INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/110

TURKEY

April 2018

2018 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 2018 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 30, 2018 consideration of the staff report that concluded the Article IV consultation with Turkey.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 30, 2018 following discussions that ended on February 13, 2018, with the officials of Turkey on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 16, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Turkey.

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

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April 30, 2018

International Monetary Fund
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IMF Executive Board Concludes 2018 Article IV Consultation with Turkey

On March 30, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

Following a slowdown in activity in 2016, growth recovered strongly last year. Large fiscal stimulus (including increased PPP activity) and policy-driven credit impulse boosted consumption and investment in 2017. Exports also increased sharply, but a pick-up in imports in the second half of the year tempered the growth contribution of net exports. Such has been the strength of the recovery that the economy now faces clear signs of overheating: a positive output gap, inflation well above target, and a wider current account deficit. Signs of possible oversupply in the building and construction sector are also emerging.

Fiscal and quasi-fiscal policies have become more expansionary. The fiscal deficit increased in 2017, due to temporary tax reductions, continued minimum wage subsidies, and employment incentives. Contingent liabilities are increasing, due to still-high public-private partnerships (PPP) activity and the expansion of state loan guarantees.

Monetary policy has been tightened but inflation rose to almost 12 percent during 2017. The central bank (CBRT) increased the effective cost of funding to banks by almost 500 basis points since November 2016 to contain inflation spillovers from the large Lira depreciations in the last quarters of 2016 and 2017. The ex-post, real effective policy rate has, however, remained close to zero until recently.

The sizeable expansion of state loan guarantees was the main driver behind the acceleration of bank credit growth in 2017, although the relaxation of macroprudential measures also contributed. Commercial loan growth has since moderated, as the impulse from state loan guarantees fell towards the end of the year.

Bank capital levels remain high, although some buffers are decreasing. Higher profits improved capital adequacy in 2017, reflecting in part the relaxation of prudential norms and

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[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.

the conservation of capital through the use of state loan guarantees. The headline non-performing loans ratio remains low, but a broader definition of loan impairment signals emerging loan quality weakness and signs of difficulties in some large corporate borrowers are emerging.

In 2018, economic activity is expected to decelerate to close to 4½ percent. Continued accommodative monetary, fiscal, and financial policies will support growth, but inflation is projected to remain well above target and the current account deficit is expected to remain elevated.

Executive Board Assessment[2]

Executive Directors welcomed Turkey's solid economic performance last year, driven by strong policy stimulus and favorable external conditions. At the same time, Directors noted that rapid growth has contributed to economic overheating, in the form of widening internal and external imbalances, including a positive output gap, high inflation and a wider current account deficit.

Directors noted that large external financing needs, limited foreign exchange reserves, changes in investor sentiment towards emerging markets, and persistent domestic and geopolitical risks also pose challenges. Noting that the economy has been resilient thus far, Directors emphasized that, looking ahead, macroeconomic policies should be geared towards addressing the imbalances, lowering inflation, and strengthening buffers. In addition, comprehensive structural reforms will be necessary to boost Turkey's growth prospects.

Directors called for frontloaded monetary tightening to help contain inflation, re-anchor expectations, underpin the Lira, and allow reserves to be rebuilt. They agreed that moving over time to more conventional monetary instruments would help underpin the transparency and effectiveness of monetary policy. Directors underscored the importance of central bank independence.

While noting the low starting point for public debt, Directors emphasized that rising risks call for fiscal prudence and further containing fiscal and quasi-fiscal policies. They highlighted that sustained measures are needed to achieve a general government primary surplus next year. These could include broadening the revenue base, raising direct taxation, improving VAT efficiency, limiting public wage rigidities, and reducing ad-hoc subsidies.

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

Directors welcomed the authorities' initiatives to strengthen the PPP risk management and reporting framework. They underscored that building on this work would help preserve fiscal space. Directors indicated that the scope and role of extra-budgetary and other non-central government entities, and institutions such as the newly created Sovereign Wealth Fund, should be transparent as well as carefully defined and monitored.

Directors called for further strengthening the oversight and governance of the banking sector, as outlined in the FSAP assessment. They supported the authorities' decision to better target the Credit Guarantee Fund and introduce limits on SME foreign currency borrowing. Directors encouraged continued efforts to strengthen bank supervision and to make the macroprudential regime more robust, in particular, addressing the risks related to non-financial corporates, given their increased leverage and large negative foreign exchange positions.

Directors encouraged the authorities to take advantage of the current strong growth environment to push ahead with structural reforms to increase productivity and Turkey's medium-term growth potential. They emphasized that reform efforts should give priority to maintaining strong institutional capacity and improving regulatory predictability to strengthen the investment climate. Directors also noted that labor market reform is crucial, especially on public wage indexation, minimum wages, addressing skills gaps, and further increasing female labor force participation, including by promoting flexible work options. They saw merit in further reforms of the voluntary pension system to increase domestic savings. Directors commended the authorities for hosting the large number of refugees and for their efforts to integrate them into the labor market.

Table 1. Turkey: Selected Economic Indicators, 2016–23

Population (2017): 80.8 million
Per capita GDP (2017): US$10,512
Life expectancy (2015): 75.4 years
Gini index (2016): 40.4
Quota (2017): SDR 4,658.6 million

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.	Proj.					
Real sector				*(Percent)*				
Real GDP growth rate	3.2	7.0	4.4	4.0	3.6	3.6	3.6	3.6
Contributions to real GDP growth								
Private consumption	2.2	3.8	2.5	2.2	2.1	2.0	2.0	2.1
Public consumption	1.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Investment (incl. inventories)	1.1	2.3	1.1	1.1	1.1	1.1	1.0	1.0
Net exports	-1.4	0.7	0.4	0.2	0.1	0.1	0.1	0.1
GDP deflator growth rate	8.1	11.0	11.6	11.1	9.3	8.2	7.8	7.8
Nominal GDP growth rate	11.5	18.8	16.5	15.5	13.3	12	11.7	11.6
Inflation (period-average)	7.8	11.1	11.4	10.5	9.0	8.0	8.0	8.0
Inflation (end-year)	8.5	11.9	10.9	10.0	8.5	8.0	8.0	8.0
Unemployment rate	10.9	11.0	10.7	10.7	10.5	10.5	10.5	10.5
				(Percent of GDP)				
Fiscal sector								
Nonfinancial public sector								
Primary balance	-0.6	-0.9	-1.5	-1.3	-0.7	-0.3	-0.3	-0.3
Overall balance	-2.0	-2.2	-3.1	-3.3	-2.9	-2.5	-2.4	-2.3
General government cyclically adjusted primary balance 1/	-0.7	-1.5	-1.9	-1.9	-1.2	-0.7	-0.7	-0.7
General government gross debt (EU definition)	28.3	28.5	27.8	27.9	27.9	28.0	28.1	28.1
External sector								
Current account balance	-3.8	-5.5	-5.4	-4.8	-4.5	-3.9	-3.6	-3.3
o/w Nonfuel current account balance	-1.3	-1.8	-1.0	-0.7	-0.7	-0.3	-0.1	0.1
Gross international reserves (billions of US dollars)	106.3	107.7	107.7	107.7	107.7	107.7	107.7	107.7
Ratio to ARA Metric for emerging markets (percent)	89.5	81.9	...	...	...	...	...	...
Gross financing requirement	22.9	24.9	25.1	26.3	26.5	26.1	25.3	24.4
Gross external debt 2/	46.9	53.2	54.1	54.6	54.3	53.6	52.9	52.1
Net external debt	30.2	35.4	37.5	38.9	39.4	39.6	39.5	39.4
Net international investment position	-42.4	-53.4	-55.2	-57.0	-57.9	-58.5	-58.7	-58.7
Short-term external debt (by remaining maturity)	19.0	21.2	22.7	23.4	23.5	23.1	21.8	20.6
Terms of trade (year-on-year percent change)	2.3	-3.6	-1.3	2.5	1.7	1.2	0.9	0.0
Monetary conditions				*(Percent)*				
Real average cost of CBRT funding to banks	0.6	0.4	...	...	...	...	...	...
Nominal growth of M2 broad money	18.3	15.7	...	...	...	...	...	...
Memorandum items								
GDP (billions of U.S. dollars)	863	849	...	...	...	...	...	...
GDP (billions of Turkish lira)	2,609	3,099	3,611	4,170	4,723	5,292	5,913	6,602
Real effective exchange rate (year-on-year percent change)	-0.4	-10.3	...	...	...	...	...	...

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ In percent of potential output.
2/ The external debt ratio is calculated by dividing external debt in U.S. dollars by GDP in U.S. dollars estimated by staff.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

March 16, 2018

KEY ISSUES

Context: Growth rebounded sharply in 2017, helped by strong policy stimulus in the wake of the 2016 post-coup attempt slump and by favorable external conditions. Although expansionary policies were initially warranted, they are no longer appropriate as the economy is showing clear signs of overheating. Monetary policy appears too loose and its credibility is low; and on- and off-budget fiscal policies (including credit guarantee schemes and PPP activities) are expansionary and risk undermining Turkey's hard-earned fiscal credibility. As a result, the economy faces internal and external imbalances: a positive output gap, inflation well above target, and a current account deficit of more than 5 percent of GDP. Meanwhile, political uncertainty and regional instability remain elevated, and the integration of the many refugees poses challenges.

Policies: The main policy challenges are to rein in domestic demand to reduce imbalances, contain other growing risks, and rebuild buffers. This requires tightening and rebalancing policies in a measured yet credible manner, and focusing on critical structural reforms:

- Monetary policy needs to be tightened further in a frontloaded manner to contain inflation, re-anchor expectations, underpin the Lira, and allow reserves to be built to more comfortable levels. Moving, over time, to more conventional monetary policy instruments would help underpin transparency and effectiveness.

- Overall fiscal and quasi-fiscal stimulus needs to be contained, which will also help avoid overburdening monetary policies. PPP activity needs to be managed and monitored carefully, and state loan guarantees should be gradually wound down and limited to cases of clear market failure. Additional efforts are required to underpin the planned fiscal consolidation and more would be needed should quasi-fiscal stimulus persist.

- Financial sector policies should aim at strengthening the oversight and governance of the banking sector, where progress has been limited on FSAP recommendations. Macroprudential policies should be revisited in areas where vulnerabilities are highest, specifically the highly leveraged corporate sector.

- Structural reforms should focus on increasing labor market flexibility and strengthening the business climate, which would help underpin medium-term growth. The former would also help lower unemployment and the output costs of disinflation; the latter would help improve the composition of external inflows and allow buffers to be rebuilt.

Approved By
Philip Gerson and Mark Flanagan

Discussions took place in Istanbul and Ankara during January 31–February 13, 2018. The team comprised Messrs. McGettigan (Head), Iossifov, Vacher and Ms. Jirasavetakul (all EUR), Mr. Ismail (SPR), Ms. Zdzienicka (FAD), Messrs. Seshadri, Çeçen and Ms. Akcayoz (Senior Res. Rep. office). Mr. Thomsen (EUR), and Ms. Erbenova and Mr. Bayar (all OED) participated in some meetings. The mission met with Deputy Prime Minister Şimşek, Development Minister Elvan, Minister of Finance Ağbal, Central Bank Governor Çetinkaya, Treasury Undersecretary Çelik, Ministry of Finance Undersecretary Kaya, other senior officials, and private sector representatives. Mses. Meng and Mahadewa assisted in the preparation of the staff report.

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ANNEXES

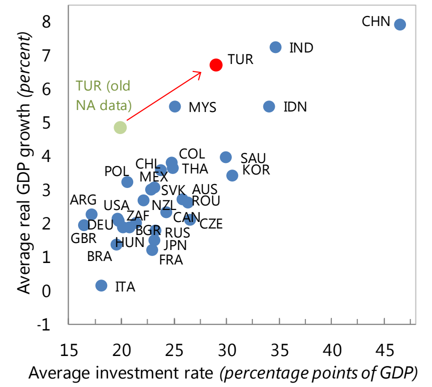
CONTEXT

1. **Turkey's growth has been higher than that of nearly all its peers in the wake of the global crisis.** The end-2016 revision of national accounts data underscored both the strength of the post-2008 recovery and its heavy reliance on investment financed by rapid credit growth (Annex I).

2. **Both external and internal imbalances are widening, however.** Rapid growth over the past year has been accompanied by a wider current account deficit, inflation well above target, and rising private domestic and external indebtedness.

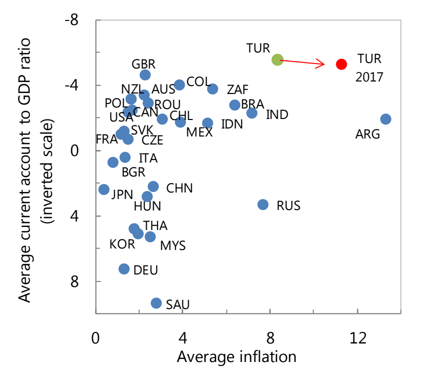
3. **Meanwhile, economic and political uncertainty remain elevated.** The state of emergency put in place after the 2016 failed coup attempt and associated measures affected the predictability of the regulatory environment. Geopolitical tensions in the region are high. Local, parliamentary and presidential elections are expected in 2019.

Turkey: Growth and Investment Relative to Peers, 2010-16



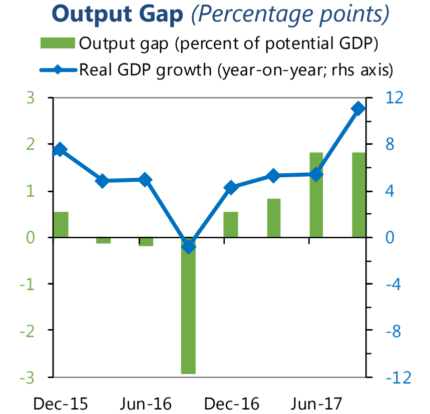
Source: TurkStat and WEO.

Turkey: Inflation and Current Account Relative to Peers, 2010-16 *(Percent)*



Source: TurkStat and WEO.

Turkey: Quarterly GDP Growth and Output Gap *(Percentage points)*



Source: TurkStat and staff estimates.

RECENT ECONOMIC DEVELOPMENTS

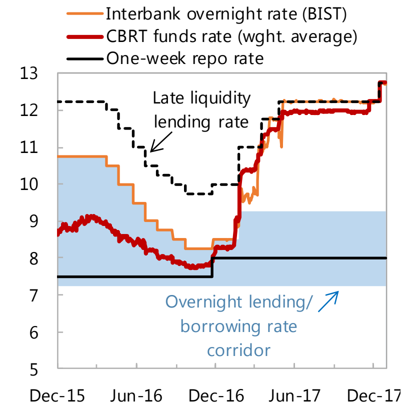
4. **Growth rebounded strongly in 2017.** Real GDP growth averaged 7.4 percent (year-on-year) in the first three quarters (Figure 1). Fiscal stimulus and a large credit impulse—supported by state loan guarantees and relaxed macroprudential measures—boosted domestic demand. Exports also contributed strongly to headline growth, spurred by stronger external demand and sizeable Lira depreciation. Imports increased rapidly in the second half of 2017, however, tempering the growth contribution of net exports. High-frequency data suggest slower, albeit still-robust, growth in the final quarter of 2017 (Figure 2). While unemployment has fallen in 2017, it remains high, suggesting ongoing labor market rigidities (Figure 1).

5. Inflation is at its highest since 2003, despite the benign global inflation environment, and expectations are well above target. Initially sparked by the large Lira depreciation, inflation has received further impetus from higher demand, rising cost pressures, and rising inflation expectations. Accelerating core inflation replaced food and energy prices as the main inflation driver in 2017 (Figure 1).

6. Monetary policy tightening was insufficient to contain inflation. In response to the 20 percent Lira depreciation in late-2016/early-2017 and rising inflationary pressures, the central bank (CBRT) increased the effective cost of funding to banks by almost 500 basis points since November 2016. This was achieved by shifting liquidity provision from the policy rate facility to the more expensive late liquidity window. The ex-post, real effective rate has, however, remained low relative to that in some peer EMs. Moreover, the transmission of monetary policy was blunted by the easing of financial conditions (see paragraph 7), brought about by the Lira weakening and policy-induced credit growth. As a result, inflation remained in double digits and expectations moved further away from target.

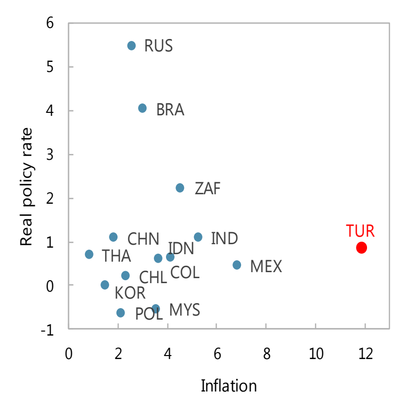
7. Financial conditions were expansionary in 2017. The increase in state loan guarantees through the Credit Guarantee Fund (CGF) was the main driver behind the surge in Lira loans that has led to a doubling of the growth rate of commercial credits since the start of the year (Figure 3). At the same time, the growth of FX loans has been weak, reflecting in part elevated FX debt burdens. The share of state-owned banks in total loans increased by 2 percentage points in 2017, increasing their share to 44 percent of loans. The relaxation of macroprudential policies from September 2016—including the lowering of provisioning requirements for commercial, consumer and restructured loans; the reduction of risk weights of consumer loans; and the increase in the LTV limit for housing loans and the maximum maturity of general purpose and credit card loans—have also added to the credit momentum. Following a significant increase in supply, the residential and commercial real estate market is starting to cool, with pockets of oversupply in some regions and market segments. Growth of commercial loans has tapered off, as the impulse from state loan guarantees decreased towards the end of the year.

Turkey: Monetary Policy Rates
(Percent)



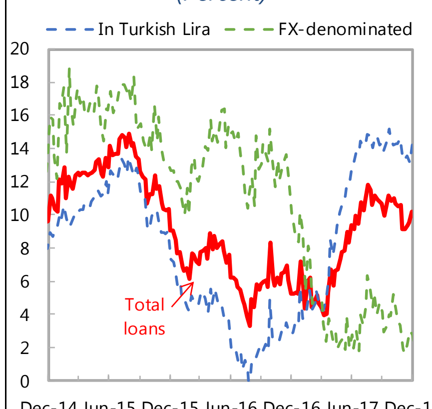
Source: CBRT and Fund staff estimates.

Turkey: Real Policy Rate and Inflation Relative to Peers *(Percent)*



Source: Haver Analyticsand Fund staff estimates. Note: Nominal policy rates are deflated by 12-month inflation outcomes.

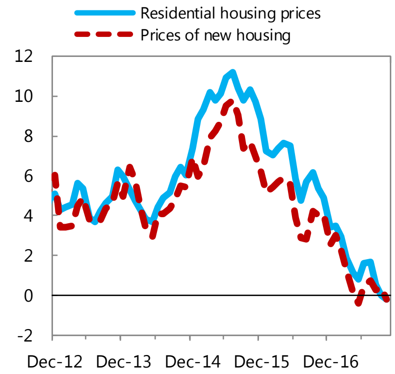
Turkey: Real Bank Credit Growth
(Percent)



Source: BRSA and staff estimates. Notes: Deflated by CPI. FX-denominated and indexed loans adjusted for valuation effects.

8. Bank capital levels remained high, although some buffers are decreasing. Since end-2016, the system-wide Tier 1 CAR has increased by one percentage point to 14.1 percent (Figure 3). The negative effect from the large Lira depreciation was offset by robust retained earnings, the lower risk weights on CGF-backed loans, and the relaxation of macroprudential measures. Capital adequacy levels were further strengthened with Tier 2 bond issuance. The headline non-performing loans (NPL) ratio remains low at 3 percent. However, a broader definition of impaired loans—including restructured credits, "watch list" loans, and NPLs sold to third parties—amounts to around 8 percent of all loans, signaling emerging loan quality weakness. This is especially a concern in consumer credit and small- and medium-size enterprise (SME) loans, while signs of distress have also emerged in some larger corporate groups. CGF-backed loans could have temporarily helped contain NPLs, to the extent they have been used for working capital and helped alleviate corporate payment delays. The banking system's negative, on-balance sheet, net FX position, which is almost completely hedged by its off-balance sheet position, more than doubled to minus 50 percent of regulatory capital in 2017, mainly on account of the increase in resident FX deposits and banks borrowing from abroad to fund CGF-backed loans in domestic currency.

Growth of Real House Prices
(Percent)



Source: CBRT and IMF staff estimates.

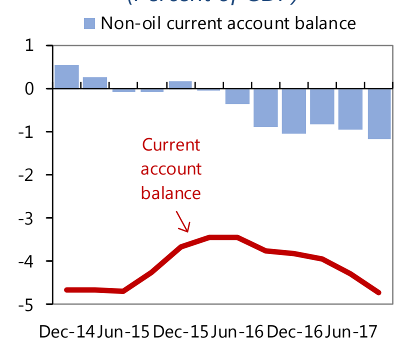
9. Fiscal and quasi-fiscal policies have become more expansionary. The on-budget fiscal deficit expanded in 2016–17, due to temporary tax reductions, continued minimum wage subsidies, and an employment incentive scheme launched in 2017 (Figure 4). The 2017 general government primary deficit exceeded the target set in the 2017–19 Medium-Term Program (MTP), but was below the upward revision made in the 2018-20 MTP. In cyclically-adjusted terms, the resultant fiscal impulse is estimated at close to one percentage point of GDP in 2017. Public debt increased slightly to a still-low 28½ percent of GDP, with financing rollover ratios exceeding 100 percent. Contingent liabilities have, however, increased rapidly, due to still-high public-private partnership (PPP) activity and the expansion of state loan guarantees.

Turkey: General Government Primary Balance 1/
(Percent of GDP)

	2015	2016	2017 2/	MTP projections for 2017 3/	
				MTP 2017-19	MTP 2018-20
General Government (GG)	0.6	-1.0	-1.1	-0.6	-1.6
Central Government	0.4	-0.5	-0.5	-0.5	-1.0
Other GG Institutions	0.2	-0.4	-0.6	-0.2	-0.6
GG Cyclically-adjusted primary bal.	0.3	-0.8	-1.7	-1.2	-2.2

Sources: Turkish Authorities; and IMF staff calculations.
1/ All numbers presented are in the IMF-program definition.
2/ Actual executions for the CG and UIF, and IMF staff projections for others GG institutions.
3/ The MTP 2017-19 numbers are re-based, using the new GDP series.

Turkey: Current Account
(Percent of GDP)



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

10. The current account deficit widened to more than 5 percent of GDP. Exports increased on the back of strong global and EU growth, the significant Lira depreciation, and the rebound in tourism arrivals (Figure 5). This was more than offset by higher energy prices, strong gold imports—that play a role in hedging against inflation and uncertainty—and demand-driven import increases. Turkey's external position remains weaker than the level consistent with medium-term fundamentals and desirable policy settings (Box I, Annex II). The widening of the current account deficit took place against the backdrop of a real depreciation of around 10 percent (Box 2). At around 50 percent of GDP, Turkey's external debt is sustainable, but has increased rapidly, and is sensitive to exchange rate valuation risks, as well as liquidity risks stemming from the large annual rollover needs of around 20 percent of GDP (Annex V).

11. Turkish financial markets are sensitive to changes in international investor sentiment. Turkey was among the countries most affected by the November 2016 emerging market asset selloff (Figure 6). Domestic and external government bond yields fell following the April 2017 referendum, against the backdrop of the global asset rotation back to emerging markets. However, gains were partly reversed in the last quarter of 2017, as the Lira came under renewed pressure.

OUTLOOK AND RISKS

12. Over the medium term, growth is expected to fall to its potential of about 3½-4 percent annually, with inflation remaining above target. The moderation of growth in 2018 is expected to be driven by the weaker policy stimulus. Inflation is forecast to remain in double digits this year, driven by expected Lira depreciation and higher energy prices. It is expected to moderate, as energy prices and exchange rate effects fade (assuming expectations remain contained), and the CBRT's current interest rate should be enough to stabilize it, albeit at a level well above target. The current account deficit and external financing needs are expected to remain elevated over the medium term. Looking further ahead, and absent deep structural reforms, weak productivity growth is projected to remain a drag on potential growth (Annex I).

13. Risks to the medium-term baseline are tilted to the downside (Annex III):

- Reflecting policy imbalances, downside risks are increasing, including from Turkey's large gross external financing needs, low reserves and dependence on short-term capital inflows (Box 1), the widening negative NIIP, high corporate exposure to FX risk, and higher reliance on market funding (with bank loan-to-deposit ratios of 123 percent). These weaknesses could exacerbate the negative effects of any increase in the cost of external financing caused by a normalization of monetary policies in advanced economies or increasing emerging market risk premia.

- Inadequate policy adjustment could lead to accelerating inflation. Although inflation is expected to remain well above its 5 percent target over the medium term under the baseline, risks of materially higher-than-projected inflation and weaker CBRT credibility remain.

