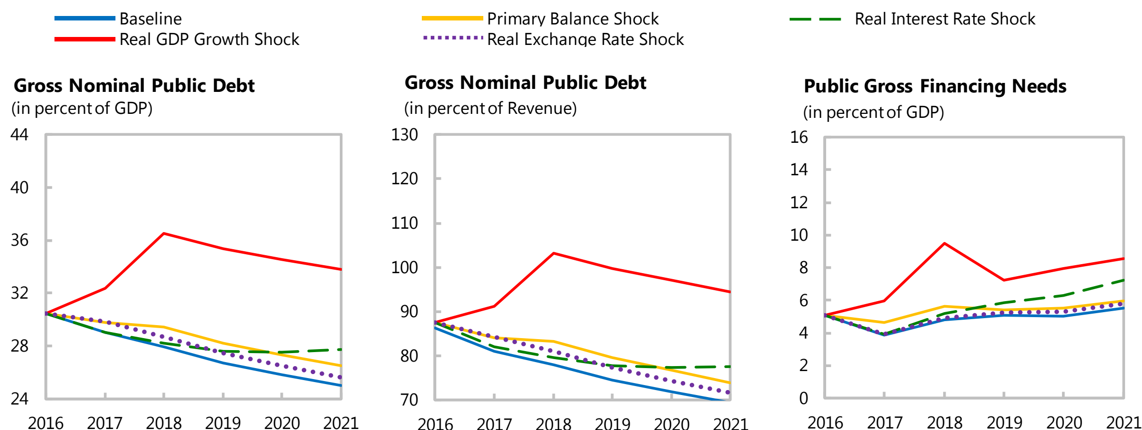
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Turkey has had a cumulative increase in private sector credit of 2 percent of GDP, 2012-2015. For Turkey, t corresponds to 2016; for the distribution, t corresponds to the first year of the crisis.

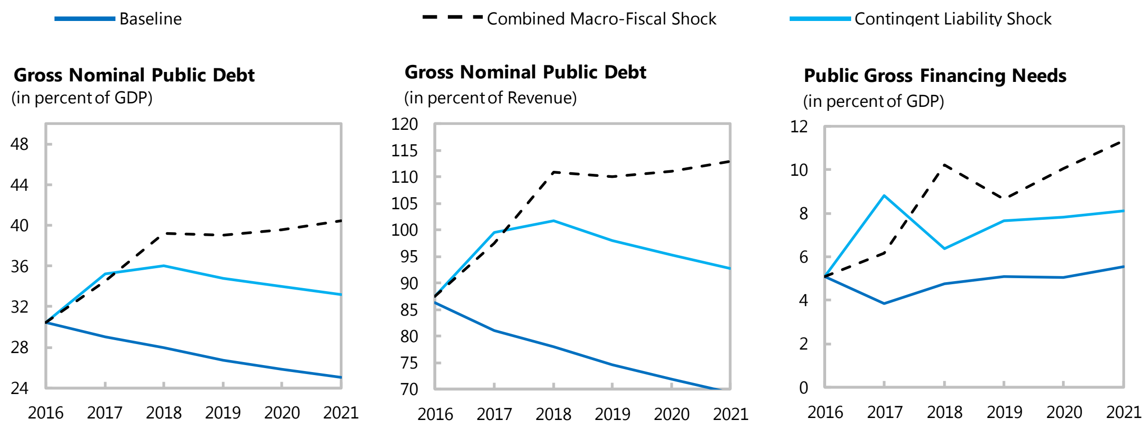
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Turkey: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	3.8	3.4	3.5	3.5	3.5	3.5
Inflation	11.5	8.6	7.2	6.6	6.3	6.1
Primary balance	0.3	0.2	0.2	1.2	1.3	1.3
Effective interest rate	8.2	8.7	8.8	8.6	9.4	9.9
Real Interest Rate Shock						
Real GDP growth	3.8	3.4	3.5	3.5	3.5	3.5
Inflation	11.5	8.6	7.2	6.6	6.3	6.1
Primary balance	0.3	0.9	1.0	1.2	1.3	1.3
Effective interest rate	8.2	8.7	9.8	10.9	12.9	14.1
Combined Shock						
Real GDP growth	3.8	-0.7	-0.6	3.5	3.5	3.5
Inflation	11.5	7.6	6.1	6.6	6.3	6.1
Primary balance	0.3	-0.8	-2.6	1.2	1.3	1.3
Effective interest rate	8.2	9.1	9.9	11.6	13.2	14.3

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	3.8	-0.7	-0.6	3.5	3.5	3.5
Inflation	11.5	7.6	6.1	6.6	6.3	6.1
Primary balance	0.3	-0.8	-2.6	1.2	1.3	1.3
Effective interest rate	8.2	8.7	8.9	9.0	9.6	9.9
Real Exchange Rate Shock						
Real GDP growth	3.8	3.4	3.5	3.5	3.5	3.5
Inflation	11.5	13.1	7.2	6.6	6.3	6.1
Primary balance	0.3	0.9	1.0	1.2	1.3	1.3
Effective interest rate	8.2	9.1	8.5	8.3	9.2	9.7
Contingent Liability Shock						
Real GDP growth	3.8	-0.7	-0.6	3.5	3.5	3.5
Inflation	11.5	7.6	6.1	6.6	6.3	6.1
Primary balance	0.3	-3.3	1.0	1.2	1.3	1.3
Effective interest rate	8.2	10.3	9.1	8.9	9.4	9.9

Source: IMF staff.

Turkey: Public DSA Risk Assessment

Heat Map

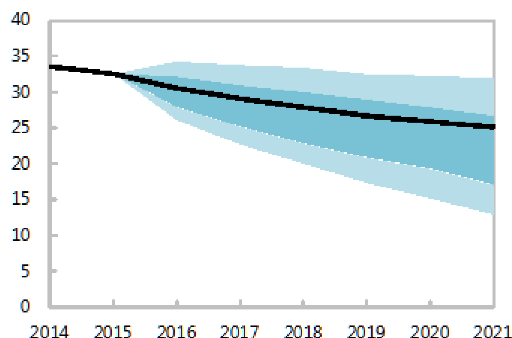
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception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

Evolution of Predictive Densities of Gross Nominal Public Debt

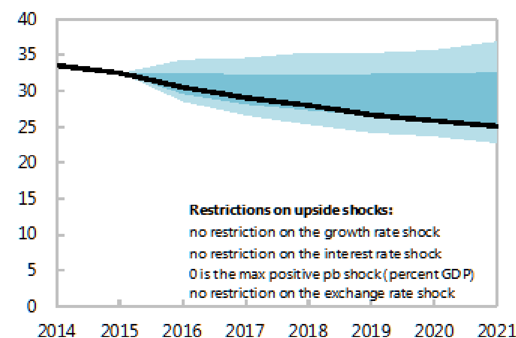
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution

