INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/32

TURKEY

February 2017

2017 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 2017 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 January 11, 2017 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 January 11, 2017, following discussions that ended on October 31, 2016, with the officials of on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 20, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Turkey.

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

Selected Issues
Financial Stability System Assessment

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

Press Release No. 17/34
FOR IMMEDIATE RELEASE
February 3, 2017

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

IMF Executive Board Concludes 2017 Article IV Consultation with Turkey

On January 11, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Following a strong performance in 2015, growth has slowed. The July failed coup attempt heightened the spectrum of political uncertainty, and Russian sanctions have also negatively affected confidence. Growth remains consumption-driven. Investment is weak amid heightened uncertainty and a sharp deceleration of credit growth. Inflation has moderated but is still well above target. The current account deficit remains sizeable, as the decline in tourism offsets savings from low energy prices. Progress on structural reforms has been slow.

Fiscal policy turned expansionary in 2016. Higher government spending is driven by an increase in the minimum wage and related subsidies, hiring in the education and health sectors, as well as higher security outlays. The government granted a number of temporary tax reductions/exemptions and expanded investment incentives during the second half of the year to revive growth.

The central bank of Turkey (CBRT) eased monetary conditions, by cutting the overnight lending rate by 250 basis points in the process of narrowing the interest rate corridor between March and September 2016. After a sharp depreciation of the Lira in November, the CBRT raised the repo rate to 8 percent and partly withdrew the liquidity provided to banks in the wake of the failed coup attempt.

[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.

Bank capital levels remain high, although some buffers are decreasing. Higher profits boosted capital adequacy, reflecting in part lower overnight borrowing costs and relaxation of prudential norms. Non-performing loans are increasing from a low level that partly reflects accommodating rules for loan restructuring. Credit growth slowed markedly in 2016, due to both demand and supply factors. Progress in strengthening the financial stability framework was assessed in detail during this Article IV consultation as part of the IMF's Financial Sector Assessment Program (FSAP), which analyzes financial sector health and associated policies. The FSAP's findings are summarized in the accompanying Financial System Stability Assessment (FSSA).

Growth is projected to be below potential in 2016–17. The political focus on transitioning to a presidential system; renewed questions over the future of the EU-Turkey relations; and tense security situation in the South-East and conflicts in neighboring countries are expected to prolong the uncertainty, keeping domestic demand subdued. Fiscal stimulus and the expected completion of the gradual lifting of Russian sanctions are expected to support growth. Over the medium-term, growth is projected to firm around 3.5 percent. Inflation is expected to stay above target and the current account deficit to remain sizeable.

Executive Board Assessment[2]

Executive Directors welcomed the Turkish economy's resilience in the face of severe and increasing challenges and the authorities' efforts to avoid an excessive slowdown in the near term. At the same time, Directors cautioned that the economy faces considerable downside risks—with high inflation, external imbalances, and substantial reliance on external financing continuing to generate vulnerabilities—while dealing with complex geopolitical and security challenges. They underscored the overarching priority of rebalancing the economy through policies aimed at increasing domestic savings and raising potential growth, while ensuring strong and credible public institutions and policy frameworks that are clearly communicated.

Most Directors supported a near-term moderate fiscal expansion to address cyclical developments, given the current available fiscal space. However, Directors advised that a tighter fiscal stance is required in the medium term to reduce external imbalances and lower inflation. They encouraged the authorities to strengthen the fiscal risk management framework, given that contingent liabilities are increasing, in particular due to a continued expansion in infrastructure-related PPPs.

Directors welcomed the authorities' steps to simplify the monetary policy framework. Continued efforts in this area would further improve communications and enhance monetary

[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.

policy transmission and credibility. Directors emphasized that the authorities should remain vigilant and tighten monetary policy to address sharp lira depreciation, contain high and rising inflation, and counteract intensifying external pressures. Directors also recommended rebuilding international reserve buffers as conditions permit.

Directors welcomed that the banking sector remains well capitalized, and encouraged continued vigilance in light of a deterioration in asset quality. Directors cautioned that banks face substantially higher credit risks, and called for further strengthening of supervision and bank governance. Directors recommended that macroprudential policy should be strengthened, focusing on foreign exchange and other systemic risks, and not be used for demand management. They welcomed the FSAP's findings and recommendations, and highlighted the desirability of further strengthening the independence of financial sector supervisory authorities, deepening and broadening the risk assessment nature of financial supervision and follow up, and strengthening the role of the Financial Stability Committee to support more effective systemic risk oversight and management.

Directors encouraged the authorities to intensify the pace of structural reforms to promote economic rebalancing and boost productivity. They welcomed progress made to reform the voluntary pension system, and urged continued efforts to increase domestic saving. Directors also underscored the importance of improving the investment climate and labor market competitiveness. They commended the authorities for hosting a large number of refugees and for their efforts to integrate them into the labor market, while stressing the importance of continued international assistance.

Turkey: Selected Economic Indicators, 2014−21

Population (2015): 78.2 million
Per capita GDP (2015): US$9,182
Quota (2015): SDR 1,455.8 million

	2014	2015	2016	2017	2018	2019	2020	2021
					Proj.			
				(Percent)				
Real sector								
Real GDP growth rate	3.0	4.0	2.7	2.9	3.3	3.6	4.0	3.9
Contributions to real GDP growth								
Private domestic demand	0.9	3.2	2.5	1.5	2.8	3.0	3.4	3.6
Public spending	0.1	1.1	1.8	0.6	0.4	0.4	0.4	0.4
Net exports	2.0	-0.3	-1.6	0.7	0.1	0.2	0.2	-0.2
GDP deflator growth rate	8.3	7.4	7.4	7.4	7.4	7.5	7.3	7.0
Nominal GDP growth rate	11.5	11.7	10.2	10.5	10.9	11.4	11.6	11.2
CPI inflation (12-month; period-average)	8.9	7.7	7.7	8.0	7.9	7.4	7.3	7.0
Unemployment rate	9.9	10.3	10.5	11.0	11.0	10.5	10.0	10.1
				(Percent of GDP)				
Nonfinancial public sector								
Primary balance	0.6	0.7	-0.6	-1.3	-0.7	0.5	0.8	0.9
Net interest payments	2.2	2.1	2.1	2.0	1.8	1.8	1.8	1.8
Overall balance	-1.6	-1.5	-2.6	-3.4	-2.5	-1.3	-1.0	-0.9
Debt of the public sector								
General government gross debt (EU definition)	33.5	32.9	34.6	35.8	36.6	35.8	35.2	34.8
External sector								
Current account balance	-5.5	-4.5	-4.5	-5.3	-5.5	-5.0	-4.7	-5.0
o/w Nonfuel current account balance	0.7	0.2	-1.3	-1.4	-1.5	-1.0	-0.8	-1.1
Gross financing requirement	26.5	27.9	27.2	30.7	31.5	30.9	29.6	29.2
Foreign direct investment (net)	0.7	1.7	1.1	1.2	1.3	1.4	1.5	1.6
Gross external debt 1/	50.4	55.4	59.6	67.1	67.8	66.6	64.9	63.5
Net external debt	30.8	35.7	38.7	44.6	45.9	45.8	45.1	44.6
Short-term external debt (by remaining maturity)	21.0	22.6	23.8	27.1	27.4	26.6	25.7	24.4
Monetary conditions								
Average real policy rate 2/	-0.2	-0.1	-0.2	…	…	…	…	…
Nominal growth of broad money (percent)	11.9	17.1	11.1	…	…	…	…	…

Sources: Turkish authorities; and IMF staff estimates and projections.
Notes: 1/ The external debt ratio is calculated by dividing external debt by GDP in U.S. dollars estimated by Staff. 2/ Using central bank's one-week repo rate. In current year, the average is up to the latest observation.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

December 20, 2016

KEY ISSUES

Context: After robust growth through Q1 2016, the expansion has slowed. Growth is projected at 2.7 percent in 2016 and 2.9 percent in 2017 with considerable downward risks. Domestic consumption is the main growth driver, supported by a large increase in public expenditure and a hike in the minimum wage. However, political uncertainty, weakened corporate profitability, anemic credit growth, and a sharp fall in tourism have taken a toll on investment and net exports. The monetary stance and macro prudential measures were loosened, but credit growth continues to slow. A negative output gap is opening, but sticky expectations are keeping inflation above target. External imbalances persist: the current account deficit remains large and the NIIP is projected to become more negative. External financing conditions were favorable in the first semester, helping the rollover of large financing needs and supporting the Lira. However, political uncertainty after the failed coup attempt and a less favorable external environment are weakening the Lira and increasing the cost of external financing.

Policies: The overarching goals are twofold: (1) avoiding an excessive slowdown of the economy; and (2) addressing external imbalances and reducing inflation. In 2017, some discretionary fiscal measures should be used. In outer years, tightening is needed as external imbalances and inflation remain high. The authorities should continue simplifying the monetary framework, keeping a broadly neutral monetary policy stance. Monetary tightening could be required to limit excessive Lira volatility and its spillovers to inflation. The central bank should continue to accumulate foreign reserves to build buffers, against the backdrop of a choppier external environment. Macroprudential policies should focus squarely on ensuring the soundness of the financial system. Structural reforms should focus on increasing private domestic savings, improving the business climate, and reducing informality.

Approved By
Philip Gerson and Mark Flanagan

Discussions took place in Istanbul and Ankara in October 19–31, 2016. The team comprised Messrs. Spilimbergo (Head), Impavido, Iossifov, and Ms. Jirasavetakul (all EUR), Ms. Novikova (SPR), Mr. Komatsuzaki (FAD), Messrs. Seshadri, Çeçen, and Ataş (Senior Resident Representative office). The mission met with Deputy Prime Ministers Şimşek and Canikli , Development Minister Elvan, Minister of Finance Ağbal, Treasury Undersecretary Çelik, Central Bank Governor Çetinkaya, other senior officials, and the private sector representatives. Mses. Chen and Mahadewa assisted in the preparation of the staff report. The FSAP mission chief, Mr. Jenkinson, joined the mission to present the main finding of the FSAP.

CONTENTS

TABLES

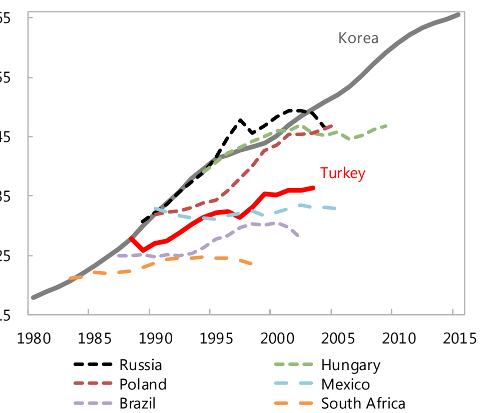
ANNEXES

CONTEXT

1. **Turkey has a dynamic economy, but needs to invigorate growth.** Since the 2001 financial crisis, strengthened macroeconomic policies have dramatically improved socio-economic outcomes. Over the period, real per capita income increased by 50 percent, the incidence of poverty was more than halved, and life expectancy increased by 5 years. Enrolment and graduation rates increased significantly at all education levels, while gender gaps narrowed. The transformation into an industrial and service economy is ongoing, with agriculture still accounting for over one fifth of total employment. However, Turkey's catch-up with advanced economies has slowed since 2008, and progress has increasingly diverged from the historic record of best performers. Moreover, growth has been unbalanced, as it has been accompanied by rising private sector and external indebtedness, leading to increased private balance-sheet stress.

Turkey: Per Capita GDP in 2010 PPP U.S. Dollars Relative to the United States

(Percent)



Source: WEO.

Notes: Data for Korea are 5-year centered averages. Data for other countries are for 2000–15, shifted back in time to comparable level of development of Korea. E.g., Turkey income relative to the US in 2000 (27 percent of US per capita GDP) was similar to that of Korea in 1987.

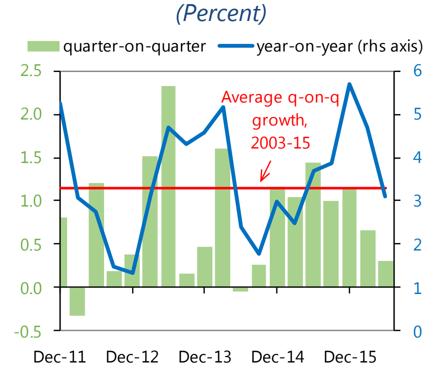
2. **Political and economic uncertainty have increased following the failed coup attempt in July 2016.** Since then, a state of emergency has been imposed. More than 140,000 public employees, including one fifth of all judges and prosecutors and over one third of the staff of the banking supervisory agency (BRSA) and some economic ministries, have been suspended or dismissed. Around 40,000 people have been detained and over 4,000 companies and institutions with assets of close to US$4 billion have been shut, or taken over by the state. A referendum that would expand presidential powers is likely in 2017.

RECENT ECONOMIC DEVELOPMENTS

3. **Following a strong performance in the preceding year, growth slowed in 2016.** In the first half of 2016, GDP growth was 3.9 percent (year-on-year), but its quarter-on-quarter pace decelerated sharply, despite the easing of fiscal and monetary policies. Growth remains consumption-driven, reflecting the boost to real disposable incomes from the January minimum wage hike and low energy prices. Investment is weak, on the back of heightened uncertainty and a sharp deceleration of credit growth. The external sector subtracted from growth, due to the surge in real imports and fall in tourist arrivals. The latter has had a negative effect on a range of sectors, especially for accommodation, transportation, and food services (Box 1).

Turkey: Real GDP Growth

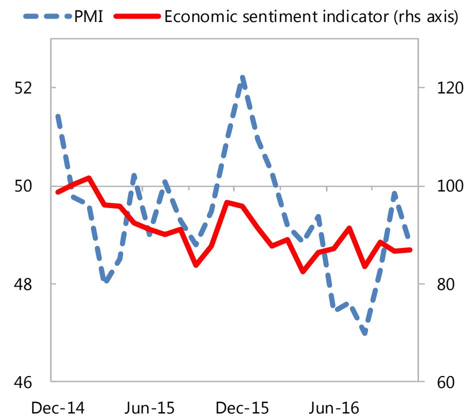
(Percent)



Source: TurkStat and staff estimates.

4. Output contracted in the third quarter, but some pickup is expected by the year's end. Security concerns and Russian sanctions cut the number of tourists from Europe by a quarter and from Russia by more than two-thirds in January-September. Also, the cereals harvest is estimated to be 9 percent lower than last year's. The failed coup attempt and its aftermath have further disrupted economic activity. While the outlook for industrial production has recently improved, economic sentiment remains subdued amid heightened uncertainty. Government measures to spur consumption and investment and the gradual removal of Russian sanctions would contribute to the expected pickup of economic activity in the last quarter of 2016.

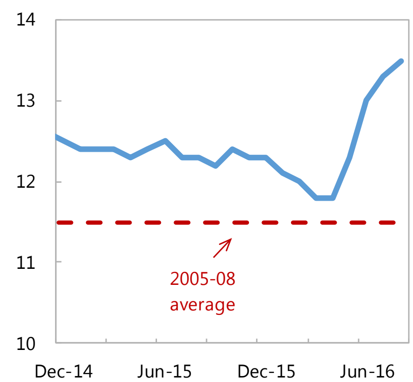
Turkey: High Frequency Indicators key: High Frequency Indicators
(Indices)



Source: IHS Markit, European Commission, and staff estimates. Note: PMI value of 50 indicates no change from the previous period. Economic sentiment index has a long-term value of 100.

5. The unemployment rate has increased steadily since March, as the labor force grew faster than employment. The 30 percent minimum wage increase boosted average real hourly wages in the formal sector—by more than 10 percent in construction and services, and to a smaller extent in industry. The number of hours worked in the formal sector fell, while employment in the grey economy increased. At the same time, public employment in the education and health-care sectors grew strongly. Between May and July, seasonally-adjusted employment declined by 2.5 percent in industry and 5 percent in construction.

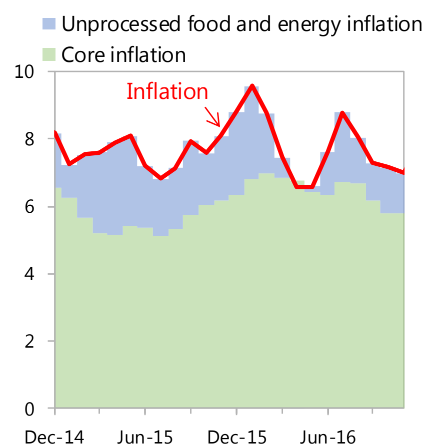
Turkey: Non-Agricultural Rate of Unemployment *(Percent)*



Source: TurkStat and staff estimates.

6. Inflation has moderated but remains volatile and well above target. Inflation volatility is mainly driven by unprocessed food and energy prices. The latter reflect oil price changes, the September fuel tax hike and October cut in the administered price of gas, as well as exchange rate pass-through. The economic slowdown and REER appreciation dampened core inflation, though it remains elevated, reflecting unanchored expectations.

Turkey: Contributions to Inflation
(Percentage points)



Source: TurkStat and staff estimates.

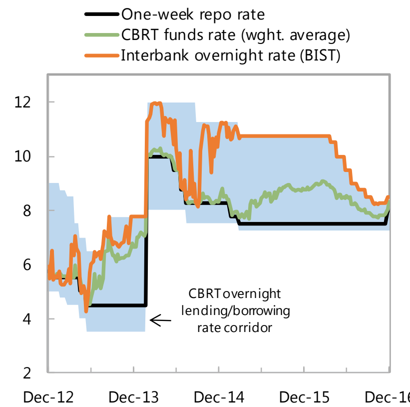
7. The central bank (CBRT) has eased monetary conditions in the process of simplifying the monetary framework. From March to end-September 2016, the CBRT gradually lowered the overnight lending rate by 250 basis points to 8¼ percent, leading to a commensurate decline in the interbank overnight lending rate. At end-November, the CBRT raised the one-week repo and overnight lending rates after a steep Lira depreciation. In the wake of the failed coup attempt, the CBRT lowered reserve requirements, allowed greater use of gold and foreign currency, and offered unlimited Lira liquidity against FX collateral. In an effort to release FX liquidity, the latter was capped again at end-November with higher than the pre-coup attempt limits and changes were made to the reserve option mechanism and reserve requirements in FX.

8. Credit growth slowed markedly, due to both demand and supply factors. The large Lira depreciation in 2015 pushed private debt-to-GDP ratios to multi-year highs, limiting risk appetite (Box 2). The heightened political uncertainty also weighed on corporate investment. On the supply-side, macroprudential measures taken in previous years to rein in household loans proved effective, while banks maintained tight credit standards. Corporate credit growth decelerated, with SMEs loans expansion falling from 21 percent in 2015:Q3 to 6 percent in 2016:Q3. The macroprudential regime was loosened in the Spring and again in September 2016 to support the flagging credit and output growth. Retail credit growth has since picked up from around 4 to 7 percent, led mainly by state-owned banks. In terms of borrowers collateral, house prices have accelerated since 2015:Q2, but housing affordability has deteriorated (Box 3).

9. Bank capital levels remain high, although some buffers are decreasing. Higher bank profits and the credit growth slowdown boosted the system-wide Tier 1 CAR to 13.7 percent (Table 6). However, part of the CAR improvement was due to a relaxation of prudential norms that released provisions and lowered regulatory risk weights on consumer loans. Regulatory changes reduced the provisioning requirements for restructured loans in the tourism and energy sectors, as well as consumer loans and credit cards. A broader definition of impaired loans that includes restructured credits shows a deterioration in asset quality, especially in the household and SME sectors.[1] Bank profitability has increased, as the drop in domestic funding costs has not been fully passed on to borrowers, and also due to cost saving measures and one-off factors. Banks' negative on-balance-sheet, net open FX position decreased from minus 30 to minus 8 percent of regulatory capital as residents' FX deposits declined and the reliance on short term FX funding decreased.

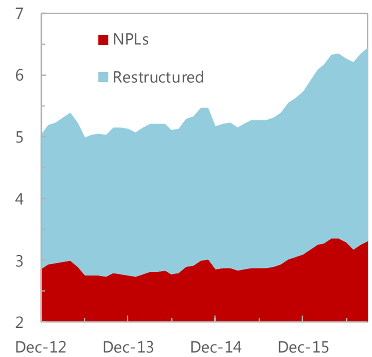
10. The fiscal stance turned expansionary in 2016. The central government overall balance widened in the first half of

Turkey: Monetary Policy Rates
(Percent)



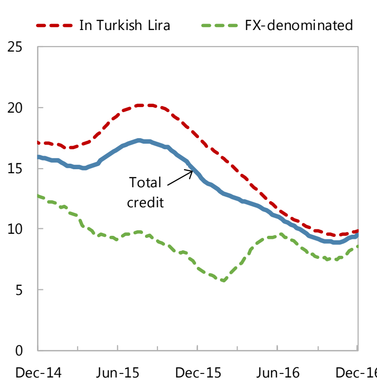
Source: CBRT and staff estimates. Notes: End-of-week data. Five-day moving averages for CBRT and BIST overnight rates.

Turkey: Share of NPL and Restructured Loans *(Percent)*



Source: Turkish Bank Association.

Turkey: Bank Credit Growth
(Percent)



Source: BSRSA and staff estimates. Notes: 13-week moving averages of end-of-week data adjusted for FX valuation effects by staff.

[1] NPL data are of poor quality. In Turkey, even more so due to evidence of: (i) increased loan restructuring; by (ii) problems in loan classification by banks and (iii) deficiencies in the BRSA's supervision of loan classification practices (Turkey: Basel Core Principles for Effective Banking Supervision—2016 Detailed Assessment of Observance).

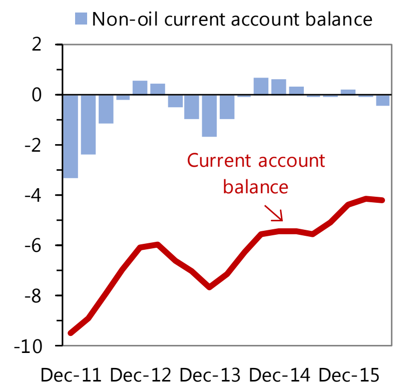
2016. Through October, primary expenditures increased by 16.4 percent, on the back of new hires in the education and health sectors, inflation indexation, security spending, and the subsidy for the minimum wage increase. Interest payments decreased, as a result of falling interest rates. The increased spending was partially offset by higher tax and non-tax revenues. Following the failed coup attempt, the government announced a number of temporary tax reductions/exemptions partly offset by an increase in fuel excises. The current Medium Term Program (MTP) envisions a widening of the 2016 general government deficit by around 2 percent of GDP. The public debt is sustainable, but a combination of growth and contingent liability shocks would lead to a substantial increase in the public debt to GDP ratio (Annex IV.)

Central Government Fiscal Outturn
(Percent of semi-annual GDP)

	2015:H1	2016:H1
Primary Revenue	24.0	24.3
Primary Expenditure	22.4	24.3
Primary Balance	1.6	0.1
Overall Balance	-1.6	-2.5

11. **The current account deficit remains sizeable at over 4.5 percent of GDP.** The positive contribution from low world oil prices has been broadly offset by the weak tourism season and lower export prices. Non-oil real imports surged in 2016: H1, spurred by the pick-up in consumption and REER appreciation. Turkey's external position remains weaker than the level consistent with medium-term fundamentals and desirable policy settings. The current account deficit is 1–4 percent higher than the estimated norm, implying a REER overvaluation of 5–15 percent on average in 2016 (Annex II).

Turkey: Current Account
(Percent of GDP)



Source: TurkStat and staff estimates.
Note: The nominator and denominator of the ratios are 4-quarter rolling sums.

12. **Large external financing needs have been comfortably met, but costs have risen.** Both the government and the private sector have so far refinanced maturing debt in international markets flush with global liquidity. As of 2016:Q3, the pace of external debt accumulation has slowed, reflecting the weakening economy and domestic credit, but also increased investor concerns. Sovereign rating downgrades contributed to a rise in the cost of external funding, with interest rates on syndicated loans increasing by 25-40 basis points. Portfolio inflows turned positive with a net inflow reaching US$8 billion in the first nine months of 2016, following a drought in 2015. The positive trend reversed in 2016:Q4, with non-resident withdrawals of US$2.5 billion by mid-November reflecting Moody's cut of the sovereign rating to below-investment and the November emerging markets rout.

13. **Turkey's external debt is sustainable, but remains vulnerable to interest and exchange rate risks.** Turkey's external debt of around 60 percent of GDP is vulnerable to valuation shocks (Annex III). Debt service costs are sensitive to tightening of global liquidity conditions and changes in investor sentiment, given the still large share of short-term liabilities and loans with variable interest rates.

14. **Net international reserves (NIR) have increased from a low base.** NIR (adjusted for public sector FX deposits) increased to about US$33 billion by November 2016, as the CBRT suspended FX auctions in April and reduced FX sales to state-owned energy companies. This,

alongside the issuance of government debt in foreign currency and CBRT measures to provide Lira liquidity against FX collateral, contributed to the increase in gross international reserves (GIR) (Figure 2). The November CBRT measures in support of the weakening Lira pared some of the gains in GIR, which hover slightly above 90 percent of the IMF's reserves adequacy (ARA) metric.

15. Turkish financial markets have underperformed other large emerging markets in 2016. Markets sagged in the wake of the failed coup attempt, but Turkey was also among the countries most affected by the sell-off of emerging market assets that started in November 2016 (Figure 5).