- A possible further deterioration in geopolitical tensions in the region, as well as domestic political risk factors ahead of the election cycle, could also undermine investor and consumer confidence. The guilty verdict in an US court against a senior official of a state-owned bank on money laundering and evasion of US sanctions on Iran poses reputational and financial risks.

- On the upside, US dollar weakness and Euro strength could reduce the external debt servicing burden and help narrow external imbalances.

POLICY DISCUSSIONS

14. Expansionary economic policies are contributing to the build-up of internal and external imbalances, against the backdrop of falling buffers. Robust investment activity is driven by strong PPP activity, government guarantees and investment incentives, and an earlier relaxation of the macroprudential regime. Estimates of the private credit gap, which attempt to measure the deviation of private debt from what fundamentals would support, put the credit oversupply in the range of 10 to over 20 percent of GDP (Annex I). The macroprudential regime may not adequately internalize the increase in corporate leverage and the risks stemming from the large negative FX position of the economy. Procyclical fiscal and quasi-fiscal policies have boosted domestic demand and credit growth, putting further pressure on the current account deficit. Against the backdrop of the slowdown of potential growth, the expansionary policy stance has led to internal and external imbalances, and the cost of bringing inflation down to target is estimated between 4 and 11 percentage points of potential GDP. In addition, the external position remains weaker than implied by fundamentals, despite the real effective exchange rate being broadly consistent with such fundamentals (Box 1). Turkey's low international reserves do not appear to provide an adequate buffer for sizeable external shocks, especially against the backdrop of Turkey's large external financing needs.

15. The main policy challenge is to recalibrate macroeconomic policies in a measured yet credible manner that fosters sustainable growth, while reducing the vulnerability of the Turkish economy to downside risks. The recalibrated policy mix would entail further monetary, fiscal and quasi-fiscal tightening, and careful management of the associated build-up of direct and contingent liabilities. Macroprudential policies need to be squarely focused on maintaining financial stability and adequate buffers. Combined with structural reforms targeted to underpin medium- and longer-term growth, this would leave Turkey better placed to handle any possible weakening of global sentiment towards emerging markets.

Authorities' Views

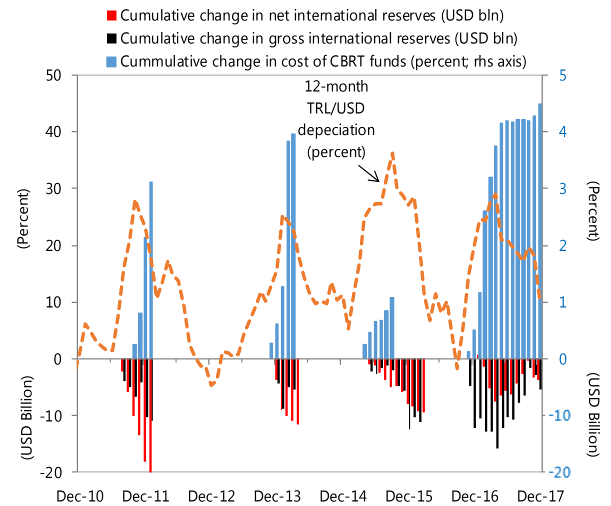
16. While the authorities agree that last year's growth was above potential, they do not see a risk of overheating going forward. They estimate the economy's growth potential to be about 5–5½ percent, and maintain that the output gap should, as a result, close this year and remain around zero going forward on current policies. In particular, the authorities view the current monetary stance as sufficiently tight. The authorities also re-affirmed their commitment to fiscal discipline and advancing the structural reform agenda.

17. The authorities saw the wider current account deficit as largely reflecting external factors, but agreed that reserves could be rebuilt as conditions allow. They expected the current account deficit to narrow, while growth returning to its potential would also help. They saw its financing as underpinned by the attractiveness of Turkish assets to foreign investors. The authorities considered the recent reliance on short-term inflows (Box 1) to be mainly driven by cost factors and did not expect it to continue as a longer-term trend.

A. Monetary Policy

18. The monetary tightening already undertaken is welcome, but further steps are needed to lower inflation meaningfully and re-anchor expectations. Although the effective CBRT rate has been increased by almost 500 bps since November 2016, this has not been sufficient to contain inflation and prevent inflation expectations from becoming unanchored. The real effective policy rate (Table 1) appears well below what a simple Taylor rule would imply (a 200–300 bps mark-up over the neutral rate, estimated by staff in the range of 1–3 percent) in the face of a positive output gap and inflation well above its target. To address these concerns, the binding real policy rate—since March 2017, in effect, the late liquidity window (LLW) rate—should be increased by a further 100–300 bps, in addition what would be needed to keep pace with any US Fed Fund Rate hikes. This should preferably occur in a frontloaded manner, along with a clear commitment to additional measures as needed to restore credibility. Ideally, this would be accompanied by a change in the policy (one-week repo) rate to move it closer to the LLW rate, helping to improve the transparency of the policy framework. Over time, the aim should be to move to more conventional monetary policy instruments to help underpin credibility.

Monetary Policy Response to Large Devaluations



Source: CBRT and staff estimates.

19. A credible monetary tightening would help underpin the Lira and allow the CBRT to rebuild international reserve buffers. Gross international reserves (GIR) should be raised to cover at least 100 percent of the ARA metric over 2018–19 from the current 82 percent cover and move closer to the midpoint of the ARA range over the medium term. With still-favorable global liquidity conditions, the CBRT could gradually increase NIR through sterilized intervention—as market conditions permit—using preannounced regular auctions to help minimize market disruptions. Non-deliverable forwards—introduced by the CBRT to manage the demand for FX and support hedging by banks and corporates—have been useful in managing exchange rate volatility without depleting reserves, but their use should be limited to circumstances when the market for hedging instruments is illiquid. Following up on the 2017 FSAP recommendations, the improvement in systemic FX liquidity management should continue, notably through the ceasing of off-market sales to state-owned energy companies. The repayment of export rediscount credits in Lira instead of FX to the CBRT at below-market conversion rates should not be used as a tool to support FX liquidity conditions.

Authorities' Views

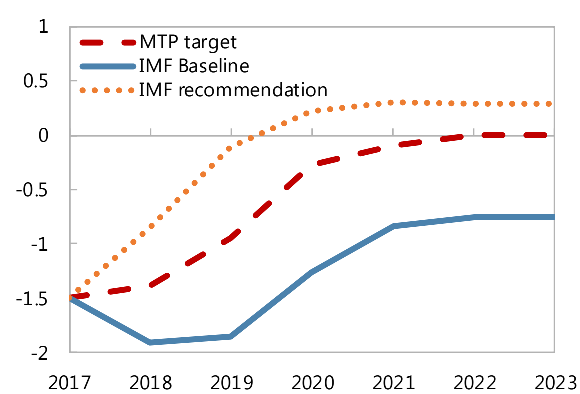
20. The authorities acknowledged the risks of inflation inertia and FX-depreciation passthrough to inflation. They saw monetary policy as sufficiently tight, however, to bring inflation below 8 percent by the end of 2018. They considered that in 2017, despite a tighter monetary policy stance, aggregate demand and credit conditions delayed the improvement in inflation. They also argued that better coordination between fiscal and monetary policy and administrative measures to reduce inefficiencies along the agricultural supply-chain and boost its productive capacity would help the disinflation effort.

B. Fiscal Policy

21. Front-loaded fiscal consolidation would support internal and external rebalancing, and buoy investor sentiment.

- **Meeting the MTP target.** The expiration of temporary tax breaks (on white goods, furniture, construction materials, and luxury housing) and new tax measures in 2018—such as the CIT rate increase, reductions of income tax exemptions, and an increase in consumption taxes on motor vehicles—were welcome. However, consolidation is likely to be slower and weaker than envisaged in the MTP, due to new tax exemptions, the continuation of the minimum wage subsidy, and new employment incentives. High outlays on security, public wage rigidities, and the conversion of temporary workers into permanent public employees added to overall spending pressures, which are expected to persist in the run-up to the 2019 elections. As a result, the general government primary deficit is expected by staff to remain at around 1.3 percent of GDP during 2018-19 on current policy intentions. This implies a required adjustment in the cyclically-adjusted general government primary balance of about 1 percentage point to meet the MTP's deficit target of 0.4 percent by 2019. Annual public gross financing needs are projected at around 5-5½ percent of GDP, with around 20-25 percent of that total to be met by external borrowing.

Turkey: Cyclically-Adjusted Primary Balance of the General Government [1/] *(Percent of GDP)*



Sources: Turkish Authorities; and IMF staff calculations.
1/ Primary balances presented are in the IMF-program definition.

- **Going beyond the MTP target.** Stronger and front-loaded fiscal consolidation—aimed at achieving general government primary surplus of about ½ percent of GDP by 2019—would help counteract continued expansionary quasi-fiscal and financial policies. Such a target would be equivalent to an adjustment in the cyclically-adjusted, general government primary balance of about 1¾ percentage points during 2018-19 relative to the baseline.

22. Fiscal consolidation should be backed by well-defined and comprehensive revenue and spending measures.

Turkey: Measure Options for Fiscal Consolidation
(Percent of GDP)

	2018	2019
Fiscal adjustment to meet the MTP target	0.5	0.5
Fiscal adjustment to meet the recommended scenario	1	0.8
Measure options:		
(1) Wage bill controls	0.1	0.2
(2) Rationalization of transfers/subsidies	0.5	0.4
(3) Rationalization of investment incentives	0.1-0.3	0.1-0.3
(4) Raising income taxes	0.1	0.1
(5) Streamlining VAT exemptions, and raising and unitfying the VAT reduced rates	0.4-0.7	0.5-1.0
(6) Containment of net lending	0.2	0.2

Sources: IMF staff estimates.

- On the **revenue** side, efforts to broaden the tax base and enhance revenue efficiency would be critical. As recommended by IMF TA, potential measures might include raising and unifying reduced VAT rates to be in line with international practice, as well as streamlining various tax exemptions. Revenues from direct taxes could also be mobilized further by revisiting the top personal income tax rates and improving coverage of the informal economy. On the VAT refund mechanism, the reform plan needs to be carefully designed in a simple and budget-neutral way, with its implementation accompanied by compensating revenue measures (Box 4).

- On the **expenditure** side, savings could be achieved by withdrawing untargeted transfers and temporary subsidies, and refraining from ad-hoc incentives. Containing wage bill increases, as envisaged in the MTP, could provide additional gains, but need to be backed by concrete measures on public employment and wages, including reforming the current system of guaranteed real purchasing power through backward-looking inflation indexation. Given signs of over-investment and high private debt (see Annex I, which discusses Turkey's private debt in an international context), cuts to discretionary investment incentives, state loan guarantees, and PPP activity are warranted (see below).

23. Progress has been made in strengthening the risk management and reporting of quasi-fiscal operations, further curtailing of such activities and their full integration into the budget are called for. Public-private partnership (PPP) activity has risen sharply in recent years. Other fiscal risks—stemming from the expansion of state loan guarantees and public bank balance sheets, as well as the impact of energy price setting on SOEs performance—are also on the rise. A growing share of fiscal risks has fallen outside of Treasury's approval and monitoring system (Box 1). The sovereign wealth fund (SWF)—not yet fully operational—carries added potential fiscal and financial risks. Progress in implementing international accounting standards for recording PPP activity and the fiscal risk report that was expected to be published shortly are welcome. At the same time, there is a need for further strengthening contingent liability management, including through (i) enhancing investment prioritization procedures with a strict selection of PPP projects that provide value-for-money even under adverse macroeconomic scenarios; (ii) establishing comprehensive PPP legislative and institutional frameworks with strong central oversight and a centralized database; and (iii) comprehensive and regular fiscal risk reporting. In addition, some of the objectives and planned activities of the SWF—such as managing state-owned enterprise assets and supporting infrastructure and economic development—would, when operational, add to existing quasi-fiscal operations. Hence, its governance and statistical treatment in public accounts need to be fully aligned with international best practices, including published annual reports, audited financial statements, transparent investment policy, and, reflecting the nature of its planned operations, categorization under general government in official statistics.

24. Turkey has some fiscal space to cushion negative shocks, but discretionary measures should not be used given current imbalances. Public debt is low and sustainable over the medium term, being most sensitive to the contingent liability shock (Annex IV). The use of Turkey's fiscal space is best preserved for systemic events, and remains conditional on maintaining market access.

Authorities' Views

25. The authorities pointed to the important role that fiscal policy has played in stimulating the economy, while reaffirming their commitment to fiscal discipline as a key policy anchor. They argued that tax exemptions and employment incentives would encourage businesses to increase investment and employment, both of them crucial drivers of economic growth. Higher economic activity and growth would, in turn, help raise tax revenues and ensure that the overall MTP fiscal targets are met. In addition, they emphasized that as the new employment incentives are likely to be financed by the Unemployment Insurance Fund, the planned stimulus would not result in central government budget overruns and higher government borrowing.

26. The authorities considered fiscal risks to be low—given the economy's resilience and ample fiscal buffers—but agreed that there were merits to better monitoring and management. Plans were in place to expand the disclosure of fiscal risks beyond the central government and strengthen PPP management, including through improving inter-agency cooperation, central supervision, and fiscal risks analyses. The authorities were also considering seeking early views of Eurostat and the IMF's Statistics Department on the appropriate statistical treatment of the sovereign wealth fund.

C. Financial Sector Policies

27. State loan guarantees should be phased out over time and limited to cases of clear market failure. The CGF expansion helped counteract the 2016 economic dip, but at close to half of the stock of end-2016 SME loans and 7 percent of GDP, it was large and frontloaded and, in the event, ended up contributing to a procyclical credit increase. There are also indications that most of the outstanding CGF-backed loans were used for working capital, with some ending up rolling over existing loans, on the back of favorable risk weighting and provisioning requirements (Box 5). Tight domestic Lira initially put pressure on Lira deposit rates, and subsequently on swap rates (as FX deposits were swapped into Lira). The government has announced that it will release the unused capacity of the CGF (about TL 50 billion), which will be targeted to supporting investment and credit to exporters. The move to better target the CGF is appropriate, but there is scope to further focus the scheme on SMEs. Support should not be made permanent, nor should its use for multiple loan restructurings be allowed.

28. Macroprudential tools should be used to build buffers and contain systemic financial vulnerabilities. Such tools should focus on risks rather than demand management and, as such, some aspects of the post-2015 relaxation of the macroprudential regime could be revisited, in particular for the corporate sector where bank exposure has grown significantly and vulnerabilities are high. Although now late in the cycle, the build-up of pockets of vulnerability in the construction and real estate sectors could be tackled through a tightening of prudential regulations.

29. Further progress could be made on bank governance and supervision. Progress in implementing recent FSAP recommendations in bank supervision and regulation is uneven and could be stepped up (Annex VI). In particular, the independence of the BRSA and the quality of NPL data could be strengthened, loan restructuring activity fully accounted for, and bank loan classifications and bank governance standards further strengthened. The authorities should evaluate and revise the definition of credit classifications and intensify enforcement in this area.

30. Recent initiatives to manage the large, negative, net FX position of the private sector are steps in the right direction but need to be strengthened. Banks continue to rely on wholesale FX funding and the corporate FX debt burden is high and increasing, specifically, in some sectors with limited FX revenues, such as energy and construction. The authorities have put in place measures to restrict new FX borrowing by SMEs, by introducing FX debt to FX-income limits and banning new FX-indexed corporate loans starting in May 2018. Though the new framework contains exemptions and covers just 16 percent of FX borrowers, it is a first step in implementing the 2017 FSAP recommendation of restricting FX borrowing without natural hedges (Annex VI). Staff commended the authorities' plans to introduce additional measures targeting large companies. Ongoing efforts to assess and adequately monitor the vulnerabilities of the corporate sector, in particular through stress-testing exposure to FX and interest rate risks, are being supported by Fund technical assistance.

Authorities' Views

31. The authorities considered the rapid CGF expansion and the macroprudential relaxation as necessary to deal with the severe economic uncertainty in the wake of the failed coup attempt in 2016. Although they pointed to the good asset quality performance, thus far, of the CGF backed loans to date, they acknowledged that the framework of the CGF needed more focus and strengthening and had reflected this in their plans for this year. The authorities viewed their macroprudential policies as being in line with international best practice and as helping them manage credit growth.

D. Contingency Planning

32. In case tail risks materialize, the authorities should raise the policy rate, allow an orderly depreciation of the exchange rate and let automatic stabilizers play out. In case of a "sudden stop" of capital inflows, the policy rate would need to be increased sharply to avoid a more damaging and disruptive depreciation of the Lira. The policy response should be proportionate and take into account the balance of risks (especially to the corporate sector) stemming from exchange rate and interest rate movements. Automatic stabilizers should be allowed to cushion negative shocks, while discretionary measures should be reserved in the event of a serious recession. The use of fiscal space would be conditional on maintaining market access. Given that net international reserves are low, the scope for credible FX intervention would be limited. Preemptive build-up of FX reserves and strengthening of bank and corporate balance-sheets—through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX—would help insulate the real economy from any negative shocks.

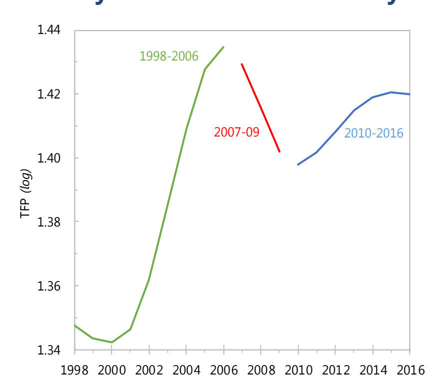
Authorities' Views

33. The authorities highlighted the strengths of the fiscal position and the banking system as being sufficient to absorb negative external shocks. They concurred that further build-up of FX reserves over time would help improve Turkey's buffers.

E. Structural Reforms

34. Focused structural reforms would help underpin medium-term growth. The sustainability of the current growth model, which relies on rapid accumulation of capital and a growing labor force, is approaching its limits, as the marginal boost to real activity from additional credit expansion diminishes and labor market rigidities become more binding constraints on growth. Advantage should be taken of the current strong cyclical growth conditions to implement structural reforms to address the lackluster total factor productivity growth over the past decade:

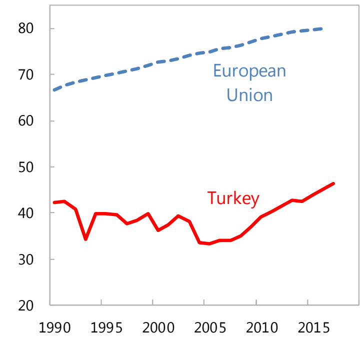
Turkey: Total Factor Productivity



Source: TurkStat and Staff estimates.

- **Improving labor market conditions.** The formal labor market could be made more flexible by reforming the severance pay system, which is overly burdensome for employers in the formal sector and discourages labor mobility due to the non-transferable built-up rights. The backward-looking component of public wage indexation should also be reformed, as it can increase disinflation costs and, with spillovers to private sector collective wage bargaining, that can lead to negative wage-inflation spirals as well as exacerbating informality. Future minimum wage increases should be aligned with expected inflation and tied to productivity gains. Other priorities include the full implementation in practice of the liberalized regime for temporary employment and measures to increase access to childcare facilities with its potential to boost the still-low female labor force participation (33½ percent in 2017). Improving educational outcomes and further supporting vocational training would help reduce skill-mismatches.

Ratio of Female to Male Labor Force Participation Rates *(Percent)*



Source: Turkstat and World Bank Development Indicators (for EU).

- **Promoting productive private investment.** Recent initiatives seek to enhance the ease of doing business by simplifying the procedures for setting up new companies and shortening bankruptcy proceedings. At the same time, policy uncertainty is found to negatively affect productive investment. It is, therefore, important to restore policy certainty by addressing investors' concerns about public institutional capacity, the predictability of the regulatory environment, and commitment to structural reforms.

35. Further progress is needed with some long-standing reform priorities:

- **Further reforming the pension system.** Private pension automatic enrollment started in 2017, but participation has been limited. Areas for improvement include centralizing collection, fostering more competitive asset management practices, and removing the age limit for participation.

- **Easing refugee integration.** Turkey's generosity in hosting refugees—the numbers hosted is estimated at more than 3½ million—serves as a global example. The introduction of work permits for those under temporary protection is an important step, but the informal sector remains the main employer for Syrian and other refugees. To ensure formal labor market integration, the application process for work permits and business creation could be simplified. The authorities' effort to develop an active communication strategy related to refugee work permits are welcome.

Authorities' Views

36. The authorities expressed their continued commitment to structural reforms. They highlighted the following priorities:

- Structural reforms to enhance the business climate include simplification of administrative and bureaucratic procedures, and provision of investment incentives and technological support to high value-added sectors.

- Labor market policy would focus on improving human capital quality and labor force participation. Provisions of vocational education, relevant training, and effective traineeship programs will be enhanced and coordination with the private sector on required skills will be strengthened. Greater supports for childcare facilities and flexible employment will facilitate more female labor force participation. More progress is needed on the severance pay reform, but this may take time given a need for careful and broad-based consultation with stakeholders to support successful implementation.

- The coverage of the new auto-enrollment pensions system has been extended as planned. The authorities have been working to remove design weaknesses and improve the communication strategy.

STAFF APPRAISAL

37. **Following a slowdown in 2016, growth recovered sharply last year, helped by strong policy stimulus and favorable external conditions.** In 2017, a sizeable credit impulse—driven by state loan guarantees—and fiscal policy (including increased PPP activity) supported the economy, which had, in the previous year, shown signs of weakness. Exports also increased sharply, due to stronger external demand, against the backdrop of a softer Lira.

38. **As a result, external and internal imbalances have widened, increasing Turkey's potential exposure to changing global conditions.** Such has been the strength of the recovery that the economy shows signs of overheating: a positive output gap, inflation well above target, and a wider current account deficit. This adds to underlying vulnerabilities, which include large external financing needs, limited foreign exchange reserves, increased reliance on short-term capital inflows, and high corporate exposure to foreign exchange risk. Signs of possible oversupply in the building and construction sector are also emerging. While risk triggers are, by their nature, difficult to project, they could stem from domestic developments, regional or international geopolitical developments or changes in investor sentiment towards emerging markets.

39. **The economy has so far been resilient to a series of shocks, yet more difficult challenges may lie ahead, underscoring the need for recalibration of policies.** The input-intensive growth model is increasingly ripe for a reset as the marginal boost to real activity from additional credit expansion diminishes and labor market rigidities become more binding constraints on growth. Accommodative international financing conditions have allowed a sharp increase in private sector leverage, helping increase growth, and masking an underlying deceleration of total factor productivity growth. External financing conditions and commodity prices cannot be relied upon to remain supportive and hence the focus of policies should shift toward addressing Turkey's short- and medium-term challenges.

40. **The immediate policy challenge is to recalibrate macroeconomic policies in a measured yet credible manner that fosters sustainable growth and guards against downside risks.** This should be accompanied, over time, by focused structural reforms.

41. **Monetary policy should be tightened further in a frontloaded manner.** This will help contain inflation, re-anchor expectations, underpin the Lira, and allow reserves to be rebuilt. Over time, a move should be made to more conventional instruments to help underpin the transparency and effectiveness of monetary policy.

42. Fiscal and quasi-fiscal policies need to be further contained, as do associated contingent liabilities. Further measures will be needed to achieve a general government primary surplus next year. Potential steps include broadening the revenue base, raising direct taxation, improving VAT efficiency, limiting public wage rigidities, and containing ad-hoc subsidies. Measures to strengthen the PPP risk management and reporting framework, supported by IMF and World Bank technical assistance, are welcome. Building on this would help preserve fiscal space. More broadly, the scope and role of extra-budgetary and other non-central government entities, and institutions such as the newly created SWF, need to be carefully defined and monitored, with the maximum degree of transparency.

43. Financial sector policies should aim at further strengthening the oversight, stability and governance of the banking sector. Steps have been taken to enhance the risk management and reporting of quasi-fiscal operations, including the CGF, and to introduce limits on borrowing in foreign currency, starting with SMEs. Further efforts are needed to strengthen bank supervision and macroprudential policies, in the latter case in areas where vulnerabilities are highest, in particular in the corporate sector.

44. Focused structural reforms would help underpin medium-term growth. Total factor productivity growth has been lackluster over the past decade. Advantage should therefore be taken of current strong cyclical growth conditions to implement needed growth-friendly reforms. Maintaining strong institutional capacity and improving the predictability of the regulatory environment would help strengthen the investment climate. Labor market reform is also crucial. Skills gaps risk undermining what should be Turkey's natural demographic advantage. Equally important is raising the improving, but still low, female labor participation rate. Further reforms could focus on: improving educational outcomes including vocational training; enhancing opportunities for more flexible work; and reforming the severance pay system.

45. Other structural reforms could also help growth prospects. Creating conditions conducive to long-term local currency borrowing—including the institutional aspects, and generating a deeper pool of domestic saving—would help alleviate one of Turkey's main vulnerabilities, the sizable current account deficit. In this regard, fostering higher participation in the voluntary private pension system would also help.