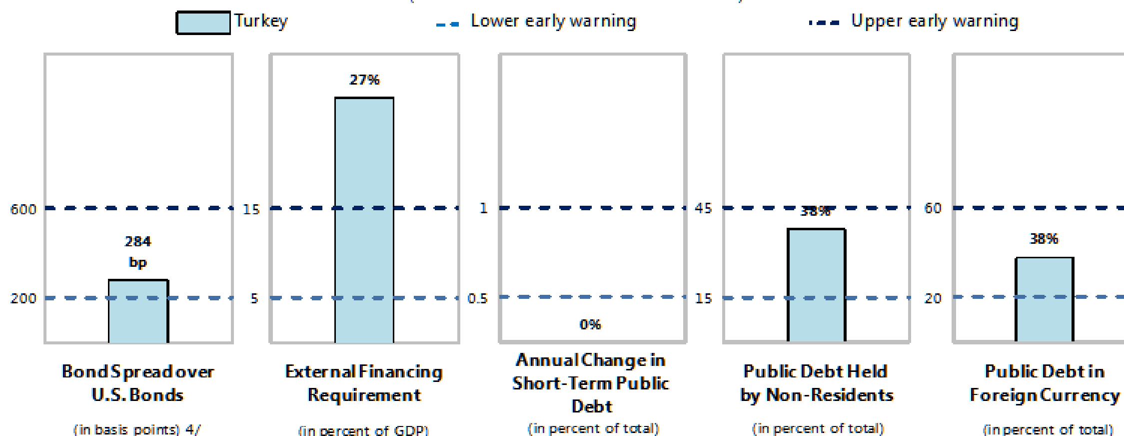


Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

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

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

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

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

4/ An average over the last 3 months, 07-Nov-14 through 05-Feb-15.

Annex IV. 2015 External Sector Assessment

<table>
<tr><th></th><th>Turkey</th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. Despite a modest improvement in 2015, at -51 percent of GDP Turkey's net international investment position (NIIP) remains somewhat weaker than those of peers. Foreign liabilities are in excess of 80 percent of GDP, with short-term debt and portfolio investments in debt securities accounting for about 30 percent of GDP and about half of long-term debt have floating interest rates.
Assessment. A significant share of foreign liabilities in Turkish lira has provided a buffer during currency depreciation. However, large favorable valuation effects cannot be sustained in the medium term. Moreover, the currency composition of foreign liabilities exposes Turkey to liquidity shocks and increases in global interest rates. Unless the current account (CA) deficit improves substantially in the years ahead, Turkey's NIIP would continue to deteriorate by some 10 percentage points of GDP in the medium term.</td><td rowspan="4">Overall Assessment:
In 2015, Turkey's external position was weaker than the level consistent with medium-term fundamentals and desirable policy settings.
The external position could strengthen in 2016 due to terms of trade gain from lower oil import prices.
However, net international reserves are still low, and the NIIP will continue to deteriorate until the CA deficit is reduced. Moreover, given large financing needs and a high share of short-term capital inflows, Turkey remains vulnerable to capital flow reversal.

Potential policy responses:
Reducing the CA deficit further is necessary to diminish vulnerabilities. Monetary policy should keep real interest rates solidly in positive territory. The CBRT should increase net international reserves, limiting foreign exchange intervention to smoothing periods of excessive volatility.
Structural reforms aimed at increasing private sector savings, including pension reform, are needed to enhance private savings and allow high growth with a sustainable current account deficit. These reforms should be supported by fiscal policy tightening over the medium term to</td></tr>
<tr><td>Current account</td><td>Background. The CAD is estimated to have narrowed to 4.4 percent of GDP in 2015 mainly due to lower fuel prices. The trade balance excluding gold and fuel also deteriorated. The CA deficit is expected to narrow further in 2016 as the effect of lower energy import costs is likely to outweigh weak performance of selected trading partners and strong domestic consumption. However, the CAD is forecast to widen to 4.5 percent of GDP in the medium term as the oil price recovers. The EBA model estimates that in 2015 the cyclically-adjusted CA was some 3.7 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies. According to the external sustainability (ES) approach, CA deficit was 1-2 percentage points above the level consistent with stabilizing NIIP at the current level.
Assessment. Staff assesses that the CA gap in 2015 was in the range of -1 to -3 percent of GDP. This is consistent with a CA norm in the range of -2 to -3.5 percent of GDP, reflecting large investment needs of a fuel importing emerging economy. While lower oil prices are expected to reduce the CA deficit and gap for 2016, tighter monetary and fiscal policies are still necessary to reduce the CA remaining gap.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The real effective exchange rate (REER) registered a 12 year minimum in 3Q 2015, the trend reversed in 4Q as the monetary stance remained too loose and inflation increased. On an annual average basis, however, it depreciated by only 2.5 percent from 2014. The EBA REER index approach estimates a 5.9 percent overvaluation in 2015; the REER level regression suggests a 19.5 percent overvaluation. Based on the ES approach, a 5-8 percent REER adjustment is required to stabilize NIIP. As of January 2016 the REER stood close to its 2015 average level.
Assessment. Consistent with the assessment of the CA gap, staff assesses that the REER was overvalued by about 5-10 percent in 2015. As of early 2016, the improved terms of trade, combined with a broadly unchanged REER, would suggest some reduction in the REER gap.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. Turkey experienced a major fall in net capital inflows in 2015. In 2015 net inflows (excluding US$9.6 billion in net errors and omissions and a US$11.8 billion fall in reserves) shrank to some 1.5 percent of GDP. On the other hand, targeted macro prudential measures forced banks to lengthen maturity of external financing. Turkey has not made use of capital controls on inflows or outflows.
Assessment. A large share of short-term debt exposes Turkey to significant rollover risks. Gross external financing needs are estimated at over 26 percent of GDP in 2016, making Turkey vulnerable to changes in global market conditions.</td></tr>
</table>