OUTLOOK AND RISKS

16. Growth is projected to be below potential in 2016–18. Domestic political turmoil, uncertain future of the EU-Turkey relations, tensions in the South-East regions, and military involvement in neighboring countries are expected to weigh in on domestic demand. However, population growth and rising wages will support consumption, while macroprudential loosening and fiscal incentives will benefit investment.[2] Bank credit to the private sector is expected to remain subdued and, hence, not to be a significant factor in the growth recovery.[3] Net exports are expected to improve somewhat, as a result of the Lira depreciation, the domestic demand retrenchment, and the expected lifting of Russian sanctions but security concerns are likely to hold back the full recovery in tourist arrivals. Uncertainty and changing global financing conditions are expected keep the cost of external borrowing elevated. As a result, short-term growth prospects have worsened considerably. Over the medium-term, growth is projected to be at around 3.5 percent, unchanged from previous estimates,[4] but internal and external imbalances are expected to persist, with inflation remaining well above target and external debt rising.

17. On balance, the risks to the medium-term baseline are tilted to the downside (Annex I):

- On the upside, increased trade with Iran and a stronger than expected recovery in the EU could help reduce external imbalances. Prompt implementation of planned structural reforms may yield better results earlier than currently envisaged.

- Downside risks relate to the high exposure to FX risk of non-financial corporations,[5] large annual external financing needs against the backdrop of low net international reserves (NIR), the sizeable short-term capital inflows, and the expected further widening of the negative

[2] In part driven by the 2016 minimum wage hike and planned indexation in 2017, reflecting the role of the minimum wage as a benchmark in wage negotiations.

[3] Reflecting the weak outlook for productivity growth; tight lending standards amid the deterioration in bank loan quality; high interest rates due in part to scarcity of domestic savings; and the Lira depreciation, which exacerbated the burden of corporate FX-denominated debts.

[4] IMF Country Report No. 16/105. Those estimates also highlight that potential growth will decrease if recovery in TFP growth fails to materialize or investment continues to be weak.

[5] While the largest firms seem relatively resilient to both FX and interest rate shocks, the performance of second-tier firms (between top 20–100 largest firms) is noticeably weaker given their weak starting positions and lack of hedges against currency depreciation (Turkey 2016 FSSA). The consequent deterioration in corporate credit quality from these second tier firms under the stress scenarios is rapid and significant.

NIIP. These weaknesses could exacerbate the negative effects of a possible increase in the cost of external financing caused, for instance, by rapid interest rate increases by the U.S. Federal Reserve or a generalized increase in global risk premia. Deleveraging could accelerate, leading to a credit-income contraction cycle and ultimately to a recession. A possible further deterioration in geopolitical relations could undermine investor confidence.

Authorities' views

18. **The authorities believe growth will recover strongly in 2017.** They attribute the economic slowing primarily to the drop in tourism, which shaved more than 1 percentage point off growth in 2016. However, thanks to a relaxation in macroprudential measures, a reduction in domestic interest rates, and investment stimulus packages, consumption and investment is expected to recover in 2017. Improved relations with Russia and growth in traditional trading partners will help the recovery of tourism and exports. With the help of political stability and structural reforms, they expect Turkey to perform strongly. The Medium-Term Program projects growth at 4.4 percent in 2017 and 5.0 percent in 2018.

POLICY AGENDA

19. **The overarching goals are: (1) avoiding an excessive slowdown of the economy; and (2) addressing external imbalances and reducing inflation**. The growth slowdown and the Lira depreciation have put pressure on non-financial corporations and could ultimately generate risks for the financial sector. Avoiding an adverse loop between the slowing economy, large depreciation, and private balance sheets is the immediate goal. Addressing the external imbalances remains the main medium-term priority, requiring macro policies and structural reforms to increase private saving and reduce dependence on external financing.

20. **These challenges call in the short run for a broadly neutral monetary stance—to the extent consistent with orderly FX market conditions—and a moderately looser fiscal stance.** Monetary policy tightening could be required to prevent excessive Lira volatility in the short-run and contain its spillovers to inflation. Use of some fiscal space could help cushion the impact of negative shocks and possible tighter liquidity conditions on the economy. Financial sector policies should aim at preserving financial stability via maintaining a robust macroprudential regime, including measures to lower foreign exchange risk in the economy, and further strengthening supervision and bank governance.

A. Monetary Policy

21. **Staff welcomed the simplification of the monetary framework.** A framework in which liquidity is provided at a policy rate would improve the transmission of monetary policy. Future steps in this direction should aim at closing the gap between the average cost of CBRT funding and the policy (one-week repo) rate and making the interest rate corridor symmetric around that rate, while keeping the real cost of liquidity provision in positive territory. This would help better manage the

variability of interest rates and liquidity certainty, and increase the clarity of the monetary policy signal. The increase of the one-week repo rate at end-November helps achieve this objective.

22. Staff advised maintaining the current monetary stance. Staff saw the current positive, real CBRT funds rate as balancing the need to contain imbalances and provide a backstop to the slowing economy. The monetary stance should be tightened if the recovery is stronger than expected and/or inflation fails to decline to its target. A tighter monetary stance could be also required to limit excessive Lira volatility and its inflationary spillovers. The enhanced provision of Lira liquidity after the failed coup attempt was appropriate, but this extra liquidity should be gradually withdrawn.

23. Staff recommended increasing international reserves. Staff welcomed the suspension of the regular foreign exchange auctions and reduced FX sales to state-owned enterprises. Conditional on global liquidity conditions being favorable, staff advised a further increase of net international reserves (NIR) through (partially) sterilized interventions communicated in advance to avoid market disruptions, and by increasing the credit limit facility for the EXIM Bank. NIR would need to be increased by about US$10 billion for GIR to reach 100 percent of the IMF's ARA metric.

Authorities' views

24. The authorities re-affirmed their commitment to complete the simplification of the monetary policy framework. They saw the timing of further steps in the process as being dependent on inflation dynamics and external conditions. The authorities have also started a gradual withdrawal of the extraordinary provision of Lira liquidity against FX collateral in the aftermath of the failed coup attempt. While agreeing on the need to build reserves, they considered the current conditions unsupportive of a rapid accumulation.

B. Fiscal Policy

25. Moderate fiscal loosening in 2017 is appropriate, but a credible medium-term consolidation plan is needed. The projected widening of the general government structural primary balance by ½ percent of GDP in 2017 would support domestic demand, without exacerbating external imbalances. Staff urged authorities to let automatic stabilizers work and argued that an extension of the minimum wage subsidy at an appropriately lower level could be an effective means of supporting growth and employment. Staff welcomed the planned increase in public investment. However, staff cautioned that the announced investment incentives may not be effective to achieve the desired effect, given the high level of uncertainty and elevated private debt burden (Box 2). Tax incentives would have to be well-targeted and supported by macroeconomic stability and rule of law to be effective. While broadly supportive of the authorities' 2017 expenditure plan, staff considers the authorities' 2017 revenue projections to be overly optimistic, with the tax-to-GDP ratio projected to increase by 0.4 percent of GDP in 2017. Tax expenditures remain an issue and revisions suggest they are in fact over 3 percent of GDP higher than previously estimated. For 2018-19, the planned reduction of current transfers by 1 percent of GDP in 2018–19 is appropriate, but needs to be backed by specific measures to contain the wage bill, pension and health care spending and limit the increase in the debt-to-GDP ratio in the medium term.

26. Turkey has some fiscal space to provide the recommended temporary stimulus, Access to financing remains solid, despite some increase in costs. The fiscal position is sound: the debt-to-GDP ratio is moderate and is projected to eventually resume its declining trend under the baseline and most stress scenarios; gross financing needs are low, and projected primary balances exceed the debt-stabilizing level over the medium term (Annex IV). However, persistent external imbalances, and dependency of the banking and corporate sectors on external markets with substantial rollover needs, call for prudence in using the fiscal space.

Selected Indicators of Fiscal Space
(Percent of GDP)

	2016
Output Gap 1/	-0.3
Gross public debt	34.6
Gross financing needs	6.5
EBA current account gap	-3.6

1/ Percent of potential GDP.

27. Enhanced management of fiscal risks is warranted. Contingent liabilities are increasing, due to continued reliance on PPPs for infrastructure investment. At the same time, the legal and oversight framework for PPPs is fragmented. A growing share of fiscal risks falls outside the Treasury's established approval and monitoring system and is not public (Box 4). Staff urged stronger central oversight, approval, and disclosure procedures for all public guarantees, backed by a comprehensive PPP framework law. Staff viewed the newly announced investment incentives as adding to existing fiscal risks, as in some cases they would involve the extension of purchase and other guarantees.[6] The recently established sovereign wealth fund, to be funded by privatization receipts and possible capital market financing, carries added potential for fiscal and financial risks. Staff therefore recommended that the governance of the fund should be aligned with international best practices, including published annual reports, audited financial statements, and a transparent investment policy. Staff reiterated its recommendation to publish an explicit fiscal risk statement.

Authorities' views

28. The authorities believe that their policies appropriately address the need to stimulate the economy while remaining fiscally responsible. They emphasized the relatively low level of public debt and its composition as strengths, and reiterated their intention to maintain fiscal discipline. The central government overall deficit is envisioned to remain below 2 percent of GDP throughout the MTP horizon, which would ensure a declining trend in public debt. They believed that the new incentive schemes would boost investment as they offer a wide spectrum of benefits to the potential investors in a flexible manner.

29. The authorities deem fiscal risks to be manageable. They also acknowledged the desirability of expanding fiscal risk disclosure to entities beyond the Treasury, and strengthening PPP governance. The authorities also reiterated their intention to align the sovereign wealth fund with international best practices.

C. Financial Sector Policies

30. Staff advised further strengthening of supervision and bank governance, building on the enhanced legal framework for financial regulation. Banks face rising credit risks in the

[6] In contrast to existing schemes that provide incentives to investments that satisfy predetermined conditions, the new scheme enables the cabinet to grant a broad spectrum of incentives to specific projects on an ad-hoc fashion.

downward phase of the economic cycle. The share of non-performing loans has increased in consumer and more recently corporate loans. Restructuring of credits to sectors hit hardest by the economic slowdown masks the extent of asset quality impairment. Drawing upon the findings of the recent FSAP assessment (Box 5), staff urged authorities to evaluate and revise the definition of credit classifications to bring them more in line with international norms and strengthen enforcement, and to strengthen the supervisory processes and banks' governance standards.

31. Staff questioned the rationale behind the recent loosening of macroprudential regulations for consumer loans. Macroprudential policies should focus squarely on ensuring the soundness of the financial system—not on active domestic demand management. Staff argued that the macroprudential loosening risks being counterproductive in the context of high private indebtedness. Even if it is temporarily successful in spurring demand, it adds to existing financial vulnerabilities that policies would need to address in the future.

32. Staff argued that the macroprudential regime for corporate FX borrowing should aim at lowering the foreign exchange risk in the economy. Specific measures in this area, drawn from the recent FSAP assessment, are manifold: (i) quicker phase-in of reserve requirement measures aimed at lengthening the maturity of banks' external financing as well as the net stable funding ratio; (ii) increasing the remuneration differential between Lira and FX reserves to further slow banks' FX wholesale borrowing; (iii) increasing capital charges and/or provisioning on FX loans aimed at internalizing the increased indirect credit risk associated with FX lending; (iv) bringing the prudential treatment of FX-indexed lending in line with that of FX lending; and (v) introducing tax measures to discourage NFCs from borrowing in FX, both domestically and externally.

33. Turkey continues to make progress toward implementing international standards for anti-money laundering/combating the financing of terrorism. Staff encouraged the authorities to implement the FSAP recommendations in the area (Box 5).

Authorities' views

34. The authorities see the loosening of macroprudential measures for consumer lending as stabilizing domestic demand and thereby lowering financial sector risks. While aware of the challenges stemming from the corporate sector's elevated negative FX position, the authorities maintain that relaxation in macroprudential measures will help recovery in credit growth, which has been subdued for three years.

D. Contingency Planning

35. Additional policy space should be used in case of a marked growth slowdown. Political uncertainty could take a heavier toll, particularly if actions related to the private sector have the effect of elevating counterparty risk. The weak business climate could further dampen anemic private investment, and bring consumption growth to a standstill. Such dynamics could engender a vicious macro-financial cycle of deleveraging, cuts in investment by over-indebted corporates, and ultimately income contraction.[7] Staff argued that in such a situation some additional fiscal space could be used and monetary policy could assign a bigger weight on the output gap than on the overshooting of the inflation target; however, relaxation of macroprudential policy should not be used for countercyclical purposes. The authorities should require prompt recapitalization if stress tests show a capital shortfall.

36. **In case of large capital outflows—or, *in extremis*, a sudden stop—a tighter monetary stance would be unavoidable.** In disorderly market conditions, banks and corporates would have difficulties rolling over external debt, and the renewal of FX hedges could become prohibitively expensive. Banks would likely react by not rolling over corporates' domestic FX loans, precisely at the time when corporates would be under strain to repay them. In such a scenario, a recession would be likely, and the Lira would be under pressure. Under such circumstances, staff argued that the policy rate would need to be increased sharply to avoid a more damaging and disruptive depreciation. Given that net international reserves are low, the scope for credible FX intervention is limited. In the event of a recession, fiscal policy should be loosened, as public debt sustainability is not an immediate concern. Still, corporate default and bank liquidity or solvency problems could occur. In this regard, staff reiterated the recommendation to strengthen supervisory processes and banks' governance standards and emphasized the importance of putting in place of a robust debt-restructuring framework.

Authorities' views

37. **The authorities stressed that the economy has been resilient in the face of several negative shocks.** The low level of public debt and its composition, solid bank balance sheets, flexibility of the real sector, and renewed political stability contribute to the stability of the economy.

E. Structural Reforms

38. **Restoring business confidence and improving the investment climate are key priorities.** This will require enhancing the predictability of the regulatory environment, while ensuring adequate public institutional capacity in the wake of the failed coup attempt. The investment climate should be further enhanced by simplifying regulations and administrative procedures for starting a business, as well as increasing the efficiency of the legal system.

39. **There was agreement on the need to make labor markets more flexible, and on raising competitiveness.** Staff welcomed recent legislative amendments aimed at liberalizing fixed-term contracts and temporary work agency services. Staff reiterated the importance of reforming and pre-funding the severance pay system—which currently covers only part of formal employment and is overly burdensome for enterprises—for enhancing labor mobility. In addition, staff argued that extension of the minimum wage subsidy at an appropriately lower level would provide relief to strained firms in the formal sector. The 2016 minimum wage increase was large and its impacts will be staggered over the next two years, as union contracts are typically negotiated every 2 to 3 years

[7] This is described in details in the 2016 Article IV Staff report

and use the minimum wage increases as a starting point in negotiations. While a nominal freeze in the minimum wage will help restore competitiveness more quickly, it is not politically feasible. Hence, staff called for moderate minimum wage increases aligned with expected inflation and productivity gains, which in turn differ across regions. To this end, staff argued that the cost of labor could be appropriately differentiated according to regional economic developments.

40. Staff welcomed the new pension auto-enrollment law, but cautioned that its current form curbs its impact on private saving. While it is a step in the right direction, important design weaknesses risk undermining its key policy objectives (Box 6). Staff advocated for the need to (i) centralize the collection of contributions in the Social Security Institute; (ii) create capacity in the Pension Monitoring Center to act as procurement board and carry out record keeping; and (iii) open competitive international auctions for asset management now and for custodianship in the future. In addition, staff argued that the contribution rate should be increased to at least 6 percent, in order for the new regime to have a meaningful impact on private saving.

41. There was agreement on the need for better integration of refugees. Turkey is hosting a large number of refugees, who are entitled to public services and work in the informal sector. Legislative changes in January 2016 allowed Syrian refugees to apply for work permits. Thus far, the uptake has been very low, due to legislative restrictions, skill mismatches, and administrative hurdles for employers and employees (Box 7). Staff argued for simplification of the application process for work permits and an active communication strategy to improve the uptake. In March 2016, the EU and Turkey agreed on a framework to reduce irregular migration and channel international assistance to refugees in Turkey. The disbursement of earmarked funds has been slow, due to the complexity of the task of coordinating the work of a large number of NGOs and public agencies, while ensuring proper utilization of funds. Full implementation of the agreement would help improve the refugees' access to education, health care, and public utilities.

Authorities' views

42. The authorities agreed on structural reform objectives, and their associated challenges. They highlighted their structural reform vision as follows:

- The new private pension automatic enrollment law should help stimulate saving and rebalance the economy. The specific design features of the reform were prepared based on extensive research of international best practices. They pointed to the fact that government has the authority to increase contribution rates, if necessary.

- Structural reforms to enhance the business climate will focus on legislative amendments to simplify administrative and bureaucratic procedures, and implementation of the regional investment incentive scheme.

- Labor market conditions are to be improved through changes to the labor code to support flexible employment, increased access to childcare facilities, and provision of relevant skill training and effective internship programs. More progress is needed on the severance pay reform, and a careful, broad-based consultation with stakeholders is needed to support successful implementation.

43. **The authorities broadly shared staff views on rising labor costs, competitiveness, and refugee integration.** They viewed the temporary minimum wage subsidy as appropriate. On the integration of refugees into the workforce, the authorities attributed the slow uptake in work permits to skill mismatch rather than administrative hurdles. The authorities called for strong commitment of international financial assistance to make further progress on integrating refugees.

STAFF APPRAISAL

44. **The challenges facing Turkey have increased considerably since the last Article IV Consultation**. Domestic political uncertainty has increased significantly, taking a toll on economic activity and testing several key domestic institutions. International conditions have also become more challenging, marked by a rise in interest rates and dollar strength. Weak confidence and a rapidly depreciating lira are reinforcing one another, raising concerns about the resilience of the nonfinancial sector. The preceding benign period has not resolved pre-existing weaknesses, including large current account deficits, high external financing needs, large FX-denominated debt in nonfinancial corporates, a weak business climate, and high inflation. Moreover, productivity is lagging and growth potential has declined against the background of structural bottlenecks and low private investment rates.

45. **Institutional strength is a pre-requisite to tackle these challenges.** Particularly in the aftermath of the failed coup attempt, it is essential that key economic and financial public institutions remain strong and credible, with their mandates preserved, and their policy frameworks brought further towards international best practice. As staff has emphasized, there is a need to strengthen the monetary transmission mechanism, and to enhance the management of contingent liabilities. The FSAP underscores important avenues by which financial sector oversight and supervision could be strengthened.

46. **Stronger macro-financial policies are necessary to bring down stubbornly high inflation and reduce external vulnerabilities.** The root causes of Turkey's vulnerabilities are structural (low private saving) and cyclical (externally funded, private sector up-leveraging favored by easy international financing conditions). These weaknesses are exacerbated by the persistent overshooting of the inflation target and risks stemming from the large, negative FX position of the economy. Banks and corporates are leveraged and highly exposed to risks stemming from the high share of borrowing in foreign currency.

47. **Avoiding an excessive slowdown is essential in the short run.** While some near-term slowdown in economic activity is beneficial to reduce external imbalances, a large fall in GDP growth could lead to a vicious credit-income contraction cycle. Appropriate demand management calls for a broadly neutral monetary stance—to the extent consistent with orderly FX market conditions—and allowing automatic fiscal stabilizers to operate in full. Tighter monetary stance could be required to prevent excessive Lira volatility. Turkey has some fiscal space to provide discretionary measures,

however any fiscal stimulus should internalize the role played by fiscal policy as a stability anchor, particularly given the scarce credibility of monetary policy.

48. In the medium-term, rebuilding buffers and tackling structural weaknesses is important. Simplifying of the monetary policy framework and rebuilding credibility by appropriate tightening of monetary policy are necessary steps toward reducing inflation. The recent loosening of macroprudential measures risks being counterproductive in the context of high private indebtedness. The focus of macroprudential policies should be kept squarely on maintaining the soundness of the financial system. Finally, net international reserves should be increased.

49. Slow progress with structural reforms and heightened political and economic uncertainty are keeping the economy from reaching its full potential. Policies should aim at improving the investment climate and ensuring adequate public institutional capacity in the wake of the failed coup attempt. Further steps are needed to boost the internal and external competitiveness of the formal economy, including keeping future minimum wage increases in check and addressing labor market rigidities. The low private saving rate is limiting the balanced growth potential of the economy. In this respect, the reform of the voluntary pension system is a step in the right direction, but its impact will be limited unless its design is further aligned with international best practices.

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

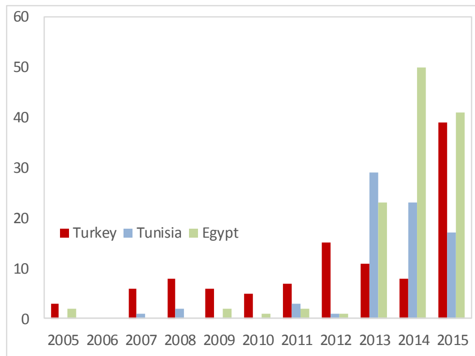
Box 1. Assessing the Impact of Shocks to Tourism

A decade of vibrant development made the tourism sector an important driver of the economic activity. Turkey's share in the global inbound tourist flows increased from 1.5 percent in early 2000s to about 3 percent in 2015. Over that period the number of foreign tourists' arrivals tripled and reached 36.2 million people. In 2007 the government launched a sector development program (Strategy 2023), which included investment incentives, measures to address transportation and infrastructure bottlenecks, and marketing activities. In 8 years, country's capacity to accommodate tourists increased 2.5 times. In 2015, travel services earned around US$27bn of exports revenues (3.7 percent of GDP and about 13 percent of total export proceeds). In selected regions, it is one of the key employers. Overall, the tourism sector was estimated to directly generate about 600 000 jobs (2.3 percent of the total employment), additional approximately one million of is estimated to be created indirectly[1].

In 2016 Turkey was hit by a major fall in foreign tourists' arrivals, and recovery prospects remain subdued. Tourist arrivals from Europe fell by over 30 percent, against the backdrop of a sharp rise in the number of and a severity of terrorist attacks in Turkey in the last few years. In addition to that, Russian restrictions on charter flights and travel tours cut the Russian tourists by more than two-thirds in January-September. This contributed to about 30 percent drop in exports of transportation services, and had negative spillovers to the food and accommodation sectors. Studies show that repeated terrorist attacks coupled with political uncertainty tend to have long lasting effect on foreign tourist arrivals. While the Russian sanctions were lifted in 3Q 2016, repeated incidences of violence suggest that recovery of the tourist inflows may appear weak due to security concerns.

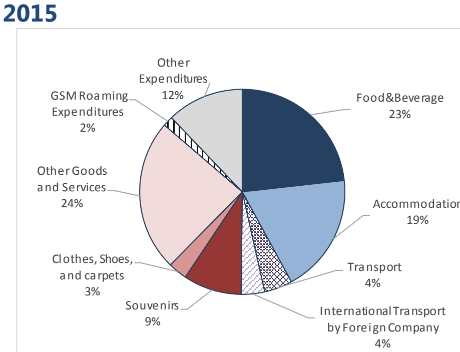
Given linkages between tourism and other sectors, a 10 percent shock to foreign arrivals is estimated to have 0.3-0.5 percent impact on GDP in the first year after the shock.[2] This accounts for the fall in gross value added in food and accommodation and transportation of about 2 percent and 3 percent respectively. These three sectors represent over 46 percent of total tourist expenditures, and are the first to experience the shock. The assessment is based on a Bayesian VAR model estimated on quarterly data between 1998 and 2015. The model predicted that absent of policy measure to offset the impact of the weak tourism sector and other positive shocks GDP would decelerate to around 2 percent in 2016.

Number of terrorist attacks in major touristic areas



Source: GTD, staff estimates.

Tourist Expenses by Types of Expenditure, 2015



Source: TUIK, staff estimates.

1/ Source: Estimates by the World Travel and Tourism Council. The travel and tourism sector includes hotels, travel agencies, restaurants, airlines and other passenger transport, as well as the activities of the restaurant and leisure industries directly supported by tourists.

2/ The model included the following variables: real tourism exports, gross value added for food & accommodation, transportation and the rest of sectors. Weighted GDP of source countries and REER were included as a control variable capturing drivers of foreign demand. Trend variable was used to capture the build-up of tourism capacities.

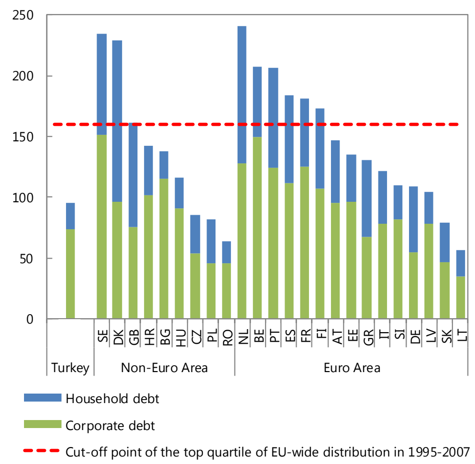
Box 2. Turkey: Benchmarking Private Debt Burdens

Aggregate debt risk metrics appear relatively benign in Turkey. Turkey's private debt-to-GDP ratio is significantly below the threshold of 160 percent, used for unconsolidated data in the EU Macroeconomic Imbalances Procedure. At the same time, the aggregate debt burden in Turkey is higher than in the Czech Republic and Poland—two European countries with higher per capita incomes known for a balanced development of credit markets.

However, sector-specific solvency risk metrics raise important concerns.[1/] There has been a significant increase in the exposure of Turkish corporates and households to vulnerabilities stemming from indebtedness in the years following the global financial crisis. As a result, Turkey now ranks second in solvency risk exposure across European countries outside the euro area. The readings of both the corporate and household risk metrics exceed the indicative thresholds given by the cut-off point of the top quartile of the EU-wide distribution of these indicators in 1995–2007.