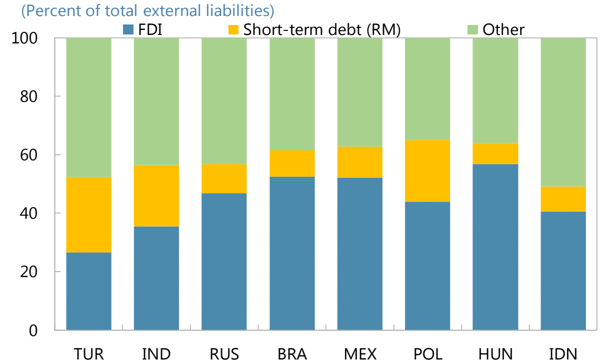
46. It is recommended that the next Article IV consultation with Turkey be held on the standard 12-month cycle.

Box 1. Recent Developments in the External Position[1/]

In 2017, the current account deficit (CAD) widened and gross external financing requirements increased to over 25 percent of GDP. This was against the backdrop of increased reliance on external financing through short-term flows and reserve use. Staff assess the external position as weaker than implied by fundamentals. However, staff assess the real effective exchange rate as broadly consistent with fundamentals, following the sizable depreciation over 2016-17.

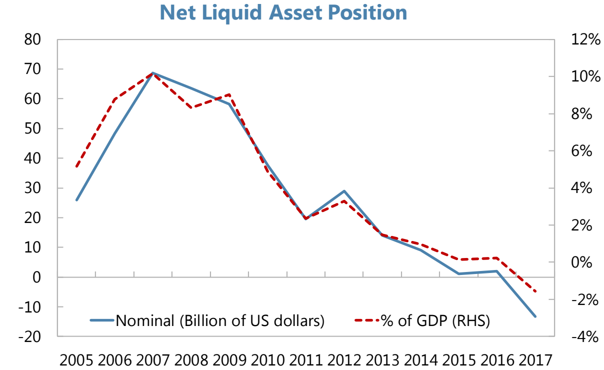
Widening external imbalances are reflected in a growing negative NIIP, which at around 53 percent of GDP is estimated to be the lowest among G20 EMs. While valuation factors contributed 5 percent of GDP to the 10 percent of GDP decline in the NIIP in 2017, large current account deficits have been the main driver of the decline in NIIP since 2010. External liabilities increased to nearly 80 percent of GDP, with FDI comprising less than a quarter of the total, a low share relative to peers despite a relatively open capital account. External assets, half of which are gross reserves, are mostly liquid. Gross liquid external assets (reserves + currency and deposits + other liquid assets) are nearly sufficient to cover short-term debt at remaining maturity, but they have been on a decline since the global financial crisis. At around 50 percent of GDP, Turkey's external debt is sustainable, but has increased rapidly, and is sensitive to exchange rate valuation risks, as well as liquidity risks stemming from the large annual rollover needs of around 20 percent of GDP (Annex V). More than a third of external debt falls due within the next 12 months.

External Liabilities Composition, 2017 (Proj)
(Percent of total external liabilities)



Source: IMF staff estimates.

Net Liquid Asset Position



Sources: Haver Analytics; and IMF staff calculations.

The CAD is higher than warranted by fundamentals. The CAD reached 5.5 percent of GDP in 2017. Staff estimates the underlying cyclically-adjusted CAD to be around 4 percent of GDP, after controlling for the output gap and the one-off impact of large non-monetary gold imports. The EBA CA approach gives a deficit norm of close to 0.5 percent of GDP, while the external sustainability (ES) approach suggests a medium-term norm of 2.5 percent. With a higher weight placed on the ES approach given the relatively low NIIP, staff assesses the CA gap as -0.5 to -2.5 percent of GDP consistent with a norm in the range of -0.5 to -2.5 percent of GDP.

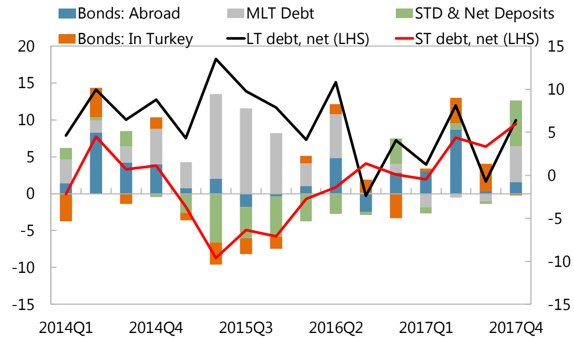
	Current Account (2017 for EBACA, 2023 for ES)	Current Account (cyclically adjusted)	Current Account (cyclically adjusted, excluding demeaned gold balance)	Current Account norm	Gap
EBA CA approach (EBACA)	-5.5	-4.6	-3.9	-0.4	-3.5
ES approach (ES) (benchmark NIIP = -45%)	-3.3	-2.6	...	-2.5	-0.1

[1] Prepared by K. Ismail.

Box 1. Recent Developments in the External Position (continued)

External financing has increasingly relied on reversible flows and reserves drawdown. Net FDI declined to less than 1 percent of GDP in 2017. The share of non-resident net purchases of government and bank debt securities in total net inflows more than doubled in 2017 (Figure 6), reflecting the broader emerging markets rally and attractive carry yields. However, financing became increasingly reliant on easily reversible flows, with net inflows into government domestic securities and through short-term debt and deposits, making up a rising share of net funding. Capital outflows in the first and fourth quarters of 2017 triggered a sizable drawdown of reserves.

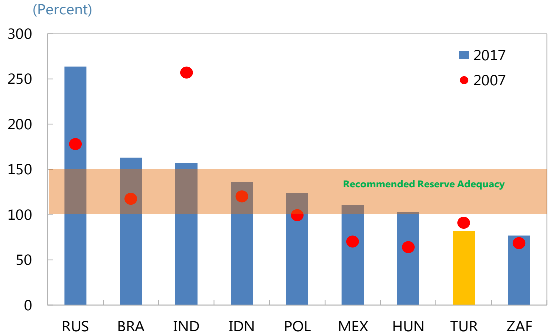
The Composition of Debt Financing
(Billion of U.S. dollars)



Sources: Haver Analytics; and IMF staff calculations.

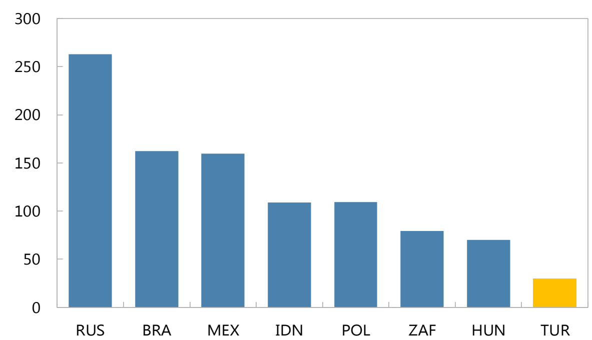
Reserves are relatively low. Net international reserves declined by 13 percent in 2017, as the central bank allowed exporters to repay rediscount credits in Lira instead of FX, continued direct sales to energy importing SOEs, and provided FX liquidity through deposit auctions. Gross reserves were at around 82 percent of the IMF reserve adequacy (ARA) metric at end-2017 continuing a declining trend since 2013. Gross reserves cover only around half of the external financing need. With the bulk of reserves constituting liabilities to banks for reserve requirements, net reserve coverage is significantly lower when compared to peers.

Reserves ARA Metric
(Percent)



Source: IMF staff estimates.

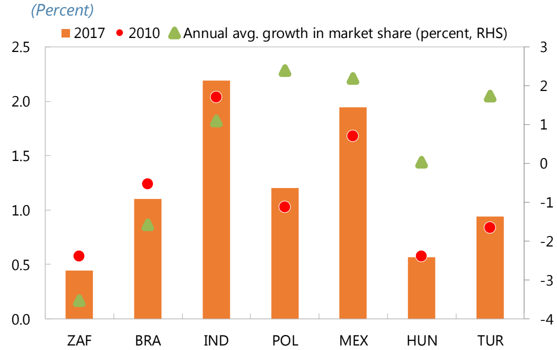
Net Reserves ARA Metric, 2017
(Percent)



Source: IMF staff estimates and Statistics Department's IRFCL database.

The share of Turkey in global exports increased by 42 percent since 1999. More recently, the share of exports of goods and services is now 0.94 percent compared to 0.84 in 2010, helped in part by the REER depreciation. The improvement in export shares was significant relative to most EMs, but still weaker than EMs more integrated into the global supply chain, such as Mexico and Poland.

Country Shares in Global Exports of Goods and Services
(Percent)



Source: IMF and staff estimates.

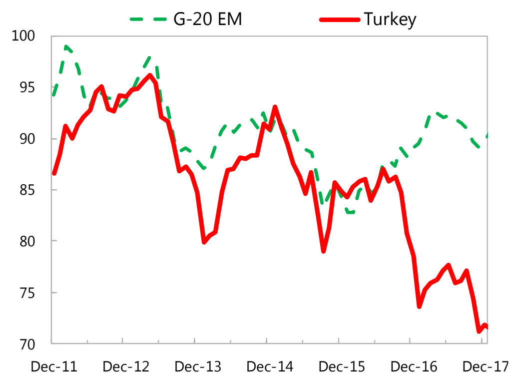
Box 1. Recent Developments in the External Position (concluded)

Staff assesses the REER as broadly consistent with medium-term fundamentals. EBA REER index and level estimations indicate a slight to moderate undervaluation (the EBA index approach gives a 9 percent undervaluation, while the level approach gives a 2 percent undervaluation). However, drawing on the external sustainability approach and the other indicators above, staff considers the REER to be broadly aligned with fundamentals following the significant recent depreciation. (Box 2 discusses the wedge between REER and CA developments.)

Alternative measures of the REER confirms the sizable recent depreciation. In line with the REER depreciation in CPI-based measures, the REER based on manufacturing unit labor costs has depreciated by around 10 percent since 2016 and by 26 percent from its peak in 2010. In addition, a new unit-labor cost REER index covering 75 percent of exports reflect a similar trend.[2]

Notwithstanding rising market shares, there is significant scope to improve competitiveness through reforms. Structural indicators point to relative weaknesses in the solvency regime, the ease of starting a business, and labor market flexibility (the Global Competitiveness Index ranks Turkey 127 out of 137 countries on labor market efficiency with noted weakness in female labor participation and severance costs.)

Turkey: Real Effective Exchange Rates
(Index, 2010=100)



Source: IMF.
Notes: Increase = appreciation. G-20 EMs = average for other G-20 emerging economies (Brazil, Mexico, India, Indonesia, South Africa).

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[2] Extending the Coverage of the Unit Labor Cost Based Real Effective Exchange Rate Index" Erduman and Yavuz, CBT Research Notes in Economics No. 17/10, December 26, 2017.

Box 2. Current Account and Real Effective Exchange Rate[1/]

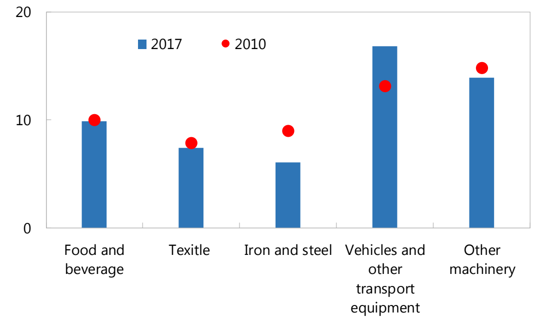
Since 2013, the estimated gap between the current account deficit and that implied by fundamentals has persisted despite significant REER depreciation. This box aims to explain the drivers for this.

The orientation of exports towards import-intensive sectors played a role in slowing the current account adjustment. Exports of manufacturing sectors with lower import-content (textiles, food processing) declined slightly, while import-intensive sectors, such as vehicles, became more dominant. (Since 2013, vehicle exports increased by nearly 40 percent, far outpacing growth in other exports.) This resulted in raising the import intensity of exports over time, blunting the transmission of REER depreciation to trade balance improvements in the short term.

A relatively inelastic fuel trade balance to energy prices also muted the narrowing of the CA gaps. The relationship between prices and quantities in the energy sector is weak. Despite a sizable increase in real fuel prices in 2017, real fuel imports are estimated to have increased by nearly 20 percent year-on-year. This is partly due to lags in the adjustment of administered energy prices.

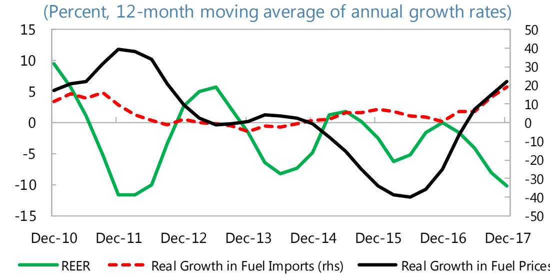
The increase in quasi-fiscal activities may have led to some decoupling of imports from REER movements. The rise in investment underwritten by the government through PPPs, including megaprojects, may have also muted the impact of REER depreciation on import demand. The high tradable intensity of capital spending resulted in import leakage without commensurate pressures on the price of non-tradables, leaving the REER on a declining path while the CAD remained high. As an example, since the 2013 increase in PPP activities, Turkey has become a net importer of steel and iron, both staples of construction activity.

Exports of Goods by Commodity Group
(Percent of total exports)



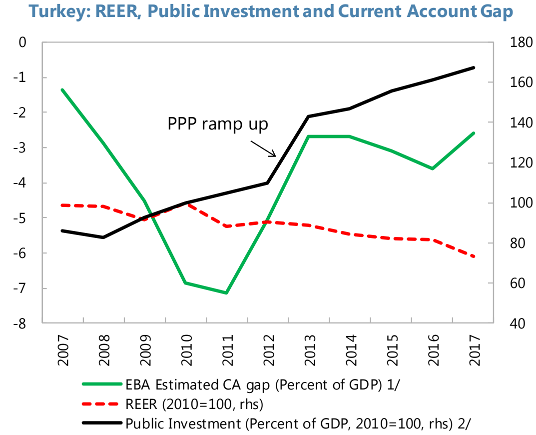
Sources: Haver Analytics; and IMF staff calculations.

REER Changes and Fuel Import Growth
(Percent, 12-month moving average of annual growth rates)



Sources: TurkStat, Haver Analytics, and IMF staff estimates.

Turkey: REER, Public Investment and Current Account Gap



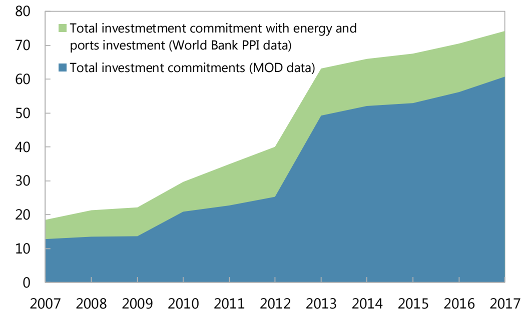
Sources: IMF staff estimates; CBRT and Undersecretariat of Treasury.
1/ The cyclically adjusted current account is adjusted by the output gap, cyclically terms of trade changes, and the demeaned non-monetary gold trade balance.
2/ Public investment is the sum of on-budget capital spending, investment by SOEs, and PPP investment.

[1] Prepared by K. Ismail.

Box 3. Fiscal Risks from Public-Private Partnership Projects[1/]

The size of the overall Public-Private Partnership (PPP) investment portfolio in Turkey has increased rapidly in recent years. The investment size is currently estimated at about US$61 billion (covering 221 projects), six times more than the level observed a decade ago and with a concentration in the transportation, energy, and health sectors. Of the total PPP portfolio, a total investment value of US$36.6 billion or 60 percent of the total portfolio is still under construction.

Cumulative PPP Investment Portfolio
(Billion of US dollars)



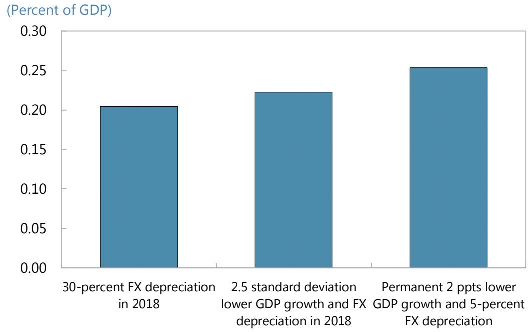
Sources: Ministry of Development; and World Bank.

Fiscal risks related to PPP projects arise from both direct and contingent liabilities. Direct liabilities come from government-funded PPPs. Meanwhile, contingent liabilities could stem from demand, exchange rate, and investment guarantees, as well as contract termination clauses and any debt guarantees, issued either by the Treasury or other procuring public institutions. Besides the potential reclassification of PPP debt into the general government in case of any bailout of PPP projects or loan guarantees, many PPP projects in Turkey involve explicit minimum revenue guarantees (MRGs) and components expressed in FX terms, which exposes the government to demand and exchange rate risks.

Information on PPP projects to assess related fiscal risks remains limited and the legal and institutional PPP framework is fragmented. Total commitments on PPP contracts and investments published by the Ministry of Development (MoD) do not include some PPP projects contracted by SOEs and municipalities, and Private Participation in Infrastructure (PPI) projects related to energy and ports. In addition, there is neither detailed information on all issued guarantees and associated risks nor on the structure and risks composition of the overall PPP portfolio. Debt Assumption Commitments (DACs) reported in the monthly Public Debt Management Report covers only the Treasury's loan guarantees to five PPP projects with a total investment value of US$14.6 billion or a total loan amount of US$11.3 billion. Furthermore, the legal and institutional framework for PPPs is fragmented across sectors, projects, and public agencies without a strong central overview unit in charge of assessing, monitoring, reporting, and managing the entire PPP portfolio.

Staff's analysis shows that the stock of contingent liabilities related to revenue guarantees is sensitive to the macroeconomic assumptions underlying PPP revenue projections. With limited information, macroeconomic shocks are simulated on the stock of contingent liabilities related to MRGs of just under half of the total PPP investment portfolio. Staff's simulation shows that macroeconomic shocks could trigger an increase in primary expenditure to finance the materialized contingent liabilities, and hence result in an increase in the fiscal primary deficit of about 0.2-0.25 percent of GDP a year.[2/]

Sensitivity of Contingent Liabilities Related to MRGs
(Percent of GDP)



Source: IMF staff estimates.

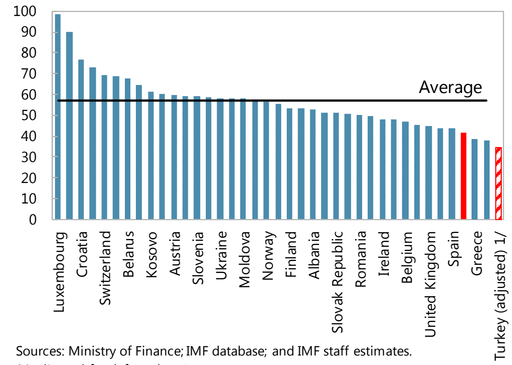
1/ Prepared by R. Çeçen, F. Jirasavetakul, I. Rial, and A. Zdzienicka.

2/ For instance, a permanently lower GDP growth by 2 percentage points and a 5 percent depreciation of the Lira could increase the stock of contingent liabilities by 0.25 percentage point of GDP per year. The 2-percentage point lower growth could be seen as equivalent to staff's medium-term growth projection of 3.5 percent, compared with the 5.5 percent growth envisaged in the MTP.

Box 4. VAT Efficiency and Reform Priorities[1/]

Turkey's VAT collection performance is relatively weak compared to other European countries. VAT revenue collection captures less than 40 percent of the potential VAT base, and collection efficiency has also worsened over time, mainly due to increasing use of reduced rates and exemptions, weakening compliance, and shortcomings of the overall VAT design.[2/] In addition, VAT collection is helped by "deferred" VAT refunds incurred from the requirement for taxpayers to carry forward their excess input VAT credits until fully offset against the output VAT.[3/] The current stock of deferred VAT refunds is estimated to be more than 5 percent of GDP.

VAT Collection Efficiency
(Percent)



Sources: Ministry of Finance; IMF database; and IMF staff estimates.
1/ Adjusted for deferred VAT.

A comprehensive VAT reform, as planned by the authorities, should focus on improving revenue potential, removing distortions, and simplifying the VAT system. The reform package should focus on eliminating the zero rate for domestic supplies, limiting the use of reduced rates, and enhancing compliance by revisiting anti-avoidance and anti-fraud measures. In addition, adopting a clear principle-based VAT legislation and a modern VAT system without too many permanent and temporary exemptions and with a limited number of special regimes, could help simplify the overall system and enhance compliance.

A reform to improve the VAT refund mechanism has to be designed carefully. To eliminate the burden on business and encourage voluntary compliance, the system needs to allow for unrestricted refunds of excess input VAT credit and the existing stock of deferred VAT refunds needs to be amortized. However, these actions have to be carefully undertaken in a simple and budget-neutral way. The reform of the VAT refund system will result in revenue losses, and hence has to be implemented in tandem with compensating revenue measures. Reforms to increase VAT revenue collection efficiency—for instance by unifying and raising reduced rates, eliminating exemptions, and implementing a unified flat rate of VAT on real property—could enhance revenues and offset the cost of fixing the VAT refund mechanism.

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1/ Prepared by F. Jirasavetakul, A. Swistak and A. Zdzienicka.

2/ The VAT legal system is complex with a large number of legal provisions and temporary legislative amendments that create uncertainty and can distort business decision.

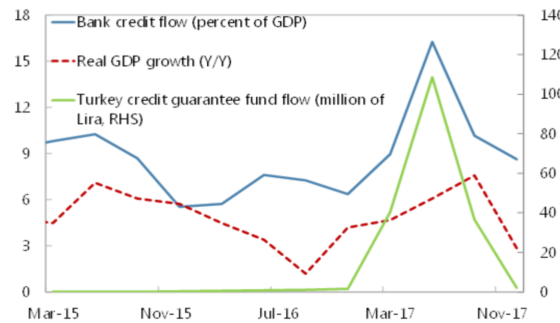
3/ Only exporters and taxpayers with zero-rate domestic supplies, subject to reduced rate and VAT withholding, are entitled to claim VAT refunds.

Box 5. Credit Guarantee Fund[1/]

Background. Initially created in 1993, the Credit Guarantee Fund (CGF) was expanded tenfold in 2017 to a total size of about 7 percent of GDP. The state guarantee (100 percent of export loans, 90 percent of SME loans, 85 percent of commercial loans) applies as long as the individual bank portfolio does not reach an NPL ratio of 7 percent. 80 percent of the guarantee-supported credits are selected directly by banks. The maturity of the portfolio is about 3 years on average, and the average interest rate stands at 15 percent (vs. 17 percent for non-CGF backed corporate loans). The usage fee charged to banks is just 0.03 percent of the face value of the guarantees made. Compared to the CGF, mechanisms in other countries (e.g., Chile, Korea) typically provide a lower level of guarantee coverage, charge much higher fees, are restricted to SMEs, and occasionally provide other types of support for SMEs (technical guidance etc.).

Impact on credit and the economy. In 2017, the CGF contributed close to half of overall corporate credit growth and three quarters of TL-denominated corporate loan growth. Its impact on 2017 GDP growth has been estimated by private sector analysts at around 1½ percentage points in total. The quick take up (in about four months) and the heavy use for working capital purposes (90 percent of CGF loans are recorded as such) suggest that it has been used for a variety of purposes, including rolling over loans, liquidity, and even purchase of consumption goods. Three sectors (trade, manufacturing, construction) took more than 80 percent of guarantee-supported loans.

Turkey: Bank Credit Impulse and Real GDP Growth
(Percent)



Sources: Haver Analytics; and IMF staff calculations.

Effect on banks. The portion of the loan guaranteed by the CGF is currently risk weighted at zero, while the remainder of the loan, if any, is risk weighted in line with the risk weight of the counterparty. This has provided a powerful incentive for banks to supply credit, with an estimated capital adequacy relief of about 0.7 percent in 2017. However, it has also amplified banks' needs for TL funding, further increasing TL loan-to-deposit ratios (now at 145 percent), exerting pressure on Lira deposit rates and driving up swap costs when banks seek Lira with FX.

Fiscal impact. The government provided the CGF with an amount equivalent to 0.8 percent of GDP to cover a maximum exposure equivalent to 8 percent of GDP. From that envelope, the government has paid out the equivalent of 0.02 percent of GDP in 2017, and budgeted 0.1 percent of GDP for 2018. NPL ratios at 0.4 percent are currently low, but loan vintages are too recent to show a deterioration in asset quality.

Future of the CGF. In February 2018, the Turkish authorities announced a new protocol for the still-unused amount of 50 billion Lira and 5 billion Lira in returned guarantees. It envisages up to 18 billion Lira loan guarantees to be granted for capital investment and up to 14 billion Lira to exporting firms, and with other stated specific beneficiaries as well (for companies located in regions benefiting from an investment incentive package, for agriculture, and for female and young entrepreneurs). Additional funds are also expected to be available, as earlier loans are repaid under the previous protocol, and a possibility to roll over those was granted in December. This would bring the maximum amount of guarantees in 2018 to 135 billion Lira (equivalent to 3¾ percent of GDP), with a smaller credit impulse than in 2017.