	Turkey	Overall Assessment
FX intervention and reserves level	**Background**. The exchange rate is floating. The central bank sells foreign exchange to commercial banks through regular auctions (since June 2013) and to energy importing SOEs via direct sales (since December 2014). The cumulative total amount of these sales was about US$23 billion in 2015 increasing from about US$12 billion in 2014. Turkey's gross reserves fell to 86 percent of the IMF composite adequacy metric at end-2015 (from 95 percent at end-2014). Adjusting the level of reserves for ROM-related reserve holdings in foreign currency reduced it to 82 percent of the composite adequacy metric in the end of 2015. Reserve cover of short-term debt declined to 64 percent at end-2015.[4] At US$29 billion at end 2015, net reserves available for intervention are significantly lower than gross reserves. **Assessment**. Given Turkey's low net international reserves, reserve accumulation is warranted.	increase public saving.
Technical Background Notes	1/ NIIP narrowed from -55 percent of GDP in 2014 to -51 percent in 2015, despite of a CA deficit in excess of 4 percent of GDP. Large net errors and omission (about 1.3 percent of GDP) could explain part of the discrepancy; The remaining improvement is to a large extent driven by favorable valuation effects, which reflect significant share of FDI and debt in Turkish lira in foreign liabilities. 2/ The windfall of lower energy prices are estimated at about 1.6 percent of GDP in 2015. Fuel trade balance was -5.8 percent of GDP on average in 2010-2014. 3/ The simulations under the ES approach included an assumption of a positive annual average capital gain of 0.5 percent of GDP. 4/ ROM (Reserve Option Mechanism) allows commercial banks to meet their reserve requirements on lira-denominated liabilities by using foreign exchange and gold.	

Annex V. Recent Macroprudential Measures

Measure	Description	Implementation Date
Loan-to-value (LTV) ceilings	Implements loan-to-value ceilings on housing loans to consumer (at 75 percent) and on purchases of commercial real estate (at 50 percent).	December 2010
Implicit Nominal Credit Growth Target	The authorities provided guidance to banks that credit growth (adjusted for FX movements) in 2011 should not exceed 25 percent	Spring 2011
High risk weights for consumer loans	Higher risk weights introduced for fast growing consumer loans. For new general purpose loans with maturities below two years, the risk-weighting increased to 150 percent (from 100 percent). For new general purpose loans with maturity greater than two years, the risk-weight increased to 200 percent (from 100 percent).	June 2011
Increased provisions for consumer loans	For new (performing) general purpose loans, general provisions were increased from 1 percent to 4 percent. General provisions for (pre-nonperforming) loans increased from 2 percent to 8 percent. The higher provisioning requirements are conditional on banks having a consumer loan portfolio exceeding 20 percent of total loans or having a general purpose loan NPL greater than 8 percent.	June 2011
Limits to credit card payments	If three or more monthly payments within a calendar year are less than half of the outstanding balance for the period, the individual credit card limits cannot be increased and cash advances for such credit cards cannot be permitted, unless the outstanding balance for the period is fully covered.	June 2011
Interest Rate Risk	Announced by the Banking Regulation and Supervision Agency (BRSA) to contain interest rate risk through capital charges on large maturity mismatches, discouraging duration gaps. Effective from 2012.	August 2011

Changes to minimum Capital Adequacy Requirements	Amended by the BRSA in September 2011 to apply to banks with foreign strategic shareholders as of January 2012. The minimum ratio would depend on various factors such as the CDS spread of the parent and its sovereign, EBA stress test results and the public debt ratio in the country of origin.	September 2011 Abolished February 2013
Changes to deposit insurance premiums	The deposit insurance fund introduced a premium surcharge for large banks and a new factor to calculate the banks' score for the deposit premium determination.	September 2011
Abolition of loan to value ratios for commercial real estate loans	Loan to value ratios for loans financing commercial real estate were abolished.	April 2013
Credit card limits introduced	Consumer credit card limits were tied to incomes. Minimum payment limits and risk weights were increased. Limit increases were linked to prior income tests.	October 2013
Changes to provisioning rate	Increased general provisioning rates for uncollateralized consumer loans to 4 percent from 1 percent; Decreased general provisioning rates on export and SME loans to 0 percent and 0.5 percent respectively from previous 1 percent.	October 2013
Increase in risk weights for consumer car loans	Risk weights of those consumer car loans were increased for loans with a remaining maturity longer than a year.	October 2013
Maturity limit on consumer loans	Maturity of consumer loans is capped at 36 months for consumer loans excluding housing loans and other real estate related loans, and at 48 months for car loans.	December 2013
Limits to installments and credit card cash advances	As a general requirement, maximum number of installments is capped at 9 months. In addition to that, installments are banned for telecommunication device, jewelry, dining, groceries and fuel products.	February 2014

Loan to value requirements for car loans	Consumer loans for the purchases of passenger cars (including purchases through financial leasing) shall be subject to an LTV ratio of 70 percent for those cars worth up to TRY 50,000 and 50 percent for the incremental car value in excess of TRY 50,000.	February 2014
Remuneration of TRL required reserves	The CBRT starts paying an interest rate on banks and financing companies' required reserves (RR) in TRL. The interest rate on RR will be the weighted average cost of the CBRT's funding rate minus 700bps for all banks for 2014. Starting with 2015, the interest rate on RR will be the weighted average cost of the CBRT's funding rate minus 500bps for banks and financing companies that have a core funding (i.e., (deposit + shareholder's equity)/credit) ratio higher than the sector average and that maintain or increase their own core funding ratios with regard to the reference period, and minus 700bps for the remaining banks and financing companies.	November 2014
Reserve Requirement Ratio	The CBRT raised the reserve requirement ratios (RRR) of foreign exchange (FX) denominated liabilities of banks and financing companies as a way to encourage the extension of maturities of non-core FX liabilities. The RRRs for the FX liabilities other than deposits were changed as follows:	February 2015

Liabilities other than deposits with maturity	**Current Ratios (percent)**	**New Ratios (percent)**
up to (and including) 1 year	13	18
up to (and including) 2	11	13
up to (and including) 3	11	8
up to (and including) 5 years	6	7
longer than 5 years	6	6

Reserve Requirement Ratio	The CBRT raised the reserve requirement ratios (RRR) of foreign exchange (FX) denominated liabilities of banks and financing companies as a way to increase the marginal cost of FX liabilities and therefore defend the currency from its slide from TL/USD 2.35 to TL/USD 2.60 in January–February 2015. The RRRs for the FX liabilities other than deposits were changed as follows:	March 2015

Liabilities other than deposits with maturity	**Current Ratios (percent)**	**New Ratios (percent)**
up to (and including) 1 year	18	20
up to (and including) 2	13	14
up to (and including) 3	8	8
up to (and including) 5 years	7	7
longer than 5 years	6	6

Reserve Option Coefficients	The CBRT changed the reserve option coefficients (ROC) of foreign exchange (FX) RRR for TL denominated liabilities of banks and financing companies as a way to increase the marginal cost of FX liabilities and therefore defend the currency from its slide from TL/USD 2.35 to TL/USD 2.60 in January–February 2015. The ROCs changed as follows:	March 2015

FX Tranches (percent)	**Current ROC**	**New ROC**
0–30	1.2	1.0
30–35	1.5	1.5
35–40	1.9	1.9
40–45	2.3	2.3
45–50	2.7	2.7
50–55	3.1	3.1
55–56	3.3	3.9
56–57	3.5	4.1
57–58	3.7	4.3
58–59	3.9	4.5
59–60	4.1	4.7

Reserve Requirement Ratio

The CBRT raised the reserve requirement ratios (RRR) of foreign exchange (FX) denominated liabilities of banks and financing companies as a way to encourage the extension of maturities of non-core FX liabilities. *Unlike previous changes, the higher RRR will apply to new borrowing while old RRR will apply to existing stock till maturity*. New reserve requirement ratios will be applied to the liabilities after 28 August 2015, as of the maintenance period dated 23 October 2015. The current ratios will continue to be applied to stock of liabilities on 28 August 2015 until the end of their original maturities.