Europe: Aggregate Debt Risk Metric, 2014

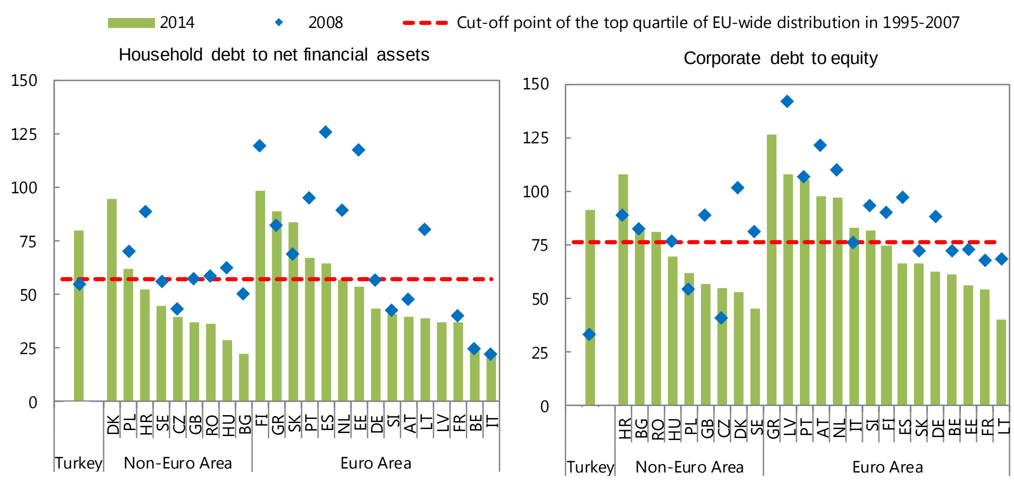
(Percent of GDP)



Source: CBRT Financial Accounts; EUROSTAT Annual Sector Accounts; and Fund staff calculations. Notes: 2015 data for Turkey. The debt stock includes outstanding amounts of loans and debt securities, except financial derivatives. Data is unconsolidated within each sector.

Europe: Sectoral Solvency Debt Risk Metrics, 2014

(Percent)



Source: CBRT Financial Accounts; EUROSTAT Annual Sector Accounts; and Fund staff calculations. Notes: Data for Turkey are for 2009 and 2015, respectively. 2008 data for DK, LV, RO and GR are censored in charts. Data are unconsolidated within each sector.

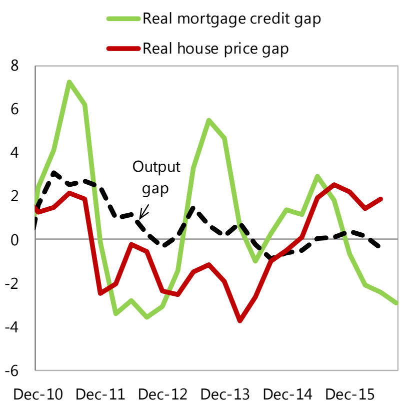
[1/] Official data for calculating sectoral liquidity risk metrics is not available for Turkey.

Box 3. Turkey: Residential House Prices

Turkish house prices have been markedly increasing for several years. The prices for homes rose cumulatively by 110 percent in nominal and 35 percent in real terms between end-2010 and July 2016. Valuation appears stretched by a number of metrics, such as price-to-income and price-to-rent ratios. The burden of household debt has also increased.

Turkey: Housing Market Cycle

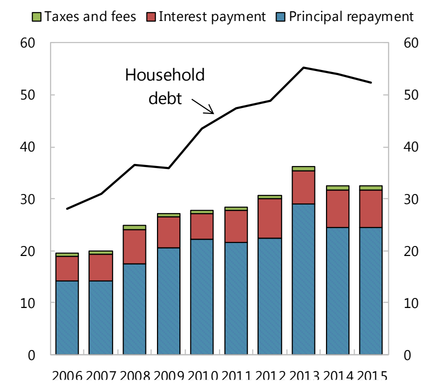
(Deviation from HP-Trend, Percent)



Source: TurkStat and staff estimates.

Turkey: Household Debt Burden

(Percent of disposable income)

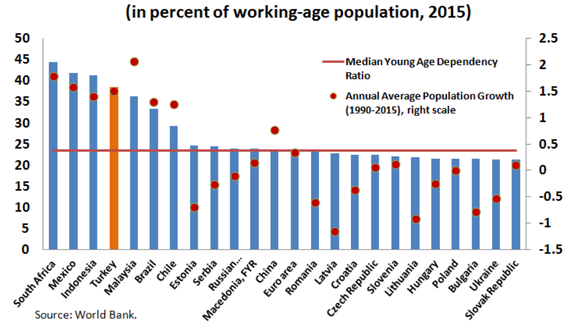


Source: TurkStat and staff estimates.

Demographic and socio-economic factors underpin the strong demand for housing. A young and rapidly growing population combined with a high and rising rate of urbanization drive demand for residential housing. In addition, the number of households has increased with a decline in average household size. Household preferences have also shifted toward newer and larger houses, with stronger construction codes.

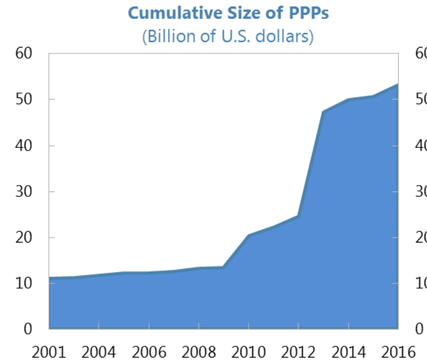
Special sales campaigns and government stimulus have buoyed house sales since July 2016. The government launched a campaign for subsidized sales of 60,000 houses with mortgages offered at below-market lending rates and higher LTV ratios than the regulatory ceiling, in addition to applying moral suasion on banks to lower mortgage rates. Following the adoption of these measures, total house sales rose by 2 percent year-on-year in August. Since then, the LTV ceiling was raised from 75 to 80 percent.

Young Age Dependency Ratio
(in percent of working-age population, 2015)



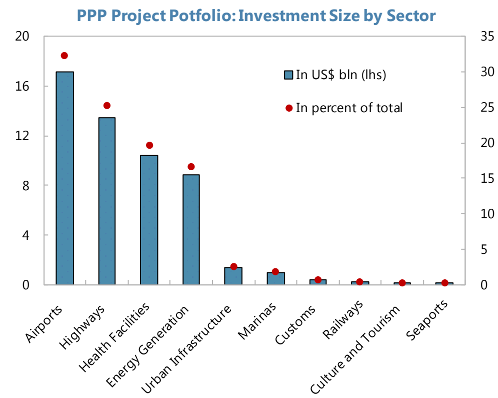
Box 4. Turkey: Contingent Liabilities Related to PPP and other Treasury Guarantees

The size of the overall PPP portfolio in Turkey has sharply risen in recent years, reflecting the active infrastructure agenda of the authorities. Total investment size has increased fivefold since 2010, mostly in transportation, energy, and health (Figure 1). Total investment value stands at $53 billion for 211 projects, of which 33 PPP projects with total investment value of US$38.8 billion are under construction.



Source: Ministry of Development

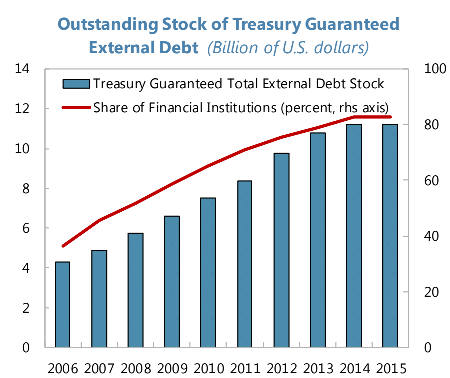
Management of PPPs and their fiscal risks is fragmented. The legal and regulatory framework for PPPs is highly fragmented both across sectors and type of PPP arrangements. For example, health, education, and energy PPPs are subject to specific legislation apart from the existing BOT law. Similarly, fiscal risks arising from PPP-related guarantees are subject to different degrees of monitoring, depending whether they are under the control of the Treasury or other public entities (see below). Annual budget laws set upper limits for contingent liabilities, but only for those provided by the Treasury.



The Treasury's contingent liability commitments are regularly disclosed in its monthly Public Debt Management Reports. Of the various guarantees that the Treasury provides, the external debt repayment guarantee is most actively used. In addition, the Debt Assumption Commitments (DACs)—wherein senior loan payment guarantees could be extended by the Treasury as well as by the special budget administrations and SOEs for PPP projects that satisfy certain conditions—have also been used from 2012 onwards. The outstanding stock of Treasury guaranteed external debt stood at US$12 billion, and separately, the loans for which Treasury offered debt assumption for 3 PPP projects stood at US$8.7 billion.

Information on guarantees issued by other public entities is scarce. The size and terms of contractual obligations are generally not disclosed for PPP projects under line ministries and other public agencies. This applies to both DACs issued by other public entities and FX-denominated price and volume guarantees provided to various PPP projects. Quantification of the size of overall exposure is challenging due to lack of information. Focusing on exposure from DACs on projects under construction and assuming that: (a) only the minimum 20 percent of the total investment is equity financed; and (b) all of the remaining financing is external debt covered by DACs, the estimated size of contingent liabilities would be roughly 4 percent of GDP (including the Treasury DACs above). The size of overall contingent liabilities could vary in reality, depending on whether there are older and new projects with separate price and volume guarantees, and the actual amounts of equity and external finance match the assumptions made.

The stock of standard Treasury guarantees to public banks has risen in recent years. The share of financial institutions in Treasury guaranteed external debt has risen to over 80 percent in 2015 from 43 percent in 2006 (Figure 2). The share of public banks increased especially sharply, from 2 percent of external debt guarantees in 2006 to 55 percent in 2015. The authorities justified this shift by the superior internal risk management expertise of these institutions relative to other beneficiaries.



1/ Financial Institutions inlcude public banks, Vakif Bank, and TSKB

Box 5. Turkey: Summary of FSAP Findings and Recommendations

Turkish banks can reasonably withstand severe stress provided it is short-lived, but capital shortfalls can become significant should stress persist, and systemic risks and spillovers become high.

Supervision of banks, insurance companies, and FMIs. Assessments against international standards spotlighted areas requiring further enhancements: (i) further development and deepening of the risk assessment nature of banking inspections and follow up; (ii) applying greater rigor to the supervisory evaluation and enforcement of credit risk and corporate governance rules; (iii) stronger governance, independence and accountability would advance insurance supervision, which would be further enhanced by the closer integration of supervisory functions, and additional focus on corporate governance and internal controls within insurers; (iv) for the National Payments System (NPS), authorities should address concentration of intraday liquidity at the end of the day, and institute a risk management framework for interdependencies among FMIs.

Oversight and management of systemic risks. Stronger arrangements would be beneficial. In particular: (i) additional clarity on the roles and responsibilities of the Financial Stability Committee (FSC), the Council of Ministers, and of FSC member authorities, would be helpful; (ii) an explicit financial stability objective could be provided for all FSC members; (iii) procedures to support more integrated risk identification and ensure ex ante review of alternative policy options by the FSC could be implemented; (iv) coordination of policy actions and follow-up would be strengthened by an agreement by member agencies to consider and to respond to FSC recommendations in advance of taking policy decisions; and (iv) overall transparency and disclosure need to be enhanced to foster credibility and accountability.

Crisis management and resolution., Key priorities include: legal changes to (i) equip BRSA with effective recovery planning powers and empower SDIF to undertake resolvability assessments and resolution planning, and to empower both agencies to require banks to make necessary changes to make plans implementable; (ii) establish new resolutions tools for the SDIF, including powers for more comprehensive business transfer, for establishing and capitalizing bridge banks, and for implementing bail-in; and (iii) facilitate international bank data sharing by SDIF. Institutional arrangements should be strengthened to: (i) provide additional clarification on various agencies' responsibilities; (ii) limit BRSA involvement to pulling the trigger for resolution and not also defining the type of resolution; (iii) provide more effective coordination with FSC activities; and review resolution funding arrangements with the aim to reduce contingent claims on taxpayers. Cross-border recovery and resolution arrangements should be bolstered

Systemic liquidity management. key priorities include: (i) orienting liquidity provision towards a single key policy rate; (ii) increase net reserves such that gross reserves are within the range of 100–150 percent of the ARA metric; (iii) redefine CBRT FX lending facility as ELA and increase conditionality; and (v) improve ELA capacity (testing procedures, expand range of collateral, processes for government indemnities for CBRT).

Development of capital markets. This could decrease reliance on foreign currency. Policies to support the consolidation of an interest rate derivatives market and stimulate liquidity in government and corporate bond markets could facilitate hedging against interest rate fluctuations and enhance demand for capital market products. Improvements in issuance regulations, disclosure and governance standards could restore investor confidence, which has been recently shaken by renegotiations of corporate debt and poor performance of IPOs.

Anti Money Laundering (AML) and Combating the Financing of Terrorism (CFT). Priorities include: (i) completing the national ML/TF risk assessment; (ii) addressing the low level of convictions for ML; and (iii) introducing customer due diligence requirements for politically exposed persons in line with the FATF standard, as well as measures to mitigate the associated risks; (iv) effectively implementing the UN Security Council Resolutions requirements relating to terrorist funds, and implementing and strengthening measures to monitor cross-border transportation of cash.

Source: Turkey 2016 FSSA.

Box 6. Turkey: Reform of Voluntary Private Pension System

Starting in 2017, workers will be enrolled automatically in a private pension plan, with a minimum contribution of 3 percent of their gross wages. Staying in the system after the two-month opt-out period would be rewarded by a one-off payment of TL1,000. In addition, the government will top-up employee contributions by 25 percent and offer a 5 percent bonus on the accumulated amount, if at the time of withdrawal, participants elect to receive an annuity.

The reform is a welcome step in the right direction. It preserves the freedom of individuals to choose; exploits consumer inertia to maximize the impact on aggregate savings; caps asset management fees to much lower levels than observed in the existing voluntary system; and attempts to reduce wasteful competition in the market. However, the legislation passed suffers from serious design weaknesses that weaken consumer protection and risk popular resentment, thereby undermining the reform's key objectives:

- The reform does not establish a public procurement board for periodic auctions of pension services, with the exception of asset management. Employers are unlikely to be more skilled than individuals in choosing pension plans for their workers.
- Fee rates are charged on heterogeneous bases (asset under management) thus promoting competition in the market and unnecessary marketing expenses. Fee rates would become obsolete over time and it will be necessary to lower them periodically exposing the authorities to the risk of regulatory capture.
- The Social Security Institute will not collect pension contributions so average costs are not minimized.
- Pension firms' sales forces are used to retain individuals in the system, generating incentives and opportunities for mis-selling. A political appointee is in charge of investment rules.
- The governance of the investment advisory committee is yet to be defined. Only Turkey-incorporated asset managers are allowed to participate in the auctions.
- Finally, the reform is not projected to increase sufficiently national savings.

Box 7. Turkey: Refugees in Turkey – Recent Developments

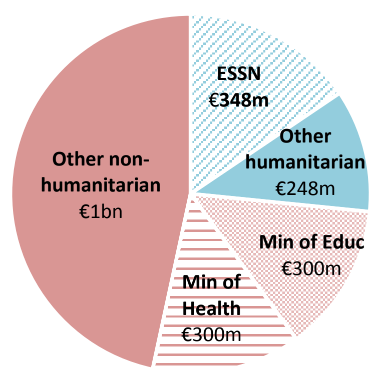
Turkey is one of the largest refugee-hosting countries with around 3 million of refugees. Officially registered Syrian refugees are about 2.75 million (45 percent of whom are children aged below 18) (UNHCR, 2016), and refugees of other nationalities are estimated to be almost 0.3 million. However, some registered refugees might have left, while there may be other non-registered refugees in Turkey, making precise estimation of refugee numbers difficult. The government has begun validating the registration records and plans to complete this exercise by mid-2017. This would also provide information on refugee movements within Turkey, and thus improve targeting of financial assistance.

Given the large number of refugees, social and economic integration is challenging but crucial. Around 90 percent of Syrian refugees had left the temporary protection centers (AFAD, 2016). Prior to 2016, they could only work in the informal sector, which seems to have negatively affected local informal workers with low labor force attachments, such as women and the low-skilled (Del Carpio and Wagner, 2015). Legislative changes in January 2016 allow Syrian refugees to apply for work permits. However, at end-October, only around 13,000 applications by Syrian refugees have been received (of which 10,000 were approved, with one-third of the permits granted to the textile and wholesale and retail industries). The low uptake may be explained by restrictions, such as firm-level quotas and requiring refugees to apply for permits only in the municipality of initial registration, administrative hurdles, and limited communication. Qualifications recognition, skill mismatch, and language difficulties may also contribute to limited integration into formal employment.

International assistance could play an important role. Under the EU-Turkey agreement to reduce irregular migration, the Facility for Refugees in Turkey was set up to provide support to refugees in Turkey in the areas of humanitarian assistance, education, migration management, health, municipal infrastructure, and socio-economic development. The Facility has an initial budget of €3 billion for 2016–17, and additional funding of up to €3 billion by end-2018. As of end-October, of the overall initial budget, the total funding allocated for implementation on humanitarian and non-humanitarian actions stood at €2.2 billion. Of these €2.2 billion, 34 projects have been contracted worth €1.2 billion, out of which €677 million have been disbursed to the implementation units.

- The largest humanitarian support under the Facility is the Emergency Social Safety Net (ESSN), which provides direct monthly cash transfers through debit cards to cover basic needs of the most vulnerable refugee families. The entire €348 million in allocated funding from the Facility has been contracted, of which €278.4 million have been disbursed to implementing partners. The ESSN support aims to reach one million refugees by the first quarter of 2017.
- Of the funding allocated to non-humanitarian support, two direct grants worth €300 million each will be provided to the Ministry of National Education and the Ministry of Health for costs incurred in their efforts to integrate Syrian children into the Turkish education system and to ensure Syrian refugees have access to health care. This is particularly important since more than two-thirds of school-aged Syrian refugees remain out of the national education system. The direct grant for education should enable around half a million Syrian students to receive education in Turkish.

EC's Facility for Refugees in Turkey (allocated only): Total of €2.2 billion



Source: The European Commission (2016).

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

Population (2015): 78.2 million
Per capita GDP (2015): US$9,182
Quota (2015): SDR 1,455.8 million

	2014	2015	2016	2017	2018	2019	2020	2021
			Proj.					
				(Percent)				
Real sector								
Real GDP growth rate	3.0	4.0	2.7	2.9	3.3	3.6	4.0	3.9
Contributions to real GDP growth								
Private domestic demand 1/	0.9	3.2	2.5	1.5	2.8	3.0	3.4	3.6
Public spending	0.1	1.1	1.8	0.6	0.4	0.4	0.4	0.4
Net exports	2.0	-0.3	-1.6	0.7	0.1	0.2	0.2	-0.2
GDP deflator growth rate	8.3	7.4	7.4	7.4	7.4	7.5	7.3	7.0
Nominal GDP growth rate	11.5	11.7	10.2	10.5	10.9	11.4	11.6	11.2
CPI inflation (12-month; period-average)	8.9	7.7	7.7	8.0	7.9	7.4	7.3	7.0
Unemployment rate	9.9	10.3	10.5	11.0	11.0	10.5	10.0	10.1
				(Percent of GDP)				
Nonfinancial public sector								
Primary balance	0.6	0.7	-0.6	-1.3	-0.7	0.5	0.8	0.9
Net interest payments	2.2	2.1	2.1	2.0	1.8	1.8	1.8	1.8
Overall balance	-1.6	-1.5	-2.6	-3.4	-2.5	-1.3	-1.0	-0.9
Debt of the public sector								
General government gross debt (EU definition)	33.5	32.9	34.6	35.8	36.6	35.8	35.2	34.8
External sector								
Current account balance	-5.5	-4.5	-4.5	-5.3	-5.5	-5.0	-4.7	-5.0
o/w Nonfuel current account balance	0.7	0.2	-1.3	-1.4	-1.5	-1.0	-0.8	-1.1
Gross financing requirement	26.5	27.9	27.2	30.7	31.5	30.9	29.6	29.2
Foreign direct investment (net)	0.7	1.7	1.1	1.2	1.3	1.4	1.5	1.6
Gross external debt 3/	50.4	55.4	59.6	67.1	67.8	66.6	64.9	63.5
Net external debt	30.8	35.7	38.7	44.6	45.9	45.8	45.1	44.6
Short-term external debt (by remaining maturity)	21.0	22.6	23.8	27.1	27.4	26.6	25.7	24.4
Monetary conditions								
Average real policy rate 2/	-0.2	-0.1	-0.2	...	...	...	...	...
Nominal growth of M2 broad money (percent)	11.9	17.1	11.1	...	...	...	...	...

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ Includes changes in stocks. 2/ Using central bank's one-week repo rate. In current year, the average is up to the latest observation. 3/ The external debt ratio is calculated by dividing external debt in U.S. dollars by GDP in U.S. dollars estimated by Staff.

Table 2. Turkey: Medium Term Scenario, 2014–21

	2014	2015	2016	2017	2018	2019	2020	2021
			Proj.					
Real sector				(Percent)				
Real GDP	3.0	4.0	2.7	2.9	3.3	3.6	4.0	3.9
Real domestic demand	1.0	4.2	4.2	2.1	3.1	3.4	3.7	4.0
Private consumption	1.4	4.8	3.8	2.4	3.6	3.6	4.0	4.3
Private investment	0.3	3.1	-1.0	-0.5	2.1	3.1	3.6	4.2
Public spending	0.8	7.0	11.1	3.7	2.6	2.5	2.4	2.5
Exports	7.4	-0.9	-1.0	4.4	4.7	4.7	5.1	4.0
Imports	-0.3	0.2	5.0	1.3	4.1	3.7	4.0	4.5
Output gap (percent of potential GDP)	0.0	0.5	-0.3	-0.9	-1.1	-1.0	-0.5	0
Contributions to real GDP growth								
Real domestic demand	1.0	4.3	4.3	2.2	3.2	3.4	3.8	4.1
Private consumption	1.0	3.2	2.5	1.6	2.4	2.5	2.7	2.9
Private investment	0.1	0.6	-0.2	-0.1	0.4	0.6	0.6	0.7
Public spending	0.1	1.1	1.8	0.6	0.4	0.4	0.4	0.4
Net exports	2.0	-0.3	-1.6	0.7	0.1	0.2	0.2	-0.2
Exports	1.9	-0.2	-0.3	1.1	1.2	1.2	1.3	1.1
Imports	0.1	-0.1	-1.4	-0.3	-1.1	-1.0	-1.1	-1.2
				(Percent of GDP)				
Shares in nominal GDP								
Private Consumption	68.9	69.1	68.0	67.0	67.2	67.0	67.2	67.8
Public Consumption	15.3	15.7	17.7	17.5	17.3	17.0	16.7	16.5
Private Investment	15.9	16.0	16.2	16.7	16.7	16.5	16.3	16.1
Public Investment	4.3	4.4	4.5	5.1	5.2	5.1	5.1	5.0
Exports	27.9	28.0	27.0	30.6	31.2	31.0	30.9	30.5
Imports	32.1	30.8	30.1	34.1	34.7	34.0	33.6	33.5
Fiscal sector								
Nonfinancial public sector								
Primary balance	0.6	0.7	-0.6	-1.3	-0.7	0.5	0.8	0.9
Overall balance	-1.6	-1.5	-2.6	-3.4	-2.5	-1.3	-1.0	-0.9
Gen. gov. structural primary balance 1/	1.0	0.4	-0.9	-1.3	-0.6	0.8	0.9	0.8
Gen. gov. gross debt (EU definition)	33.5	32.9	34.6	35.8	36.6	35.8	35.2	34.8
External sector								
Current account 2/	-5.5	-4.5	-4.5	-5.3	-5.5	-5.0	-4.7	-5.0
Gross external debt 3/	50.4	55.4	59.6	67.1	67.8	66.6	64.9	63.5
Net international investment position	-55.5	-52.9	-55.7	-64.9	-68.0	-69.2	-69.6	-70.5
Saving-investment balance								
Public	-1.3	-0.6	-2.8	-3.5	-3.0	-2.0	-2.1	-2.3
Private	-3.8	-3.4	-1.2	-1.4	-2.0	-2.5	-2.2	-2.3
Memo Items								
Employment rate (percent)	45.5	46.0	...	...	...	...	...	...
Unemployment rate (percent)	9.9	10.3	10.5	11.0	11.0	10.5	10.0	10.1
Headline Inflation (Period average)	8.9	7.7	7.7	8.0	7.9	7.4	7.3	7.0
Headline Inflation (End of Period)	8.2	8.8	7.8	8.0	7.5	7.4	7.0	7.0
Nominal GDP (billions of Turkish lira)	1,748	1,953	2,152	2,379	2,638	2,939	3,280	3,648

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 discrepancy between the current account and the sum of public and private saving-investment balances is due to different definitions of exports and imports in national and BOP statistics. 3/ The external debt ratio is calculated by dividing external debt in U.S. dollars by staff forecasts of GDP in U.S. dollars.