Recommendations. The scaling down of new guarantees and the focus away from working capital and towards investment are steps in the right direction. Other measures to improve the functioning of the CGF and to limit risks include: (1) revisiting the possibility granted to roll-over loans for up to 36 months under the old protocol; (2) making sure the support goes only to SMEs, and not to larger companies (currently a quarter of the usage) that do not suffer from market imperfections associated with the lack of collateral; (3) increasing fees which would allow the funding of enhanced monitoring and a greater risk management capacity for the CGF; (4) revising downwards the level of guarantee coverage (e.g., for rolled over loans).

[1] Prepared by J. Vacher.

Table 1. Turkey: Selected Economic Indicators, 2016–23

Population (2017): 80.8 million
Per capita GDP (2017): US$10,512
Life expectancy (2015): 75.4 years
Gini index (2016): 40.4
Quota (2017): SDR 4,658.6 million

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.	Proj.					
Real sector				*(Percent)*				
Real GDP growth rate	3.2	7.0	4.4	4.0	3.6	3.6	3.6	3.6
Contributions to real GDP growth								
Private consumption	2.2	3.8	2.5	2.2	2.1	2.0	2.0	2.1
Public consumption	1.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Investment (incl. inventories)	1.1	2.3	1.1	1.1	1.1	1.1	1.0	1.0
Net exports	-1.4	0.7	0.4	0.2	0.1	0.1	0.1	0.1
GDP deflator growth rate	8.1	11.0	11.6	11.1	9.3	8.2	7.8	7.8
Nominal GDP growth rate	11.5	18.8	16.5	15.5	13.3	12.0	11.7	11.6
Inflation (period-average)	7.8	11.1	11.4	10.5	9.0	8.0	8.0	8.0
Inflation (end-year)	8.5	11.9	10.9	10.0	8.5	8.0	8.0	8.0
Unemployment rate	10.9	11.0	10.7	10.7	10.5	10.5	10.5	10.5
				(Percent of GDP)				
Fiscal sector								
Nonfinancial public sector								
Primary balance	-0.6	-0.9	-1.5	-1.3	-0.7	-0.3	-0.3	-0.3
Overall balance	-2.0	-2.2	-3.1	-3.3	-2.9	-2.5	-2.4	-2.3
General government cyclically adjusted primary balance 1/	-0.7	-1.5	-1.9	-1.9	-1.2	-0.7	-0.7	-0.7
General government gross debt (EU definition)	28.3	28.5	27.8	27.9	27.9	28.0	28.1	28.1
External sector								
Current account balance	-3.8	-5.5	-5.4	-4.8	-4.5	-3.9	-3.6	-3.3
o/w Nonfuel current account balance	-1.3	-1.8	-1.0	-0.7	-0.7	-0.3	-0.1	0.1
Gross international reserves (billions of US dollars)	106.3	107.7	107.7	107.7	107.7	107.7	107.7	107.7
Ratio to ARA Metric for emerging markets (percent)	89.5	81.9	...	...	...	...	...	...
Gross financing requirement	22.9	24.9	25.1	26.3	26.5	26.1	25.3	24.4
Gross external debt 2/	46.9	53.2	54.1	54.6	54.3	53.6	52.9	52.1
Net external debt	30.2	35.4	37.5	38.9	39.4	39.6	39.5	39.4
Net international investment position	-42.4	-53.4	-55.2	-57.0	-57.9	-58.5	-58.7	-58.7
Short-term external debt (by remaining maturity)	19.0	21.2	22.7	23.4	23.5	23.1	21.8	20.6
Terms of trade (year-on-year percent change)	2.3	-3.6	-1.3	2.5	1.7	1.2	0.9	0.0
Monetary conditions				*(Percent)*				
Real average cost of CBRT funding to banks	0.6	0.4	...	...	...	...	...	...
Nominal growth of M2 broad money	18.3	15.7	...	...	...	...	...	...
Memorandum items								
GDP (billions of U.S. dollars)	863	849	...	...	...	...	...	...
GDP (billions of Turkish lira)	2,609	3,099	3,611	4,170	4,723	5,292	5,913	6,602
Real effective exchange rate (year-on-year percent change)	-0.4	-10.3	...	...	...	...	...	...

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ In percent of potential output.
2/ 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, 2016–23

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.			Proj.			
Real sector					*(Percent)*			
Growth rates								
Real GDP, *including*	3.2	7.0	4.4	4.0	3.6	3.6	3.6	3.6
Final domestic demand	4.0	6.3	3.9	3.6	3.5	3.4	3.4	3.5
Private consumption	3.7	6.4	4.2	3.8	3.5	3.5	3.5	3.5
Public consumption	9.5	1.2	3.0	3.0	3.0	3.0	3.0	3.0
Investment	2.2	8.4	3.6	3.7	3.6	3.6	3.5	3.5
Exports	-1.9	11.5	6.5	5.1	4.6	4.1	4.4	4.2
Imports	3.7	7.2	4.2	3.8	3.8	3.5	3.6	3.5
Contributions to real GDP growth								
Real domestic demand	4.6	6.3	4.0	3.8	3.5	3.5	3.5	3.5
Private consumption	2.2	3.8	2.5	2.2	2.1	2.0	2.0	2.1
Public consumption	1.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Investment	0.7	2.5	1.1	1.1	1.1	1.1	1.0	1.0
Inventories	0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-1.4	0.7	0.4	0.2	0.1	0.1	0.1	0.1
Exports	-0.4	2.5	1.6	1.3	1.2	1.1	1.1	1.1
Imports	-1.0	-1.8	-1.2	-1.1	-1.1	-1.0	-1.0	-1.0
Output gap (percent of potential GDP)	-0.7	1.7	1.9	1.9	1.7	1.6	1.5	1.5
Unemployment rate (percent)	10.9	11.0	10.7	10.7	10.5	10.5	10.5	10.5
Inflation (Period average)	7.8	11.1	11.4	10.5	9.0	8.0	8.0	8.0
Inflation (End of Period)	8.5	11.9	10.9	10.0	8.5	8.0	8.0	8.0
					(Percent of GDP)			
Shares in nominal GDP	100	100	100	100	100	100	100	100
Private Consumption	60	59	59	58	58	58	58	58
Public Consumption	15	14	14	14	14	14	14	14
Investment	28	31	31	31	31	31	30	30
Exports	22	25	26	26	26	26	26	25
Imports	25	29	30	30	29	28	28	27
Fiscal sector								
Nonfinancial public sector								
Primary balance	-0.6	-0.9	-1.5	-1.3	-0.7	-0.3	-0.3	-0.3
Overall balance	-2.0	-2.2	-3.1	-3.3	-2.9	-2.5	-2.4	-2.3
General government structural primary balance 1/	-0.9	-1.7	-2.1	-2.0	-1.3	-0.8	-0.7	-0.6
General government gross debt (EU definition)	28.3	28.5	27.8	27.9	27.9	28.0	28.1	28.1
External sector								
Current account 2/	-3.8	-5.5	-5.4	-4.8	-4.5	-3.9	-3.6	-3.3
Gross external debt 3/	46.9	53.2	54.1	54.6	54.3	53.6	52.9	52.1
Net international investment position	-42.4	-53.4	-55.2	-57.0	-57.9	-58.5	-58.7	-58.7
REER (CPI-based, 2003=100)	99.1	88.9	…	…	…	…	…	…
Saving-investment balance								
Public	-2.3	-2.3	-2.9	-3.2	-2.8	-2.4	-2.3	-2.2
Private	-1.4	-2.9	-2.4	-1.5	-1.6	-1.4	-1.2	-1.0

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ In percent of potential output. 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, 2016–23

(Billions of US$, unless otherwise noted)

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.			Proj.			
Current account balance	-33.1	-47.1	-49.1	-45.9	-46.0	-42.8	-41.4	-40.8
Balance on goods and services	-25.6	-38.5	-37.6	-32.2	-28.5	-25.8	-23.7	-22.2
Goods, net	-40.9	-58.6	-62.6	-60.0	-58.9	-59.1	-60.3	-62.4
Exports of goods	150.2	165.8	186.8	197.9	208.1	218.5	227.8	236.6
Imports of goods	191.1	224.4	249.4	257.8	266.9	277.6	288.1	299.0
of which Fuel imports	27.2	37.2	46.0	44.8	44.4	45.0	46.2	48.0
Services, net	15.3	20.1	25.0	27.8	30.4	33.3	36.6	40.2
Credit	37.4	43.9	50.0	53.8	57.6	61.8	66.3	71.1
Debit	22.1	23.8	25.0	26.0	27.2	28.6	29.8	30.9
Primary income, net	-9.2	-11.3	-14.2	-16.4	-20.2	-19.6	-20.3	-21.2
of which interest expenditure	-5.6	-6.4	-9.9	-14.7	-19.5	-20.4	-22.7	-25.5
Secondary income net	1.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	11.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	-22.1	-47.1	-49.1	-45.9	-46.0	-42.8	-41.4	-40.8
Direct investment, net	-10.2	-8.1	-8.7	-9.9	-11.0	-12.1	-13.4	-14.7
Portfolio investment, net	-6.3	-24.3	-18.8	-15.5	-15.8	-13.0	-11.5	-10.4
of which government eurobonds, net	-2.7	-5.8	-1.4	-2.0	-3.2	-4.9	-4.9	-4.9
Other investment, net	-6.5	-6.5	-21.6	-20.5	-19.2	-17.7	-16.5	-15.6
of which short-term borrowings	5.2	-4.0	-8.0	-3.9	-1.1	0.8	1.6	1.5
Reserve assets	0.8	-8.2	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent of GDP)				
Current account balance, *of which*	-3.8	-5.5	-5.4	-4.8	-4.5	-3.9	-3.6	-3.3
Nonfuel current account balance	-1.3	-1.8	-1.0	-0.7	-0.7	-0.3	-0.1	0.1
Trade account balance (incl. shuttle trade)	-3.0	-4.5	-4.1	-3.3	-2.8	-2.4	-2.1	-1.8
				(Percent year-on-year)				
Export value growth	-5.6	11.8	12.9	6.3	5.6	5.5	4.9	4.6
Import value growth	-4.2	16.4	10.6	3.4	3.6	4.1	3.8	3.8
Export of goods, volume growth	3.7	9.0	6.6	5.6	4.2	3.7	3.7	3.5
Import of goods, volume growth	5.4	9.4	4.2	3.8	3.8	3.5	3.6	3.5
Oil price (US$ per barrel)	42.8	52.8	62.3	58.2	55.6	54.1	53.6	53.6
Change in terms of trade	2.3	-3.6	-1.3	2.5	1.7	1.2	0.9	0.0
Gross international reserves (billions of US dollars)	106.3	107.7	107.7	107.7	107.7	107.7	107.7	107.7
Ratio to ARA Metric for emerging markets (percent)	89.5	81.9	...	...	...	...	...	...
Net international reserves	35.5	31.0	31.0	31.0	31.0	31.0	31.0	31.0
Net international reserves (exl. govt. FX deposits)	32.7	29.4	...	...	...	...	...	...
Ratio of external debt service to exports (percent)	90.6	81.3	80.1	87.9	92.2	93.3	93.1	90.2

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

Table 4. Turkey: External Financing Requirements and Sources, 2016–23
(Billions of US$, unless otherwise noted)

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.			Proj.			
Gross external financing requirements	197.4	211.3	228.8	252.5	271.4	284.1	292.6	299.1
Current account deficit	33.1	47.1	49.1	45.9	46.0	42.8	41.4	40.8
Government eurobonds (amortization)	2.8	3.8	5.1	4.5	6.6	3.1	3.1	3.1
Medium- and long-term debt amortization	56.1	58.9	56.2	60.3	61.8	70.9	77.1	83.5
Government 1/	2.6	3.7	5.7	5.7	2.2	5.8	5.8	5.8
Banks	34.0	36.4	28.8	31.4	35.0	39.0	43.5	48.2
Other sectors	19.5	18.7	21.7	23.1	24.6	26.1	27.8	29.5
Short-term debt amortization	105.4	101.5	118.4	141.8	156.9	167.2	171.0	171.7
Government 1/	0	0	0	8.5	13.1	16.4	16.4	16.4
Banks	68.0	60.8	66.5	71.9	76.5	78.3	77.9	74.4
Other sectors	37.2	40.3	52.1	61.3	67.4	72.5	76.8	80.9
Available financing	197.4	211.3	228.8	252.5	271.4	284.1	292.6	299.1
Sale of assets (net) 2/	-7.7	-7.8	-4.5	-5.5	-4.6	-4.9	-4.9	-5.2
Foreign direct investment (net)	10.2	8.1	8.7	9.9	11.0	12.1	13.4	14.7
Portfolio flows	10.6	27.9	25.3	21.5	24.0	17.8	16.4	15.4
Government eurobonds (drawings)	5.5	9.7	6.5	6.5	9.5	8.0	8.0	8.0
Domestically-issued government bonds (net)	0.8	7.3	8.7	4.5	3.3	0.0	0.0	0.0
Banks' equity and bonds (net)	3.0	7.3	7.4	7.4	7.6	6.3	4.8	3.7
Other sectors' equity and bonds (net)	1.3	3.6	2.8	3.1	3.3	3.4	3.6	3.7
Medium and long-term debt financing	66.1	60.1	68.5	76.5	79.6	90.4	98.4	104.3
Government 1/	1.3	2.1	5.6	5.6	2.1	5.6	5.7	5.7
Banks	36.7	37.0	34.5	40.8	45.5	50.7	56.6	60.2
Other sectors	28.1	21.0	28.3	30.1	32.0	34.0	36.1	38.4
Short-term debt financing 3/	106.8	112.6	128.6	147.9	159.4	166.5	167.2	167.7
Government 1/	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	60.8	66.5	71.9	76.5	78.3	77.9	74.4	70.8
Other sectors	46.1	46.2	56.7	71.4	81.1	88.6	92.8	97.0
Official transfers	1.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Other 4/	11.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
GIR change (- denotes increase)	-0.8	8.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Net public sector financing (incl. IMF, excl. reserves)	3.0	6.3	3.3	4.0	4.8	6.8	6.8	6.8
Government debt rollover rate (in percent)	120	153	114	65	53	54	54	54
Banks' loan rollover rate (in percent)	96	106	112	114	111	110	108	107
Other sectors' loan rollover rate (in percent)	131	114	115	120	123	124	123	123
Gross external financing requirements (percent of GDP)	22.9	24.9	25.1	26.3	26.5	26.1	25.3	24.4
International Investment Position (percent of GDP)	-42.4	-53.4	-55.2	-57.0	-57.9	-58.5	-58.7	-58.7

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

1/ Includes CBRT and the general government, excluding eurobonds issuance.

2/ Includes sales and purchases of portfolio assets by the government, banks, and other private sectors; and sale of assets classified under Other Investments.

3/ Includes currency and deposits of non-residents; 4/ Includes errors and omissions and other liabilities.

Table 5. Turkey: Public Sector Finances, 2016–23

(Percent of GDP, unless otherwise noted)

	2016	2017	2018	2019	2020	2021	2022	2023
		Est.			Proj.			
Nonfinancial public sector primary balance	-0.6	-0.9	-1.5	-1.3	-0.7	-0.3	-0.3	-0.3
Central government	-0.5	-0.5	-0.8	-0.7	-0.5	-0.2	-0.2	-0.2
Primary revenue	20.0	19.4	19.6	19.6	19.7	19.7	19.7	19.7
Tax revenue	17.6	17.3	17.7	17.7	17.8	17.8	17.8	17.8
Personal income taxes	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Corporate income taxes	1.6	1.7	1.9	1.9	1.9	1.9	1.9	1.9
VAT	5.0	5.0	5.0	5.0	5.1	5.2	5.2	5.2
Special consumption tax	4.6	4.5	4.6	4.6	4.6	4.6	4.6	4.6
Other	2.6	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Nontax revenue 1/	2.4	2.1	2.0	1.9	1.9	1.9	1.9	1.9
Primary expenditure, *of which:*	20.5	19.9	20.4	20.4	20.2	20.0	19.9	19.9
Personnel	6.7	6.1	6.2	6.3	6.4	6.4	6.4	6.4
Goods and services	2.1	2.0	2.1	2.1	2.0	2.0	2.0	2.0
Current transfers, *of which* :	8.7	8.6	8.7	8.7	8.6	8.4	8.4	8.4
Social security institutions	4.1	4.1	4.0	3.9	3.9	3.7	3.6	3.6
Agricultural subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Transfers of revenue shares	2.4	2.3	2.6	2.5	2.5	2.5	2.5	2.5
Capital transfers	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Capital expenditure	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2
Net lending	0.5	0.4	0.6	0.5	0.4	0.4	0.4	0.4
Rest of the public sector	-0.1	-0.4	-0.6	-0.6	-0.3	-0.1	-0.1	-0.1
Extrabudgetary funds	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.1	0.1	-0.2	-0.2	0.0	0.1	0.1	0.1
Local governments 2/	-0.4	-0.3	-0.3	-0.3	-0.1	-0.1	-0.1	-0.1
State owned enterprises	0.3	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Nonfinancial public sector overall balance 3/	-2.0	-2.2	-3.1	-3.3	-2.9	-2.5	-2.4	-2.3
Interest expenditure (net)	1.4	1.4	1.6	1.9	2.1	2.1	2.1	2.1
Memorandum items:								
General government primary balance	-1.0	-0.9	-1.3	-1.3	-0.7	-0.3	-0.2	-0.2
General government cyclical adjusted primary balance	-0.7	-1.5	-1.9	-1.9	-1.2	-0.7	-0.7	-0.7
General government overall balance	-2.3	-2.3	-2.9	-3.2	-2.8	-2.4	-2.3	-2.2
General government cyclical adjusted balance	-2.1	-2.9	-3.6	-3.8	-3.3	-2.9	-2.8	-2.7
General government gross debt	28.3	28.5	27.8	27.9	27.9	28.0	28.1	28.1

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

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.

Table 6. Turkey: Financial Soundness Indicators, 2010–17

(Percent, unless otherwise noted)

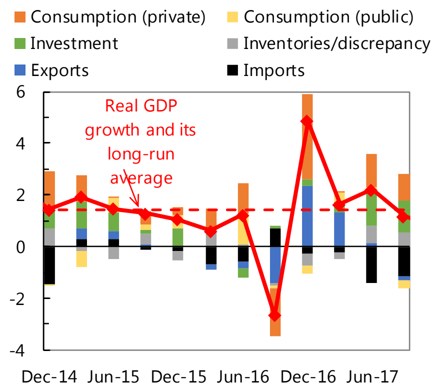
	2010	2011	2012	2013	2014	2015	2016	2017
Capital Adequacy								
CAR	19	17	18	15	16	16	16	17
CT1R	17	15	15	13	14	13	13	14
RWA / Assets	72	78	80	84	83	83	82	76
Asset Quality								
NPLs / Gross Loans	3.7	2.7	2.9	2.8	2.9	3.1	3.2	3.0
Provisions / Gross NPLs	84	79	75	76	74	75	77	79
Profitability								
Total Int. Income / Int. Bearing Assets (av) 1/ 2/	9.2	8.2	9.1	7.6	7.9	7.8	8.3	8.8
Cost / Income (Efficiency) 3/	68	74	73	71	74	76	72	73
ROAA 1/ 4/	2.5	1.7	1.8	1.6	1.3	1.2	1.5	1.6
ROAE 1/ 4/	18	14	14	13	11	11	13	15
Funding and Liquidity								
Loan-to-Deposit ratio	85	98	103	111	118	119	119	123
Loan-to-Deposit ratio (TL)	89	105	113	127	133	142	134	148
Loan-to-Deposit ratio (FX)	77	84	82	84	92	89	99	90
Non-Core / Core Liabilities 5/	34	45	44	52	55	56	56	57
Non-Core / Core Liabilities (TL) 5/	23	29	26	29	30	32	29	32
Non-Core / Core Liabilities (FX) 5/	67	87	91	103	113	101	106	101
Leverage Ratio 1/ 6/	6.2	5.3	5.0	5.2	5.7	5.3	5.1	4.8
Liquid Assets / Assets 7/	28	26	26	24	23	22	21	23
Assets / Liabilities (3 months, int. sensitive)	72	72	82	79	75	74	76	73
FX Risk								
FX Assets / FX Liabilities (on-balance sheet) 6/	93	92	94	91	91	91	94	88
NOP / Regulatory Capital	0.1	0.4	2.0	-0.6	-2.2	1.3	-1.3	0.5
NOP before hedging / Regulatory Capital	-16	-22	-14	-29	-29	-30	-22	-44
Balance Sheet				*(Percent of GDP)*				
Total Assets	87	87	87	96	98	101	105	105
o/w Gross Loans	45	49	51	58	61	63	66	68
Liabilities	75	77	76	85	86	90	93	93
o/w Deposits	53	50	49	52	51	53	56	55
Shareholders' Equity	12	10	12	11	11	11	12	12
Off-Balance Sheet				*(Percent of GDP)*				
o/w Commitments	75	102	110	90	84	89	95	104
o/w Contingencies	14	16	15	18	19	20	21	21
Miscellaneous								
Deposit Interest Rate (Percent) 8/	7.9	10.6	7.6	8.0	9.5	11.0	9.6	12.8
Loan Interest Rate (Percent) 9/	11	17	12	13	13	16	15	18

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

Figure 1. Turkey: Real Sector Developments

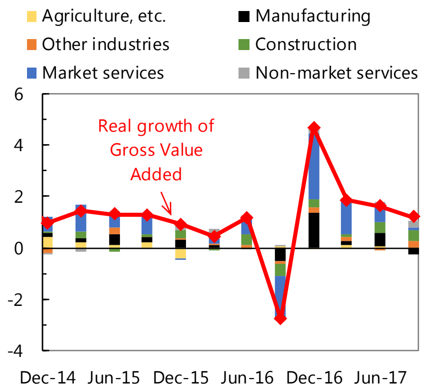
Growth has rebounded from the 2016:Q3 slump, as higher exports and fiscal stimulus spurred demand.

Turkey: Contributions to Real GDP Growth *(quarter-on-quarter, percent)*



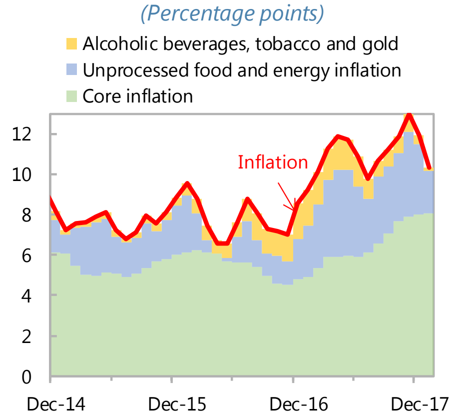
On the supply side, the main growth drivers were services, manufacturing and construction.

Turkey: Contributions to Real GVA Growth *(quarter-on-quarter, percent)*



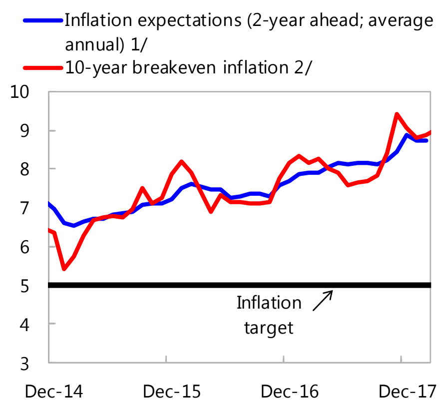
Accelerating core inflation helped drive headline inflation higher in 2017.

Turkey: Contributions to Inflation
(Percentage points)



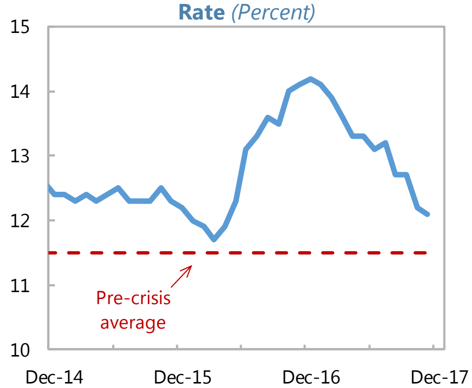
Inflation expectations are diverging from the central bank target.

Turkey: Inflation Expectations
(Percent)



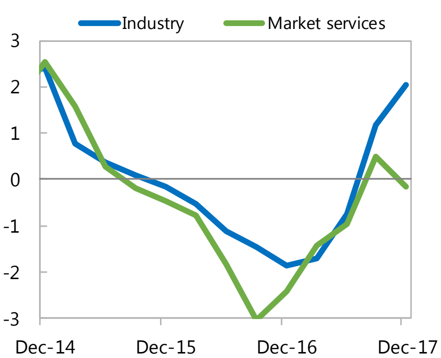
The unemployment rate has declined, but remains high ...

Turkey: Non-agricultural Unemployment Rate *(Percent)*



... as formal employment recovers slowly.