October 2015

FX Liabilities other than deposits/participation funds with maturity	**Current Ratios for Stock (percent)**	**New Ratios for Flow (percent)**
up to (and including) 1 year	20	25
up to (and including) 2 years	14	20
up to (and including) 3 years	8	15
up to (and including) 5 years	7	7
longer than 5 years	6	5

The full impact will start to reflect starting from 2018 and is estimated at around 1 percent of annual NI of the banking sector, assuming average cost of FX funding at 3 percent and no drastic change in the current balance sheet mix.

Remuneration of TL Required Reserves

The remuneration rate for the required reserves maintained in Turkish liras will be raised by 150 basis points in total within the frame of following timeline:

- 50 basis points as of 1 September 2015
- 50 basis points as of 1 October 2015
- 50 basis points as of 1 December 2015

By December 2015, the Bank will start paying 300bps lower than the CBT's average funding rate to a Bank with above sector's average core liability ratio (CLR) and 500bps lower for those below sector's average.

August 2015

Marginal Loosening of Maturity Limits on Household Credit	The BRSA eased maturity limits on credit card installment plans from 9 to 12 months for purchases of furniture, white goods and education services. At the same time, it exempted retail loans extended for the purchase of education services from the 36 month installment cap in effect for other personal loans.	November 2015

Sources: Turkish authorities; and IMF staff.

Annex VI. Authorities' Response to Past Policy Recommendations

1. **Traction of past Fund advice**. The authorities and staff agree that the external imbalance should be reduced, and that this should be done while preserving investment. They also concur that lowering inflation is a key objective. Moreover, to preserve financial stability, the authorities introduced well-targeted macroprudential measures to slow the rise in household leverage and encourage banks to increase core funding. They plan to tackle structural issues through the 10th Development Plan. However, the authorities believe risks are lower than what Staff believes and that the economy has enough buffers to withstand reasonable shocks. Thus, fiscal and monetary policies would remain more accommodative than recommended by staff.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 2, 2016

Prepared By European Department

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FUND RELATIONS

(Data as of January 31, 2016)

A three-year SDR 6,662.04 million (691.1 percent of quota) **Stand-By Arrangement** was approved in May 2005 and expired on May 10, 2008. Cumulative purchases amounted to SDR 4,413,601,500.

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.

There is no outstanding Fund credit as of January 31, 2016.

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).

General Resources Account

	SDR Million	Percent Quota
Quota	1,455.80	100.00
Fund holdings of currency	1,343.03	92.25
Reserve position in Fund	112.78	7.75

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	1,071.33	100.00
Holdings	966.12	90.18

Outstanding Purchases and Loans

None

Latest Financial Arrangements

	Approval Date	Expiration Date	Amount Approved	Amount Drawn
				In millions of SDRs
Stand By	05/11/05	05/10/08	6,662.04	4,413.60
Stand By	02/04/02	02/03/05	12,821.20	11,914.00
Stand By	12/22/99	02/04/02	15,038.40	11,738.96
Of Which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

Projected Payments to the Fund[1/]

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

	Forthcoming				
	2016	2017	2018	2019	2020
Principal	--	--	--	--	--
Charges/Interest	0.07	0.07	0.07	0.07	0.07
Total	0.07	0.07	0.07	0.07	0.07

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

Safeguard Assessments

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

Exchange Rate Arrangement:

The currency of Turkey is the Turkish lira, which replaced the new Turkish lira on January 1, 2009. The *de jure* exchange rate arrangement is free floating; the *de facto* exchange rate arrangement is floating.

Article IV Consultations:

The last Article IV staff report (IMF Country Report (14/329) was issued on December 5, 2014. Board discussion for the last Article IV staff report took place on November 21, 2014.

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	March 7, 2014	
IAIS	March 7, 2014	

Recent Technical Assistance

Dept.	Timing	Purpose
STA	January 2016	Compilation system for independent annual estimates of GDP
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
FAD	September 2012	G–20 budget institutions
MCM	October 2012	Early warning system and stress testing
FAD	November 2012	Measurement of structural fiscal balances
STA	January 2013	National account statistics
MCM	December 2013	Stress testing
STA	December 2013	Monetary and financial statistics
STA	March 2014	Government finance statistics
STA	March 2014	National accounts statistics
FAD	April 2014	Performance-based budgeting
FAD	May 2014	Tax revenue modeling
STA	May 2014	Financial sector accounts
STA	July 2014	Government finance statistics – public sector debt statistics

WORLD BANK RELATIONS

1. **Turkey and the World Bank Group have a strong partnership, which has continuously deepened**. Turkey's National Development Plans form the basis of the partnership between Turkey and the World Bank Group. The Ninth (2007–13) and the new Tenth Development Plan (2014–18) overlap the CPS period. The main pillars of both Development Plans are fully consistent with the CPS and the alignment has been further fine-tuned through the CPS Progress Report (PR) of September 2014 which extended the CPS by one year to include FY16. The three main strategic objectives and CPS pillars; namely (i) enhanced competitiveness and employment; (ii) improved equity and social services; and (iii) deepened sustainable development remain highly relevant. The CPS PR reflects less than anticipated demand for lending in support of education and increased emphasis on governance and transparency as critical elements of Turkey's competitiveness. The CPS PR also aligns the WBG's engagement with the new WBG Strategy and its twin goals of boosting shared prosperity and eradicating poverty.

2. **The current CPS has so far delivered financing of over US$9.3 billion during FY12–16**. This includes US$4.3billion through the International Bank for Reconstruction and Development (IBRD), US$4.0 billion through the International Finance Corporation (IFC), and US$982 million through the Multilateral Investment Guarantee Agency (MIGA).