Table 3. Turkey: Summary of Balance of Payments, 2014–21

(In Billions of US dollars)

	2014	2015	2016	2017	2018	2019	2020	2021
			Proj.					
Current account balance	-43.6	-32.3	-31.5	-35.4	-37.3	-36.4	-36.4	-40.9
Balance on goods and services	-36.8	-24.0	-24.6	-25.2	-26.1	-24.3	-23.2	-26.2
Goods, net	-63.6	-48.1	-40.2	-40.9	-41.6	-42.0	-44.6	-49.0
Exports of goods	168.9	152.0	151.8	161.2	171.0	179.4	187.8	195.6
Imports of goods	232.5	200.1	192.0	202.1	212.7	221.3	232.4	244.7
of which Fuel imports	55.0	37.8	25.8	29.5	31.2	32.8	34.8	36.7
Services, net	26.8	24.1	15.6	15.7	15.5	17.7	21.4	22.8
Credit	51.7	46.3	37.6	40.1	42.0	45.4	51.0	54.5
Debit	24.9	22.2	22.0	24.4	26.5	27.7	29.6	31.7
Primary income, net	-8.1	-9.6	-8.5	-11.7	-13.4	-14.3	-15.4	-16.8
of which interest expenditure	5.6	5.2	5.2	9.6	12.8	14.8	16.6	19.5
Secondary income net	1.4	1.3	1.5	1.5	2.2	2.2	2.2	2.2
Capital account	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.6	9.3	5.2	0.0	0.0	0.0	0.0	0.0
Financial account balance, excl. reserves (change in stocks, + = increase)	-41.6	-11.2	-32.0	-35.4	-37.3	-36.4	-36.4	-40.9
Direct investment, net 1/	-5.5	-12.0	-7.6	-8.2	-9.8	-10.9	-11.3	-12.8
Portfolio investment, net	-20.1	15.7	-12.1	-14.4	-10.5	-11.7	-14.3	-15.2
of which government eurobonds, net	4.2	0.3	2.7	3.5	0.4	0.6	1.9	1.4
Other investment, net	-16.0	-14.9	-12.2	-12.8	-17.0	-13.8	-10.7	-12.8
of which short-term borrowings	4.1	-21.3	-3.7	3.0	5.5	2.5	2.3	1.9
of which banks (loans)	3.8	-21.3	-5.0	1.7	3.6	1.7	1.6	1.3
of which other sector (loans)	0.3	0.0	1.3	1.3	1.9	0.9	0.8	0.6
Reserve assets (change in stocks, + = increase)	-0.5	-11.8	5.6	0.0	0.0	0.0	0.0	0.0
				(Percent of GDP)				
Current account balance	-5.5	-4.5	-4.5	-5.3	-5.5	-5.0	-4.7	-5.0
Nonfuel current account balance	0.7	0.2	-1.3	-1.4	-1.5	-1.0	-0.8	-1.1
Trade account balance (incl. shuttle trade)	-4.6	-3.3	-3.6	-3.9	-4.0	-3.4	-3.1	-3.4
Capital and financial account balance	-5.3	-3.2	-3.8	-5.3	-5.5	-5.0	-4.7	-5.0
				(Percent year-on-year)				
Export value growth	5.3	-10.1	-4.4	6.1	5.5	5.4	6.2	4.7
Import value growth	-3.1	-13.7	-3.3	5.7	5.6	3.5	5.5	5.6
Change in terms of trade	1.1	5.6	5.0	-2.9	-0.6	0.9	-0.5	-0.4
Gross foreign reserves (CBRT)								
In billions of U.S. dollars	127.3	110.5	117.8	117.8	117.8	117.8	117.8	117.8
Net international reserves	42.9	28.7	32.8	32.8	32.8	32.8	32.8	32.8
Net international reserves (exl. govt. FX deposits)	39.9	27.4	29.7	29.7	29.7	29.7	29.7	29.7
Debt service ratio (percent) 2/	19.7	20.8	34.2	33.2	35.1	36.6	36.7	38.2

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

1/ Including privatization receipts. 2/ 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
(In Billions of US dollars)

	2014	2015	2016	2017	2018	2019	2020	2021
			Proj.					
Gross external financing requirements	211.5	199.9	193.4	204.4	217.3	225.2	230.0	240.6
Current account deficit	43.6	32.3	31.5	35.4	37.3	36.4	36.4	40.9
Amortization of government eurobonds	3.1	2.8	2.8	3.9	5.1	4.4	3.1	3.1
Medium- and long-term debt amortization	34.6	33.2	56.6	54.0	58.0	63.0	68.2	73.3
Government 1/	3.1	2.8	2.5	2.5	2.5	2.5	2.5	2.5
Banks	9.2	11.5	34.6	28.3	30.7	33.8	37.2	40.8
Other sectors	22.3	18.9	19.5	23.1	24.8	26.7	28.5	30.0
Short-term debt amortization	130.3	131.6	102.4	111.1	116.9	121.4	122.3	123.3
Government 1/	0.8	0.3	0.2	4.6	6.8	7.0	7.2	7.4
Banks	92.2	94.8	65.0	63.4	62.7	64.6	64.2	62.9
Other sectors	37.2	36.5	37.3	43.1	47.4	49.7	50.9	52.9
Available financing	211.5	199.9	193.4	204.4	217.3	225.2	230.0	240.6
Sale of assets 2/	-2.4	-20.9	-3.6	-7.1	-6.5	-7.9	-9.6	-9.1
Foreign direct investment (net)	-5.5	-12.0	-7.6	-8.2	-9.8	-10.9	-11.3	-12.8
Portfolio flows	20.9	-9.6	12.0	15.5	11.7	12.9	15.7	16.7
Government eurobonds	7.3	3.0	5.5	4.0	5.5	5.0	3.0	4.5
Domestically-issued government bonds(net)	0.4	-7.7	4.5	2.2	0.2	0.2	0.2	0.2
Banks' bonds (net)	10.4	-0.7	2.9	6.9	7.9	8.9	10.2	11.6
Other sectors' equity and bonds (net)	4.9	0.2	0.7	1.7	2.1	2.3	2.7	2.9
Medium and long-term debt financing	45.8	68.5	67.4	67.1	74.7	81.1	84.5	90.8
Government 1/	0.3	0.8	1.2	2.4	2.4	2.4	2.4	2.4
Banks	17.3	37.9	36.7	33.8	38.4	42.9	46.5	50.3
Other sectors	28.3	29.8	29.5	30.9	34.0	35.8	35.6	38.1
Short-term debt financing 3/	149.8	152.0	124.4	136.0	145.4	148.3	149.1	153.3
Government 1/	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Banks	94.8	65.0	63.4	62.7	64.6	64.2	62.9	62.3
Other sectors	55.4	87.2	61.0	73.3	80.8	84.1	86.2	91.0
Official transfers	0.5	0.5	0.9	0.9	1.6	1.6	1.6	1.6
Other 4/	2.0	9.4	5.6	0.1	0.1	0.1	0.1	0.1
GIR change (- denotes increase)	0.5	11.8	-5.6	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
Memorandum items:								
Net public sector financing (incl. IMF, excl. reserves)	1.5	-1.4	2.2	0.9	1.9	2.1	1.3	2.8
Government's loan rollover rate (in percent)	-3	22	42	33	25	25	24	24
Banks' loan rollover rate (in percent)	110	97	101	105	110	109	108	109
Other sectors' loan rollover rate (in percent)	141	211	159	158	159	157	153	156
Gross external financing requirements (percent of GDP)	26.5	27.9	27.2	30.7	31.5	30.9	29.6	29.2
International Investment Position (percent of GDP)	-55.5	-52.9	-55.7	-64.9	-68.0	-69.2	-69.6	-70.5

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

(In Percent of GDP)

	2014	2015	2016	2017	2018	2019	2020	2021
			Proj.					
Nonfinancial public sector primary balance	0.6	0.7	-0.6	-1.3	-0.7	0.5	0.8	0.9
Central government	0.5	0.4	-0.3	-1.3	-0.7	0.3	0.5	0.6
Primary revenue	23.3	23.6	23.7	23.5	23.6	23.5	23.7	23.8
Tax revenue	20.2	20.9	20.9	20.9	21.1	21.1	21.3	21.4
Personal income taxes	4.2	4.4	4.5	4.4	4.4	4.4	4.5	4.6
Corporate income taxes	1.8	1.7	2.0	1.9	1.9	1.9	2.0	2.1
VAT	5.9	6.2	5.9	6.2	6.4	6.3	6.4	6.4
SCT	5.2	5.4	5.4	5.4	5.3	5.3	5.2	5.2
Other	3.0	3.2	3.1	3.1	3.1	3.1	3.1	3.1
Nontax revenue 1/	3.1	2.7	2.8	2.6	2.5	2.5	2.4	2.5
Primary expenditure	22.8	23.2	24.0	24.8	24.2	23.3	23.2	23.3
Personnel	7.4	7.5	8.1	8.2	8.1	7.8	7.7	7.7
Goods and services, *of which*:	2.3	2.3	2.5	2.2	2.1	2.0	2.0	2.0
Transfers, *of which*:	10.3	10.5	10.8	11.5	11.0	10.5	10.5	10.6
Social security institutions	4.4	4.1	4.5	5.0	4.7	4.3	4.3	4.4
Agricultural subsidies	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Transfers of revenue shares	2.7	2.8	3.1	2.9	3.0	2.9	3.1	3.1
Capital transfers	0.4	0.5	0.4	0.5	0.4	0.4	0.4	0.4
Capital expenditure	2.8	2.9	2.5	3.0	3.0	3.0	3.0	3.0
Rest of the public sector	0.1	0.3	-0.2	0.0	0.0	0.3	0.3	0.3
Extrabudgetary funds	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 2/	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0
Social security institutions	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.1	0.1	0.1	0.0	0.0	0.0
Local governments 2/	0.1	-0.1	-0.4	-0.2	-0.2	0.2	0.2	0.2
State owned enterprises	0.0	0.1	0.2	0.2	0.2	0.1	0.1	0.1
Nonfinancial public sector overall balance 3/	-1.6	-1.5	-2.6	-3.4	-2.5	-1.3	-1.0	-0.9
Interest expenditure (net)	2.2	2.1	2.1	2.0	1.8	1.8	1.8	1.8
Memorandum items:								
General government primary balance	0.6	0.6	-0.7	-1.5	-0.9	0.4	0.7	0.8
General government overall balance	-1.6	-1.5	-2.8	-3.5	-3.0	-2.0	-2.1	-2.3
General government structural primary balance 4/	1.0	0.4	-0.9	-1.3	-0.6	0.8	0.9	0.8
General government cyclical adjusted balance	-0.9	-1.3	-2.7	-3.2	-2.6	-1.6	-1.9	-2.3
General government gross debt	33.5	32.9	34.6	35.8	36.6	35.8	35.2	34.8

Sources: Turkish authorities; and IMF staff estimates.

1/ Excluding privatization proceeds, transfers from CBRT, and interest receipts. 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 dividend payments from Ziraat Bank from revenue. 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, 2010–16

(In Percent)

	2010	2011	2012	2013	2014	2015	2016Q1	2016Q2	2016Q3
Balance Sheet				Percent of GDP					
Total Assets	91.6	93.8	96.7	110.5	114.1	120.7	111.9	115.1	117.7
o/w Gross Loans	47.9	52.6	56.1	66.8	71.0	76.0	70.2	73.0	74.8
Liabilities	79.4	82.7	83.9	98.2	100.8	107.3	99.2	101.9	104.1
o/w Deposits	56.2	53.6	54.5	60.3	60.2	63.8	59.2	60.9	62.3
Shareholders' Equity	12.2	11.1	12.8	12.4	13.3	13.4	12.7	13.2	13.6
Off-Balance Sheet									
o/w Commitments	79.6	109.7	121.4	103.8	97.9	106.3	100.7	105.9	103.7
o/w Contingencies	14.9	16.8	17.0	21.3	21.9	23.5	21.4	22.6	23.1
Asset Quality				Percent					
NPLs / Gross Loans	3.7	2.7	2.9	2.8	2.9	3.1	3.3	3.3	3.3
Provisions / Gross NPLs	83.8	79.4	75.2	76.3	73.9	74.6	75.2	76.2	76.4
Credit Growth (YoY) 7/	33.9	29.9	16.4	31.8	18.5	19.7	14.2	12.3	8.6
Profitability									
Total Int. Income / Int. Bearing Assets (av) 2/ 3/	9.2	8.2	9.1	7.6	7.9	7.8	7.7	7.9	8.1
Cost / Income (Efficiency) 9/	67.8	74.4	72.6	71.2	74.5	76.3	76.0	74.4	72.3
ROAA 2/ 8/	2.5	1.7	1.8	1.6	1.3	1.2	1.2	1.3	1.5
ROAE 2/ 8/	18.1	14.3	14.5	13.1	11.5	10.6	10.9	11.9	13.2
Funding and Liquidity									
Loan-to-Deposit ratio	85.2	98.2	102.9	110.7	117.9	119.2	118.6	119.7	120.1
Loan-to-Deposit ratio (TL)	88.5	105.4	113.1	126.7	133.2	141.6	142.0	140.2	133.0
Loan-to-Deposit ratio (FX)	77.4	84.1	82.0	83.8	91.9	89.0	87.3	90.8	99.8
Non-Core / Core Liabilities 4/	33.9	44.9	43.7	52.0	55.2	56.4	55.6	55.2	55.1
Non-Core / Core Liabilities (TL) 4/	23.3	28.5	26.4	29.0	29.7	31.8	32.6	31.9	30.8
Non-Core / Core Liabilities (FX) 4/	66.8	87.2	90.8	103.4	112.9	101.4	97.7	100.1	106.7
Leverage Ratio 2/ 5/	6.2	5.3	5.0	5.2	5.7	5.3	5.3	5.3	5.5
Liquid Assets / Assets 11/	28.2	26.2	26.0	24.3	23.3	21.6	21.9	21.5	21.2
Assets / Liabilities (3 months, int. sensitive)	72.5	71.7	81.9	79.5	75.4	74.1	76.4	73.8	74.9
Capital Adequacy									
CAR	19.0	16.6	17.9	15.3	16.3	15.6	15.5	15.8	16.0
CT1R	17.0	14.9	15.1	13.0	13.9	13.2	13.3	13.5	13.7
RWA / Assets	72.0	78.4	80.2	84.3	83.4	83.4	83.1	83.2	82.8
FX Risk									
FX Assets / FX Liabilities (on-balance sheet) 5/	93.0	92.4	94.3	90.9	90.7	91.4	92.5	94.1	97.6
NOP / Regulatory Capital	0.1	0.4	2.0	-0.6	-2.2	1.3	0.9	-0.5	0.1
NOP before hedging / Regulatory Capital	-15.8	-21.6	-14.1	-29.0	-28.5	-30.1	-26.0	-19.8	-7.7
Miscellaneous									
Nominal GDP (TL billion) 1/	1098.8	1297.7	1416.8	1567.3	1748.2	1952.6	2152.4	2152.4	2152.4
Deposit Interest Rate (Percent) 10/	7.9	10.6	7.6	8.0	9.5	11.0	11.0	10.1	10.0
Loan Interest Rate (Percent) 12/	10.6	17.1	11.9	12.6	13.1	16.4	17.0	16.4	15.3
TL/US$, EOP	1.5	1.9	1.8	2.1	2.3	2.9	2.8	2.9	3.0

Sources: IMF staff calculation based on Table 7 if not noted otherwise.

1/ WEO and estimated for current year. 2/ Current year data are annualized using 12 months rolling sums. 3/ Net of NPL provisions. 4/ Core liabilities include deposits and shareholders' equity. 5/ Proxied by T1 Capital over last 2 months average balance sheet assets and average off-balance sheets exposures (> 3 percent). 6/ Including FX-indexed assets and liabilities. 7/ Non-FX adjusted. 8/ Net income as a share of last 12 monttth average assets or equity. 9/ Other non-interest income added to expenses when <0. 10/ On TRY only, excluding sight and interbank. 11/ Liquid assets as reported by the BRSA in their liquidity position table. 12/ Consumer Loans (Personal+Vehcles+Housing).

Table 7. Turkey: Banking System Detailed Data, 2010–16

(In Billions of Turkish Lira)

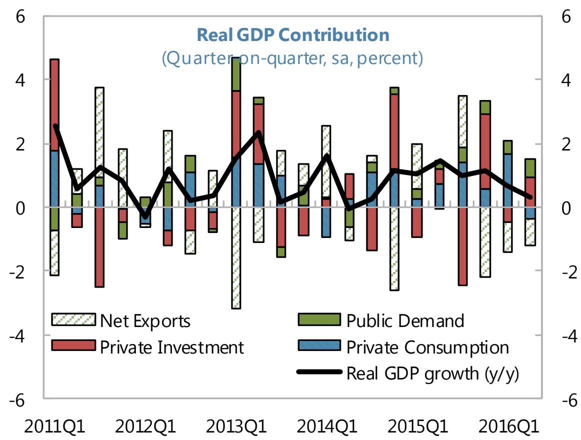
		2010	2011	2012	2013	2014	2015	2016Q1	2016Q2	2016Q3
Balance Sheet										
Total Assets		1,007	1,218	1,371	1,732	1,994	2,357	2,408	2,477	2,534
o/w Total Assets (FX)		258	369	416	591	693	904	926	950	980
o/w Assets (FX-indexed)		27	37	40	61	64	71	70	73	73
o/w Gross Loans		526	683	795	1,047	1,241	1,485	1,512	1,570	1,610
o/w Gross Loans (FX)		142	198	206	295	360	472	475	493	521
o/w Liquid Assets 1/		284	319	356	421	465	509	526	533	536
Liabilities		872	1,073	1,189	1,539	1,762	2,095	2,135	2,193	2,241
o/w Libilities (FX)		307	441	484	716	837	1,070	1,078	1,090	1,081
o/w Liabilities (FX-indexed)		0	0	0	0	0	0	0	0	0
o/w Deposits		617	695	772	946	1,053	1,245	1,274	1,312	1,341
o/w Deposits (FX)		184	236	252	352	391	530	544	544	522
Shareholders' Equity		135	145	182	194	232	262	273	284	293
o/w Sahreholders' Equity (FX)		1	0	4	1	4	2	3	3	2
Income Statement Annualized 2/										
(a)	Interest Income	77	88	110	111	139	164	174	180	188
(b)	Interest Expenses	39	49	58	53	73	87	92	97	100
(c = a - b)	Net Interest Income	39	39	52	57	66	77	81	83	88
(d)	NPL Provisions	5	4	8	11	14	16	17	19	20
(e = c - d)	Net Interest Income (after NPL prov.)	33	35	44	47	52	62	64	65	68
(f)	Non-Interest Income	24	27	27	33	38	42	43	46	46
(g)	Non-Interest Expenses	30	36	43	50	56	64	65	66	66
(h)	Other non-interest income	0	0	2	1	-3	-6	-7	-6	-3
(I = f - g + h)	Net Non-Interest Income	-6	-10	-14	-16	-21	-28	-29	-25	-23
(j = e + i)	Gross Profits	27	25	30	31	31	33	35	39	45
(k)	Net Income	22	20	24	25	25	26	28	31	36
Off-Balance Sheet										
Total Off Balance Sheet Transactions		1,038	1,643	1,961	1,961	2,095	2,535	2,628	2,766	2,729
o/w Commitments		875	1,424	1,720	1,627	1,711	2,076	2,167	2,279	2,232
o/w Contingencies		164	219	241	334	384	458	461	487	497
Capital										
Regulatory Capital		138	158	196	223	271	306	310	326	336
T1 Capital		124	143	166	190	231	259	266	279	287
Risk Weighted assets		725	954	1,099	1,461	1,663	1,967	2,001	2,062	2,097
FX Risk										
NOP		0.1	0.6	3.9	-1.2	-6.0	3.9	2.8	-1.6	0.4
NOP before hedging		-21.5	-33.5	-27.6	-64.4	-77.0	-91.9	-81.0	-64.1	-25.9
Memo										
Nominal GDP (TL billion) 3/		1,099	1,298	1,417	1,567	1,748	1,953	2,152	2,152	2,152
Deposit Interest Rate (Percent) 4/		7.9	10.6	7.6	8.0	9.5	11.0	11.0	10.1	10.0
Loan Interest Rate (Percent) 5/		10.6	17.1	11.9	12.6	13.1	16.4	17.0	16.4	15.3
TL/US$, EOP		1.5	1.9	1.8	2.1	2.3	2.9	2.8	2.9	3.0

Sources: Banking Regulation and Supervison Agency as available in Haver if not otherwise noted.
1/ Liquid assets as reported by the BRSA in their liquidity position table. 2/ Current year data are annualized using 12 months rolling sums.
3/ WEO and estimated for current year. 4/ On TRY only, excluding sight and interbank. 5/ Consumer Loans (Personal+Vehcles+Housing).

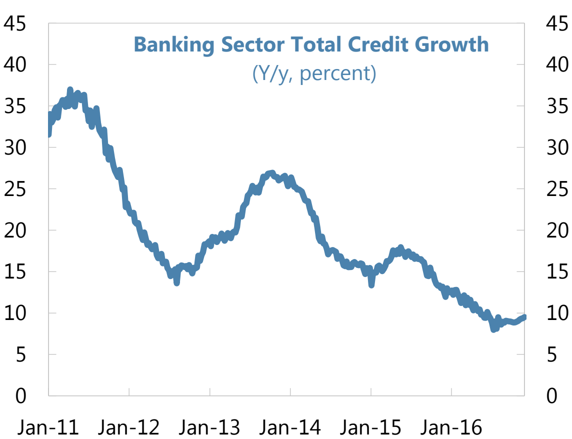
Figure 1. Turkey: Recent Developments

Growth has weakened…

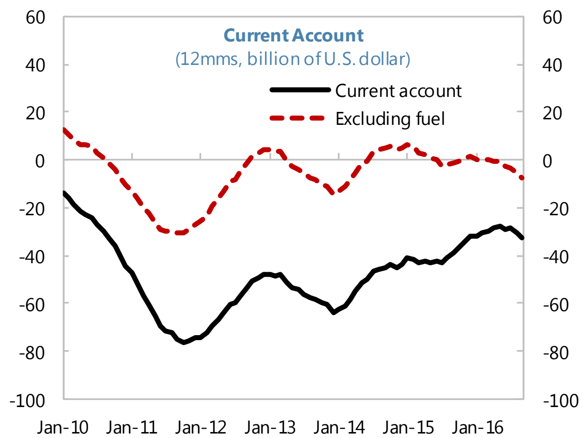
…and the composition has shifted to private consumption…



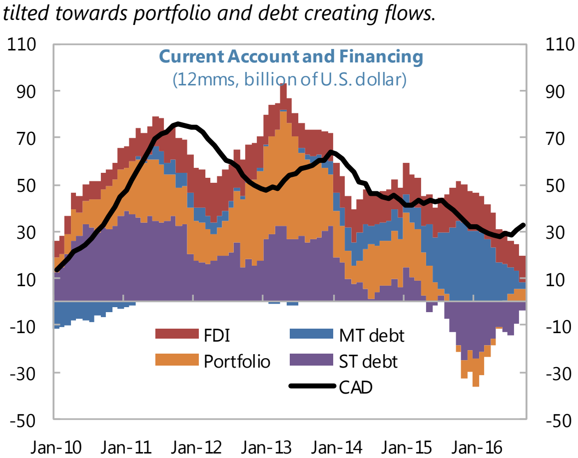
Credit growth is also slowing…



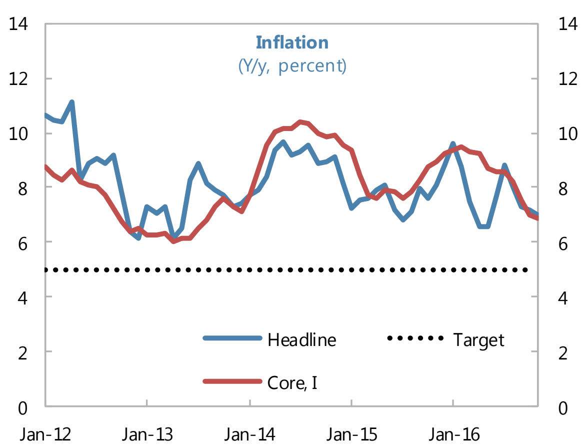
but external imbalances remain high…



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



Headline and core inflation remain well-above target.