Turkey: Formal Employment Growth
(Percent)



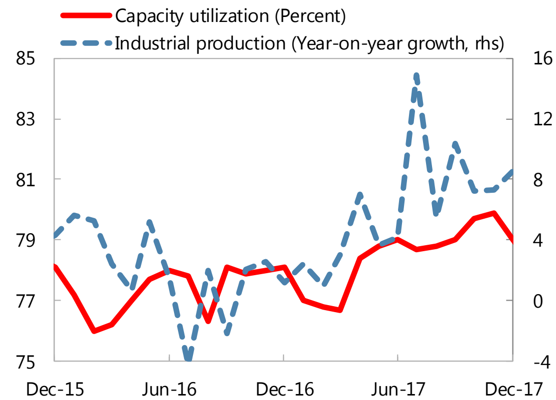
Sources: TurkStat, CBRT, European Commission, Bloomberg Financial Markets L.P., and IMF staff calculations.
1/ Average of 12-month ahead and 24-month ahead, end-period inflation expectations.

2/ Difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond.

Figure 2. Turkey: Coincident and Leading Indicators

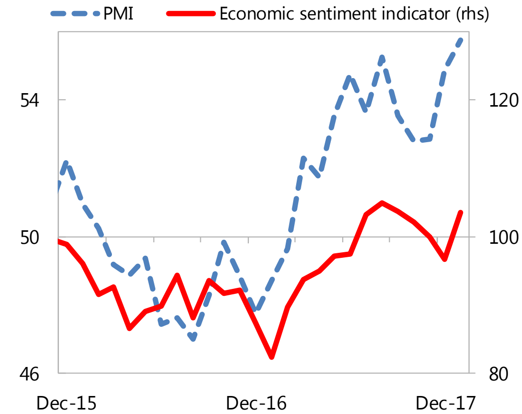
Industrial activity is increasing rapidly, and capacity utilization is at a 10 year high …

Turkey: Industrial Production and Capacity Utilization



… with forward-looking indicators pointing to continued growth momentum.

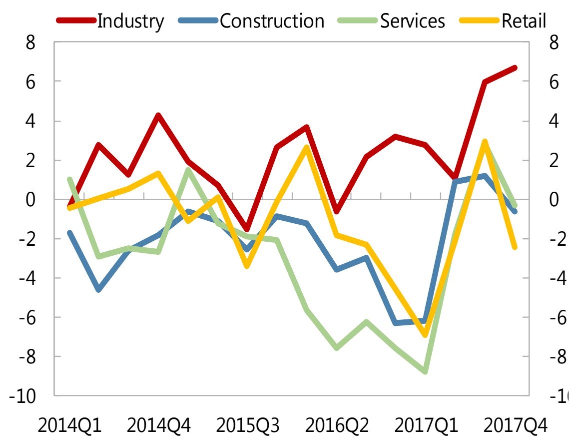
Turkey: Purchasing Managers Index and Economic Sentiment *(Indices)*



Survey-based confidence indicators outside industry peaked in the third quarter …

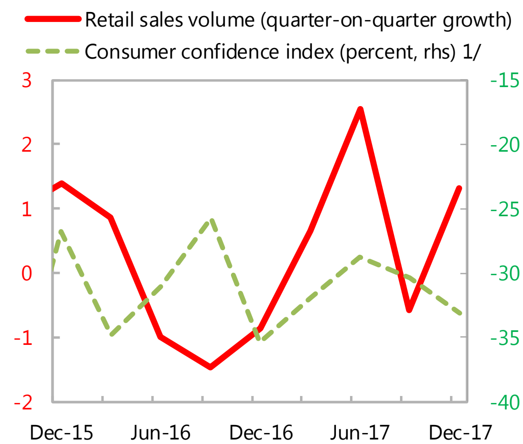
Turkey: Sectoral Confidence Indicators

(Difference from long-run average, percent)



… mirroring softer private consumption and consumer sentiment.

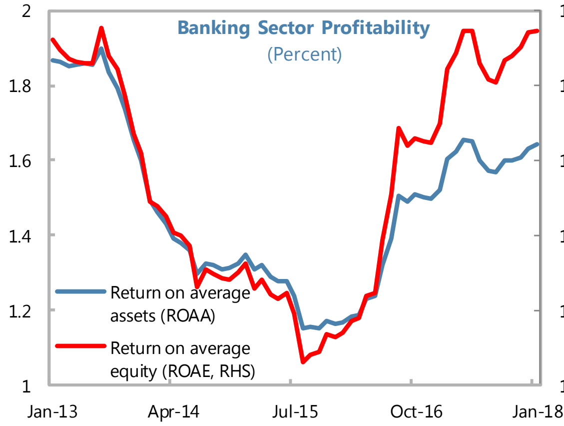
Turkey: Retail Sales Volume and Consumer Confidence Index



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

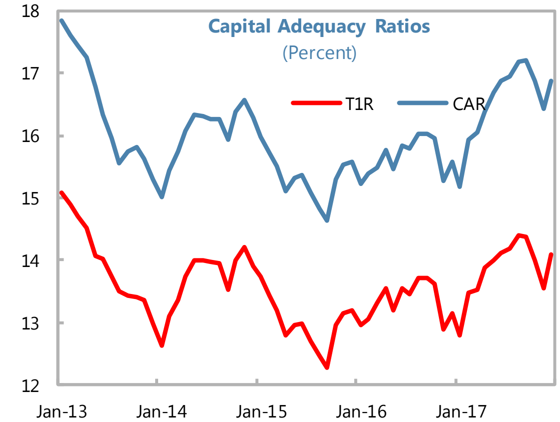
Figure 3 Turkey: Financial Sector Developments

Banking sector profitability recovered since 2015 …



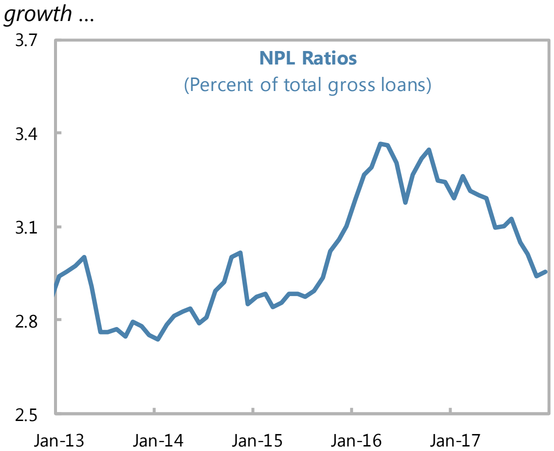
Notes: Monthly EOP NSA. Data is annualized using 12 months moving sum.

… supporting the strength of capital positions.



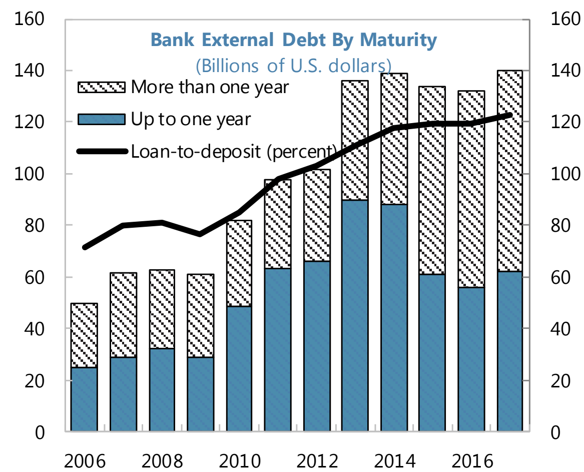
Notes: Monthly EOP NSA. CAR= Regulatory Capital/RWA. T1R= T1 Capital/ RWA.

Headline NPL ratios declined supported by buoyant credit growth …

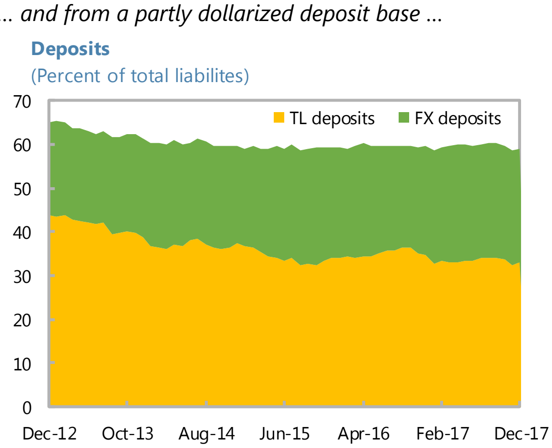


Notes; Monthly EOP NSA.

… largely funded externally …

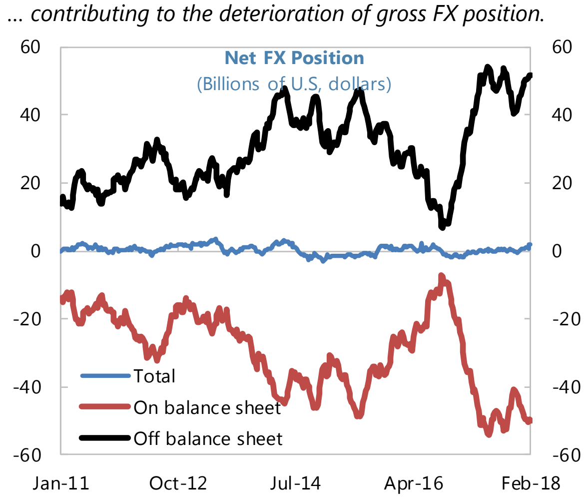


… and from a partly dollarized deposit base …



Notes: Monthly EOP NSA. Share of liabilities excluding shareholders equity. Non FX adjusted.

… contributing to the deterioration of gross FX position.

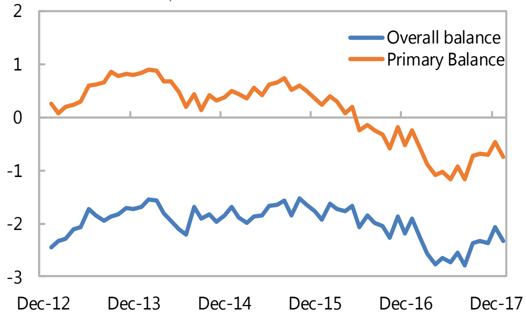


Sources: BRSA, Haver Analytics, and IMF staff calculations.

Figure 4. Turkey: Fiscal Stance

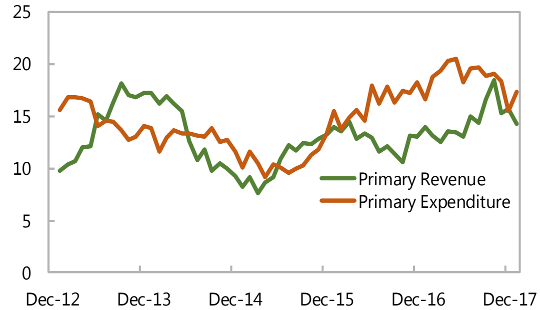
Fiscal balances have declined since 2016 …

Central Government Balance
(12-month cumulative, percent of GDP)



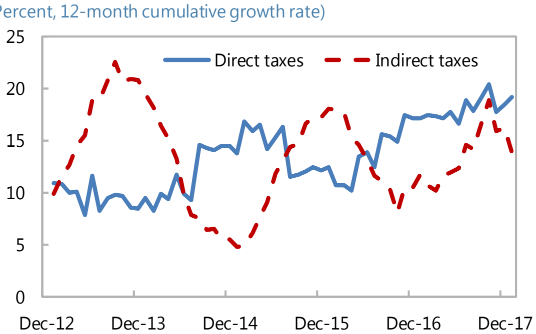
… as expenditures grew more rapidly than revenues.

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



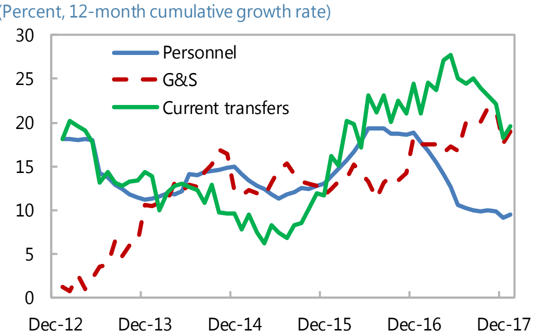
Slow growth of indirect taxes was largely driven by temporary tax breaks on such taxes …

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



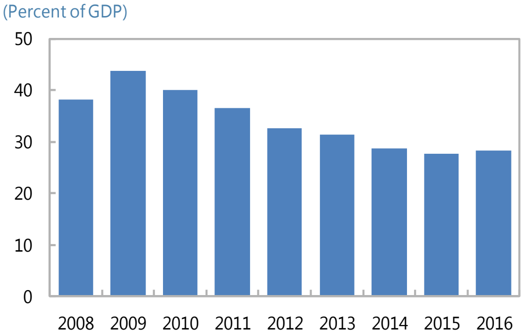
… while transfers and subsidies and goods and services spending keep expenditure growth elevated.

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



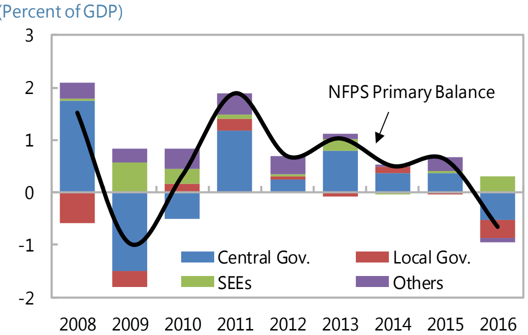
Public debt remains low …

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



… due to strong commitment to a fiscal anchor over past decade, notably at the central government level.

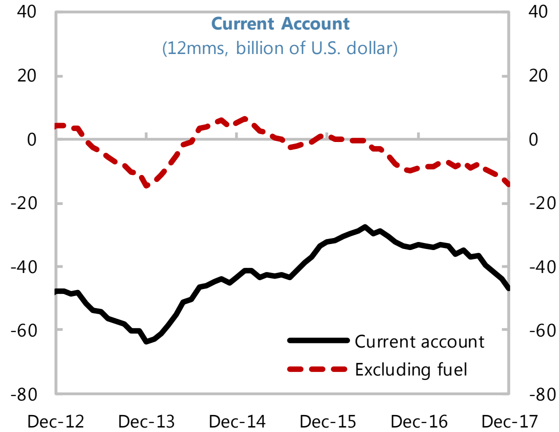
Non-Financial Public Sector Primary Balance
(Percent of GDP)



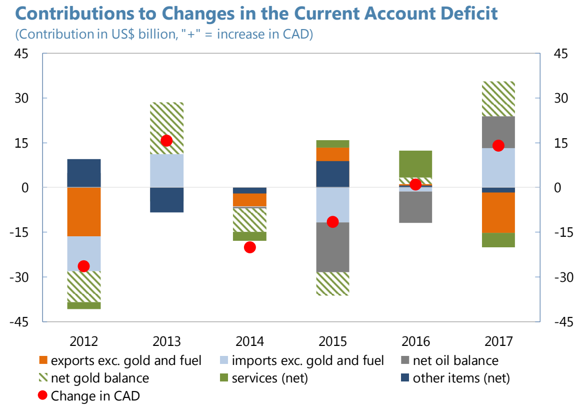
Sources: Ministry of Finance, Treasury, Haver Analytics, and IMF staff calculations.

Figure 5. Turkey: External Sector Developments

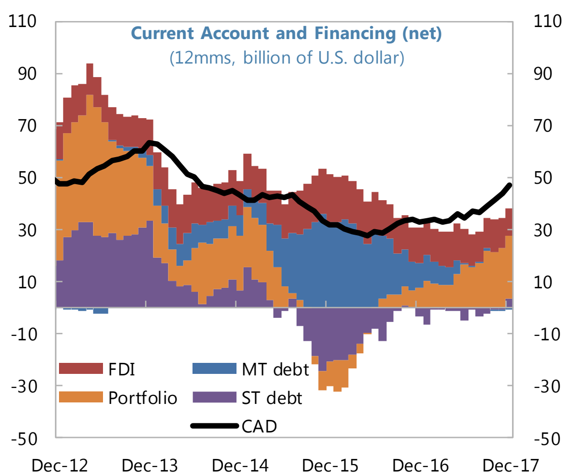
Turkey's current account deficit has widened ...



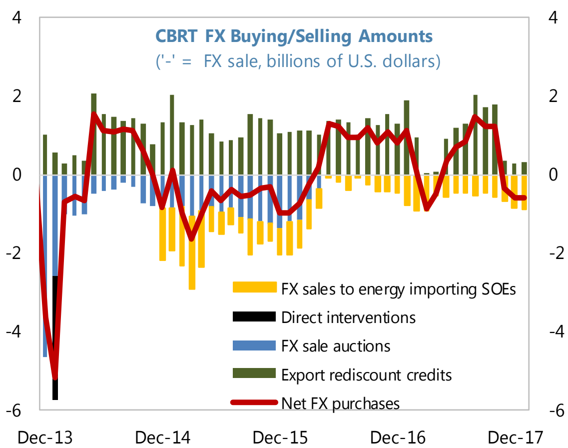
... driven mainly by rapid import growth.



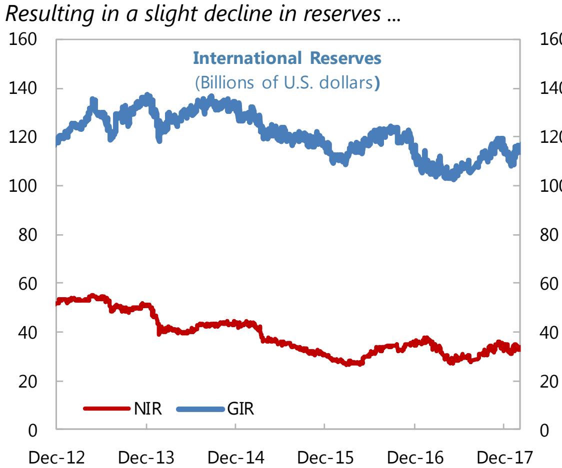
Financing is increasingly dependent on volatile portfolio inflows.



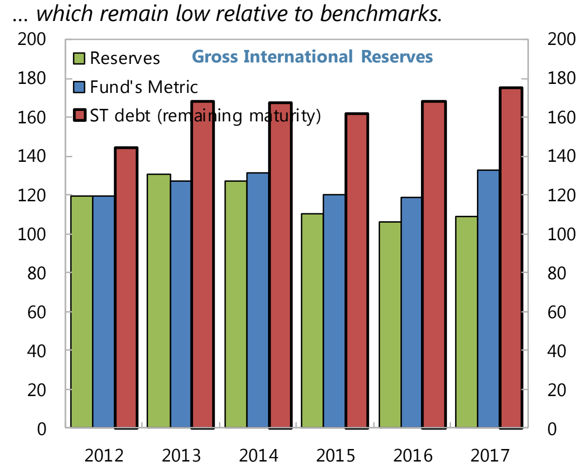
The CBRT took measures to ease FX liquidity in early- and late-2017 in response to Lira depreciation.



Resulting in a slight decline in reserves ...



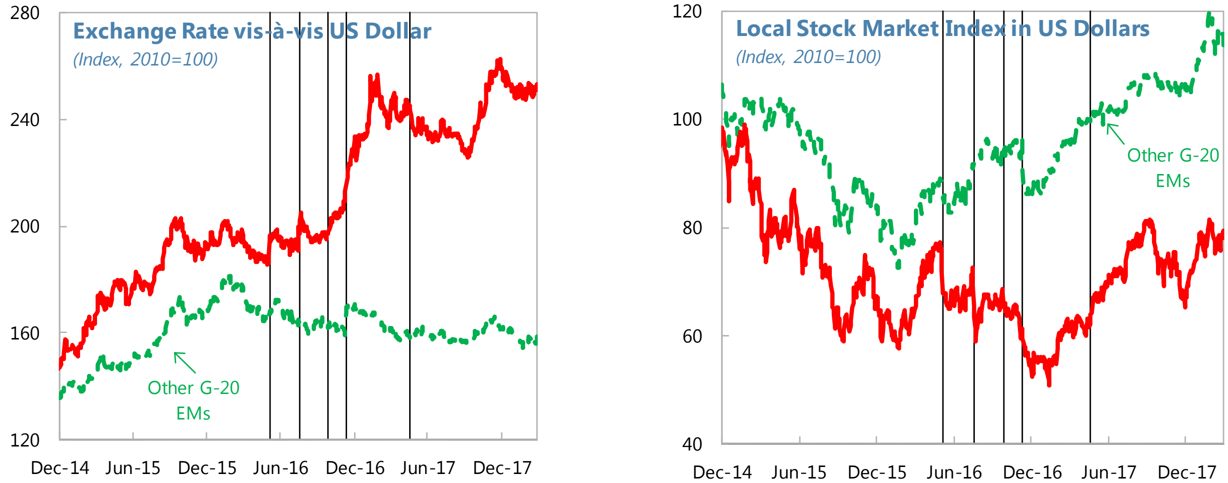
... which remain low relative to benchmarks.



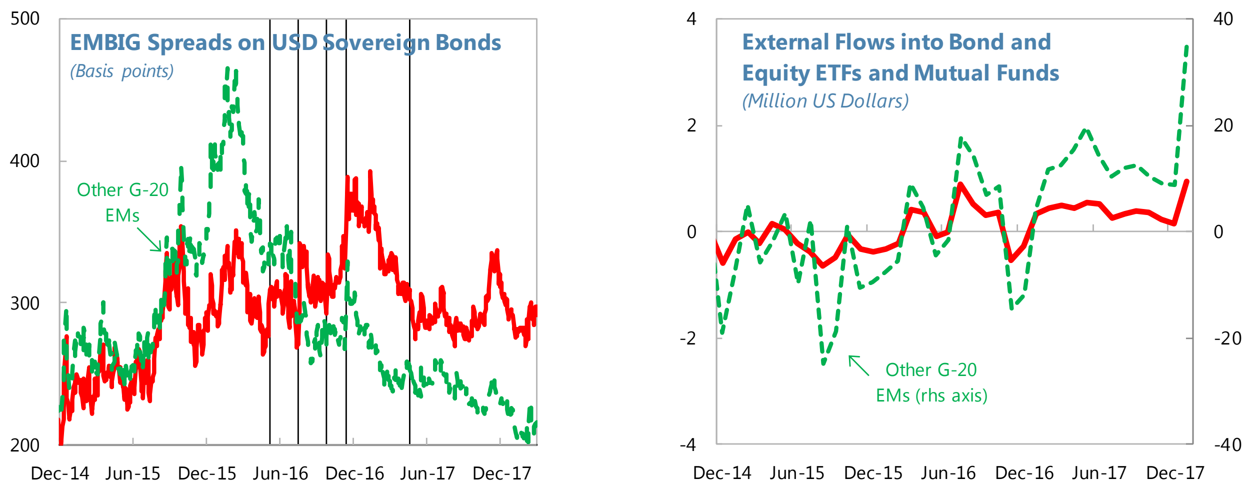
Sources: CBRT, Haver Analytics, and IMF staff calculations.

Figure 6. Turkey: Financial Markets Developments

Although Turkey has benefited from the positive turn in investor sentiment toward EMs, its financial markets have underperformed relative to other large EMs over the last three years. .



A positive risk premium gap has opened relative to peers since the failed coup attempt and the subsequent loss of Turkey's investment grade sovereign rating. External portfolio flows to Turkey continue to broadly track developments in the broader emerging markets asset class.

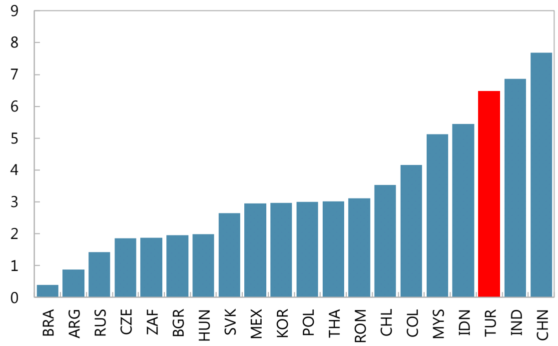


Sources: Bloomberg, Haver, and IMF staff estimates.
Notes: Average of data for other G-20 emerging markets covers Brazil, Mexico, India, Indonesia, and South Africa. Event lines indicate the timing of Turkish PM Davutoğlu resignation (May 5, 2016), the failed coup attempt (Jul 15, 2016), Moody's downgrade to below investment grade (Sep 23, 2016), US presidential elections (Nov 8, 2016), and the Constitutional Referendum (April 16, 2017).