3. **Turkey's development priorities provide ample opportunities for unlocking value from closer cooperation across the WBG and other partners**. The energy sector is an example where IBRD work on the regulatory framework has helped unlock significant IFC supported private investment to expand renewable energy and energy efficiency. The same opportunity presents itself in the health sector, the railway sector, the municipal sector and in PPPs more generally, with the health sector most advanced. In the financial sector, the combined balance sheet and product range of the WBG will be mobilized to increase the domestic funding pool and attract longer term financing, particularly to benefit Turkish exporters and SMEs and infrastructure financing. 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, the EU, UN organizations, and other key bilateral partners

A. International Bank for Reconstruction and Development

4. **Turkey is the IBRD's sixth largest borrower in terms of debt outstanding**. Turkey's active portfolio of investment operations with the World Bank's IBRD financing includes 10 projects with total net commitments of US$3.92 billion (as of February 2016). The investment portfolio and pipeline support the energy sector, financial and private sector development, urban development, water, transport, and health.

5. **Turkey greatly values the WB's knowledge work**. A growing area of common interest is sharing Turkey's experiences with other developing countries. In December 2014, the Bank launched the report, "Turkey's Transitions: Integration, Inclusion, Institutions," which looks at the lessons Turkey has learned over the past 30 years. The extensive range of knowledge products has started to shift to a more programmatic approach that will include multiyear and multiple output delivery activities. Knowledge

services inform policy in various reform areas (education, health, labor, energy) and are the Bank's primary instrument for engaging and broadening ownership through joint preparation and close cooperation with all stakeholders (human development, investment climate, gender certification in employment, sustainable urban development). Critical parts of the Bank's technical support are aligned with the EU accession process (e.g., energy, customs union, environment, competition and business regulation). Reimbursable Advisory Services (RAS) are also expected to develop strongly in the coming years from their currently low levels.

6. **The Turkey program is supported by selected Trust Funds**. The Turkey trust fund portfolio currently consists of 39 (13 Recipient and 26 Bank-executed) trust funds. They amount to US$256 million, with the bulk of funding (US$190 million) accounted for by the Clean Technology Fund (CTF).

B. International Finance Corporation

7. **With a portfolio of around US$3.43 billion, Turkey represents the second largest country exposure for IFC globally.** In FY15, IFC had a third consecutive record year in Turkey, investing US$1.8 billion in projects to support sustainable energy and infrastructure development, improve municipal services, develop public-private partnerships (PPPs), promote local capital markets, and help Turkish companies increase competitiveness and impact. IFC also advised businesses and government bodies on initiatives to encourage private sector growth.

8. **IFC is investing more than foreseen in the FY12–16 Country Partnership Strategy**. In FY15, IFC committed US$1.3 billion in equity and long-term loans across 28 projects, more than doubling the previous year total. Of this amount, close to US$500 million included financing mobilized from third party investors. IFC also provided US$530 million in short-term loans to support trade finance.

C. Multilateral Guarantee Agency

9. **Turkey is MIGA's second largest country by gross exposure representing about 7.0 percent of MIGA's gross portfolio**. In the first half of FY16, MIGA's portfolio in the country was 8 projects with a gross exposure of US$918 million or US$425 million net of reinsurance. Four projects are in the infrastructure sector, two in the financial sector and two in the services sector.

10. **MIGA support to the Turkish economy has been growing over the past couple of years**. Under the current CPS program, MIGA has delivered financing of approximately US$982 million to Turkey, and the outstanding guarantee portfolio has reached US$918 million. Turkey is the subject of targeted MIGA business development efforts to unlock opportunities for credit enhancement as well as political risk insurance (PRI) coverage. The most promising opportunities for MIGA lie in the financial sector (supporting on-lending to SMEs and exporters), urban transport, and PPPs in the health care sector.

STATISTICAL ISSUES

(As of February 22, 2016)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is broadly adequate for surveillance purposes, despite certain shortcomings especially in national accounts and government finance statistics.
National Accounts: Quarterly national accounts are published with a 2–3 month lag. The Turkish Statistical Institute (TURKSTAT) compiles and disseminates quarterly GDP by production and expenditure approaches, in current prices and in volume terms. The annual GDP is a sum of the four quarters. The GDP by income approach was estimated for 2002–2012, but the results are not yet published. The main weaknesses of the system for compiling quarterly GDP at current prices are the lack of annual benchmarks and the reliance of fixed ratios that are outdated (ratios from the 2002 Supply and Use Tables (SUTs) are used). TURKSTAT is now putting in place a regular compilation system for independent annual estimates of GDP and for quarterly GDP benchmarked to annual data. By June 2016, TURKSTAT will disseminate new series of national accounts—both annual and quarterly data, covering the period 2009–14—based on the *System of National Accounts 2008 (2008 SNA)/The European System of Accounts 2010 (ESA 2010)*. Sectoral financial balance sheets are compiled for financial corporations on a quarterly basis, and for the general government and nonfinancial corporations on an annual basis. The financial accounts for the remaining sectors (households and rest of the world) are not yet disseminated.
Price Statistics: The consumer price index (CPI) and the producer price index (PPI) generally conform to international standards. The CPI does not cover owner-occupied dwellings, 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).
Government Finance Statistics: Coverage of the budget is largely complete. Data for some fiscal operations conducted through extra budgetary funds are available only with long lags. Fiscal analysis is further complicated by some quasi-fiscal operations carried out by state banks, state owned enterprises (SOEs), 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. The latest data available for publication in the *Government Finance Statistics Yearbook* are for 2012 and cover the general government sector and its subsectors with coverage of both stocks and flows, including a full general government balance sheet. Monthly budgetary data on a cash basis and quarterly general government data on an accrual basis are reported on an irregular basis for

publication in *International Financial Statistics (IFS)*, starting from September 2009.	
Monetary and Financial Statistics: The Central Bank of Turkey (CBRT) reports monetary statistics using the standardized report forms (SRFs), which accord with the concepts and definitions set out in the IMF's *Monetary and Financial Statistics Manual*.	
Financial sector surveillance: The Banking Regulatory and Supervision Agency (BRSA) reports all 12 core FSIs and nearly all the encouraged FSIs	
External sector statistics: External sector statistics are compiled in broad conformity with the conceptual framework of the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*).	
II. Data Standards and Quality	
Turkey subscribes to the Special Data Dissemination Standard (SDDS) since 1996.	The latest Data ROSC was published in September 2009.