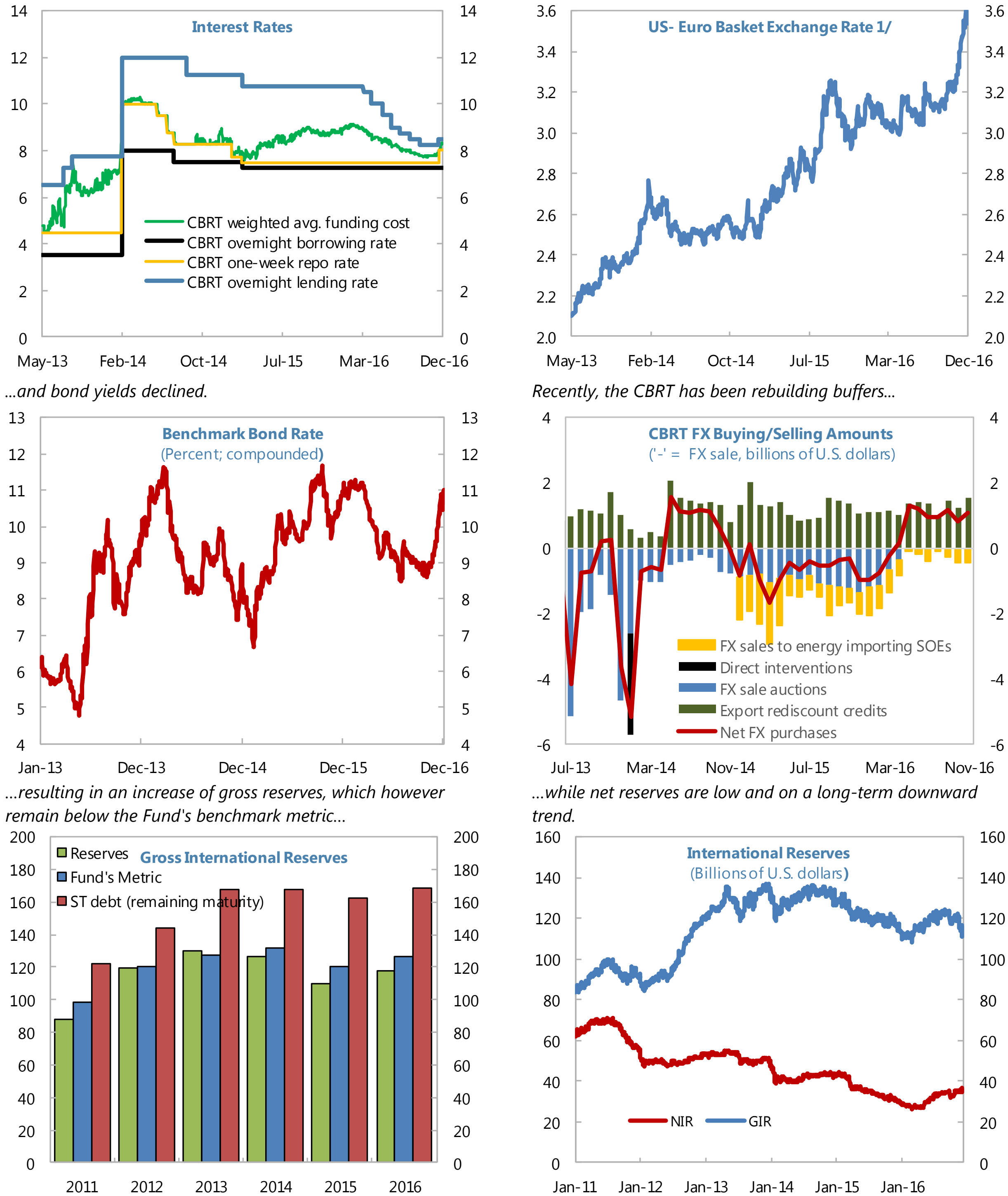


Sources: Bank for International Settlements (BIS); Central Bank of the Republic of Turkey (CBRT); Haver Analytics; Turkstat; and IMF staff calculations.

Figure 2. Turkey: Monetary Policy and International Reserves

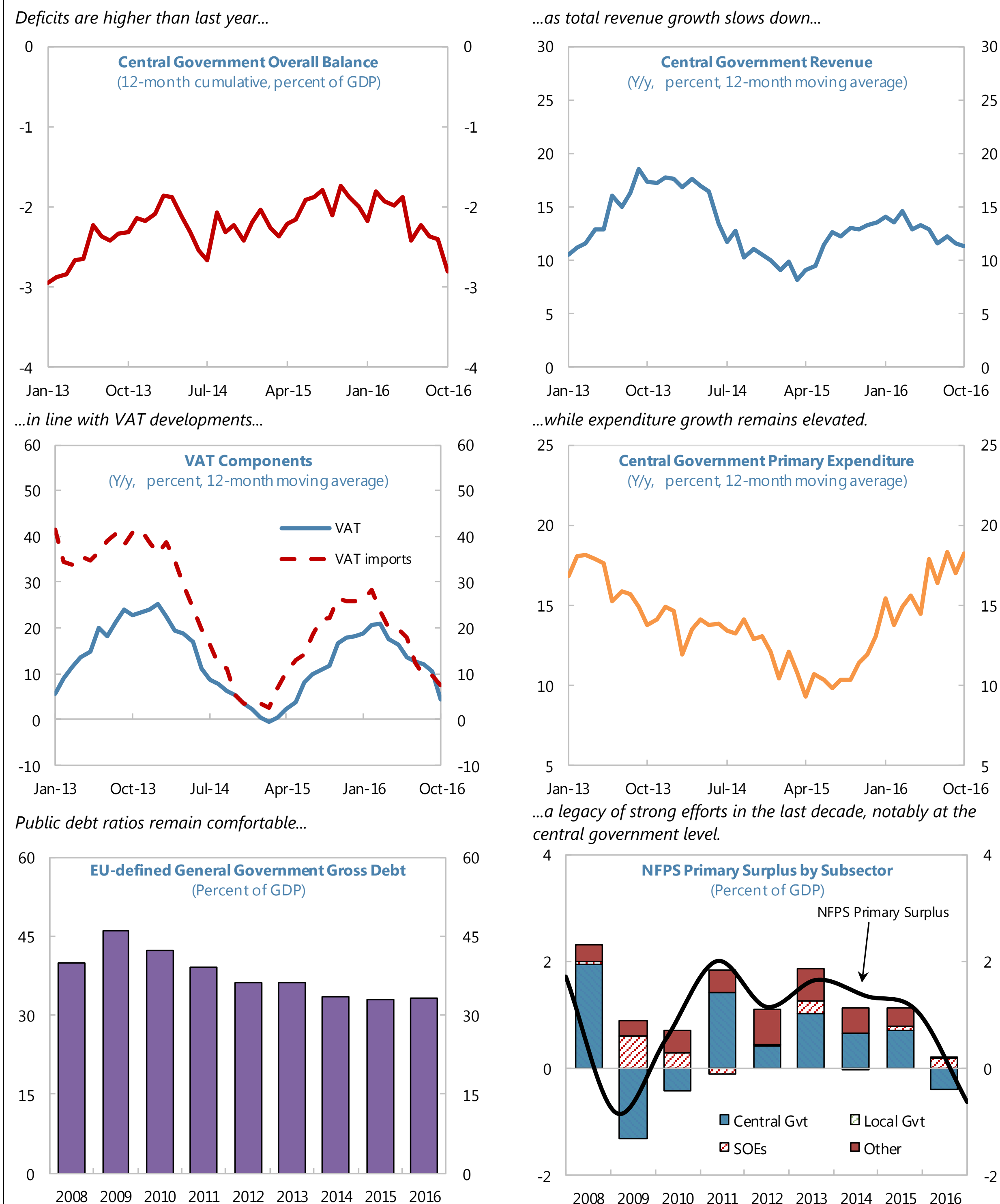
Normalization of the framework translated in loosening stance…

…while the exchange rate continued to depreciated…



Sources: Banking Regulation and Supervision Agency (BRSA); CBRT; Haver Analytics; and IMF staff estimates.
1/ Lira per equal-weight euro/dollar basket.
Note: The main difference between gross and net international reserves is accounted for by banks' FX deposits in the CBRT, which at the end of October stood at about US$83 billion, including about US$17 billion of ROM in FX and about US$10 billion of swaps.

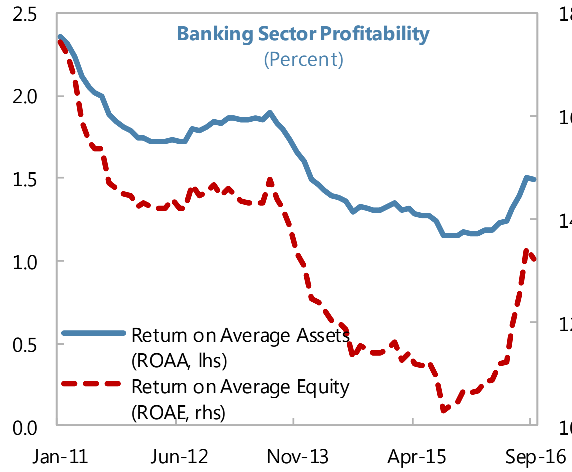
Figure 3. Turkey: Fiscal Stance



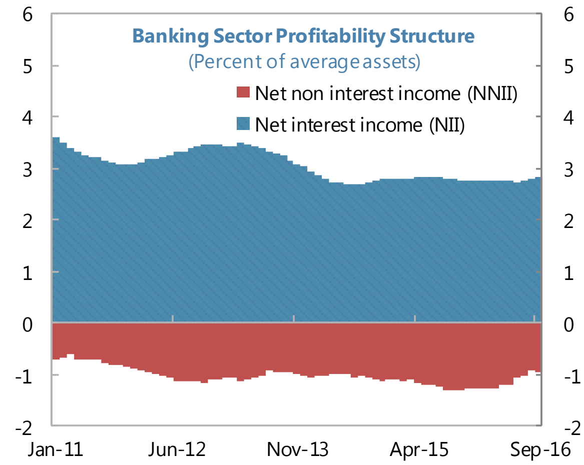
Sources: Minister of Finance; Haver Analytics; Treasury; and IMF staff calculations.

Figure 4. Turkey: Financial Sector

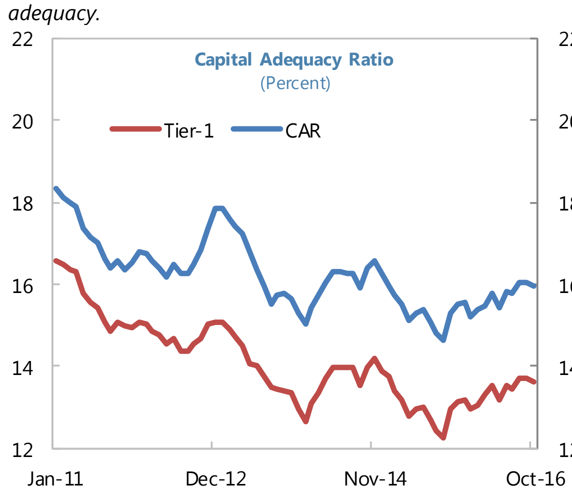
Profitability is on a downward trend but has recently improved...



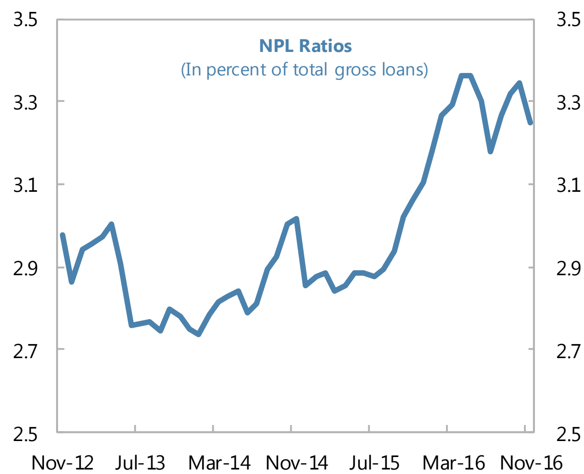
....as non-interest expenses fell...



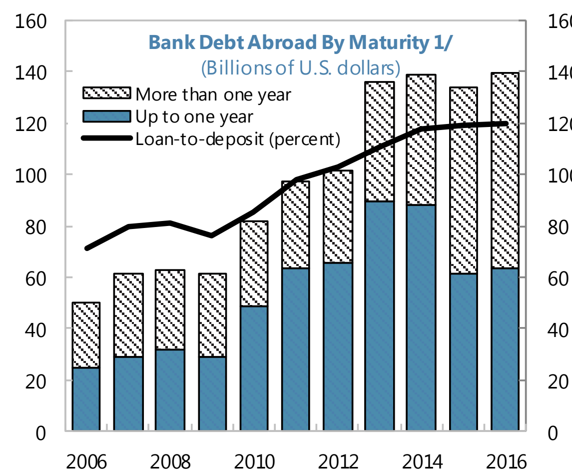
...temporally reversing the downward trend in capital adequacy.



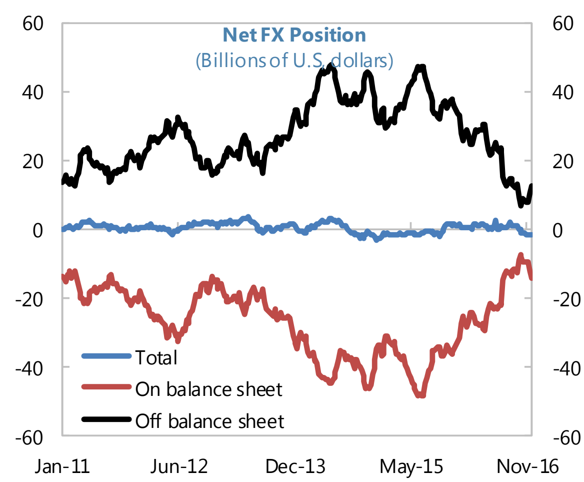
NPLs have picked up since mid-2015.



The increase in the loan-to-deposit ratio has slowed since 2015...



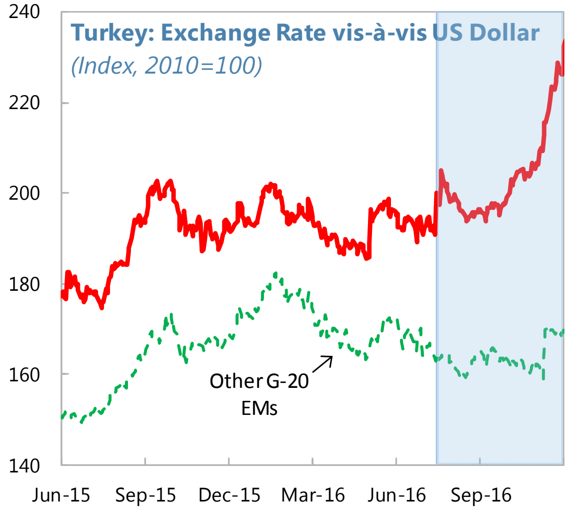
...as banks' net FX position has shrank.

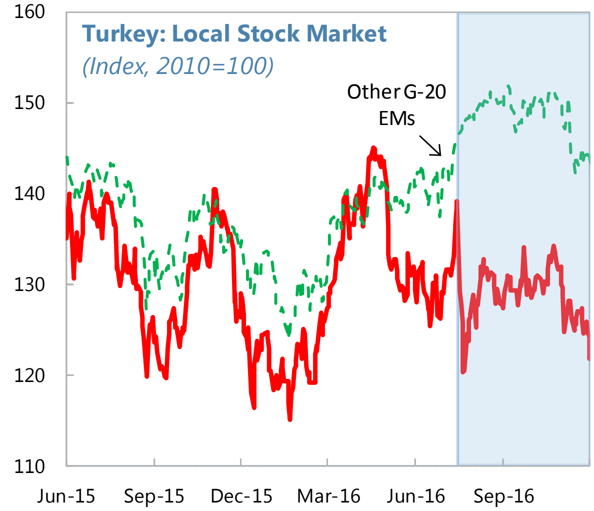


Sources: BRSA; CBRT; Haver Analytics; and IMF staff calculations.
[1]Data for 2016 is up to June.

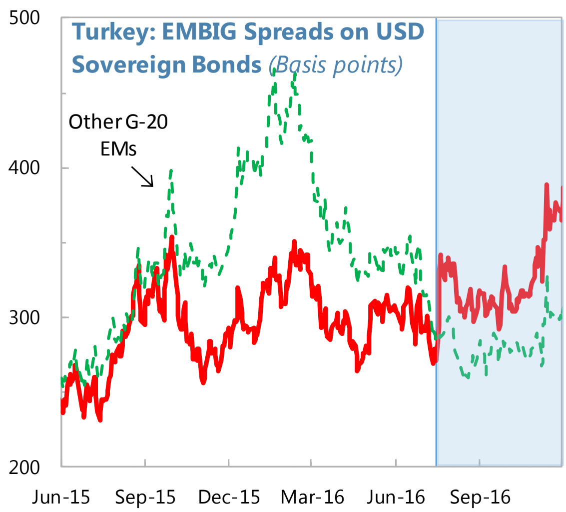
Figure 5. Turkey: Financial Markets

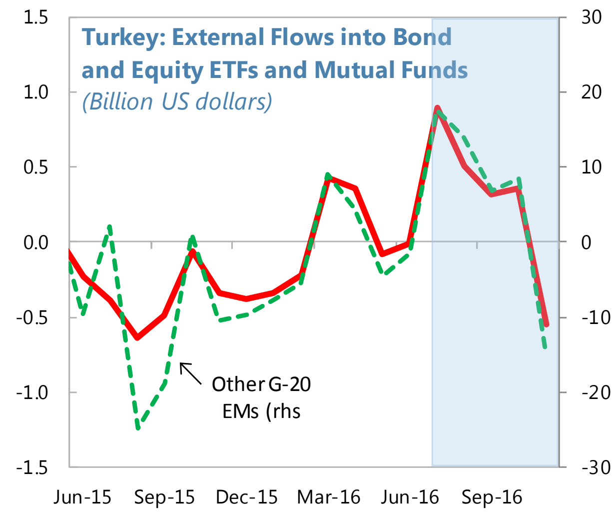
Since the failed coup attempt, Turkish financial markets have underperformed other large emerging markets, with both the FX and stock markets largely missing out on the emerging markets (EM) rally in the summer. Turkey was among the countries most affected by the EM sell-off that started in November.





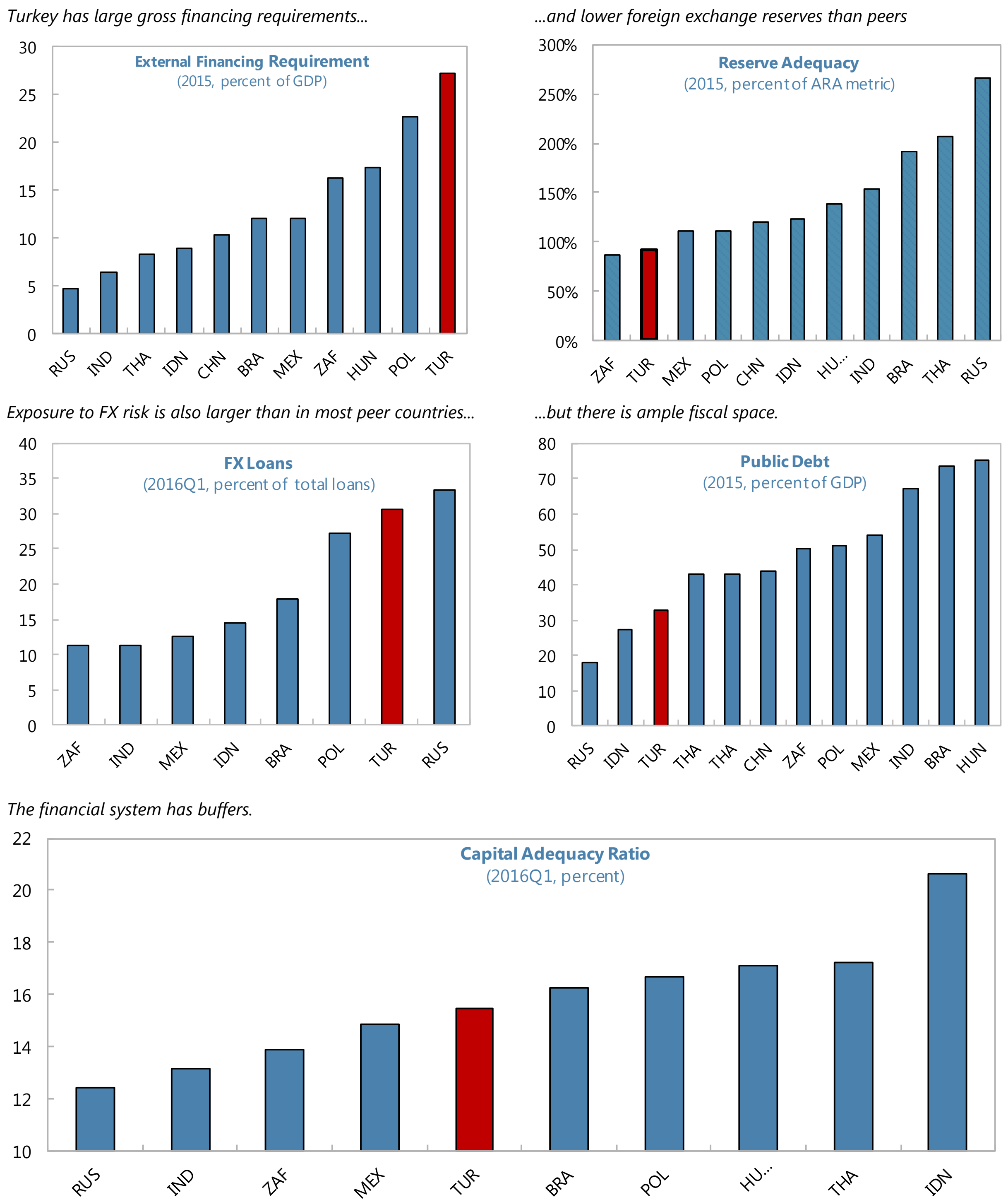
Since the failed coup attempt, a positive risk premium gap relative to peers has opened and further widened during the November EM sell-off. At the same time, external portfolio flows to Turkey continued to track developments in the broader emerging asset class.





Sources: Bloomberg, Haver, and IMF staff estimates.
Note: The period after the July failed coup attempt is highlighted in blue. Average of data for other G-20 emerging markets covers Brazil, Mexico, India, Indonesia, and South Africa.

Figure 6. Turkey vs. Peers



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.

Annex I. Risk Assessment Matrix[1]

	Source of Risks	Likelihood	Time Horizon	Impact	Policy Response
Global	**Economic fallout from political fragmentation:** • **Rise in populism and nationalism in large economies** could slow down or even reverse policy coordination and collaboration; international trade liberalization; financial, and labor flows; and lead to unsustainable policies, weighing on global growth and exacerbating financial market volatility.	High	Short to Medium Term	Low	• Preemptively increase FX reserves through sterilized intervention. • Medium term: Improve competitiveness through structural reform. • Reduce energy dependence by developing additional domestic generation capacity.
	• **Protracted uncertainty associated with negotiating post-Brexit arrangements** could weigh on confidence and investment more than expected—most prominently in the UK and the rest of Europe with possible knock-on effects elsewhere. Increased barriers could also dampen the longer-run economic performance of affected countries more than expected.	Medium	Short to Medium Term	Medium	
	• **Heightened risk of fragmentation/security dislocation in part of the Middle East, Africa, and Europe,** leading to a sharp rise in migrant flows, with negative global spillovers.	High	Short Term	Medium	
	Tighter or more volatile global financial conditions: • **Sharp rise in risk premia with flight to safety:** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening, and increases in U.S. term premia, with poor market liquidity amplifying volatility. Safe haven currencies—especially the US dollar—surge creates balance sheet strains for FX debtors.	Medium	Short Term	High	• Preemptively strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. • Tighten monetary policy • 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.

[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 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. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

	Weaker-than-expected global growth: • **Significant China slowdown and its spillovers:** Key near term risks are a loss of investor confidence, disorderly corporate defaults, a sharp fall in asset prices, and a quicker fading of the stimulus impact. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (Likelihood: low in short-term, medium thereafter). • **Significant slowdown in other large EMs/frontier economies.** Turning of the credit cycle and fallout from excess household and corporate (FX) leverage as investors withdraw from EM corporate debt, generating disorderly deleveraging, with potential spillbacks to advanced economies. • **Structurally weak growth in key advanced and emerging economies:** Weak demand, low productivity growth, and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to lower medium-term path of potential growth (the Euro area, Japan, and the United States) and exacerbating legacy financial imbalances especially among banks (the Euro area) (high likelihood). Tighter financial conditions and insufficient reforms undermine medium-term growth in emerging markets (medium likelihood).	**Low/ Medium** **Medium** **High/ Medium**	**Short to Medium Term** **Short Term** **Medium Term**	**Medium** **Medium** **Medium**	• Preemptively strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. • Medium term: Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports. • Structural reforms should be promptly implemented so to gain competitiveness. • Medium term: Tighten fiscal policy to bring it back into line with the reduced growth potential.
Domestic	**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**	**Short to Medium Term**	**High**	• Short-run: Tighten monetary policy and normalize the framework. • Medium term: Tighten fiscal policy to bring it back into line with the medium-term program. Prioritize expenditure compression.
	Private debt overhang weigh on domestic demand • The slowdown in private sector credit growth can further weighs on the real economy triggering a disorderly deleveraging cycle that results in a recession.	**Medium**	**Short to Medium Term**	**High**	• Preemptively strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. • Short-run: Some additional fiscal space could be used and monetary policy could assign a bigger weight on the output gap to the extent consistent with orderly FX market conditions. • Medium term: Robust debt-restructuring framework needs to be put in place.