Figure 7. Turkey: Macroeconomic Performance Relative to Peers

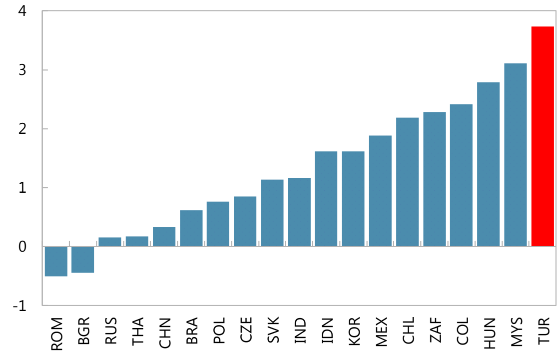
Turkey's post-crisis growth has been strong …

Average Real GDP Growth, 2011-16
(Percent, year-on-year growth)



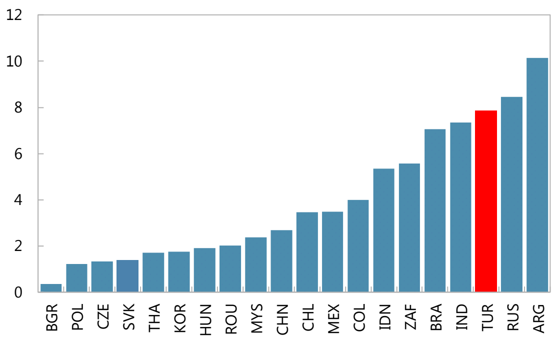
… accompanied by rapid employment growth.

Average Employment Growth, 2011-16
(Percent, year-on-year growth)



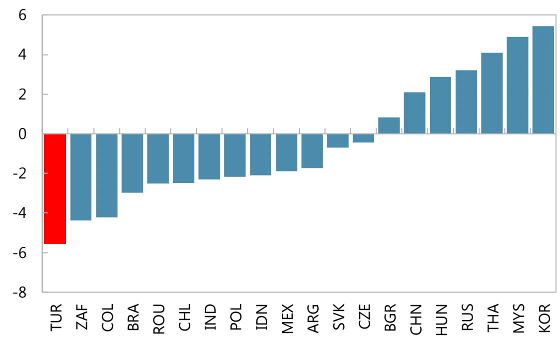
However, growth has been unbalanced, accompanied by high and rising inflation …

Average Inflation, 2011-16
(Percent, year-on-year percent change)



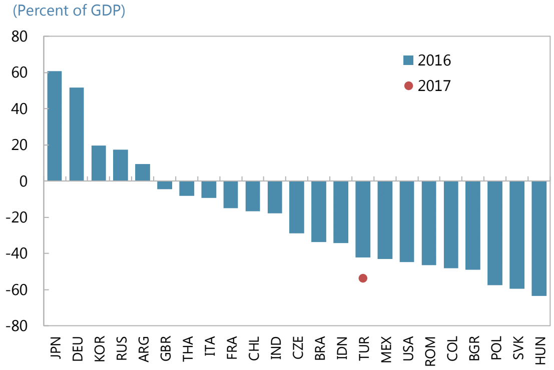
… and persistent current account deficits.

Average Current Account Balance, 2011-16
(Percent of GDP)



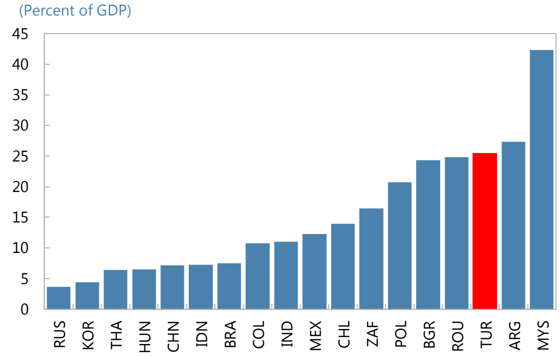
At the same time, NIIP has deteriorated, resulting in the weakest estimated position among G20 EMs …

NIIP
(Percent of GDP)



… and external financing needs are substantial.

External Financing Needs, 2017
(Percent of GDP)



Sources: IMF World Economic Outlook (WEO); and IMF staff calculations.
Note: External financing needs are calculated as the difference between the short-term debt at remaining maturity and the current account balance.

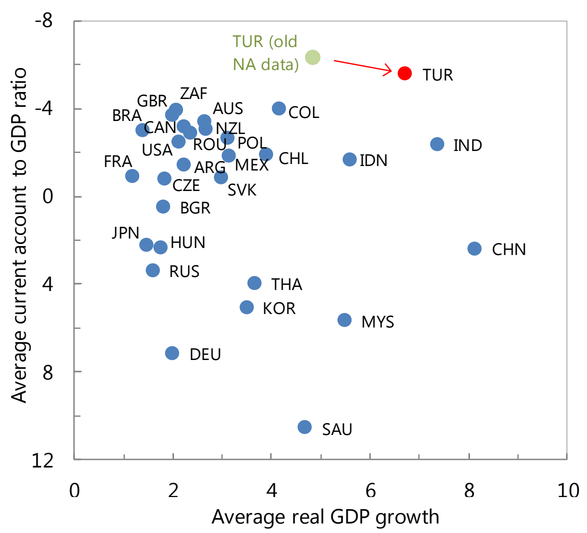
Annex I. Re-Assessing Turkey's Macroeconomic Performance After the 2016 Statistical Revision[1]

1. Prior to the December-2016 statistical revision, data pointed to a significant slowdown in post-2011 growth, against the backdrop of weak saving and investment. With growth near its estimated potential of 3–3½ percent, the dearth of savings was seen as becoming a binding constraint for growth.

2. The end-2016 revision of national accounts data raised significantly Turkey's post-crisis growth rate. The average growth of real GDP in 2011–2015 is 2.7 percentage points higher than the old estimate, resulting in a 20 percent upward revision of 2015 nominal GDP. Both investment and saving rates were revised up substantially, leaving Turkey with the largest external imbalance among G-20 and large EMs in the post-crisis years.

Growth and Current Account, 2010–16

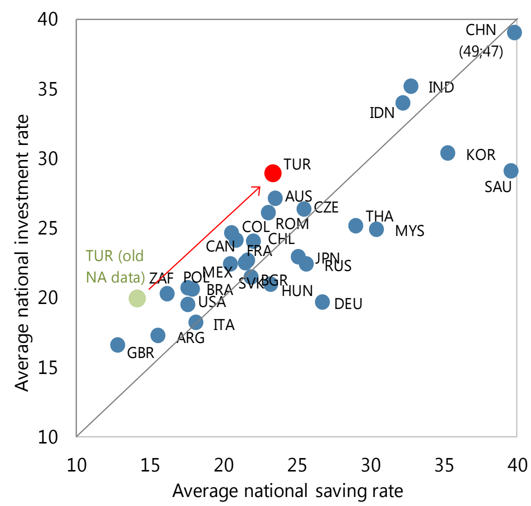
(Percent)



Sources: IMF WEO and IMF staff calculations.

Saving and Investment Rates, 2010–16

(Percent of GDP)

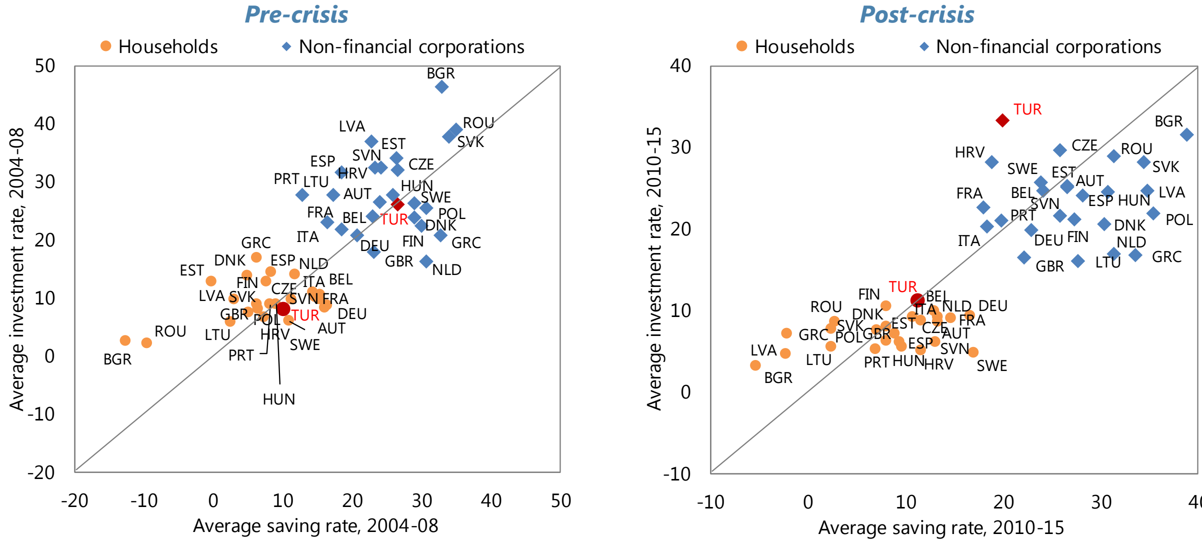


3. The post-2009 increase in the aggregate investment rate was driven by both households and corporates, though the contribution of corporates was larger. Turkey's post-crisis household and corporate investment rates are the highest in Europe. Turkey's household saving rate falls in the mid-range of other European countries both pre- and post-crisis, but is the highest among other emerging markets with similar or lower per capita incomes. Turkey's corporate saving rate was broadly in the mid-range of other European countries pre-crisis. However, post-crisis it is among the lowest in the set of emerging markets with similar or lower per capita incomes.

[1] Prepared by P. Iossifov.

Sectoral Saving and Investment Rates

(Percent of GDP)



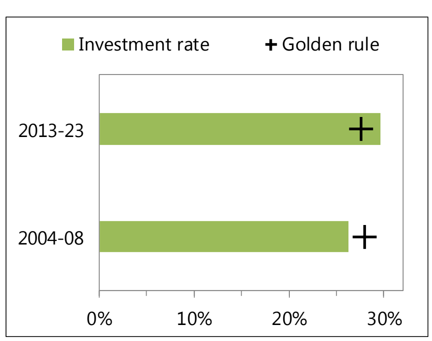
Sources: Eurostat and IMF staff calculations, and TurkStat.

Note: The denominators are gross disposable income for households and gross value added for corporates.

4. **Turkey's high investment rate relative to peers raises the question of whether it has overshot its fundamentals-consistent path in recent years.** The Ramsey-Cass-Koopmans neo-classical growth model provides a useful benchmark for the optimality of the observed investment rate. Results suggest that whereas the investment rate was below the "golden rule" benchmark before the global financial crisis, since 2012 it has been and is expected to remain higher than the optimal rate by about 2 percentage points over the medium term. Moreover, the post-crisis increase of the investment rate has been largely driven by construction. The sectoral breakdown of bank lending further suggests that a significant and rising share of construction activity is in the residential and retail trade sectors.

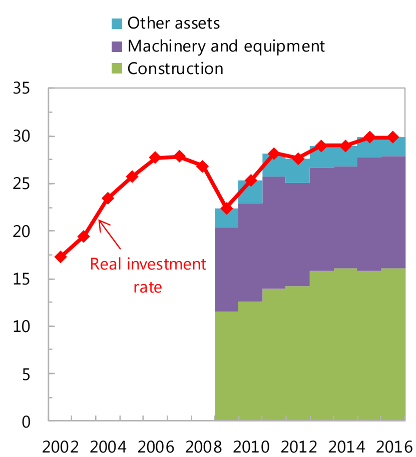
Actual vs "Golden-rule" Investment Rate Pre- and Post Crisis

(Percentage points)



Contributions to Investment Rate

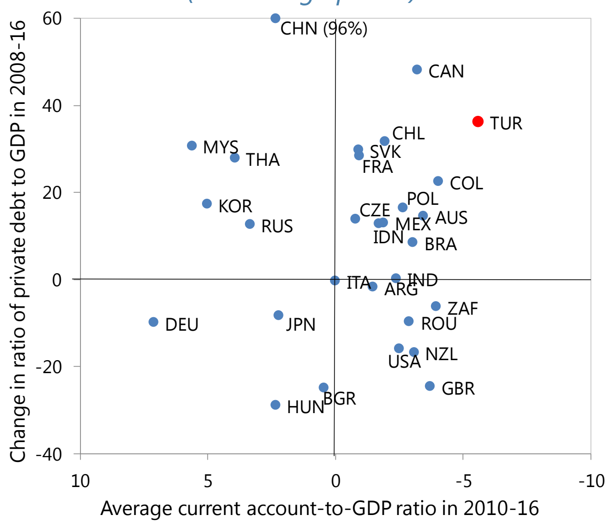
(Percentage points of GDP)



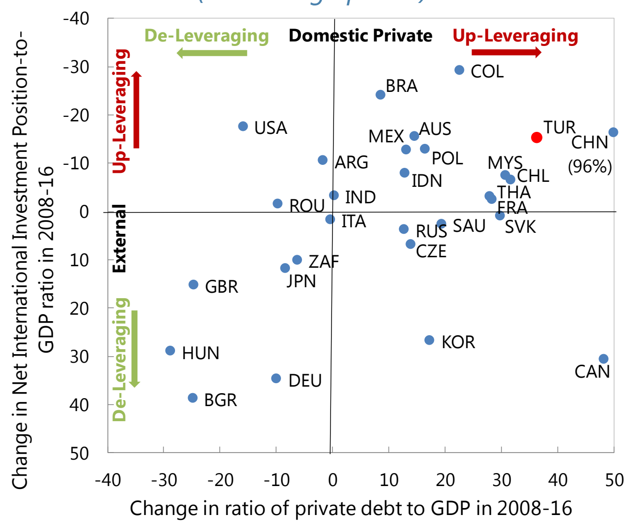
Sources: IMF staff estimations and TurkStat.

5. The domestic demand boom was financed by an increase in private debt, pushing Turkey in the top rank of countries by the post-crisis growth of private indebtedness. The rapid credit growth was in part financed by external borrowing, resulting in a deterioration of Turkey's NIIP.

Current Account and Debt Accumulation
(Percentage points)

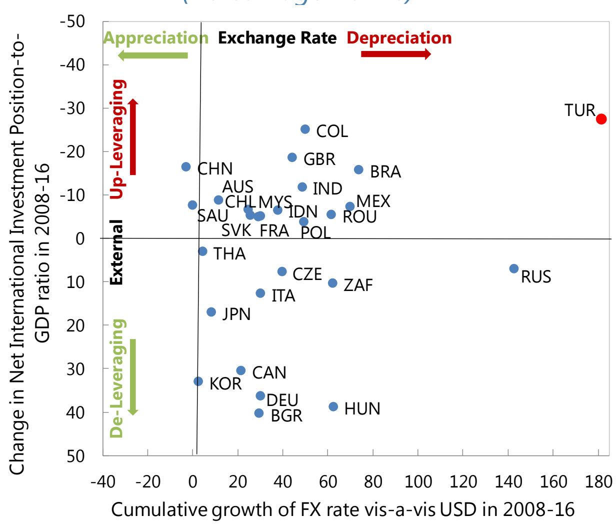


Changes in Private Debt and NIIP
(Percentage points)

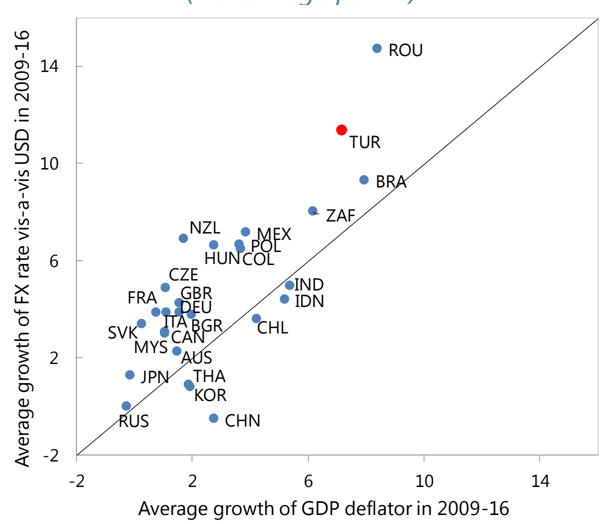


Sources: IMF WEO and IMF staff calculations.

Change in NIIP and Lira Depreciation
(Percentage Points)



Lira Depreciation and Growth of GDP Deflator
(Percentage points)



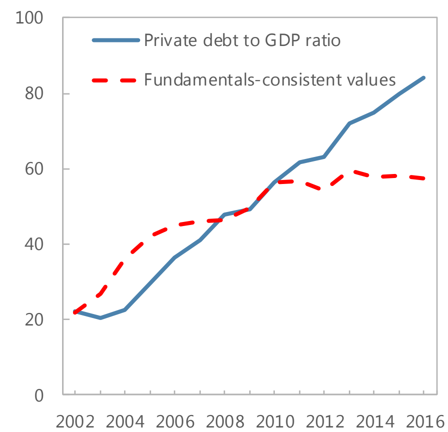
Source: IMF WEO and IMF staff calculations.

6. The increase in private debt and the worsening NIIP were also driven by the large depreciation of the Lira since the 2008 crisis. Until 2014, the Lira either appreciated or depreciated less than the growth of the GDP deflator, making it easier to service FX-denominated debt. The opposite has become the norm ever since, resulting in a sharp increase in the FX-debt burden.

The post-crisis rapid credit growth has opened a sizeable wedge between the level of private sector debt and those that would be justified by "fundamentals," proxied by time-varying benchmarks. Using as a reference the very long-run trend of credit-to-GDP ratio, the BIS estimates put Turkey's private credit gap at around 10 percent of GDP since 2007. In the May 2015 issue of the European Regional Economic Issues report,[2] Fund staff built upon this concept by using as the benchmark those components of long-run credit that can be explained by fundamentals. An update of this analysis suggests that Turkey's private credit gap has widened significantly since 2011, to more than 20 percent of GDP.

Private Debt Relative to Benchmarks

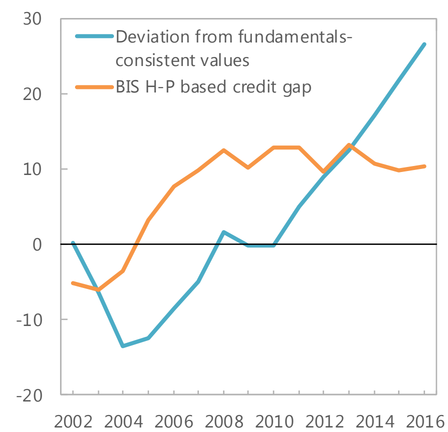
(Percentage points of GDP)



Source: BIS.

Private Credit Gap

(Percentage points of GDP)



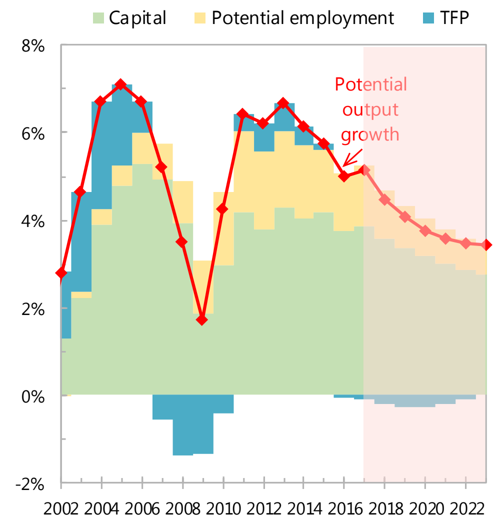
Sources: IMF WEO, IFS, and and IMF staff estimations.
Note: Long-run trend derived from one-sided H-P filter with a smoothing parameter of 400,000.

The statistical data revision does not change Fund staff's assessment of Turkey's external position and fiscal space. The upward revision of nominal GDP has lowered the estimates of fiscal, current account and debt-to-GDP ratios but the revised data also point to more limited debt servicing capacity, as measured by the ratios of fiscal and export revenues relative to the size of the economy. External and fiscal debt continue, therefore, to be sustainable, but the current account deficit is weaker than the level consistent with medium-term fundamentals and desirable policies.

[2] Iossifov, Plamen, 2015, "Estimation of the Private Sector Debt Level Consistent with Fundamentals," Annex IV IMF CESEE Regional Economic Issues, May.

Fund staff's estimate of potential growth is in the range of 3.5 to 4 percent—modestly higher than the estimate based on the old series. The upward revision of real GDP growth over 2011–2015 was accompanied by an even bigger increase in the estimate of capital inputs. This lowered to slightly negative territory the estimated average growth of productivity over 2007–17. The narrowing of various margins of development and the post-crisis lull in productivity-enhancing structural reforms suggest that low productivity is likely to persist in the coming years.

Contributions to Potential Output Growth, 2002-23 *(Percentage points)*



Sources: IMF staff estimations and TurkStat.

	Turkey	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. Turkey's net international investment position (NIIP) deteriorated significantly from -42 percent of GDP in 2016 to -53 percent of GDP at end-2017, a weak position relative to peers, reflecting a wider current account deficit and increased valuation of equity liabilities driven by rising equity prices more than offsetting the impact of Lira depreciation. 1/ Total foreign liabilities amount to 80 percent of GDP dominated by debt, which remains sustainable over the medium term. The improvements in debt maturity over 2015-16 have been slightly reversed due to the lower quality of inflows and risks remain significant, given that short-term debt and non-resident holding of domestic portfolio debt amount to around 25 percent of GDP. Debt service of the private sector is vulnerable to hikes in global rates with 40 percent of long-term debt being on adjustable interest rate terms. In addition, a large portion of private domestic debt is denominated in FX. **Assessment**. The composition of foreign liabilities exposes Turkey to liquidity shocks, shifts in investor sentiment, and increases in global interest rates. Turkey's NIIP is projected to deteriorate further by about 5 percentage points of GDP over the medium term due to sustained current account deficits. The FX component of domestic debt also comprises a balance sheet risk for corporates with the potential to worsen bank asset quality with a negative feedback on growth and financial stability.	**Overall Assessment** *In 2017, Turkey's external position was weaker than the level consistent with medium-term fundamentals and desirable policies. However, staff assesses the REER to be broadly in line with fundamentals, which should help converge the cyclically-adjusted CA norm towards its norm over the medium term.* Net international reserves are low, and the NIIP is projected to deteriorate further. Moreover, given large financing needs and a high share of short-term and portfolio inflows, Turkey remains vulnerable to capital flow reversals. **Potential Policy Responses** Vulnerabilities from the elevated external imbalances require tighter policies to address the dual deficits on the current account and fiscal sides. A tightening of fiscal, quasi-fiscal, and monetary policies will help rein in domestic demand and imports, while revisiting macroprudential policies will help improve the quality of external financing and lower risks from FX exposure in the economy. Fiscal policies should center on a credible medium-term fiscal consolidation plan to restore the strong fiscal anchor underlying macroeconomic stability. Monetary policy should aim at re-anchoring inflation expectations and building the credibility of the inflation target. A deceleration in credit growth is necessary to address the positive output and credit gaps and restore external sustainability. PPPs should be contained and aimed at critical economically viable projects. State loan
Current account	**Background**. The current account (CA) deficit widened sharply to 5.5 percent of GDP in 2017 (4.6 percent on a cyclically adjusted basis) though 1.1 percent of GDP was due to increased demand for gold against the backdrop of de-anchored inflation expectations and depreciation pressures. 2/ High import growth underpinned by strong domestic demand offset the growth in exports and recovery in tourism. The stimulus-backed recovery in domestic demand has led to the output gap turning positive in 2017 with signs of overheating. **Assessment**. The EBA model estimates that in 2017 the cyclically-adjusted CA was some 3.5 percent of GDP weaker than the level implied by medium-term fundamentals and desirable policies 3/. The external sustainability (ES) approach suggests that the CA deficit is broadly in line with fundamentals. Given the fickle nature of available CA financing, which has relied significantly on short-term and portfolio inflows, staff assesses that the CA gap to be in the range of -0.5 to -2.5 percent of GDP, with the gap primarily driven by policy factors. This is consistent with a CA norm in the range of -0.5 to -2.5 percent of GDP. 2/ 4/	
Real exchange rate	**Background**. In 2017, the average REER depreciated by 10 percent from the year before, standing 25 percent below its 2010 peak. The EBA REER level approaches suggests that the REER was broadly fairly valued in 2017 while the REER index approach suggests that the Lira was undervalued by around 9 percent. The EBA CA approaches point to an overvaluation in the REER of around 17.5 percent, while the ES approach suggest an REER broadly in line with fundamentals. **Assessment**. Staff assesses the REER to be broadly in line with fundamentals with the CA gap being mainly driven by policy gaps and delays in adjustment to REER depreciation. This is also supported by other measures of competitiveness including rising export shares and declining unit labor cost measures of the REER 3/. A scaling down of government quasi-fiscal and pro-credit growth activities would help strengthen the transmission of the sizable recent REER depreciation to narrowing CA imbalances.	
Capital and financial accounts: flows and policy measures	**Background**. The quality of financing weakened in 2017 with a decline in FDI and higher reliance on portfolio inflows into government and bank debt securities stimulated by carry trades. Turkish spreads have narrowed, but remain elevated relative to other large EMs. Rollover rates on non-financial corporate external loans declined earlier in the year as firms made more use of domestic credit supported by state guarantees, but has recovered since then. Turkey has not made use of capital controls on either inflows or outflows. **Assessment**. Following earlier improvements in the financing structure of the current account over 2015-16 with the start of credit deleveraging, the quality of financing has again deteriorated in 2017 as credit growth resumed, with increased reliance on volatile capital flows for external financing. Gross external financing needs are over 25 percent of GDP making Turkey vulnerable to adverse shifts in global investor sentiment.	