Turkey: Table of Common Indicators Required for Surveillance
(As of February 19, 2016)

	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	Jan. 2016	2/3/2016	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep. 2014	9/26/14	W	W	W		
Reserve/Base Money (narrow definition)	Sep. 2015	11/23/2015	W and M	W and M	W and M	O,O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Sep. 2015	11/23/2015	W and M	W and M	W and M		
Broad Money	Sep. 2015	11/23/2015	W and M	W and M	W and M		
Central Bank Balance Sheet	Sep. 2015	11/23/2015	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Sep. 2015	11/23/2015	W and M	W and M	W and M		
Interest Rates[2]	Oct. 2014	10/02/14	D/W/M	D/W/M	W/M		
Consumer Price Index	Nov. 2015	12/15/2015	M	M	M	O,LO,O,LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Aug. 2014	Sep. 2014	M	M	M	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug. 2014	Sep. 2014	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Aug. 2014	Sep. 2014	M	M	M		
External Current Account Balance	Aug. 2014	Sep. 2014	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Aug. 2014	Sep. 2014	M	M	M		
GDP/GNP	2014Q2	2014Q3	Q	Q	Q	O, LO,O, O	LO, O, LO, O, LO
Gross External Debt	2014Q2	2014Q3	Q	Q	Q		
International Investment Position[6]	Jul. 2014	Sep. 2014	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 asset and liability positions vis-à-vis nonresidents.

7 Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

8 These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.

9 This reflects the assessment provided in the data ROSC or the Substantive Update (published on ..., and based on the findings of the mission that took place during...) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).10 Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. İbrahim Çanakçı, Executive Director for Turkey and Mr. Cem Gökçen, Advisor to Executive Director
March 25, 2016

We thank staff for the productive and candid dialogue with the authorities, and the comprehensive Article IV report and accompanying papers.

Recent Macroeconomic Developments

Growth remained resilient and was job-rich. The Turkish economy is on a solid footing despite the weak recovery in its main trading partners, elevated geopolitical tensions, and a number of external shocks. The economy expanded by 4 percent in the third quarter of 2015, buoyed by industrial value added and a recovery in the agricultural output. Fourth quarter data is not yet available, but leading indicators suggest that the 2015 growth figure will be around 4 percent, placing Turkey among the good performers in the emerging markets.

Job creation has remained robust in 2015, buoyed by solid growth and active labor market policies. 0.8 million new jobs were added in the last 12 months, while the total increase in employment has reached 6.9 million since its trough in 2009, which could have been elaborated more in the Staff Report.

The headline inflation rate has remained elevated, but recent inflation readings show signs of moderation. Consumer prices edged up by 8.8 percent (year-on-year) at 2015 year-end, despite the tight monetary policy stance and plunging global commodity prices. The exchange rate pass-through and elevated food price inflation have been the underlying factors fueling inflationary pressures. In particular, the exchange rate depreciation drove up prices of core goods (first round effects), and passed through to the food and services inflation (second round effects). Driven by large increases in fresh fruit and vegetable prices, unprocessed food price inflation posted a 13.9 percent annual increase; another year of a double-digit rise which has kept food price inflation above expected levels. Headline inflation recently lost momentum, falling by 0.02 percent (month-on-month) in February 2016, supported by a moderation in unprocessed food and energy prices. A number of measures were introduced to curtail food prices. The Food and Agricultural Products Markets Monitoring and Evaluation Committee was founded in December 2014 with a view to monitor food prices and curb undue price changes. The Ministry of Food, Agriculture, and Livestock recently reached an agreement with producers and set a ceiling on red meat prices, while leaving the door open to meat imports.

The current account deficit has been narrowing and is financed mostly by long-term resources. The current account deficit narrowed to US$ 32.1 billion in 2015, from US$43.6 billion in 2014. Exports declined by 8.7 percent last year, driven largely by geopolitical developments and the EUR/USD parity change in favor of the US dollar. Turkish exporters have switched to traditional markets to compensate for the export contraction to Russia and the Middle East and North Africa region, which have been on a downward trend in the last two years. The slowdown in consumer loan growth and the shift in the total loan composition from consumer to commercial loans in response to two rounds of macroprudential measures (MPMs) contributed to an import contraction of

14.4 percent. Plunging global commodity prices were also supportive of the external rebalancing.

As evidenced by the favorable rollover ratios, Turkey has continued to attract sizable resources to fund its external financing needs, even during times of stress. Net FDI remained robust and covered around 36 percent of the current account deficit in 2015. At the same time, external financing tilted towards longer-term resources with the help of MPMs, whereas portfolio and short-term fund flows have weakened.

Macroeconomic Outlook and Policies

The revised Medium-Term Program 2016-2018 (MTP), announced in January 2016, is geared towards promoting strong and inclusive growth while ensuring macroeconomic stability, taming the inflation rate, and reducing external imbalances.

Macroeconomic Outlook

The authorities are more sanguine on the growth outlook. GDP growth is expected to accelerate to 4.5 percent in 2016 – slightly higher than staff's forecast – on the back of an expected increase in investment demand and domestic consumption supported by the income policy, low global commodity prices, and improvements in confidence aided by diminished political uncertainties. With the expected recovery in Europe, net exports will also make a slightly positive contribution to growth in 2016. Growth is estimated to gain further momentum and gradually rise to 5 percent in 2017-18, surpassing staff's estimates. The divergence between the authorities' and staff's growth projections is due to the different assumptions on the effectiveness of structural reforms. While the MTP's growth forecasts are based on the assumption that a number of reforms will be effectively boosting labor force participation and total factor productivity and yield higher growth in the medium to long term, staff's expectations are more modest.

Staff assumes a constant labor force participation rate for projecting medium-term growth, which is not consistent with recent trends. The staff model for projecting the labor force participation rate also does not take into account the education variable. With the increase in education levels, labor force participation rates also edge up, which has been the case for Turkey in recent years. Another important factor to consider is the positive effects of active labor market policies on female labor participation. Taking these factors into consideration, the increase in the labor force participation rate and the contribution of employment growth to potential growth may exceed staff's estimates.

Staff's growth projections also imply that the elasticity of Turkey's growth rate with respect to global growth will decline to 0.9 percent during 2016-2020, from 1.2 during 1980-2014, which is difficult to justify in an environment of low energy prices.

Inflation is projected to moderate. Weaker global commodity prices and the subsiding exchange rate pass-through are expected to offset the impacts of the minimum wage increase and administrative price adjustments made at the beginning of the year. Therefore, the Central Bank of the Republic of Turkey (CBRT) expects the inflation rate to register a slight decline to 7.5 percent in 2016, gradually converging to the target in 2018. The relatively more stable long-term inflation expectations (compared to short-term expectations) can also be considered a supportive factor for the benign medium-term

inflation outlook going forward. The authorities are well aware of the pressures and risks on the inflation outlook and remain ready to take measures if needed.