Annex II. External Sector Assessment

Foreign asset and liability position and trajectory	**Background**. Turkey's net international investment position (NIIP) widened to about -56 percent of GDP in the end of 3Q2016 (mainly on the back of debt accumulation in the beginning of the year) and remains weaker than those of peers. Foreign liabilities are just below 90 percent of GDP, including about 53 percent of GDP in foreign currency. External debt is sustainable. Debt maturity improved, but risks remain significant risks given short-term debt and portfolio investments in debt securities of about 30 percent of GDP and 42 percent of long-term debt have floating interest rates. **Assessment**. The composition of liabilities exposes Turkey to liquidity shocks, investors sentiment and increases in global interest rates. Unless the current account deficit (CAD) improves substantially in the years ahead, Turkey's NIIP would continue to deteriorate by some 10 percentage points of GDP in medium term.
Current account	**Background**. The CAD is projected to remain close to its 2015 level of 4.5 percent of GDP. Weak tourism season, Russian sanctions on trade and strong non-oil imports likely to outweigh the effect of lower energy costs[1/]. The EBA model estimates that in 2016 the cyclically-adjusted CA was some 3.6 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies. External sustainability (ES) approach suggested the CAD was 1–2 percentage points above the level consistent with stabilizing NIIP at the current level. **Assessment**. Staff assesses that the CA gap remains in the range of -1 to -4 percent of GDP. This is consistent with a CA norm in the range of -1 to -3.5 percent of GDP, reflecting the large investment needs of a fuel importing emerging economy.
Real exchange rate	**Background**. Since hitting a 12-years minimum in September 2015, REER has increased by about 10 percent, as Lira remained broadly stable and inflation showed persistence. As of October 2016 the REER was slightly above its average 2015 level. The EBA REER index approach estimates a 4.2 percent overvaluation in 2016; the REER level regression suggests a 15.4 percent overvaluation. Based on the ES approach, about 6 percent REER adjustment is required to stabilize NIIP. In November Lira depreciated by about 10 percent amid capital outflow from emerging markets. **Assessment**. Consistent with the assessment of the CA gap, staff assesses that the REER remained overvalued by about 5–15 percent on average in 2016.
Capital and financial accounts: flows and policy measures	**Background**. Significant external financing needs have been comfortably met due to ample global liquidity. The government and the private sector enjoy access to the international capital markets, net portfolio inflows turned positive in 2016 and were enough to compensate for lower rollover ratio on syndicated loans in 3Q. Turkey has not made use of capital controls on inflows or outflows. **Assessment**. Still large share of short-term debt exposes Turkey to significant rollover risks. Gross external financing needs are estimated at about 27 percent of GDP in 2016, making Turkey vulnerable to changes in global market conditions.
FX intervention and reserves level	**Background**. The exchange rate is floating. In April 2016 the central bank stopped selling foreign exchange to commercial banks through regular auctions and significantly reduced direct sales of FX to energy importing SOEs. By October, Turkey's gross reserves (GIR) have increased by about US$8 billion due to government borrowings and rediscount credit operations, and net reserves increased to US$35billion. Most of the gains in GIR were lost in November as a result of falling banks required reserves and restriction imposed on the use of FX collateral. GIR level is about 90 percent of the ARA metric, and reserves coverage of short-term debt is about 70 percent. Adjusting the level of reserves for ROM-related reserve holdings and banks swap positions vis-à-vis the CBRT, reduced it to 60 percent of the composite adequacy metric at the end of October 2016[2/]. Net reserves available for intervention are significantly lower than GIR. **Assessment**. Given low net international reserves, further reserve accumulation is warranted. Foreign exchange sales should be restricted to periods of disorderly market conditions.

Overall Assessment:

In 2016, Turkey's external position remains weaker than the level consistent with medium-term fundamentals and desirable policy settings. The current account deficit remains sizable despite gains from lower oil prices.

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 is necessary to diminish vulnerabilities The on-going economic slowdown and deceleration of credit growth help rebalancing. Some temporary fiscal loosening is appropriate to avoid excessive slowdown. However, a credible medium-term consolidation plan to support increase public saving over the medium term is necessary. Further monetary easing should be avoided, and real policy interest rates should remain positive. Macroprudential measure should be strengthened to lower foreign currency risk in the economy. The CBRT should continue to increase net international reserves, limiting foreign exchange sales to smoothing periods of excessive volatility.

Structural reforms are needed to enhance private savings and allow higher growth with a sustainable current account deficit. The new pension auto-enrollment law is a step in the right direction, however in the current form the reform will have only marginal effect on aggregate savings.

Technical Background Notes 1/ The windfall of lower energy prices are estimated at about 1 percent of GDP in 2016. The fuel trade balance was -5.9 percent of GDP on average in 2011–2015. At the same time, in the first nine months, foreign tourist's arrivals fell by 32 percent due to Russian sanctions and amid rising security concerns. This contributed to a fall in exports proceeds from travel (-31 percent), transportation (-30 percent), and the shuttle trade (-14 percent).

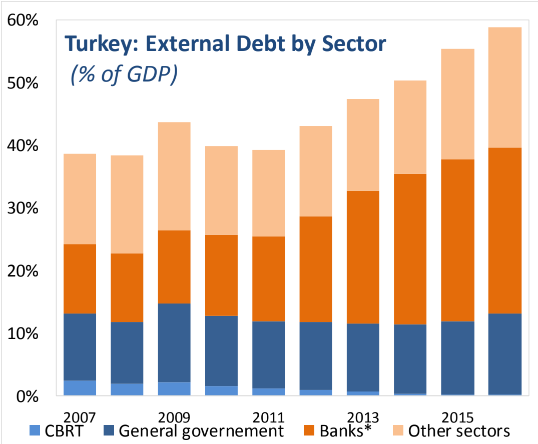
2/ ROM (Reserve Option Mechanism) allows commercial banks to meet their reserve requirements on lira-denominated liabilities by using foreign exchange and gold. The ROM FX and gold reserves are held at the blocked accounts in the CBRT for 14 days, and may be fully substituted with Lira liquidity after this maintenance period. Domestic banks may also use their FX deposits in the CBRT as collateral for Lira liquidity facilities, including swaps with maturities of up to 1 month. As of September 2016 the total amount of FX included in gross international reserves and related to ROM and swap operations with domestic banks stood at about US$27bn (23 percent of total reserves).

Annex III. External Debt Sustainability

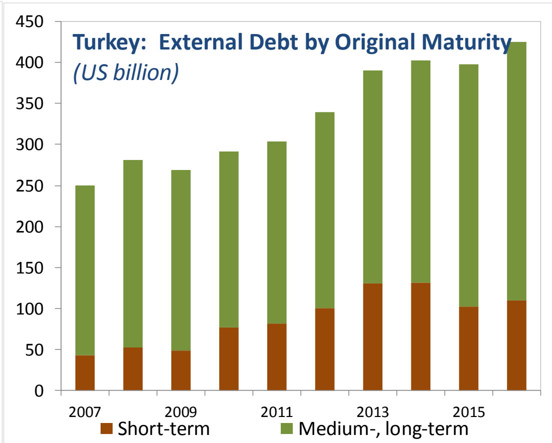
Turkey's external debt, while sustainable, is high and vulnerable to valuation shocks.[1] Under the baseline, debt is forecast to stabilize at around 60 percent of GDP in the medium term. However, it is susceptible to a large Lira depreciation. In addition, annual external financing needs in excess of 30 percent of GDP expose the economy to high liquidity and rollover risks.

Background and assumptions

1. **External debt continued to increase and is estimated to reach 59 percent of GDP in 2016.** A large share of the external debt, about 26 percent of GDP, resides with banks who intermediate capital inflows into domestic loans, mostly in Lira but also in foreign currency. Non-financial corporates (NFC) also recently have been borrowing directly from abroad. NFC's external debt is estimated to exceed 19 percent of GDP in 2016, increasing by about US$12bn over the year. Bank loans constitute about over 60 percent of total external debt of the outstanding debt stock of the private sector. However, the role of portfolio flows has increased recently, reflecting lower demand for project loans, borrower's efforts to diversify investor, as well as changes in creditor preferences in favor of more liquid instruments. Private creditors, including bondholders, hold close to 90 percent of Turkey's total external debt.



Source: Treasury, IMF staff. (*) Includes other financial institutions



Source: Treasury, IMF staff.

2. **While the maturity structure has recently improved, the cost of financing is increasing.** The stock of short-term debt with original maturity of less than 12 months fell markedly in 2015. An increase in reserve requirements on short term liabilities encouraged banks to take debt with longer maturities, while NFCs were borrowing directly from abroad with medium and long-term debt maturities. In practice, however, a significant part of the short-term syndicated loans was extended by just a few days or months beyond the critical threshold of 365 days. Rating downgrades have

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

contributed to the increase in the cost of external funding, which has already been rising due to, among other factors, maturity extension.

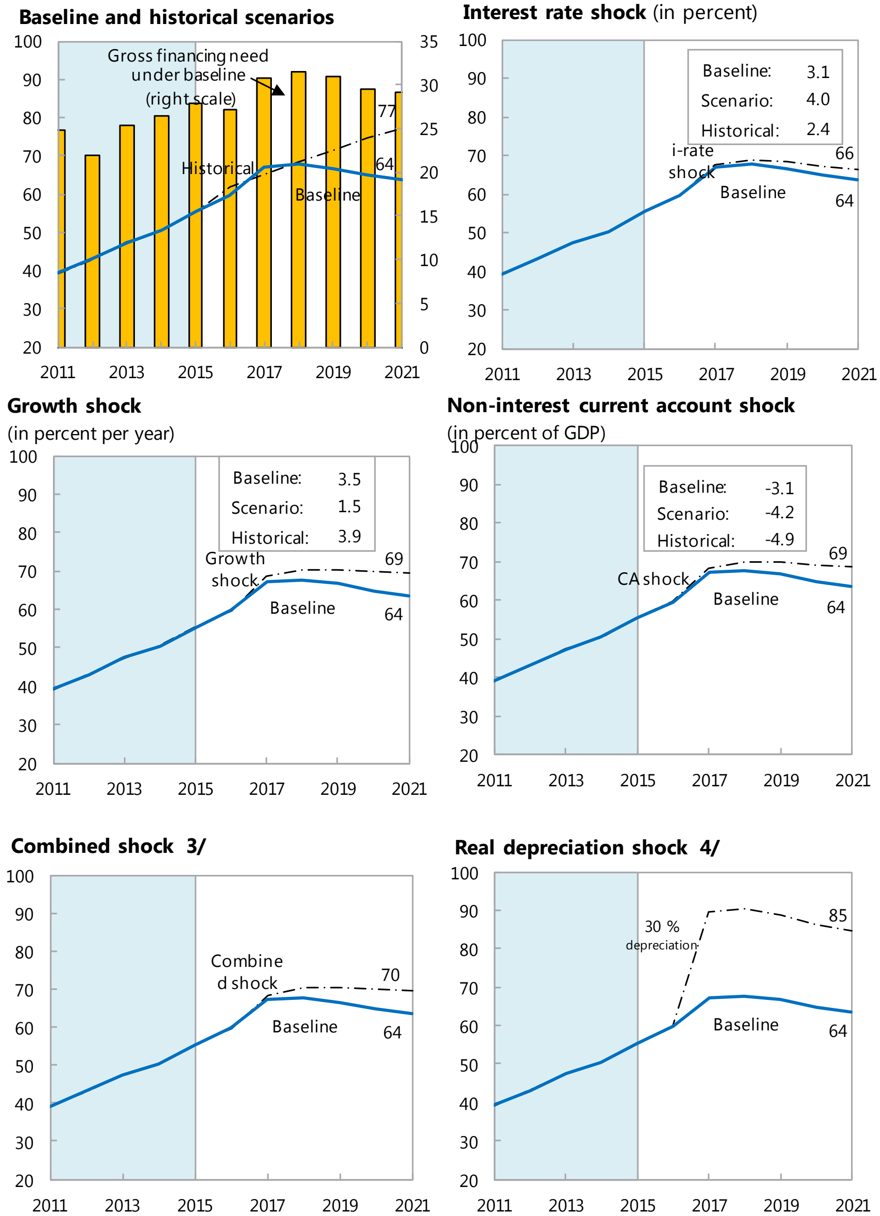
Assessment

3. Turkey's external debt, while sustainable, is vulnerable to valuation shocks. The debt trajectory stabilizes under the baseline at around 64 percent of GDP. Given that over 90 percent of Turkish external debt is denominated in foreign currency, the debt path is susceptible to exchange rate movements. Standard stress tests suggest debt level could increase substantially under the real depreciation shock. A permanent Lira depreciation by 30 percent would push the external debt stock to 85 percent of GDP by 2021. This analysis however does not account for the potential contraction of the current account deficit associated with such sharp currency movements. A steeper recovery of fuel prices, leading to non-interest current deficit of about 4.2 percent would push the debt ratio to around 69 percent of GDP over the medium term.

4. Large external financing requirements and a significant share of debt with adjustable rates make the economy vulnerable to shifts in global liquidity. Despite some increase in average maturity of external debt, annual rollover needs remain close to a quarter of GDP. Total external financing needs are about 30 percent of GDP over the next few years. Over 60 percent of total external debt, including debt with short maturities, is indexed to global interest rates. As a result, a tightening of global liquidity conditions, an increase in Turkey spreads, or capital outflows from emerging markets in general could quickly translate into higher borrowing costs. According to the DSA simulation results, an increase in interest rates by 1 standard deviation compared to the baseline would increase the debt level by additional 3 percentage points to 66 percent of GDP. Moreover, a sudden stop in capital flows may trigger a simultaneous rise in both borrowing costs and exchange rate pressure.

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 2016.

Table 1. Turkey: External Debt Sustainability Framework, 2011–21

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account 6/
Baseline: External debt	39.2	43.1	47.4	50.4	55.4			**59.6**	**67.1**	**67.8**	**66.6**	**64.9**	**63.5**	**-3.2**
Change in external debt	-0.7	3.8	4.3	3.0	5.1			4.2	7.5	0.6	-1.1	-1.8	-1.3	
Identified external debt-creating flows (4+8+9)	5.4	3.2	4.6	5.4	8.1			1.8	1.9	1.6	0.9	0.5	0.8	
Current account deficit, excluding interest payments	8.9	5.3	7.0	4.7	3.8			3.7	3.9	3.6	3.0	2.5	2.6	
Deficit in balance of goods and services	8.9	5.4	6.8	4.6	3.3			3.5	3.8	3.8	3.3	3.0	3.2	
Exports	23.7	26.0	25.5	27.6	27.6			26.6	30.3	30.9	30.8	30.7	30.3	
Imports	32.5	31.4	32.3	32.2	31.0			30.1	34.1	34.7	34.1	33.7	33.5	
Net non-debt creating capital inflows (negative)	-1.7	-2.0	-1.2	-1.0	-1.3			-1.2	-1.5	-1.7	-1.8	-1.7	-1.8	
Automatic debt dynamics 1/	-1.8	-0.1	-1.3	1.7	5.6			-0.8	-0.4	-0.3	-0.3	-0.4	0.0	
Contribution from nominal interest rate	0.7	0.7	0.7	0.7	0.7			0.7	1.4	1.9	2.0	2.1	2.4	
Contribution from real GDP growth	-3.3	-0.8	-1.7	-1.5	-2.2			-1.5	-1.9	-2.1	-2.3	-2.5	-2.4	
Contribution from price and exchange rate changes 2/	0.8	-0.1	-0.2	2.5	7.1			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-6.1	0.6	-0.3	-2.5	-3.0			2.5	5.5	-0.9	-2.0	-2.2	-2.1	
External debt-to-exports ratio (in percent)	165.8	165.6	186.2	182.4	200.6			224.1	221.8	219.2	216.3	211.4	209.5	
Gross external financing need (in billions of US dollars) 4	192.7	172.2	208.5	211.5	199.9			193.4	204.4	217.3	225.2	230.0	240.6	
in percent of GDP	24.9	21.8	25.3	26.5	27.9			27.2	30.7	31.5	30.9	29.6	29.2	
Scenario with key variables at their historical averages 5/						10-Year Historical Average	10-Year Standard Deviation	**61.8**	**65.2**	**68.3**	**71.4**	**74.4**	**77.2**	**-1.6**
Key Macroeconomic Assumptions Underlying Baseline														
Real GDP growth (in percent)	8.8	2.1	4.2	3.0	4.0	3.9	4.1	2.7	2.9	3.3	3.6	4.0	3.9	
Exchange rate appreciation (US dollar value of local currenc	-10.3	-6.8	-5.7	-13.0	-19.6	-6.4	9.0	-10.0	-15.5	-6.6	-5.0	-4.4	-4.7	
GDP deflator (change in domestic currency)	8.6	6.9	6.2	8.3	7.4	7.6	2.0	7.4	7.4	7.4	7.5	7.3	7.0	
GDP deflator in US dollars (change in percent)	-2.6	-0.3	0.2	-5.8	-13.6	0.7	9.9	-3.4	-9.2	0.3	2.1	2.6	2.1	
Nominal external interest rate (in percent)	1.8	1.9	1.7	1.4	1.3	2.4	0.9	1.3	2.3	2.9	3.2	3.4	3.9	
Growth of exports (US dollar terms, in percent)	16.6	12.0	2.1	5.3	-10.1	7.2	13.1	-4.5	6.3	5.9	5.5	6.2	4.8	
Growth of imports (US dollar terms, in percent)	28.1	-1.7	7.2	-3.1	-13.7	7.8	19.2	-3.7	5.8	5.6	4.1	5.2	5.5	
Current account balance, excluding interest payments	-8.9	-5.3	-7.0	-4.7	-3.8	-4.9	2.1	-3.7	-3.9	-3.6	-3.0	-2.5	-2.6	
Net non-debt creating capital inflows	1.7	2.0	1.2	1.0	1.3	-0.2	1.9	1.2	1.5	1.7	1.8	1.7	1.8	

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 IV. Public Debt Sustainability

At about 35 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 declined significantly and will remain low over the medium term. The DSA suggests that Turkey's government debt is sustainable under different shock scenarios. Given the debt structure (average maturity of 6.2 years, 68 percent 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 low. Lower GDP growth rates, potentially combined with other macro shocks or a contingent liability shock, would lead to an increase in the debt-to-GDP ratio. 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 debt-to-GDP ratio is moderate at 32.9 percent at end-2015. Staff forecast that the ratio will slightly increase in the short-run due to the ongoing and projected fiscal expansion before resuming its declining path. The debt-to-GDP ratio is projected to reach 34.8 percent in 2021—up by 2 pp since end-2015. The interest rate/growth differential contributes to the decline in debt-to-GDP ratio, while the primary balance first contributes to an increase then a decrease in the debt-to-GDP ratio. At 5.3 percent of GDP in 2015, gross public financing needs have declined 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. A negative output gap is opening, but is projected to close 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 volatile, although they remain below the levels of the first quarter of 2014. The spreads against the US bonds in the last three months remained on average at 331 bps, higher than its lowest value of 118 bps observed in May 2013. The effective interest rate is forecast to decline from 8.8 percent in 2015 to 8.1 percent in 2016. However, in the medium term 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 in the medium term. The maximum projected 3-year adjustment of the cyclically-adjusted primary balance is 2 percent of GDP, while the maximum projected 3-year average level of cyclically-adjusted primary balance is 0.8 percent of GDP.

---

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

5. Maturity and rollover. Given the current debt structure (average maturity of 6.2 years, 69 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 and interest rate shocks do not affect the debt dynamics substantially, while growth shock and contingent liability shocks lead to a temporary increase in debt.

- **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.

- **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 -5 percent of GDP by 2018. The deterioration in primary balance leads to higher sovereign borrowing costs. The debt-to-GDP ratio increases to about 46 percent during the growth shock and then gradually trends down. Gross public financing needs climb toward 16.3 percent of GDP before trending down to 14.2 percent of GDP by the end of the period.

- **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 reaches an implicit average interest rate of 15 percent by 2021. The debt-to-GDP ratio climbs to around 39 percent, and gross public financing needs increase to around 13 percent of GDP by 2021.

- **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 45 percent of GDP in 2018 and then gradually declines. Gross public financing needs increase to about 14 percent of GDP in the medium term.

[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 1.6 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

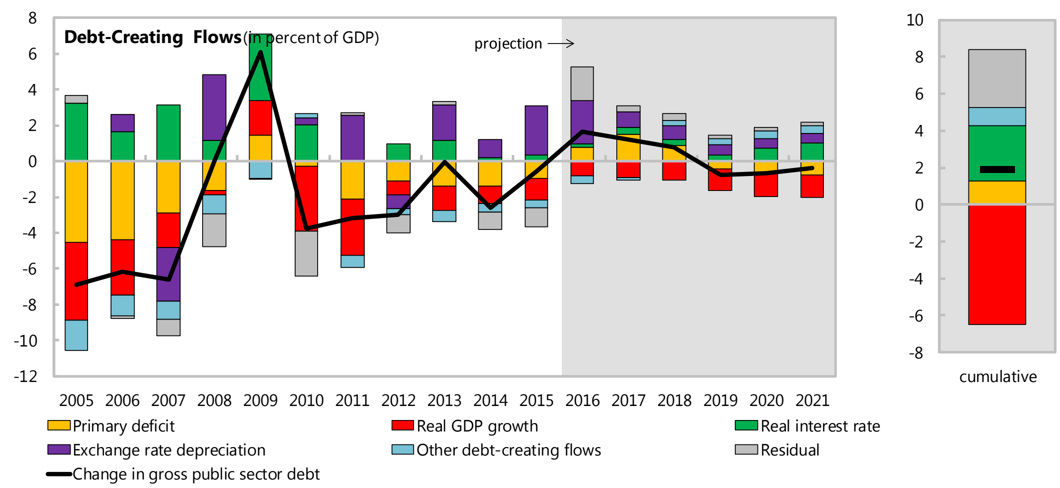
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of December 05, 2016		
	2005-2013 [2/]	2014	2015	2016	2017	2018	2019	2020	2021	Sovereign Spreads		
Nominal gross public debt	42.1	33.5	32.9	34.6	35.8	36.6	35.9	35.2	34.8	Spread (bp) 3/		387
Public gross financing needs	15.1	8.3	5.3	6.5	7.4	8.9	8.5	8.1	8.5	CDS (bp)		302
Real GDP growth (in percent)	4.4	3.0	4.0	2.7	2.9	3.3	3.6	4.0	3.9	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	7.5	8.3	7.4	7.4	7.4	7.4	7.5	7.3	7.0	Moody's	Ba1	Ba1
Nominal GDP growth (in percent)	12.3	11.5	11.7	10.2	10.5	10.9	11.4	11.6	11.2	S&Ps	BB	BB+
Effective interest rate (in percent) [4/]	12.4	9.2	8.8	8.1	8.9	8.6	8.8	9.8	10.6	Fitch	BBB-	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing
Change in gross public sector debt	-2.6	-2.6	-0.6	1.6	1.2	0.8	-0.8	-0.6	-0.4	1.9	primary
Identified debt-creating flows	-2.0	-1.7	0.5	-0.3	1.7	1.2	-0.3	-0.3	0.0	2.1	balance [9/]
Primary deficit	-1.9	-1.4	-1.0	0.8	1.5	0.9	-0.4	-0.7	-0.8	1.3	0.8
Primary (noninterest) revenue and gra	32.5	35.7	35.7	36.1	35.8	36.5	37.1	37.2	37.4	219.9	
Primary (noninterest) expenditure	30.6	34.3	34.8	36.9	37.3	37.3	36.6	36.5	36.6	221.2	
Automatic debt dynamics [5/]	0.7	0.2	1.9	-0.6	-0.5	-0.7	-0.9	-0.6	-0.2	-3.5	
Interest rate/growth differential [6/]	0.1	-0.8	-0.9	-0.6	-0.5	-0.7	-0.9	-0.6	-0.2	-3.5	
Of which: real GDP growth	-1.8	-1.0	-1.2	-0.8	-0.9	-1.1	-1.2	-1.3	-1.2	-6.5	
Exchange rate depreciation [7/]	0.6	1.0	2.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.8	-0.5	-0.4	-0.4	-0.1	0.3	0.4	0.5	0.5	1.0	
Public Sector: Privatization Proceeds	-0.8	-0.6	-0.6	-0.5	-0.7	-0.3	-0.2	-0.1	-0.1	-2.0	
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	0.6	0.6	0.6	3.0	
Residual, including asset changes [8/]	-0.6	-0.9	-1.1	1.9	0.4	0.4	0.2	0.2	0.2	3.1	



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).

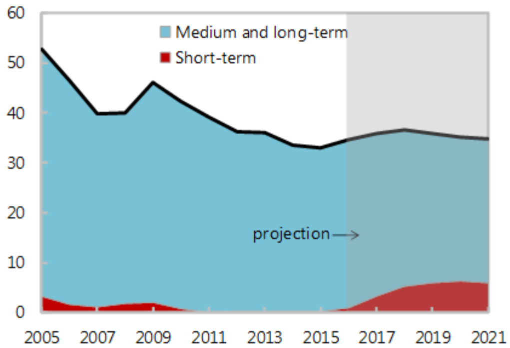
8/ For projections, this line includes exchange rate changes during the projection period.

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.