FX intervention and reserves level	**Background**. The de facto and de jure exchange rate is floating. The CBRT stopped selling foreign exchange to commercial banks in 2016 though it continues to provide direct sales of FX to energy-importing SOEs. Reserves have been impacted by several measures to support FX liquidity including 1-week FX deposit auctions, changes to the Reserve Option Mechanism aimed at releasing FX liquidity used for Lira reserve requirements, and discounted Lira exchange rates for export rediscount credit repayments. These measures have contributed to limiting the net inflow of FX into gross reserves, which have remained low at around \$108 billion USD at end-2017 (82 percent of the ARA metric) whereas net international reserves declined to \$31 billion USD. 5/ **Assessment**. Given the low reserve coverage of external financing requirements (less than half) and low net international reserves, further reserve accumulation is needed.		guarantees should be unwound over time and used only in cases where credit conditions are hampered by market failures. The CBRT should increase net international reserves, limiting interventions to periods of excessive Lira volatility. The combination of these policies would help external rebalancing without the need to rely on a weak exchange rate that is detrimental to the purchasing power of residents.
Technical Background Notes	1/ Despite persistent CA deficits, the NIIP has fluctuated with no clear upward trend over 2009–16, due to a mix of positive valuation effects and large net BOP errors and omissions. 2/ Due to significant data revisions and relevant changes in desirable policy parameters, the CA norms and gaps are not comparable with previous assessments. In December 2016, the Turkish Statistical Institute (TurkStat) announced a major revision of national accounts data. The revisions primarily affect 2009–15 data, with the 2015 nominal GDP having been revised up by 20 percent. Thus, the 2015 CA deficit and NIIP are now 0.7 and 9 percentage points of GDP lower than before, respectively. However, data revisions also imply lower export revenues relative to the size of the economy. 3/ Staff excludes the recent decline in the non-monetary gold trade balance from the calculation of the underlying current account deficit treating it as an one-off phenomenon. 4/ Staff's midpoint estimate of the CA norm range is around 2 percent of GDP lower than the estimated EBA CA norm. This reflects the significantly lower norm estimates obtained from the ES approach, which suggests a narrower CA gap than indicated by the EBA CA model. 5/ Net international reserves net out from GIR the CBRT's FX liabilities to banks. The latter includes the Reserve Option Mechanism (ROM), which allows banks to meet reserve requirements on Lira liabilities with foreign exchange and gold. The ROM balances are held at blocked accounts at CBRT for 14 days, and may be fully substituted with Lira liquidity after this maintenance period. Domestic banks may also use FX deposits at the CBRT as collateral for Lira liquidity facilities, including swaps with maturities of up to 1 month.		

Annex III. Risk Assessment Matrix[1]

	Source of Risks	Likelihood	Time Horizon	Impact	Policy Response
Global	**Retreat from cross-border integration.** A fraying consensus about the benefits of globalization lead to protectionism and economic isolationism, resulting in reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	Medium	Short to Medium Term	Low	• Efforts should continue to upgrade the Customs Union with the EU.
	Policy and geopolitical uncertainties: • **Policy uncertainty.** Two-sided risks to U.S. growth with difficult-to-predict policies; uncertainty associated with negotiating post-Brexit arrangements and associated market fragmentation risks; and evolving political processes, including elections in several large advanced and emerging market economies weigh on global growth.	Medium	Short to Medium Term	Low	• Preemptively increase FX reserves through sterilized intervention. • Use exchange rate as a shock absorber. • Allow automatic fiscal stabilizers to operate.
	• **Intensification of the risks of fragmentation/security dislocation in part of the Middle East, Africa, Asia, and Europe,** leading to socio-economic disruptions.	High	Short to Medium Term	High	
	Financial conditions: • **Tighter global financial conditions.** Against the backdrop of continued monetary policy normalization and increasingly stretched valuations across asset classes, an abrupt change in global risk appetite (e.g., due to higher-than-expected inflation in the U.S) could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases.	High	Short Term	High	• Preemptively strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights and provisioning on lending to NFCs in FX. • Tighten monetary policy. • To the extent the NIR level allows, use FX reserves to smooth volatility under disorderly market conditions. • Use exchange rate as a shock absorber. • Allow automatic fiscal stabilizers to operate.

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

	Source of Risks	Likelihood	Time Horizon	Impact	Policy Response
	Weaker-than-expected global growth: • **Significant China slowdown and its spillovers:** While ongoing efforts by the Chinese authorities to "de-risk" the financial system are welcome, too fast an adjustment and improper sequencing of actions may adversely affect near-term growth (low likelihood). Over the medium term, overly ambitious growth targets, including by over reliance on credit stimulus and investment, lead to unsustainable policies, reducing fiscal space, further increasing financial imbalances. A sharp adjustment would weaken domestic demand, with adverse international spillovers, including a pullback in capital flows to EMs.	**Low /Medium**	**Short to Medium Term**	**Medium**	• Use exchange rate as a shock absorber. • Allow automatic fiscal stabilizers to operate. • Structural reforms should aim at raising the economy's competitiveness. • Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports.
Domestic	**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**	• Tighten monetary policy and normalize the framework. • Tighten fiscal policy to bring it back into line with the medium-term program. Prioritize expenditure compression. • Structural reforms should aim at increasing underlying total factor productivity growth.
	Disorderly macro-financial cycle of deleveraging and income compression: • Turkey's sizeable estimated credit gap—capturing deviations of private debt from fundamentals—is prone to unwinding. This can trigger a vicious cycle between deleveraging and lower domestic demand, incomes, and asset prices. Possible triggers include domestic policy mistakes and/or external financing pressures giving rise to rapid exchange rate depreciation, which weakens corporate balance sheets and worsens bank asset quality, triggering sharp deleveraging and slowdown of economic activity.	**Medium**	**Short to Medium Term**	**High**	• Use exchange rate as a shock absorber, while preemptively building reserves to give space for FX liquidity support in the event of disorderly market conditions. • Allow automatic fiscal stabilizers to operate. • 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. • 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. • Robust debt-restructuring framework needs to be put in place in the medium-term.

Annex IV. Public Debt Sustainability Analysis

At about 28 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 should remain low over the medium term. The public DSA suggests that Turkey's government debt is sustainable under the baseline and various shock scenarios. Given the debt structure, the direct interest and exchange rate pass-through to the budget is relatively low. While all public debt profile indicators are below early warning benchmarks, high external financing requirements point to risks arising from the country's external debt position.

Baseline and Realism of Projections[1]

1. **Debt levels.** Turkey's debt-to-GDP ratio increased to around 28 percent at end-2016. Staff forecasts that the ratio will remain around this level over the medium term as the ongoing and projected fiscal expansion is broadly offset by the positive growth-interest rate differential.

2. **Growth.** Past projections of growth outcomes show significant forecast errors, possibly due to the high volatility of GDP in Turkey and the large national accounts revisions at end-2016. However, abstracting from the national accounts revisions, past growth projections do not seem to have any systematic bias that undermine the assessment of sustainability. Growth is expected to decelerate in 2018 but to continue to be strong in the run-up to the 2019 elections, before returning to its long-run potential of about 3.6 percent over the medium term. The output gap is estimated to remain positive throughout the projection period, driven by pro-cyclical policies. This, together with the high sensitivity of public debt to swings in GDP growth, highlights the relevance of growth shocks in the stress tests.

3. **Sovereign yields.** Turkey's yields remain volatile, although they are below the levels of 2016Q4. The spread against US bonds in the last three months remained on average at 289 bps, compared to its lowest value of 163 bps observed in May 2013. The effective interest rate has been stable at around 8¼ percent in 2017, and is expected to increase in the near and medium term due to the normalization of monetary policies in advanced countries.

4. **Fiscal adjustment.** In the baseline, the general government structural primary deficit is projected to increase from 1.7 percent of potential GDP in 2017 to 2.0-2.1 percent in 2018-19, driven mainly by pre-election spending pressures. In the medium term, the general government structural primary deficit is projected to be around 0.6 percent of potential GDP.

5. **Public debt profile.** Given the current public debt structure, the direct interest and exchange rate pass-through to the budget are small. Central government debt, which accounts for over 90 percent of public debt, has an average remaining maturity of 6.4 years. Fixed interest debt

[1] Compared to the 2017 IMF staff report, public debt and public gross financing needs, as a share of GDP, are substantially lower. This can be explained by the end-2016 revision of national accounts data.

accounts for about 74 percent share of total public debt, and around 39 percent of public debt is denominated in foreign currency. While indicators related to public debt are below the EM high-risk early warning thresholds, Turkey's debt profile is considered high risk with respect to the external financing requirements, which exceed the EM benchmark level of 15 percent of GDP.[2] This, together with moderate risks related to market perception and the share of public debt in foreign currency, points to vulnerabilities related to foreign investors' sentiments and external market conditions.[3]

Shocks and Stress Tests

6. The public DSA suggests that Turkey's government debt is sustainable under the baseline and under various shocks. Among all shocks and stress test scenarios, primary balance and interest rate shocks do not affect debt dynamics substantially. Meanwhile, growth, combined macro-fiscal, and contingent liability shocks lead to a prolonged increase in public debt.

- **Primary balance shock.** A deterioration of 1.2 percentage points of GDP in the primary balance over the next two years would raise the medium-term public debt level by around 1½ percentage points of GDP. Under this scenario, sovereign borrowing costs are also raised by 25 basis points for each 1 percentage point of GDP worsening in the primary balance. The impact on the debt-to-GDP ratio and gross financing needs levels by 2022 is modest.

- **Growth shock.** Real output growth rates are lowered by 1 standard deviation, or 4.4 percentage points, for 2 years starting in 2018.[4] The decline in growth leads to lower inflation. The primary balance deteriorates significantly compared to the baseline, as nominal revenues fall against unchanged expenditures, reaching -4¾ percent of GDP by 2019. This also leads to higher sovereign borrowing costs. The debt-to-GDP ratio increases to about 37 percent during the growth shock and remains around this level in the medium term. Gross public financing needs climb toward 9¼ percent of GDP before trending down to 7 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 845 basis points. The government's interest bill reaches an implicit average interest rate of 17¼ percent by 2022. The debt-to-GDP ratio climbs to around 32 percent, and gross public financing needs increase to around 7 percent of GDP by 2022.

[2] In the public DSA, external financing requirements are defined as current account balance, plus amortization of total short-term external debt at remaining maturity. Emerging market countries are deemed at high risks when external financing needs are above the 15 percent of GDP benchmark.

[3] Debt profile risks to be considered at moderate for EMs when the EMBIG global spread is between 200 and 600 basis points, and/or the share of public debt in foreign currency is between 20 and 60 percent.

[4] The substantial growth impact under this scenario is partly due to the large fluctuation in historical growth rates.

- **Combined macro-fiscal shock.** A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate, and interest rate). The combined macro-fiscal shock would put public debt on a continuous upward trend towards 46½ percent of GDP by 2022. Gross financing needs would also increase to around 10¼ percent of GDP in the medium term.

- **Contingent liability shock.** A one-time assumption of the contingent liabilities is assumed to increase non-interest expenditures by a hypothetical 10 percent of GDP.[5] This is combined with a 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 40 percent of GDP in 2018 and then only gradually increases towards 44 percent of GDP by end-2022. Gross public financing needs peak in 2018 before declining to about 8 percent of GDP in the medium term.

[5] The 10 percent of GDP shock could be seen to cover some combination of contingent liabilities that include (i) Treasury's outstanding external debt guarantees; (ii) investment guarantees; (iii) projected guarantees to the Credit Guarantee Fund (CGF); (iv) loans subject to the Debt Assumptions commitments; (v) estimates of PPP-related contingent liabilities; (vi) annualized costs from natural disaster; and (vii) others.

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

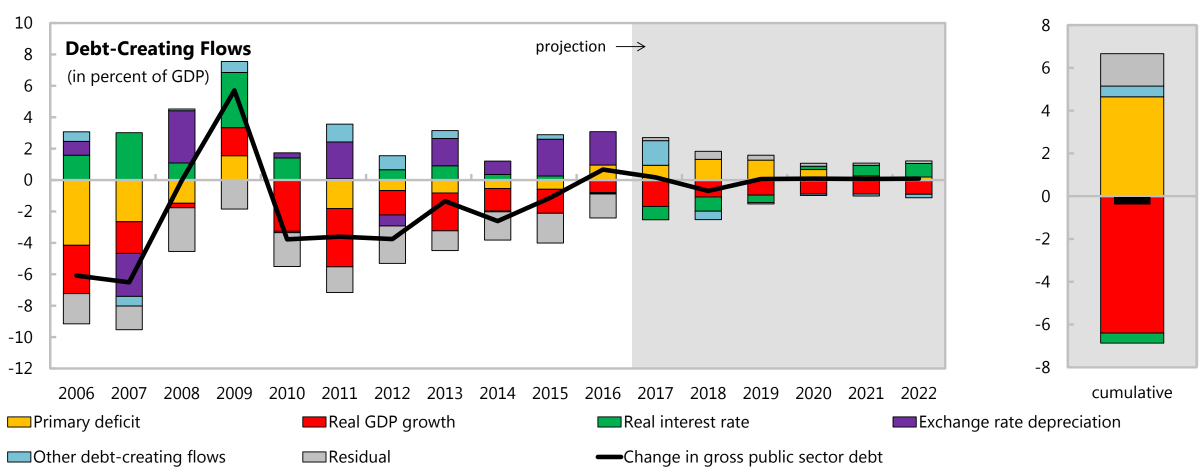
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of March 05, 2018		
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022	Sovereign Spreads		
Nominal gross public debt	37.1	27.6	28.3	28.5	27.8	27.9	27.9	28.0	28.1	EMBIG (bp) 3/		297
Public gross financing needs	12.4	4.7	5.3	5.1	5.6	5.1	5.7	5.0	5.1	5Y CDS (bp)		171
Real GDP growth (in percent)	5.1	6.1	3.2	7.0	4.4	4.0	3.6	3.6	3.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	7.7	7.8	8.1	11.0	11.6	11.1	9.3	8.2	7.8	Moody's	Ba1	Ba1
Nominal GDP growth (in percent)	13.3	14.4	11.5	18.8	16.5	15.5	13.3	12.0	11.7	S&Ps	BB	BB+
Effective interest rate (in percent) [4/]	11.9	9.3	8.2	8.2	8.4	9.6	10.5	11.2	11.6	Fitch	BB+	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.4	-1.1	0.7	0.2	-0.7	0.1	0.1	0.1	0.1	-0.2	
Identified debt-creating flows	-0.5	0.8	2.2	0.0	-1.2	-0.3	-0.1	-0.1	-0.1	-1.7	
Primary deficit	-1.2	-0.6	1.0	0.9	1.3	1.3	0.7	0.3	0.2	4.6	-0.3
Primary (noninterest) revenue and grants	31.7	31.7	32.1	30.9	30.2	30.3	30.4	30.6	30.7	183.1	
Primary (noninterest) expenditure	30.5	31.1	33.1	31.8	31.5	31.5	31.0	30.9	30.9	187.7	
Automatic debt dynamics [5/]	0.3	1.1	1.3	-2.5	-2.0	-1.4	-0.7	-0.2	0.0	-6.9	
Interest rate/growth differential [6/]	-0.4	-1.3	-0.8	-2.5	-2.0	-1.4	-0.7	-0.2	0.0	-6.9	
Of which: real interest rate	1.4	0.3	0.0	-0.9	-0.9	-0.5	0.2	0.7	0.9	-0.5	
Of which: real GDP growth	-1.8	-1.5	-0.8	-1.7	-1.1	-1.0	-0.9	-0.9	-0.9	-6.4	
Exchange rate depreciation [7/]	0.7	2.3	2.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	0.3	0.0	1.6	-0.5	-0.1	-0.1	-0.1	-0.2	0.5	
Public Sector: Privatization Proceeds & EU Def adjustments (negative)	-0.6	-0.5	-0.6	0.4	-0.3	-0.6	-0.5	-0.6	-0.7	-2.3	
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	0.9	0.8	0.6	1.2	-0.2	0.5	0.4	0.5	0.5	2.8	
Residual, including asset changes [8/]	-1.9	-1.9	-1.5	0.2	0.5	0.3	0.2	0.1	0.2	1.5	



Source: IMF staff.

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

2/ Based on available data.

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

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

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

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

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

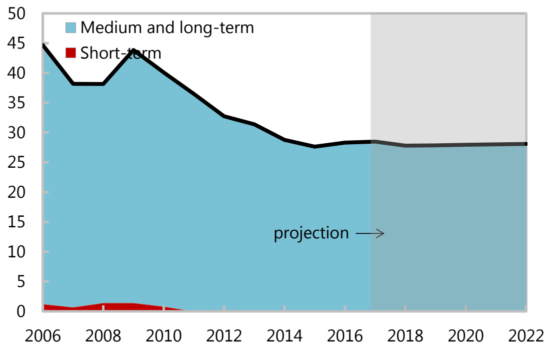
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

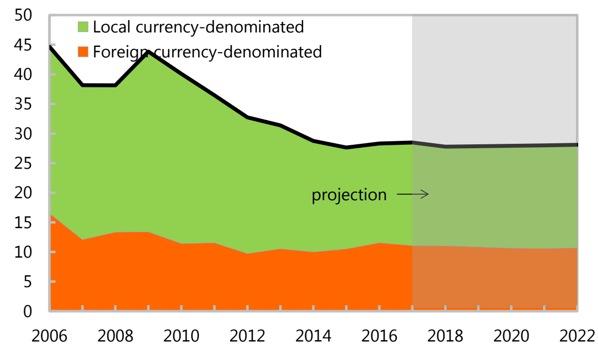
Turkey Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



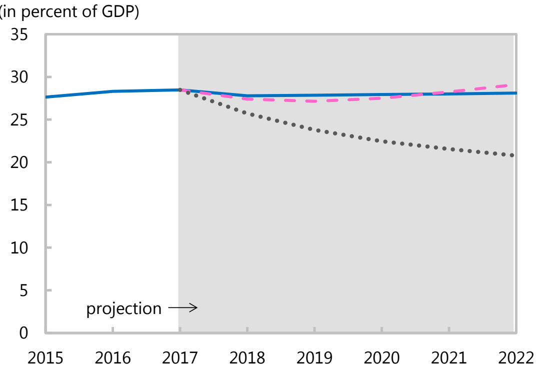
By Currency
(in percent of GDP)



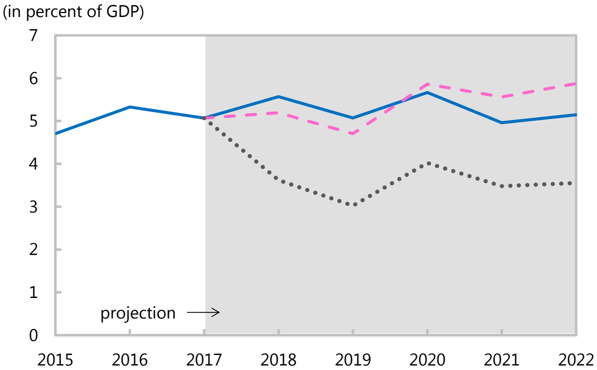
Alternative Scenarios

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	2017	2018	2019	2020	2021	2022
Real GDP growth	7.0	4.4	4.0	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	11.6	11.1	9.3	8.2	7.8
Primary Balance	-0.9	-1.3	-1.3	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.4	9.6	10.5	11.2	11.6
Constant Primary Balance Scenario						
Real GDP growth	7.0	4.4	4.0	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	11.6	11.1	9.3	8.2	7.8
Primary Balance	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Effective interest rate	8.2	8.4	9.5	10.4	11.2	11.6

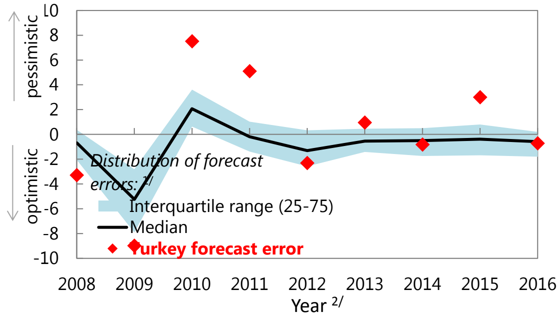
Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	7.0	4.8	4.8	4.8	4.8	4.8
Inflation (GDP, deflator)	11.0	11.6	11.1	9.3	8.2	7.8
Primary Balance	-0.9	0.6	0.6	0.6	0.6	0.6
Effective interest rate	8.2	8.4	9.7	10.9	12.1	13.0

Source: IMF staff.

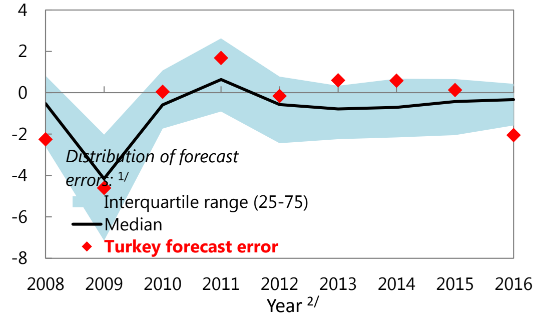
Turkey Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

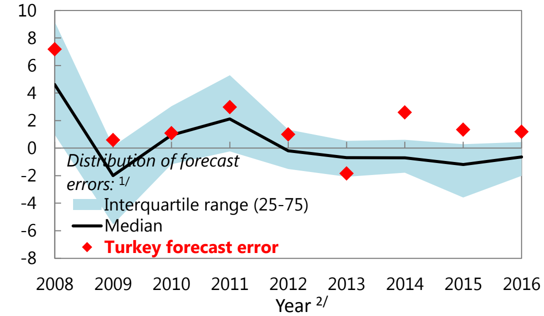
Real GDP Growth
(in percent, actual-projection)
Turkey median forecast error, 2008-2016: **-0.73**
Has a percentile rank of: **41%**



Primary Balance
(in percent of GDP, actual-projection)
Turkey median forecast error, 2008-2016: **0.04**
Has a percentile rank of: **81%**

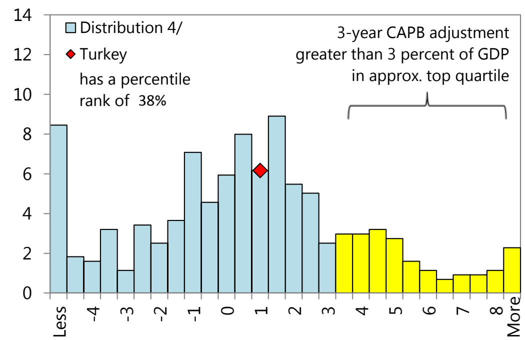


Inflation (Deflator)
(in percent, actual-projection)
Turkey median forecast error, 2008-2016: **1.20**
Has a percentile rank of: **83%**

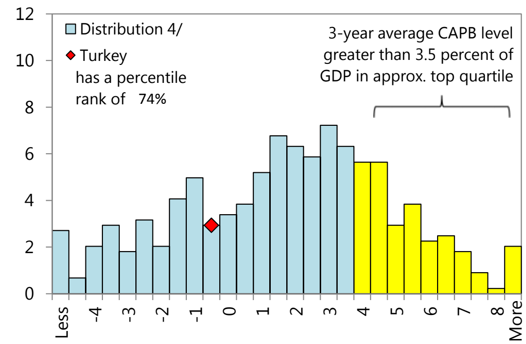


Assessing the Realism of Projected Fiscal Adjustment 3/

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



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



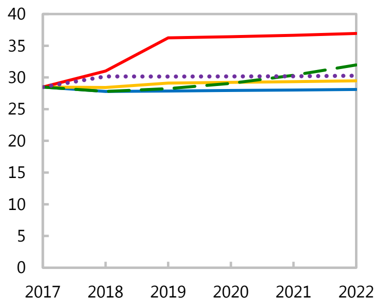
Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Boom-Bust Analysis does not apply to Turkey, as it meets neither the positive output gap criterion (i.e. a positive output gap in all year during 2014-16) nor the private credit growth criterion (i.e. private sector credit increase by more than 15 percentage points of GDP during 2014-16).
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

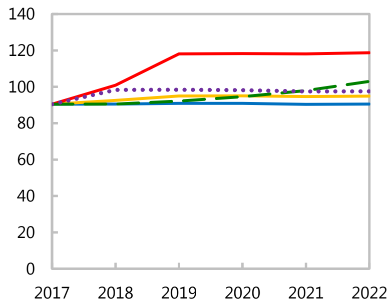
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

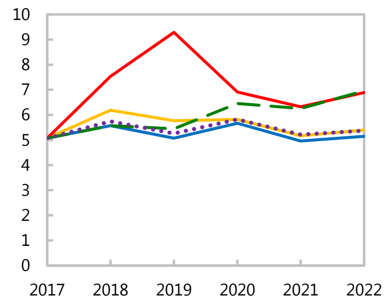
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



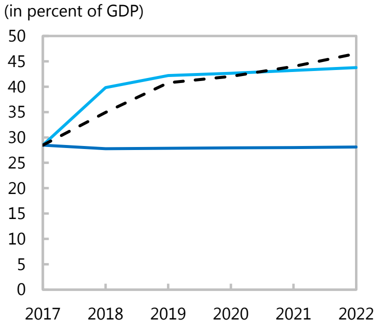
Public Gross Financing Needs
(in percent of GDP)



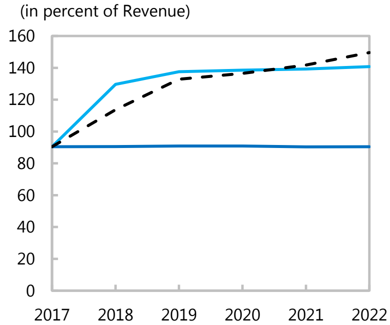
Additional Stress Tests

Baseline
Combined Macro-Fiscal Shock
Contingent Liability Shock

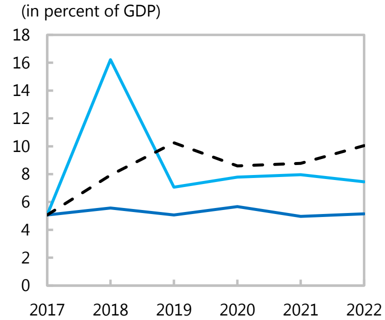
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	7.0	4.4	4.0	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	11.6	11.1	9.3	8.2	7.8
Primary balance	-0.9	-1.9	-1.9	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.4	9.7	10.6	11.3	11.7
Real Interest Rate Shock						
Real GDP growth	7.0	4.4	4.0	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	11.6	11.1	9.3	8.2	7.8
Primary balance	-0.9	-1.3	-1.3	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.4	11.1	13.5	15.7	17.2
Combined Shock						
Real GDP growth	7.0	0.0	-0.5	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	10.5	10.0	9.3	8.2	7.8
Primary balance	-0.9	-3.1	-4.8	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.9	10.9	13.9	15.8	17.2

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	7.0	0.0	-0.5	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	10.5	10.0	9.3	8.2	7.8
Primary balance	-0.9	-3.1	-4.8	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.4	9.8	11.1	11.7	12.0
Real Exchange Rate Shock						
Real GDP growth	7.0	4.4	4.0	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	16.8	11.1	9.3	8.2	7.8
Primary balance	-0.9	-1.3	-1.3	-0.7	-0.3	-0.2
Effective interest rate	8.2	8.9	9.0	9.9	10.7	11.1
Contingent Liability Shock						
Real GDP growth	7.0	0.0	-0.5	3.6	3.6	3.6
Inflation (GDP, deflator)	11.0	10.5	10.0	9.3	8.2	7.8
Primary balance	-0.9	-11.3	-1.3	-0.7	-0.3	-0.2
Effective interest rate	8.2	10.0	11.3	11.9	12.3	12.4

Source: IMF staff.