External rebalancing will continue. The current account deficit will shrink to 3.9 percent of GDP this year, on the back of the positive trend in the terms of trade and the more robust external demand, particularly from the EU. The removal of sanctions on Iran may also positively impact exports. The deficit will steadily decline to 3.5 percent of GDP by 2018, while the total domestic savings rate will reach 17.8 percent, a 3-percentage point increase compared to the 2015 level.

Gross international reserves are expected to stabilize. The CBRT provided off-market foreign exchange to energy-importing state-owned enterprises (SOEs) in order to stem undue market movements, as foreign exchange (FX) volatility spiked during instances when SOEs purchased sizable FX from the market directly. FX sales to SOEs reached US$ 11 billion in 2015. The CBRT also injects foreign exchange liquidity through daily auctions in a bid to provide signals, especially in the low liquidity environment, whereas direct FX market interventions – in line with the Fund's institutional view – have been limited to disorderly market conditions. Total liquidity provided through FX auctions was around US$ 12 billion in 2015. The FX demand of energy-importing SOEs and private companies is expected to decline in the coming months, driven by favorable energy prices. Export rediscount credits, which helped propel reserve accumulation by US$15 billion in 2015, will continue to support reserve buffers.

The Turkish economy has strong buffers including low public debt and budget deficit as well as strong capital and liquidity position of the banking sector and the authorities can deploy a wide set of instruments to manage downside pressures. We believe that staff could have made it clear that scenario depicted in the contingency planning section of the report is a tail risk not the baseline and the sudden capital reversal is not a risk specific to Turkey but pertains to the most emerging market economies. Taking into account the existing buffers and the fact that Turkish economy has proven its resilience several times against such scenarios in the recent past, staff should have been more balanced in their assessment.

Policies and Structural Reforms

Fiscal Policy

The fiscal policy stance will be growth-friendly, and fiscal prudence, the linchpin of the Turkish economy's resilience, will be maintained. The central government budget deficit fell to 1.2 percent of GDP in 2015, while the general government budget remained balanced. The 2016 central government budget, recently adopted by the Parliament, is geared towards bolstering growth potential, raising domestic savings, and curtailing inflation. Around 19 percent of the budget (or 24 percent of tax revenues) will be allocated to improve the quality and competitiveness of education, which is essential to labor productivity. The fiscal policy will also help enhance the labor force skills and address the skills mismatch. The increase in capital spending, SME incentive schemes, and R&D expenditures will be growth-supporting elements of the fiscal policy. The central government budget deficit will widen slightly to 1.3 percent of GDP in 2016 in

order to accommodate the rising public spending associated with the minimum wage hike and electoral promises. Even though debt sustainability is not a source of concern, fiscal discipline will remain intact to complement the monetary policy's efforts to tame inflation. In this regard, the central government budget deficit will fall to 1.0 percent of GDP in 2017 and to 0.8 percent in 2018. With the help of Turkey's solid growth performance, fiscal discipline, and effective debt management policies, the EU-defined general government debt stock will further drop to 29.5 percent of GDP in 2018. In view of the aforementioned figures, it is difficult to concur with staff's assessment that fiscal targets do not support rebalancing. Contingent liabilities remain limited and the risks associated with the realization of all contingent liabilities under a stress scenario would be manageable.

The authorities are determined to adopt the new income tax law, which was not legislated during the recent election cycle. With the new law, both the income tax base for salary earners and the property tax base will be broadened, and the implementation of the tax code will be simplified.

Monetary Policy

The CBRT maintained a tight monetary and liquidity stance in 2015. As we have indicated in previous Article IV discussions, judgments based merely on the level of policy rates may not give an accurate impression about Turkey's monetary policy stance. The liquidity policy and the effective cost of funding from the CBRT should also be taken into account in order to get a clear and complete picture of the monetary policy. The interest rate corridor remained asymmetric with the O/N lending rate standing at 10.75 percent, the one week repo rate (policy rate) at 7.5 percent, and O/N borrowing rate at 7.25 percent. By providing liquidity mostly at the O/N lending rate, the CBRT has delivered additional tightening without changing the policy rate. The average funding rate, which was at around 7.8 percent in March 2015, rose gradually and peaked at 9.1 percent in early February 2016, well above the one week repo rate. Taking all tools in place into consideration, the CBRT considers the financial conditions as tight.

In August 2015, the CBRT unveiled a roadmap outlining its three-pronged strategy to simplify the monetary policy framework and strengthen financial stability amid the normalization of monetary policies in advanced economies. Before the normalization started, a number of changes were made to the Turkish lira (TL) and in foreign exchange liquidity management, along with measures introduced to support financial stability. On the TL liquidity side, the lower interest rate on borrowing facilities provided to the primary dealers through repo transactions was terminated and collateral conditions were simplified. On the FX liquidity side, the CBRT raised the transaction limits for individual banks at the CBRT foreign exchange and banknote markets, and provided additional flexibility to foreign exchange sale auctions by raising the daily limit to US$ 70 million. At the same time, FX deposits were accepted as collateral against TL transactions. With these recent changes, FX assets and gold under the Reserve Option Mechanism, together with FX deposit limits, are strong enough to cover the banking sector's short-term external debt. In order to shore up the banking sector's core liabilities and lower intermediation costs, remuneration rates on TL required reserves were hiked by 150 basis

points (cumulative) between September-December 2015. The width of the interest rate corridor would be narrowed and made more symmetric around the one week repo rate, with the start of the monetary policy normalization. However, in the face of heightened global financial market volatility and rising uncertainty, the CBRT opted to postpone the simplification process, as the wide interest rate corridor has been instrumental in managing FX volatility and, supported by MPMs, has helped contain loan growth. The CBRT sees strong merit in maintaining a flexible approach in the monetary policy and is determined to maintain its tight policy stance in order to keep the inflation rate in check. Simplification will resume once global volatility subsides.

Financial Sector Policies

The Turkish banking system is well-capitalized with strong liquidity buffers and asset quality. The capital adequacy ratio of around 15.6 percent remained well above the regulatory minimum. The total non-performing loan ratio was stable, while there was a slight uptick in consumer loan credit cards and SME loans. Risk weights on consumer loans have remained well over the Basel III norms and, together with other MPMs, have significantly helped contain consumer loan growth. The 13-week annualized rate of growth has slowed down to 3.6 percent in 2015; the lowest reading since 2010. In contrast, commercial loans posted higher growth rates, which will support the external rebalancing. A number of measures were adopted to strengthen FX risk management and support FX liquidity. The required reserve ratios on banks' non-core FX short-term liabilities were raised to promote the maturity extension and the use of core liabilities. The CBRT also lowered its FX lending rate to commercial banks by cutting the foreign exchange deposit interest rates by 475 basis points to 2.75 percent in US dollars, and 525 basis points to 1.25 percent in euro. The Turkish banking sector's average FX liquidity coverage ratio currently stands at around 145 percent and banks can tap into their deposits with the CBRT under the reserve option mechanism and FX reserve requirements, should an adverse scenario unfold.