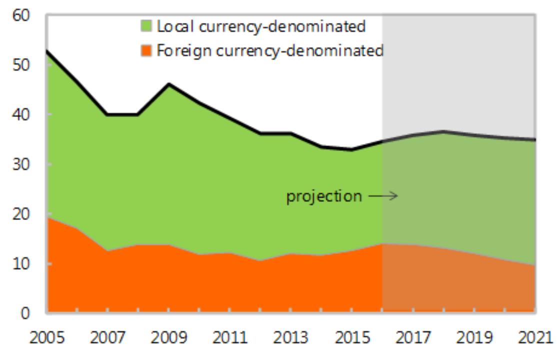
Turkey: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



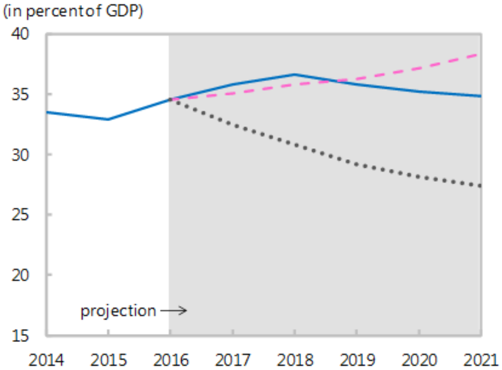
By Currency
(in percent of GDP)



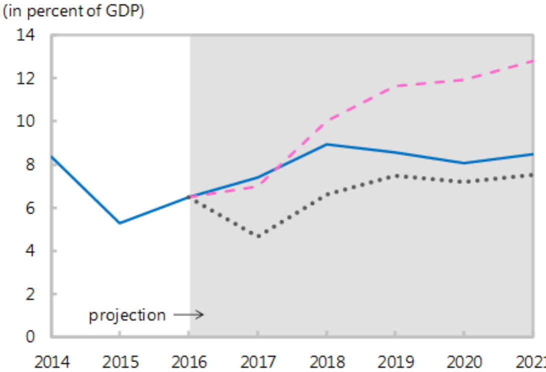
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



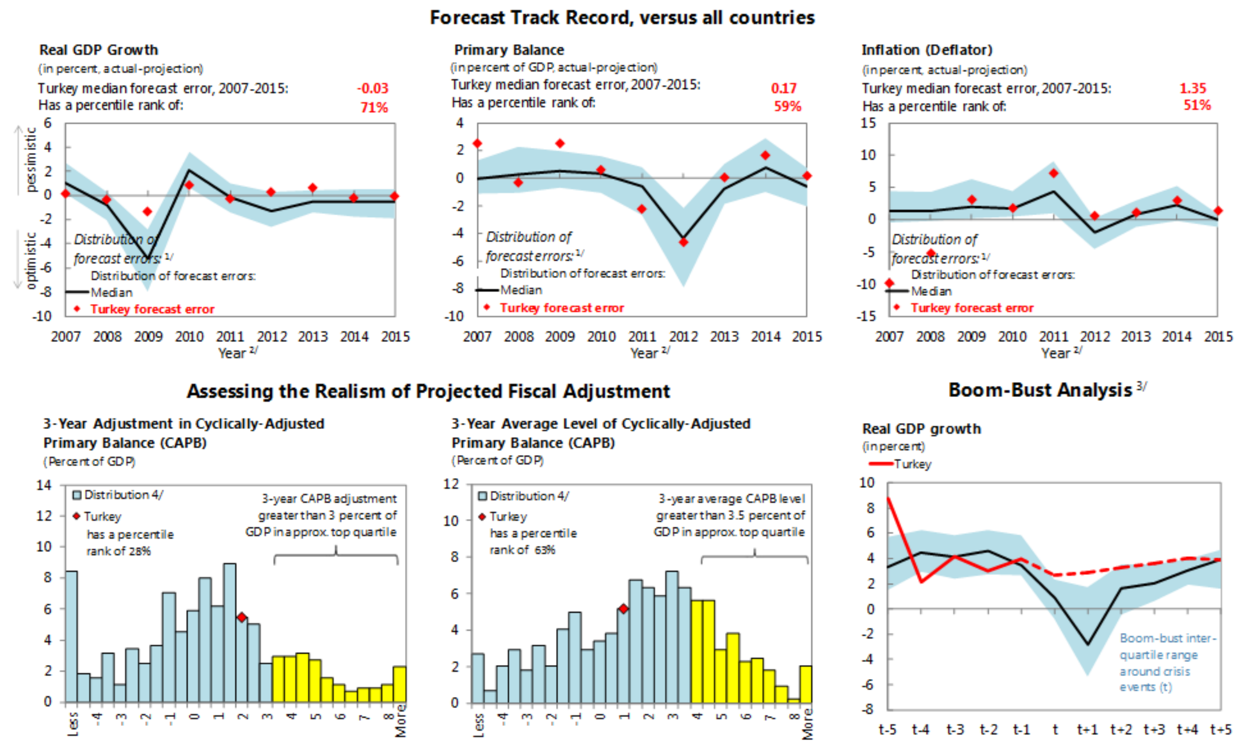
Underlying Assumptions
(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.7	2.9	3.3	3.6	4.0	3.9
Inflation	7.4	7.4	7.4	7.5	7.3	7.0
Primary Balance	-0.8	-1.5	-0.9	0.4	0.7	0.8
Effective interest rate	8.1	8.9	8.6	8.8	9.8	10.6
Constant Primary Balance Scenario						
Real GDP growth	2.7	2.9	3.3	3.6	4.0	3.9
Inflation	7.4	7.4	7.4	7.5	7.3	7.0
Primary Balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	8.1	8.9	8.6	8.6	9.8	10.6

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	2.7	3.9	3.9	3.9	3.9	3.9
Inflation	7.4	7.4	7.4	7.5	7.3	7.0
Primary Balance	-0.8	1.5	1.5	1.5	1.5	1.5
Effective interest rate	8.1	8.9	8.9	9.2	10.7	11.7

Source: IMF staff.

Turkey Public DSA – Realism of Baseline Assumptions



Source: IMF Staff.

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

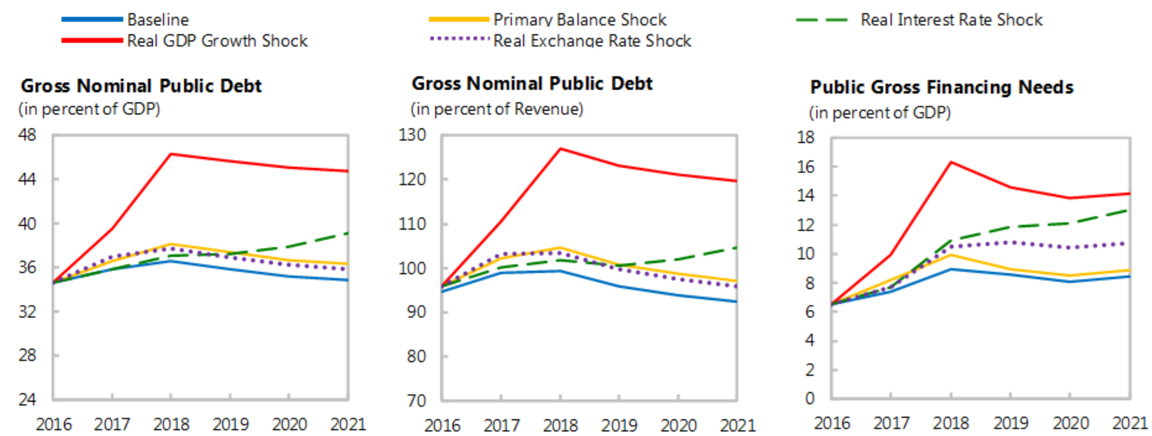
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Turkey has had a positive output gap for 3 consecutive years, 2013-2015 and a cumulative increase in private sector credit of 21 percent of GDP, 2012-2015. For Turkey, t corresponds to 2016; for the distribution, t corres

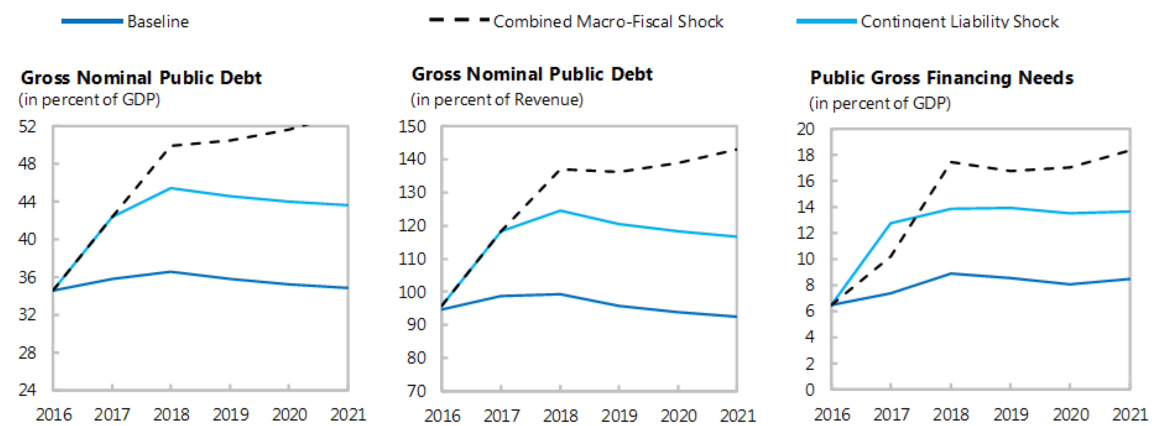
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Turkey: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2016	2017	2018	2019	2020	2021
Primary Balance Shock						
Real GDP growth	2.7	2.9	3.3	3.6	4.0	3.9
Inflation	7.4	7.4	7.4	7.5	7.3	7.0
Primary balance	-0.8	-2.3	-1.6	0.4	0.7	0.8
Effective interest rate	8.1	8.9	8.7	8.8	9.8	10.5
Real Interest Rate Shock						
Real GDP growth	2.7	2.9	3.3	3.6	4.0	3.9
Inflation	7.4	7.4	7.4	7.5	7.3	7.0
Primary balance	-0.8	-1.5	-0.9	0.4	0.7	0.8
Effective interest rate	8.1	8.9	10.1	11.5	13.6	15.0
Combined Shock						
Real GDP growth	2.7	-1.2	-0.8	3.6	4.0	3.9
Inflation	7.4	6.4	6.4	7.5	7.3	7.0
Primary balance	-0.8	-3.4	-4.8	0.4	0.7	0.8
Effective interest rate	8.1	9.2	10.1	11.9	13.8	15.0

	2016	2017	2018	2019	2020	2021
Real GDP Growth Shock						
Real GDP growth	2.7	-1.2	-0.8	3.6	4.0	3.9
Inflation	7.4	6.4	6.4	7.5	7.3	7.0
Primary balance	-0.8	-3.4	-4.8	0.4	0.7	0.8
Effective interest rate	8.1	8.9	8.7	9.2	10.0	10.6
Real Exchange Rate Shock						
Real GDP growth	2.7	2.9	3.3	3.6	4.0	3.9
Inflation	7.4	12.2	7.4	7.5	7.3	7.0
Primary balance	-0.8	-1.5	-0.9	0.4	0.7	0.8
Effective interest rate	8.1	9.2	8.4	8.5	9.6	10.3
Contingent Liability Shock						
Real GDP growth	2.7	-1.2	-0.8	3.6	4.0	3.9
Inflation	7.4	6.4	6.4	7.5	7.3	7.0
Primary balance	-0.8	-5.8	-0.9	0.4	0.7	0.8
Effective interest rate	8.1	10.2	9.0	8.9	9.8	10.5

Source: IMF staff.

Turkey: Public DSA Risk Assessment

Heat Map

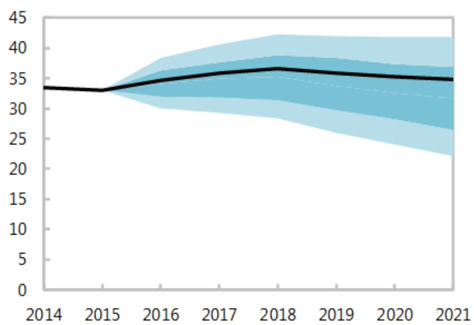
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	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

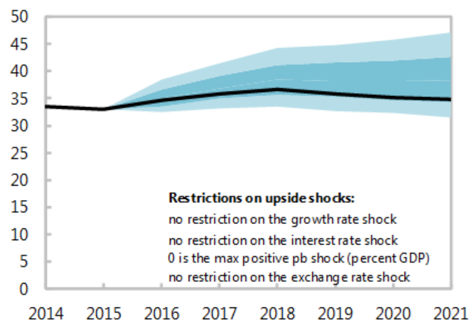
(in percent of GDP)

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

Symmetric Distribution

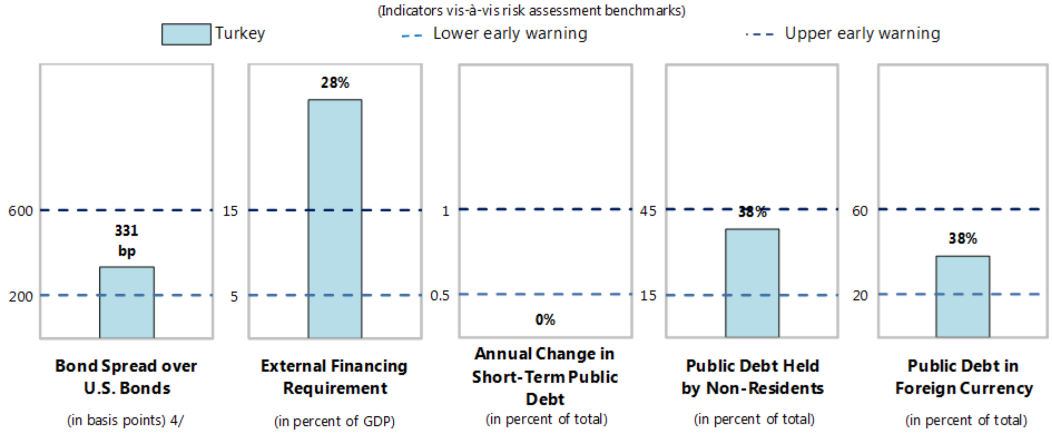


Restricted (Asymmetric) Distribution



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, 06-Sep-16 through 05-Dec-16.

INTERNATIONAL MONETARY FUND

TURKEY

December 20, 2016

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

CONTENTS

FUND RELATIONS

(Data as of October 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 October 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	4,658.60	100.00
Fund holdings of currency	4,545.83	97.58
Reserve position in Fund	112.78	2.42

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	1,071.33	100.00
Holdings	966.06	90.17

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	0.02	0.17	0.17	0.17	0.17
Total	0.02	0.17	0.17	0.17	0.17

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 (16/104) was issued on April 22, 2016. Board discussion for the last Article IV staff report took place on March 25, 2016.

FSAP

Financial stability assessments under the Financial Sector Assessment Program (FSAP), every five years, are a mandatory part of Article IV surveillance. Two recent FSAP missions to Turkey took place in April and June 2016, and the Aide Memoire was presented to the authorities. The FSAP findings are summarized in the accompanying Financial System Stability Assessment (FSSA), which will be discussed at the Board together with the 2017 Article IV Staff Report.

[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.

Resident Representative

The IMF currently has a resident representative office in Ankara. Mr. Srikant Seshadri has been the senior resident representative since August 2014.

ROSCs

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

Recent Technical Assistance

Dept.	Timing	Purpose
FAD/MFD	February 2005	Treasury cash management and state bank reform
MFD	2005–06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May 2005	Investor relations office
FAD	July 2005	Income tax reform
FAD	2005–08 (several 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
STA	April 2015	National accounts statistics
FAD	June 2015	Fiscal transparency evaluation
STA	January 2016	Compilation system for independent annual estimates of GDP
STA	April 2016	Government finance statistics – GFSM2014 and ESA10

WORLD BANK RELATIONS

1. **Turkey and the World Bank Group (WBG) have a strong partnership, that is based on Turkey's National Development Plans (NDPs).** The 10th Development Plan (2014–18) outlines the priority development areas for the Government, and the WBG's current and future programs aim to support key aspects of this plan. The WBG is preparing a Systematic Country Diagnostic (SCD), which have been shared with the Government and will soon be finalized. This SCD discusses the main challenges to reducing poverty and sustaining growth in Turkey. The SCD and NDP both provide a strong foundation for the new WBG Country Partnership Framework (CPF) that is under preparation. The CPF will outline the WBG's strategy for FY17–21 and articulate the main areas of the WBG engagement, both technically and financially.

2. **The Country Partnership Strategy (CPS) FY12-16 has delivered financing of over US$9.6 billion.** Throughout the CPS period, project implementation has been smooth, meeting disbursement targets and development objectives. The CPS financing includes US$4.3 billion through the International Bank for Reconstruction and Development (IBRD), US$3.6 billion through the International Finance Corporation (IFC), and nearly US$1.7 billion though the Multilateral Investment Guarantee Agency (MIGA).

A. International Bank for Reconstruction and Development

3. **Turkey is the sixth-largest borrower of the IBRD in terms of debt outstanding.** Turkey's active portfolio of investment operations with the World Bank's IBRD financing includes 12 projects with total net commitments of US$4.5 billion (as of November 2016). The investment portfolio and pipeline support the energy sector, financial and private sector development, urban development, and health care.

4. **Turkey values the WBG's analytical and technical knowledge work.** Analytical work allowed the WBG to provide knowledge in priority areas that were supportive of a wide range of Turkey`s development challenges. The WBG responded to client demand for partnership in delivering global knowledge and analytical work. A growing area of common interest is sharing Turkey's experiences with other developing countries.

5. **A key engagement also concerns the Syrian refugees living in Turkey.** The WBG is currently providing assistance in the area of social support and adaptation, labor markets, and the economy, and education, as well as in the cross-cutting areas of data collection, measurement, and monitoring.

B. International Finance Corporation

6. **With the committed portfolio of around US$3.8 billion, Turkey represents the second-largest country exposure for the IFC globally.** In FY16, the IFC had a fourth consecutive record year in Turkey, investing US$1.8 billion in projects to improve municipal services, combat climate change, develop local capital markets, bolster supplies of renewable energy, and support smaller businesses.

7. IFC's committed portfolio at the beginning of the CPS period (FY12) stood at US$2.3 billion (own account), while at the end of the FY16 it increased to US$3.8 billion. The portfolio has been further diversified, with financial markets operations decreasing from 48 percent in FY12 to 41 percent in FY16, infrastructure increasing from 27 to 34 percent, manufacturing, services and agriculture portfolio falling from about 22 to 20 percent, and media, technology and telecommunications increasing from 3 to 5 percent. The quality of the portfolio also improved, as NPLs decreased from $68.6 million at the beginning of the CPS period to $15.3 million at the end of FY16 (or from 3.9 percent to 0.6 percent of outstanding loan portfolio).

C. Multilateral Investment Guarantee Agency

8. Turkey is MIGA's largest country by gross exposure, representing almost 12 percent of MIGA's gross portfolio. In FY16, MIGA's portfolio in the country comprised a number of projects in the infrastructure, financial, and services sectors with gross exposure of US$1.695 billion or net exposure of US$537 million. MIGA intervention helped mobilize foreign private financing in support of key strategic areas of the economy, such as healthcare, the financial sector, and the transport sector. MIGA's product mix include the traditional political risk insurance as well as the non-honoring, credit guarantee product.

STATISTICAL ISSUES

(As of December 1, 2016)

I. Assessment of Data Adequacy for Surveillance

General: Data provision to the Fund is broadly adequate for surveillance purposes, despite some shortcomings especially in national accounts and government finance statistics.

National Accounts: 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. TURKSTAT plans to disseminate revised series of national accounts estimates—both annual and quarterly data, covering the period 2009–15—based on the *System of National Accounts 2008 (2008 SNA)/The European System of Accounts 2010 (ESA 2010)* in the coming months. Sectoral financial balance sheets are compiled on a quarterly basis. Sectoral income accounts data for 2009–15 are expected to be published in the coming months.

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 2015 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 December 1, 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]	Memo Items: Data Quality Accuracy and reliability[9]
Exchange Rates	Nov. 2016	12/01/2016	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov. 2016	11/25/2016	W	W	W		
Reserve/Base Money (narrow definition)	Oct. 2016	12/01/2016	W and M	W and M	W and M	O, O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Oct. 2016	12/01/2016	W and M	W and M	W and M		
Broad Money	Oct. 2016	12/01/2016	W and M	W and M	W and M		
Central Bank Balance Sheet	Oct. 2016	12/01/2016	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Oct. 2016	12/01/2016	W and M	W and M	W and M		
Interest Rates[2]	Nov. 2016	11/30/2016	D/W/M	D/W/M	W/M		
Consumer Price Index	Oct. 2016	11/03/2016	M	M	M	O, LO, O, LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jun. 2016	Sep. 2016	Q	Q	Q	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct. 2016	Nov. 2016	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sep. 2016	Oct. 2016	M	M	M		
External Current Account Balance	Sep. 2016	Oct. 2016	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Sep. 2016	Oct. 2016	M	M	M		
GDP/GNP	2016Q2	09/09/2016	Q	Q	Q	O, LO, O, O	LO, O, LO, O, LO
Gross External Debt	2016Q2	2016Q3	Q	Q	Q		
International Investment Position[6]	Aug. 2016	Oct. 2016	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 September 3, 2009, and based on the findings of the mission that took place during October 2016) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).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.

INTERNATIONAL MONETARY FUND

TURKEY

January 4, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared By | The European Department

The purpose of this supplement is to inform the Board about the latest economic and policy developments and recent revisions to Turkey's national accounts data. On December 8th, a policy package in support of the economy was announced. On December 12th, historical GDP data have been revised up. The measures and the statistical revision do not alter the thrust of the staff appraisal, as the underlying economic developments and their implications for policies appear unchanged.

Update of recent developments

1. **The economy contracted in Q3 2016 but there are signs of stabilization in Q4.** After slowing in Q2, the seasonally and calendar adjusted GDP contracted by 2.7 percent in Q3 2016 compared to the previous quarter, mostly as high public expenditures could not offset weakness in private consumption and investment. In Q4, high frequency indicators, including sales of durable goods, house sales, VAT on imports, consumer loan growth, suggest stabilization (and mild recovery in some sectors) for domestic private consumption. However, industrial production, consumer as well as business sentiment, and job creation remain weak.

2. **The Lira continued weakening in December, bringing the depreciation in the last three months to about 20 percent with respect to the US dollars.** This has further amplified the pressures on corporate balance sheets and bank asset quality, stemming from the high share of foreign currency (FX) loans. The government has taken steps to reduce domestic use of FX. It has instructed public institutions to collect FX receivables in lira in the short term, and make new public procurement contracts payable in lira. Gross international reserves (GIR) have declined by US$4 billion to US$114 billion in November and continued to fall in December. Net international reserves remained broadly stable, as the fall in GIR was driven mainly by the withdrawal of banks' FX deposits, including due to lower reserve requirements.

3. **On December 8th, the government announced a package of measures to revive growth and support the currency.** The measures include the following: (1) Increasing the capital of the Turkish Eximbank; (2) Providing state guarantees of up

to TRY25 billion (US$7.2 billion or 1.2 percent of GDP) through the Credit Guarantee Fund for corporate loans, with preferential terms for exporters and SMEs; (3) Capping the interest rate on public sector deposits at public banks below current market rates for longer maturities, reduction until end-2017 of general provisions on loans to firms, and easing the conditions for banks to restructure non-performing loans; and (4) Temporary cuts in taxes and deferring social security contributions of employers from the first to the fourth quarter of 2017 to support employment and promote industrial investment.

4. **The new measures are intended to be financed by (unidentified) expenditure reallocation.** The authorities estimate the cost of the state guarantees to be no greater than TRY 17.5 billion (0.6–0.7 percent of GDP) for state guarantees and TRY 15–16 billion (0.7 percent of GDP) for the other measures over three years. The authorities plan to fund these measures by shifting existing budgetary allocations, and have ruled out tax increases or additional borrowing for the new measures. However, sources of financing have not been identified within the budget.

Revision of national accounts data

5. **On December 12th, 2016, the Turkish Statistical Institute (TurkStat) announced major revisions to national accounts data.** The revision and newly published data address some areas identified by staff as needing improvement in the national statistics.[1] The revisions primarily affect the period 2009–15. The data changes are mostly on account of updated methodology, improved estimation methods, and implementation of the latest versions of international statistics standards—System of National Accounts, 2008 and European System of Accounts, 2010.[2]

6. **Both nominal and real GDP were revised up.** The largest changes are for the period 2011–2015, over which annual real GDP growth has been revised up by an average of 2.7 percentage points (Table 1.) The upward revision mostly affected construction and financial service sectors, as well as investment.

Staff assessment

7. **The authorities' policy measures build on the approach they have taken to date to strengthen demand, but staff maintains the reservations noted in the staff report.** The new measures may ease existing loan supply constraints but their effect is probably limited in the current uncertain situation. The measures do not address the underlying causes of the credit slowdown, including the heightened counterparty risk resulting from domestic uncertainty, and the effect of a weakening currency on the corporate debt overhang. At the same time, the government's

[1] See Informational Annex to the staff report on the 2017 Article IV Consultation with Turkey. GDP data for 2009–15 are now derived independently, based on the 2012 Supply and Use Table. Nominal GDP by income approach and sectoral income accounts are now published for 2009–2015.

[2] The Statistics Department of the IMF has provided technical assistance to TurkStat, most recently in January 2016. Since then, there has not been any further consultation with STA on this matter.

contingent liabilities will rise, and asset quality issues could deteriorate, requiring banks to conserve capital.

8. The data revisions improved external sector indicators but not enough to change staff's assessment of the external sector position. The revisions lower the current account (CA) deficit in 2015 to 3.8 percent of GDP (0.7 percent of GDP lower than before the revision.) Ratios of the external debt and the net international investment position (NIIP) to GDP stand at 46 and 44 percent at end-2015 (9 percentage points lower than before the revision) with similar adjustments expected in 2016. Consequently, staff assesses that the 2016 CA gap is in the range of -1 to -3 percent of GDP, and Turkey's external position remains weaker than the level consistent with medium-term fundamentals and desirable policy settings. The external debt remains sustainable, but the NIIP is still projected to widen significantly over the medium term.

9. Similarly, staff's assessment of fiscal space remains broadly unchanged. The GDP data revisions imply that the 2015 fiscal deficit is 0.2 percent of GDP lower (Figure 1.) The decline in the end-2015 public debt ratio is 5 percent of GDP. However, data revisions also imply lower fiscal revenues relative to the size of the economy. Public debt is sustainable and there is some fiscal space for temporary stimulus. However, persistent external imbalances, and the dependence of the banking and corporate sectors on external financing with substantial rollover needs, call for prudence in using fiscal space.

10. The statistical revision and policy initiatives do not alter the thrust of the staff appraisal. Staff's assessment of underlying economic developments post-data revision, is consistent with its views at the time of the Article IV consultation policy discussions. The GDP data confirm that the economy has been contracting. Therefore, staff maintains its recommendation for moderately looser fiscal and tighter monetary stance. The new measures further ease the macroprudential regime and add to public contingent liabilities, increasing the risks which are discussed in the Staff Report.