The authorities view the revision in risk weights as a transition to a more effective macroprudential measure rather than a relaxation of MPMs. As consumer credit growth decelerated far below expectations, the Banking Regulation and Supervision Agency brought the risk weights in line with Basel III standards, with changes effective as of the end of March 2016. These adjustments will support the banking sector's capital adequacy ratio and stimulate consumer loan growth, though a significant recovery is not anticipated in view of the tight financial conditions. At the same time, the authorities have considered introducing a "debt-to-income ratio" as a new MPM to replace the more costly and second best measures imposed on consumer credits. With the improvements in consumer debt and income data collection, the debt-to-income ratio will be adopted. Hence, in our view, depiction of revision in MPPs as "relaxation" is not well-grounded and mischaracterizes the authorities' intention.

The corporate sector has weathered the impacts of the strong US dollar well. There are a number of factors mitigating the FX risk of the corporate sector:

i. Most firms with FX liabilities are either hedged or have a natural hedge in the form of FX revenues or FX receipts from other group of firms in a holding company.
ii. FX loans are concentrated in large companies with the capacity to absorb the impacts of large FX depreciation.
iii. The corporate sector has its net FX long position in the short term.
iv. The maturity of FX loans has lengthened and around *75 percent of FX borrowing is long-term.*
v. Offshore FX assets held by firms act as a buffer in times of stress.
vi. The share of FX loans in corporate loan volume is falling as companies shift to TL financing in the face of FX depreciation.

Nearly two-thirds of the non-financial corporate sector's FX liabilities have been provided by the domestic banking sector. Hence, measures to strengthen FX risk management in the banking sector will eventually help contain the non-financial corporate sector's FX vulnerabilities. At the same time, in order to promote equity-based financing, the authorities amended the Turkish Corporation Tax Code. With this recent change, companies can deduct 50 percent of the interest amount calculated over the cash capital increases of the paid-in capital from the corporate tax base. While the authorities appreciate the work on non-financial corporate sector debt in Turkey and will use the policy options suggested in the Selected Issues paper as a valuable input into their assessments, we would like to highlight two points regarding the balance sheet effects examined in Box 9. First, staff could have made it clear that this analysis is a hypothetical scenario and not the baseline projection for Turkey. Second, the box could have also explicitly stated that the implications of such scenario analysis should be interpreted with caution in view of data gaps especially pertaining to the assets of NFCs, which limits the accuracy of mechanical analysis depicted in the box. Indeed, Turkey's experience is another evidence of such limitations as, contrary to the previous estimates by staff, depreciation pressures on currency in the last few years did not translate into the envisaged strains on the NFCs' balance sheets.

Structural Reforms

There is strong political ownership and resolve to implement comprehensive structural reforms in an effort to improve the Turkish economy's competitiveness, strengthen its resilience to external shocks, and address impediments to job creation and investments. The building blocks of the comprehensive structural reform agenda are:

i. Sectoral and micro-reforms unveiled in the 25 transformation programs in the context of 10th Five-Year Development Plan,
ii. Structural reforms in the areas of the labor market, business environment, public administration and finance, and judicial and education systems
iii. The EU accession process.

The authorities strongly disagree with staff's assessment that the reform program lacks prioritization and that implementation thus far has been poor. Structural reform efforts are already prioritized and, in an effort to ensure the reform agenda's timely implementation, the Reform Coordination and Monitoring Council was established in

December 2015, and has met 9 times so far. Actions on reforms that will be completed in 3 months, 6 months, and a year were identified and announced. Among the actions with a 3-month deadline, 10 out of 20 reform actions have already been completed in the first two months of 2016, which include the following:

- Financing of machinery and equipment investments in the manufacturing industry will be exempt from the Banking and Insurance Transactions Tax.
- The Istanbul Arbitration Center was established.
- Parliament adopted the trade facilitation agreement.
- The regulations on broadening the activities of private employment agencies along with temporary employment, in line with EU norms and standards, were finalized.
- Secondary legislations for dowry and housing accounts were adopted.
- The impediments to part-time employment of university students were eliminated.

To bolster labor productivity and promote inclusive growth, the authorities continue to invest in education and skills improvement policies, and formulate active labor market policies to shore up youth and female employment. In this context, the following actions have been taken:

- The draft law, introducing flexible modes of employment (i.e. temporary employment, remote working) was accepted by the relevant Committee of the Parliament.
- The maternity leave and other benefits of women were further improved.
- Parents with children under the school age were given the option to work at part-time jobs, earning half of their salaries until their children start elementary school.
- Young entrepreneurs starting their own businesses will be exempt from income tax for three years (up to TL 75,000 annual income).
- The salaries of young workers entering the job market for the first time following the completion of "on-the-job training programs" will be financed from the budget up to one year, which was previously capped at 6 months.

The authorities are considering two main avenues for boosting savings: introducing automatic enrollment in the second pillar and a severance pay reform. A draft scheme has been prepared on the automatic enrollment and is expected to be introduced after the completion of the mechanism's thorough analysis. A severance pay reform can provide a major boon to savings and also foster labor market flexibility. There are different modalities, which will be discussed with social partners.

Syrian Refugees in Turkey

From the very beginning, Turkey has adopted an open-door policy for Syrian refugees. As of now, Turkey hosts around 2.7 million Syrian refugees, making it the largest refugee-hosting country. Significant efforts and funding were mobilized to establish high-standard refugee camps along with essential public services, including education and health. Turkey has spent over US$ 10 billion on refugees since 2011. The authorities recently granted work permits to refugees under temporary protection in an effort to integrate them into the labor market. Turkey and the EU have intensified their cooperation to effectively manage the refugee crisis.

Conclusion

The Turkish economy continues to grow at relatively robust rates, with the external deficit shrinking. Fiscal prudence and sustainable debt prospects, which have been major factors behind the recent confirmation of Turkey's investment grade rating, remain in place. The CBRT plans to simplify its monetary policy framework once there is a visible drop in global volatility. The government is committed to pursuing a comprehensive structural reform agenda and adopting the relevant measures within the established timelines. At the same time, the mechanisms to ensure an effective macro-policy coordination and timely implementation of structural reforms are well-established. The authorities have a wide range of instruments that can be deployed, when needed, to manage risks. Taking all these factors into consideration, the Turkish economy's proven resilience to shocks in recent years is prone to continue. In this regard, the Staff Report could have put more emphasis on these pockets of strength and the mitigating factors.