11. The authorities indicated that the revised national accounts data will not alter their objectives and key tenets of economic policy making. Economic policies will focus on increasing stable and inclusive growth, reducing inflation, preserving the downward trend in the current account deficit, enhancing competitiveness, employment and productivity, improving the quality of fiscal discipline, and strengthening public finances in the medium term.

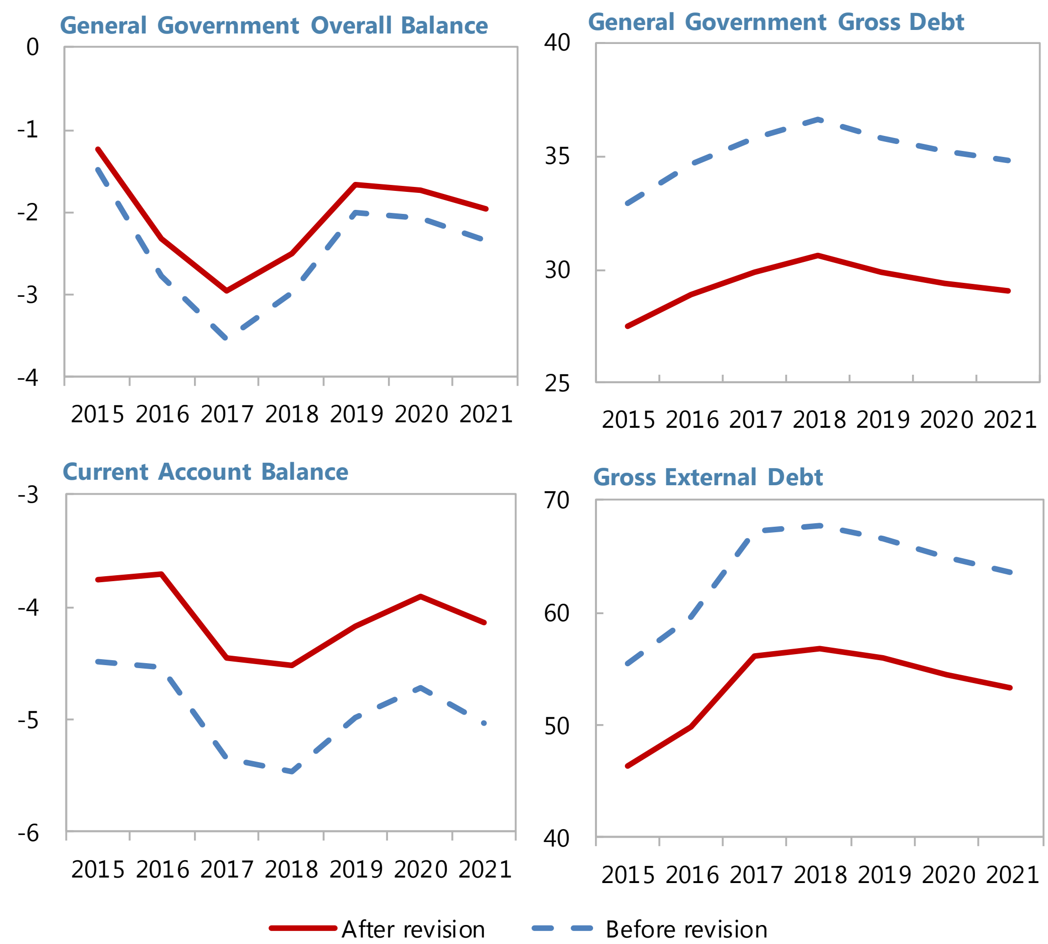
Table 1. Turkey: Revision of National Accounts Data, 2009–15

	2009	2010	2011	2012	2013	2014	2015
Newly published data				*(Percent)*			
Real growth rates							
Real GDP	-4.7	8.5	11.1	4.8	8.5	5.2	6.1
Demand-side							
Private consumption	-3.7	10.8	12.3	3.2	7.9	3.0	5.5
Public consumption	8.1	1.7	1.1	6.8	8.0	3.1	4.1
Gross fixed capital formation	-20.5	22.5	23.8	2.7	13.8	5.1	9.2
Exports	-3.7	1.7	13.4	14.9	1.1	8.2	4.2
Imports	-14.3	19.5	15.4	0.7	8.0	-0.4	1.7
Supply-side (select sectors)							
Manufacturing	-8.9	9.6	20.0	2.3	9.3	6.1	5.9
Construction	-15.9	17.1	24.7	8.3	14.0	5.0	4.9
Wholesale and retail trade	-12.0	13.7	14.6	3.1	7.8	8.1	7.7
Financial and insurance activities	30.2	7.5	5.7	0.1	25.8	10.2	7.7
Nominal GDP (billion of Lira)	999	1,160	1,394	1,570	1,810	2,044	2,338
				(Percent of GDP)			
General government							
Overall balance	-5.7	-3.2	-0.6	-1.5	-1.1	-1.4	-1.2
Gross debt (EU definition)	43.9	40.1	36.4	32.6	31.3	28.7	27.5
External sector							
Current account balance	-1.8	-5.8	-8.9	-5.5	-6.7	-4.7	-3.8
Gross external debt	41.7	37.8	36.5	38.9	41.0	43.1	46.3
Difference between new and old data				*(Percentage points)*			
Real growth rates							
Real GDP	0.1	-0.7	2.3	2.7	4.3	2.1	2.1
Demand-side							
Private consumption	-1.4	4.1	4.6	3.6	2.8	1.5	0.7
Public consumption	0.3	-0.2	-3.6	0.7	1.5	-1.6	-2.6
Gross fixed capital formation	-1.4	-8.0	5.8	5.4	9.5	6.4	5.3
Exports	1.3	-1.7	5.6	-1.4	1.3	0.7	5.0
Imports	0.0	-1.2	4.8	1.1	-1.0	-0.1	1.5
Supply-side (select sectors)							
Manufacturing	-2.0	-3.6	10.1	0.4	5.7	2.3	2.0
Construction	0.3	-1.2	13.2	7.7	6.7	2.8	3.2
Wholesale and retail trade	-1.6	0.0	3.4	3.1	2.6	6.2	5.5
Financial and insurance activities	21.6	0.7	-3.9	-3.0	16.0	2.9	-2.3
				(Percent)			
Nominal GDP	4.9	5.6	7.5	10.8	15.5	16.9	19.7
				(Percentage points of GDP)			
General government							
Overall balance	0.3	0.2	0.0	0.2	0.2	0.2	0.2
Gross debt (EU definition)	-2.2	-2.2	-2.7	-3.5	-4.8	-4.9	-5.4
External sector							
Current account balance	0.1	0.3	0.7	0.6	1.0	0.8	0.7
Gross external debt	-2.0	-2.1	-2.7	-4.2	-6.3	-7.3	-9.1

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

Figure 1. Turkey: Illustrative Impact of Data Revisions on Forecasted Indicators of Fiscal and External Sustainability, 2015–21

(Percent of GDP)



Statement by Mr. Taşkın Temiz, Alternate Executive Director for Turkey
January 11, 2017

We thank staff for the comprehensive papers. The Turkish authorities convey their appreciation for the constructive discussions and comprehensive analyses during the Article IV and FSAP consultations.

I. Overview

Political, macroeconomic and financial stability have been the basis for Turkey's economic performance and structural transformation, raising Turkey's status to an upper middle-income country and increasing its resilience to shocks.

External and domestic uncertainties have heightened recently. External headwinds include the subdued global economic and productivity growth, bouts of financial market volatility, the strengthening US dollar, sluggish global trade prospects, the ongoing realignments in China and commodity exporter countries as well as the current difficult geopolitical environment. Turkey has also faced homegrown challenges stemming from the huge influx of refugees, terrorist attacks and a failed coup attempt. Turkey has managed to mitigate the implications of all these challenges weighing on its economic outlook and preserved its resilience to both external and internal shocks mostly owing to its solid macroeconomic fundamentals and sound macro-framework, which are based on the following three long-standing pillars:

1. **A prudent public sector financial management framework.** The strong fiscal position and economic growth, together with decelerating real interest rates, put public debt on a downward trend to sustainable levels.
2. **Sound implementation of monetary policy.** An independent central bank, inflation targeting and flexible exchange-rate regimes have been essential for securing financial stability and bringing the inflation rate closer to the target.
3. **A strong financial sector with a solid regulation and supervision framework.** Together, the Turkish Treasury, the Central Bank of the Republic of Turkey (CBRT), the Banking Regulation and Supervision Agency (BRSA), the Capital Markets Board (CMB) and the Savings Deposit Insurance Fund (SDIF) have established solid risk management and monitoring capabilities. The financial system, without any solvency problems, is supported by robust macro-prudential and resolution frameworks while the regulatory framework has been significantly upgraded. The Financial Stability Committee has been an effective coordinating body. Local currency bond and equity markets have developed further; the financial instruments are diversified and maturities extended.

In addition, an open economy, Turkey has a dynamic and flexible private sector; households with no FX liabilities; increasing per capita income; a diversified and large economy; a favorable demographic structure with a young population and an increasing female labor participation; diverse trade linkages and improved physical infrastructure.

The authorities remain determined to address the persistent structural issues. The low productivity level, relatively low saving rates, a noticeable current account deficit, gross external financing need and labor market rigidities weigh on the Turkish economy. The authorities have been taking the necessary policy actions and measures to promote growth and further boost the economy's resilience by implementing sound macroeconomic policies and the structural reforms as laid out in the 2014–2018 Development Plan and in the 2017–2019 Medium-Term Program (MTP).

II. Recent Macroeconomic Developments

Despite the strong headwinds, the Turkish economy has remained resilient thanks to strong fiscal and monetary policies and a sound financial system. Economic activity remained buoyant and expanded by 3.9 percent in the first half of 2016, driven mostly by domestic demand and supported by the services and industrial sectors. The tourism sector contracted amid geopolitical tensions and the output in the agricultural sector remained lackluster due to adverse weather conditions. The failed coup attempt took its toll on confidence and weighed on consumption and investment expenditures, resulting in a decline in economic activity in the third quarter of 2016. It is worth emphasizing that calendar effects have also played a major role in limiting the growth prospects in the third quarter. Economic activity rebounded in the last quarter due to increased domestic demand following the recovery in consumer loans. The authorities estimate headline growth to remain moderate in 2016.

Immediately after the coup attempt, the Turkish authorities introduced measures to shore up financial markets operations and liquidity. The CBRT announced measures geared toward providing banks with the needed liquidity. At the same time, banks were allowed to place FX deposits as collateral without limits for needed Turkish Lira liquidity. The CBRT has started a gradual withdrawal of the unlimited provision of Turkish Lira liquidity against FX collateral since November 2016.[1]

The inflation rate has remained high mostly due to food prices and the domestic currency depreciation and the increases in energy prices on the back of tax adjustments and administered prices. Food inflation, which had been among the main drivers of headline inflation, lost steam as tourism fell and the decline in exports to Russia lifted the pressure on domestic food prices. The lagging effects of the cumulative exchange rate developments and tax adjustments continue to weigh on the annual inflation and core inflation figures. Wage developments added to the cost side pressures and limited the improvement in the consumer price inflation in 2016.

---

[1] Implementation of limits for FX collateral deposits placed with the CBRT restarted as of November 11, 2016. Banks' limits are applied as four times the limits allocated before July 17, 2016.

Plunging tourism revenues impacted the improvement in the current account shortfall. Tourism receipts have been a major element in mitigating the chronic deficit in the trade balance. Although the deterioration in tourism in 2016 is estimated to have wiped out around 1 percent of GDP, the improvement in the energy balance and the gains in market share in the EU helped mitigate the impact on the current account deficit.

TURKSTAT recently revised the GDP series and its breakdown to align the methodology with the EU and UN. The revisions may affect the assessments of the Turkish economy. But, considering the cut-off date and data set in the staff report, the economic references in this statement—unless otherwise stated—apply the old GDP series.

The revised national accounts data, despite implying great policy buffers, will not alter the objectives and key tenets of the economic policy making. Policies will be geared toward promoting stable and inclusive growth, lowering the inflation rate toward the target level, preserving the downward trend in external imbalances, enhancing competitiveness, employment and productivity, improving the quality of fiscal discipline, and strengthening public finances.

III. Economic Outlook

The 2017–2019 MTP, announced in October 2016, envisages a slightly higher growth outlook compared to staff's projections. Growth is expected to gain pace and reach 4.4 percent next year on the back of a recovery in the tourism sector and domestic demand driven by a pickup in private investment and consumption in response to measures introduced by the government recently. The authorities expect a growth rate of 5 percent in 2018 and 2019 as global and domestic uncertainties gradually wane, private investments, supported by investment incentives, should improve, while structural reforms are expected to raise total factor productivity (TFP).

Price pressures will ease gradually bringing the inflation rate closer to the target in the medium term. The authorities expect inflation to gradually decline in 2017 and reach 5 percent in 2018, supported by a cautious monetary policy stance and structural measures to reduce the rigidities especially in food prices. The CBRT remains wary of the potential upside risks which the recent currency weakness could pose on the inflation outlook and will maintain its price stability oriented monetary policy stance.

External rebalancing will prevail at a modest pace. With the normalization of the relations with Russia and the improving confidence, tourism revenues are estimated to rebound gradually. The recent depreciation in the exchange rate, even though cyclical, will also help the rebalancing. Structural reforms to decelerate Turkey's import dependency are expected to lower the current account deficit in the medium term.

IV. Monetary and Exchange Rate Policy

The CBRT intends to complete the monetary policy simplification process to improve the transmission mechanism, align the short-term market rates with the funding rate and ultimately ensure funding via a single policy rate. The CBRT slashed its marginal funding rate onwards cumulatively by 250 basis points (bp) to 8.25 percent since March 2016 while keeping the one-week repo and overnight borrowing rates constant until November. The Turkish Lira came under pressure in October due to global and local factors. Concerned about the possible spillovers of the recent FX depreciation on the inflation expectations and pricing behavior, the CBRT hiked the one-week repo rate by 50 basis points to 8.00 percent and the upper end of the corridor by 25 basis points to 8.5 percent in November. In addition to the rate hikes, the FX reserve requirement was cut by 50 bp which released US$1.5 billion to the market and the maximum maturity on FX rediscounts was extended to March 2017 allowing exporters to keep FX proceeds until March 2017. As indicated in the most recent Monetary Policy Committee meeting, inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and the cautious monetary policy stance will be maintained.

The exchange rate movements are closely monitored. The Central Bank stopped providing direct FX liquidity to the banking system through FX auctions at the end of April in a bid to preserve the level of net FX reserves[2] and did not directly intervene in the FX market in the most recent episode of currency volatility but expressed its readiness to intervene directly or provide FX liquidity through flexible auctions if deemed necessary to avert disorderly market conditions. In the meantime, the CBRT has made a number of changes in the FX liquidity provision to ease the pressure on FX supply. FX reserve option coefficients were cut in October and November, providing additional FX liquidity of US$1.3 billion. Moreover, the upper limit of FX reserve requirements that can be maintained on average were increased by 1 point in October, which enabled banks to use US$2.9 billion to meet their FX liquidity needs. To strengthen its reserves, the CBRT has continued to provide export rediscount credits to exporters, improved the conditions of these credits and recently introduced a new facility of the admission of wrought or scrap gold as required reserves.

V. Fiscal Policy

Public debt is low and sustainable with a strong composition and management. The public debt burden is projected to fall to 32.9 percent of GDP in 2016 and is envisioned to be below 30 percent at the end of 2019. In addition to the level of public debt its composition in terms of maturity, interest rate, and currency has improved in the last decade. The share of fixed rate debt is 70 percent of the central government debt, boosting the resilience to interest rate shocks. Since around 65 percent is local currency denominated, an additional buffer to foreign currency shocks is provided. The duration of domestic and external debt is around 3 years and 6.5 years respectively, implying a resilience to liquidity shocks. The Turkish Treasury also diversified its portfolio to enhance investor bases and to support local currency

---

[2] The CBRT provided US$3.4 billion through daily USD auctions through April 2016 and directly sold US$4.2 billion to state-owned energy importers in 2016.

markets with fixed and CPI-linked lease certificates (sukuks) and CPI-linked annuities to especially insurance companies.

The budget deficit has been under control and supportive for macroeconomic stability. The central government and public sector overall deficits are expected at 1.6 percent and 1.7 percent of GDP respectively in 2016 and are projected to remain below 2 percent of GDP throughout the MTP period. Taking into account the level of around 2.5 percent of GDP interest payments, the level of the overall deficits explicitly implies positive primary surpluses which would still ensure a declining trend in the public debt burden.

Public finance remains supportive to economic growth. Since the 2001 financial crisis, fiscal policy in Turkey was geared toward bringing public debt down to sustainable levels, containing the high inflation and current account deficit via creating high primary surpluses.[3] A significant tightening of the primary fiscal balance has helped contain the public debt dynamics and accumulate fiscal buffers. As public debt sustainability is not a concern and given the risks to the growth outlook, the fiscal policy stance was revised in a bid to support near-term growth and also to raise the potential growth in the medium term, while ensuring that the debt-to-GDP ratio remains on a sustainable track. In this respect, the MTP envisages that fiscal policy will aim at boosting growth, maintaining economic stability, keeping the current account deficit at a sustainable level, and stimulating domestic savings and investments. Public infrastructure investments, regional development, education, R&D support and incentives will be the main expenditures.

Fiscal risks are manageable. The Turkish Treasury closely monitors, conducts risk analyses and internally reports all contingent liabilities and risks to the Treasury Debt and Risk Management Committee on a regular basis. Additionally, the Ministry of Finance issued a secondary legislation in July 2015 to enhance the coverage of public institutions beyond the Treasury. The authorities acknowledge the desirability of expanding fiscal risk disclosure to the entities beyond the Turkish Treasury, and strengthening PPP governance. Regarding PPPs specifically, the government declared in the MTP that the process of planning, implementation, monitoring and evaluation of PPP projects will be enhanced; the capacity of public institutions will be improved, and monitoring and managing the risks to debt sustainability stemming from contingent liabilities arising from public investment guarantees and commitments including PPP schemes, will be strengthened. The authorities have already started working on a PPP Framework legislation which is envisaged to be in line with best practices in project monitoring, risk oversight and disclosure. The authorities also reiterate their intention to align the sovereign wealth fund with international best practices.

VI. Financial Sector Policies and FSAP

Turkey has a strong regulatory, supervisory and policy framework. The General Framework for the regulation and supervision of the financial sector, oversight and

[3] The average (IMF-defined) primary surplus of the public sector between 2003–2008 was 4 percent and 2.2 percent between 2003–2015. The IMF-defined primary surplus is an indicator introduced in 1999 to monitor the entire public sector (including SOEs), subtracting many one-off revenues such as dividend payments from Central Banks and state banks and privatization revenues.

management of systemic risks, managing systemic liquidity, financial safety nets, bank resolution, and crisis management arrangements and AML/CFT, has been significantly enhanced in the last five years. Moreover, the authorities have made good progress in developing a macro-prudential policy framework and have applied a wide range of tools to contain and mitigate the cyclical build-up of risks, as well as to strengthen the structural resilience and robustness of the Turkish financial system by correcting misaligned incentives and lowering systemic vulnerabilities. With the strategic oversight of the Financial Stability Committee, which brings together the heads of the financial regulatory agencies to exchange views on emerging systemic risks and policy responses, the management of systemic risks further improved.

Turkish banks are well-regulated and remain resilient to shocks[4]. Banks' capital buffers remain high with an overall capital adequacy ratio of 16 percent, conservative risk weighing and low leverage while liquidity and FX risk management has become more challenging. FSAP stress tests conclude that banks are well-placed to handle short-term liquidity stress. The banking sector dominates the Turkish financial industry, around 90 percent of all financial services, while insurance services and other financial activities also show significant growth potential. The FX debt rollover risk of the banking sector remains limited thanks to the extended maturity of external debt on the back of the amendments in reserve requirement ratios that are inversely related to the maturity of liabilities, and the improvement in the diversification of banks' external funding across countries as well as long lasting relationships with creditors. The financial sector's profitability, which has been on the rise driven by the rebound in net interest income and the decline in non-interest expenditures, will benefit from the revisions in the general provision rates in consumer loans and credit cards[5].

While the non-financial corporate sector's (NFCs) debt burden has been elevated, FX assets and the composition of the FX debt provide room to weather exchange rate volatility. NFCs' FX debt is mostly concentrated in a number of sectors including transportation, energy, construction and health which either generate FX revenues or provide services under the state-guaranteed PPP projects. Moreover, the maturity of FX loans has lengthened (over five years for the majority of loans) and firms' short-term FX positions are balanced. Additionally, the authorities have been working on a set of macro-prudential measures based on a well-structured methodology. This tool would facilitate hedging FX risks and help the non-financial corporates to be more resilient to potential shocks.

Some macro-prudential measures on consumer lending have been calibrated to revitalize domestic demand and thereby lower the risks to financial stability. A revision

[4] Regarding the banking sector, the European Commission recently included the Turkish banking sector in the list of equivalent countries. (Commission Implementing Decision (EU) 2016/2358 of 20 December 2016)

[5] The BRSA has also lowered the general provisions for corporate loans. New general provisions have been effective since January 1, 2017.

in macro-prudential measures is expected to help the recovery in credit growth, which has been subdued in the last three years.

The Turkish authorities are aware of the challenges weighing on the Turkish financial sector. The policy reaction to these challenges has predominantly been structural reforms such as developing money and capital markets, diversifying instruments, extending maturities and enhancing capacity and transparency. In this respect, **the Turkish authorities very much appreciate the FSAP,** took note of its recommendations and will take them into consideration to enhance the soundness of the Turkish financial market.

VII. Structural Reforms

The structural reform agenda is key to achieve high, sustainable and inclusive growth, to raise the national savings rates, to contain the current account deficit and reduce the reliance on external financing, to increase labor force participation and quality and productivity and to improve the rule of law. The government has announced the structural reform program in both 10th Development Plan and the 2017–2019 MTP and has introduced the following reforms in 2016:

- **Boosting domestic savings:** The government initiated a budgetary subsidy to savings account holders that have at least 3 years for the first house and/or for their marriage. Additionally, the new private pension automatic enrollment system will help stimulate total savings and contribute to the rebalancing.[6]
- **Incentivizing Research and Development (R&D):** The minimum headcount requirement for setting up an R&D company was reduced; the duration of government subsidies to researcher salaries was extended to 2 years and tax exemption was granted to these companies. The new Patent Law was ratified by the Parliament in December as well.
- **Improving judicial processes:** Istanbul Arbitration Centers and Appeals Courts were established, Expert Witness Act and Intellectual Property Act were enacted, which will help further improve the business environment by enhancing the quality of judicial system.
- **Enhancing the business climate:** The authorities have focused on legislative amendments to simplify the administrative and bureaucratic procedures and provide project-based incentives that will lower the tax burden on investment spending, support innovative high-tech projects, deepen the capital markets and strengthen the formal economy. The government has also introduced new regional investment incentive schemes to establish investment hubs in the eastern and southeastern provinces.

---

[6] The specific design features of the reform were discussed extensively with stakeholders and are based on international best practices, country specific circumstances, institutional capacities and market conditions. The government has the authority to increase the contribution rates, if deemed necessary going forward.

Additionally, leveraging public procurement will be utilized to increase localization in potential industries.

- **Enhancing the access of SMEs to bank loans**: A new regulation was enacted for collateral registries for movable assets, enabling SMEs to provide their all movable assets as collateral.
- **Improving the labor market conditions:** The flexible employment mechanism was added to the Labor Code to support employment; Private Employment Agencies were set up; maternity rights, access to childcare facilities and part-time work allowance for women until their children reach the age of entry into formal schooling were enhanced to increase female labor force participation; and provision of relevant skill training and effective internship programs implemented. The authorities acknowledge that more progress is needed on the severance pay reform, which requires broad-based consultations with relevant stakeholders in order to support the successful implementation.
- **Improving the SOE governance:** The authorities have also been working on the SOE governance in order to align the governance structure of the SOEs with international best practices and help these enterprises better compete with private companies.
- **Reforming the Turkish Development Bank:** The Turkish Development Bank, in collaboration with some key international stakeholders, is undergoing a restructuring process to enhance the corporate capacity and competitiveness in line with international best practices.

Further reforms are planned. Looking ahead, the government is going to establish an Academy for Teachers, develop vocational and technical training to increase the skill sets of the labor force, implement school-based budgeting, provide better foreign language training and compulsory pre-school. Furthermore, tax and expenditure reviews will be the backbones of the fiscal management reforms. Treasury's commitment to Credit Guarantee Funds will be raised to TRY 25 billion, which could be leveraged up by the Banks to TRY250 billion, from its current commitment level of TRY 2 billion. This step is going to improve the access to finance Turkish SMEs. To enhance entrepreneurship and access to finance, Turkey has also recently introduced the business angel scheme, and is working on the launch of the crowd-funding system.

The authorities broadly share staff's views on rising labor costs, competitiveness, and refugee integration. The temporary minimum wage government subsidy is appropriate and fiscally manageable. The integration of refugees into the workforce remains critical and requires strong international commitment.

VIII. Conclusion

Turkey has preserved its resilience to both external and internal shocks mostly owing to its solid macroeconomic fundamentals and sound macro-framework. The prudent fiscal position with sustainable low debt, sound monetary policies and a strong financial sector with a solid regulation and supervision framework have been the major pillars. Its open and large economy, dynamic private sector, diversified economy, young and dynamic demography together with its committed institutions have been supportive under high uncertainties. The

Turkish government and authorities are aware of the longstanding structural problems and continue to show their strong commitment to resolve them with ambitious structural reforms. We believe that the staff reports could have been more explicit about these factors to draw a more balanced picture of the Turkish economy.