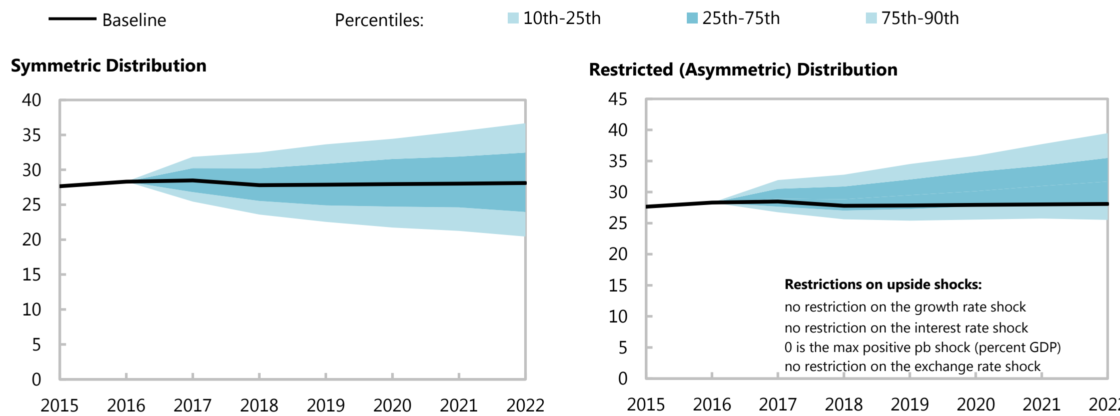
Turkey Public DSA Risk Assessment

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

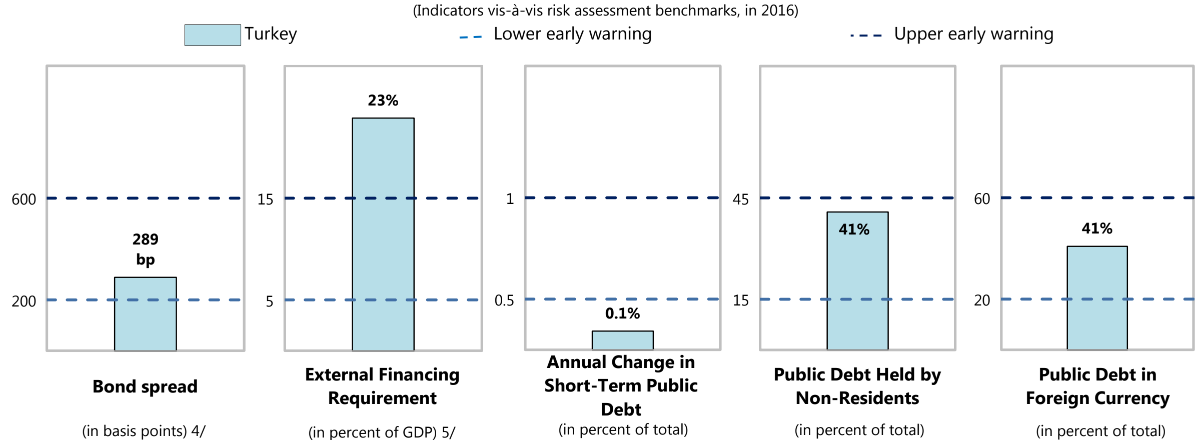
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

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

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 05-Dec-17 through 05-Mar-18.

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

Annex V. External Debt Sustainability Analysis[1]

Turkey's external debt, while sustainable, is high and vulnerable to valuation shocks. Under the baseline, debt is forecast to stabilize at around 52 percent of GDP in the medium term. However, it is susceptible to Lira depreciation and annual rollover needs of around 20 percent of GDP expose the economy to high liquidity risks.

Background and assumptions

1. **External debt continued to increase and is estimated to reach 53 percent of GDP in 2017.** The private sector comprises the bulk of external debt at 37 percent of GDP. A large share of the external debt, about 16 percent of GDP, resides with the banks which intermediate capital inflows into domestic loans, mostly in Lira but also in foreign currency. In addition, non-financial corporates are externally indebted by another 16 percent of GDP, around a third of which is short-term trade credits. Private creditors, including bondholders, hold close to 90 percent of debt.

2. **Earlier improvements in the external debt structure are being reversed.** After a period of deleveraging which helped reduce short-term external debt over 2015–16, short-term net inflows have now turned positive. Reduced FDI inflows have increased dependence on external borrowing to finance the wide current account deficit. Portfolio debt accounted for the bulk of net borrowing in 2017, with government net Eurobond issuance increasing sharply to over 5 billion USD. In addition, inflows into the government domestic debt securities market have added 10 billion USD to external debt. The government debt structure remains overall robust with an average maturity of 16 years. However, the private sector's external debt remains heavily short term and 40 percent of the debt is at adjustable rates.

Assessment

3. **Turkey's external debt, while sustainable, is vulnerable to valuation shocks.** The debt trajectory stabilizes under the baseline, and this result holds for minor changes in baseline assumptions. Standard stress tests suggest debt levels could increase substantially under a real depreciation shock. Given that over 90 percent of Turkish external debt is denominated in foreign currency, the debt path is susceptible to exchange rate movements. A permanent Lira depreciation of 30 percent would push the external debt stock to 83 percent of GDP by 2023, including about 60 percent of GDP of private debt. 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 a non-interest current account of about 5 percent of GDP would push the debt ratio above 60 percent of GDP over the medium term.

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[1] External debt sustainability analysis is based on the definition of external debt used by Undersecretary of Treasury, covering liabilities arising from loans obtained from non-residents and liabilities related to bonds issued in international capital markets. Government securities issued in Turkish Lira are excluded, while Eurobonds held by domestic banks (roughly one-third of the total) are included in this presentation of external debt. In net terms this is lower than the estimated external debt stock on a residency basis by about 1.1 percent of GDP as of end-2017.

Table 1. Turkey: External Debt Sustainability Framework, 2012–23
(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	2023	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	38.9	41.0	43.0	46.1	46.9			**53.2**	**54.1**	**54.6**	**54.3**	**53.6**	**52.9**	**52.1**	**-2.5**
Change in external debt	2.4	2.2	2.0	3.1	0.8			6.3	0.8	0.6	-0.4	-0.6	-0.8	-0.8	
Identified external debt-creating flows (4+8+9)	1.8	2.3	4.1	5.6	2.0			0.9	2.0	1.6	1.4	0.9	0.5	0.2	
Current account deficit, excluding interest payments	4.8	6.1	4.1	3.1	3.2			4.8	4.3	3.2	2.6	2.1	1.6	1.3	
Deficit in balance of goods and services	4.9	5.9	4.0	2.8	3.0			4.5	4.1	3.3	2.8	2.4	2.1	1.8	
Exports	23.5	22.0	23.6	23.1	21.7			24.7	26.0	26.2	25.9	25.7	25.4	25.1	
Imports	28.4	28.0	27.6	25.9	24.7			29.2	30.2	29.5	28.7	28.1	27.5	27.0	
Net non-debt creating capital inflows (negative)	-1.8	-1.1	-0.9	-1.2	-1.3			-1.3	-1.2	-1.2	-1.2	-1.2	-1.3	-1.3	
Automatic debt dynamics 1/	-1.2	-2.7	0.9	3.7	0.1			-2.6	-1.1	-0.5	0.0	0.1	0.1	0.3	
Contribution from nominal interest rate	0.7	0.6	0.6	0.6	0.7			0.7	1.1	1.5	1.9	1.9	2.0	2.1	
Contribution from real GDP growth	-1.7	-3.0	-2.2	-2.8	-1.5			-3.4	-2.2	-2.0	-1.9	-1.8	-1.8	-1.8	
Contribution from price and exchange rate changes 2/	-0.2	-0.2	2.5	5.9	0.9			...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.6	-0.1	-2.1	-2.5	-1.2			5.5	-1.2	-1.0	-1.8	-1.5	-1.2	-1.0	
External debt-to-exports ratio (in percent)	165.5	186.1	182.1	199.6	216.0			215.7	207.7	208.7	209.5	208.5	207.9	207.3	
Gross external financing need (in billions of US dollars) 4/	173.7	211.6	215.1	203.9	197.4			211.3	228.8	252.5	271.4	284.1	292.6	292.7	
in percent of GDP	19.9	22.3	23.0	23.7	22.9			24.9	25.1	26.3	26.5	26.1	25.3	23.9	
Scenario with key variables at their historical averages 5/						10-Year Historical Average	10-Year Standard Deviation	**55.2**	**58.2**	**60.8**	**63.3**	**65.8**	**68.3**	**70.9**	**-2.1** For debt stabilization
Key Macroeconomic Assumptions Underlying Baseline															
Real GDP growth (in percent)	4.8	8.5	5.2	6.1	3.2	4.8	4.4	7.0	4.4	4.0	3.6	3.6	3.6	3.6	
Exchange rate appreciation (US dollar value of local currency, percent change)	-6.8	-5.7	-13.0	-19.6	-9.9	-6.8	9.1	-17.2	-8.1	-8.5	-5.8	-5.2	-5.1	-5.2	
GDP deflator (change in domestic currency)	7.4	6.3	7.4	7.8	8.1	7.6	1.8	11.0	11.6	11.1	9.3	8.2	7.8	7.8	
GDP deflator in US dollars (change in percent)	0.2	0.3	-6.5	-13.3	-2.6	0.3	10.0	-8.1	2.6	1.7	2.9	2.6	2.4	2.2	
Nominal external interest rate (in percent)	1.9	1.7	1.4	1.3	1.4	2.1	0.8	1.6	2.2	3.0	3.7	3.7	3.9	4.2	
Growth of exports (US dollar terms, in percent)	12.0	2.1	5.4	-10.0	-5.6	5.4	13.5	11.8	12.9	6.3	5.6	5.5	4.9	4.6	
Growth of imports (US dollar terms, in percent)	-1.6	7.2	-3.1	-13.6	-4.2	5.4	19.1	16.4	10.6	3.4	3.6	4.1	3.8	3.8	
Current account balance, excluding interest payments	-4.8	-6.1	-4.1	-3.1	-3.2	-4.4	2.0	-4.8	-4.3	-3.2	-2.6	-2.1	-1.6	-1.3	
Net non-debt creating capital inflows	1.8	1.1	0.9	1.2	1.3	-0.1	1.6	1.3	1.2	1.2	1.2	1.2	1.3	1.3	

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).

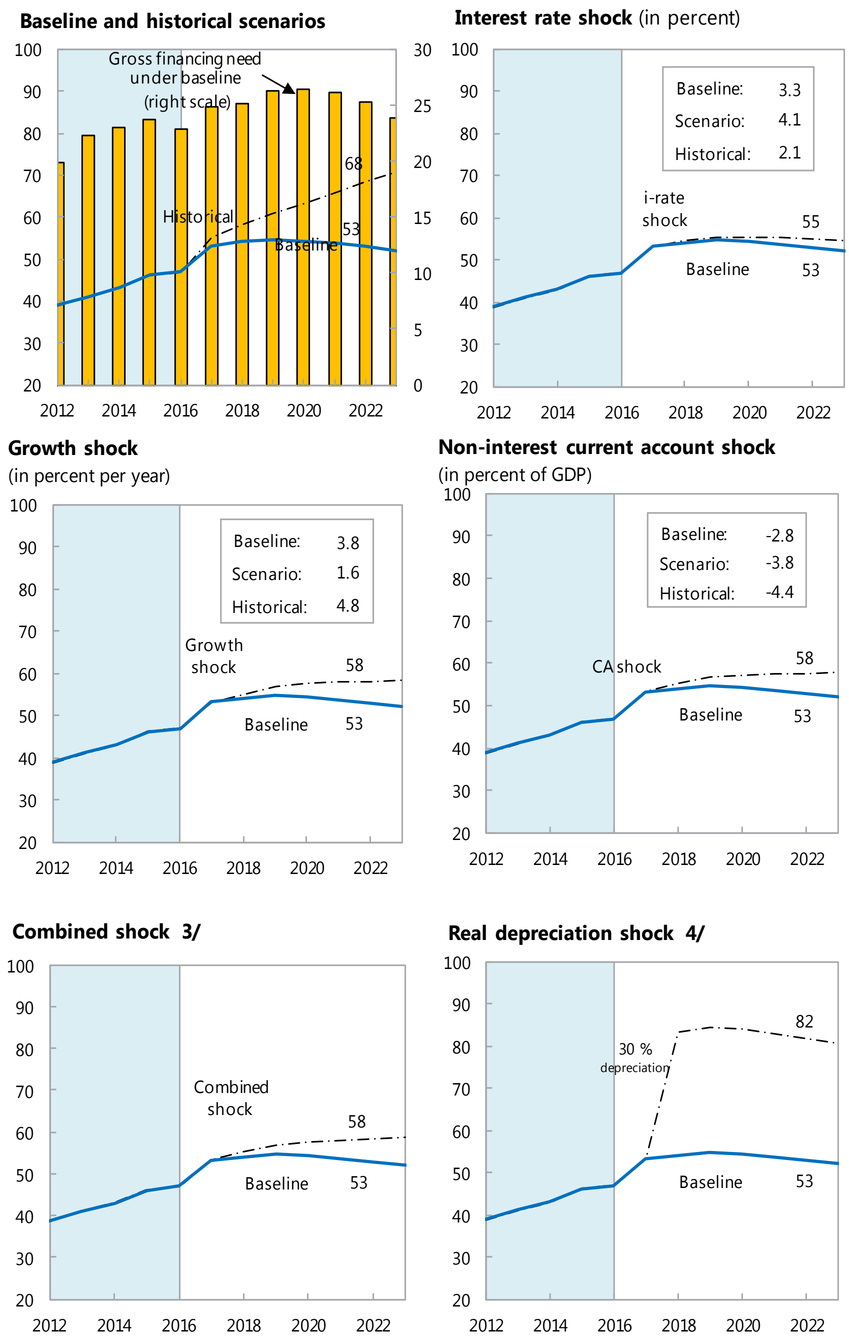
3/ For projections, line includes the impact of price and exchange rate changes.

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

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

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

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.

Annex VI. Implementation of Past Fund Advice

There has been increasing traction of Fund advice over the past year. Authorities' efforts to address risks—highlighted in past Article IV reports—stemming from the large, negative FX position of the economy will be supported by technical assistance, provided by the Monetary and Capital Markets Department, on bank and corporate risk analysis. In a similar vein, the joint recognition of the importance of proper monitoring and management of public sector contingent liabilities paved the way for a technical assistance mission, fielded by the Fiscal Affairs Department, on assessing fiscal costs and risks of Public-Private Partnerships. At the same time, however, advice on building up reserves and savings, by reducing uncertainty and improving the design of the private pension auto-enrollment, received less traction. Progress in normalizing the monetary framework was derailed by the large post-coup attempt depreciation bouts.

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

Table 1. Turkey: Progress in Implementation of FSAP Recommendations

Recommendations	Timing	Progress
Banking supervision		
Revise legislation to further strengthen BRSA independence	MT	**Not done.**
Deepen and broaden the risk assessment nature of banking inspection and follow up	MT	**In progress.** The supervisory approach and manuals were revised in 2016 and associated guidelines implemented in 2017, the risk assessment of banks strengthened in examination reports, a forward-looking component included in the CAMELS methodology, and the coordination between on-site and off-site functions enhanced.
Strengthen corporate governance rules and enforcement	MT	**In progress.** A revision of the internal system regulations to take into account the IOSCO and Basel principles is planned. The corporate governance assessment aspect of the supervisory process has been strengthened.
Evaluate and revise the definition of credit classifications and strengthen enforcement	ST	**In progress.** IFRS 9 implementation started in January 2018, and new credit classifications and provisioning rules more in line with international standards came into force.
Insurance supervision		
Improve independence, governance and accountability of supervisor; increase resources for internal control functions; integrate offsite, onsite and enforcement	ST/MT	**In progress.** A revision of the regulation on internal systems of insurance, reinsurance and pension companies and other related regulations is being prepared. Steps for

activities; develop risk-based, group supervision		establishing a compliance function within insurance companies and strengthening their risk management are being assessed. A qualitative supervisory assessment tool is being developed to assess insurers' risk management and internal control systems.
Systemic risk oversight		
Strengthen macro prudential measures to lower foreign exchange risk in the economy	I	**In progress.** The authorities have put in place measures to restrict new FX borrowing by SMEs, by introducing FX debt to FX income limits and banning new FX-indexed corporate loans starting in May 2018. The new framework contains a number of exemptions and covers just 16 percent of FX borrowers. Based on a granular assessment of Q1 2018 corporate data and surveys, the authorities plan to extend the scope of these measures and tailor them to the rest of corporate FX borrowers in 2018.
Strengthen FSC's governance and powers, provide explicit financial stability objective to all members, and limit Council of Minister's role	ST	**Not done.**
Develop procedures for improved systemic risk assessment and coordination of macroprudential policies: agree to table policy proposals for ex ante FSC discussion and request formal responses to recommendations	ST/MT	**In progress.** A systemic risk monitoring working group has been established under the FSC, and is responsible for the identification of systemic risks, including through the use of stress tests. Efforts to coordinate the stress tests of CBRT and BRSA are ongoing. The CBRT is aiming at incorporating liquidity and corporate stress tests in its current framework, with the support of forthcoming IMF technical assistance.
Base choice of policy tools on integrated assessment of systemic risk and cost-benefit analysis of alternative options	ST	**In progress.** Two working sub-groups were established in 2017 under the systemic risk assessment group: (i) the systemic risk monitoring working group and (ii) the crisis and management and resolution working group. A heat map system has been put in place to facilitate a more integrated risk assessment system.
Strengthen transparency (including FSC publishing an Annual Report)	ST	**Not done.**
Managing systemic liquidity		
Orient liquidity provision towards a single key policy rate	I	**Not done.** The CBRT has shifted its liquidity provision from the policy rate facility to the more expensive late liquidity window (LLW).
Increase net reserves such that gross reserves are within the range of 100-150	MT	**In progress.** Gross reserves are at 82 percent of the ARA metric. In November 2017, the

percent of the Assessment of Reserves Adequacy (ARA) metric		CBRT introduced the use of non-deliverable forwards to manage the demand for FX and hedging by banks and corporates as a way to manage volatility without depleting reserves.
Improve ELA capacity; redefine CBRT FX lending facility as ELA and increase conditionality	ST	**In progress.** Following technical cooperation with other central banks and the ECB, the regulation on liquidity support credit and best country practices will be discussed by the crisis management and resolution working group.
Financial crisis management		
Strengthen recovery and resolution planning and enhance resolution powers by: (i) Strengthening the banking law; (ii) Developing guidance.	MT	**In progress.** Recovery and resolution amendments are being prepared by SDIF and BRSA in a joint task force, which received technical assistance from the World Bank. Draft legislation has been prepared.
Strengthen domestic and cross-border coordination arrangements	ST	**In progress.** A domestic crisis management and resolution working group was established in 2017 under the systemic risk assessment group that operates under the FSC. No significant progress reported on cross border coordination arrangements.
Anti-money Laundering/Combating Financing of Terrorism (AML/CFT)		
Determine reason for low money laundering (ML) conviction rates and plan to address them	MT	**In progress.** The Financial Crimes Investigation Board (MASAK) has taken steps to increase its operational capacity (by increasing the number of staff), and has been undergoing a National Risk Assessment Project since 2016.
Introduce customer due diligence requirements for politically exposed persons	ST	**In progress.** Draft legislation has been prepared in order to cover the PEP concept more fully.
Ensure compliance with requirements of the United Nations Security Council Resolution (UNSCRs), and strengthen border controls on currency transportation	MT	**In progress.** With respect to the UNSCRs, the Turkish authorities are waiting for their National Risk Assessment results. With respect to currency transportation, a circular on passenger accompanied outgoing cash movements has been prepared, and training of customs personnel has been increased. Turkish customs are also working on further IT and operational capacity improvements.

INTERNATIONAL MONETARY FUND

TURKEY

March 16, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(Data as of March 5, 2018)

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 March 5, 2018.

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	965.89	90.16

Outstanding Purchases and Loans

None

Latest Financial Arrangements

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

Projected Payments to the Fund[1/]

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

	Forthcoming				
	2018	2019	2020	2021	2022
Principal	--	--	--	--	--
Charges/Interest	0.83	0.83	0.83	0.83	0.83
Total	0.83	0.83	0.83	0.83	0.83

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

Safeguard Assessments

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

Exchange Rate Arrangement:

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

Article IV Consultations:

Board discussion of the last Article IV staff report took place on January 11, 2017. The Article IV staff report (IMF Country Report No. 17/32) was published on February 3, 2017.

FSAP

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

Resident Representative

The IMF currently has a resident representative office in Ankara. Mr. 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	February 3, 2017	Country Report No. 17/35

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
FAD	December 2017	Public-Private Partnerships (PPP)
FAD	January 2018	VAT Policy Issues

WORLD BANK RELATIONS

1. Turkey and the WBG have a strong partnership that is outlined in the recently prepared WBG Country Partnership Framework (CPF). The CPF is aligned with Turkey's 10th National Development Plan, as well as the development priorities highlighted in the WBG's 2016 Systematic Country Diagnostic (SCD), which described the main challenges to reducing poverty and sustaining growth in Turkey. The CPF outlines the WBG's strategy for FY18–21 and articulates the main areas of WBG engagement, both technically and financially.

2. The CPF proposes a mix of instruments, drawing on the strengths of the International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA).

A. International Bank for Reconstruction and Development

3. Turkey is IBRD's sixth-largest borrower in terms of debt outstanding, representing 6.85% of all IBRD loan outstanding. Turkey's active portfolio of investment operations with the World Bank's IBRD financing includes 13 projects with total net commitments of US$3.9 billion (as of January 2018). The investment portfolio and pipeline support a range of sectors, with programs both underway and planned in the energy sector, financial and private sector development, urban development, social protection and inclusion, labor market development, and health care. IBRD financing for FY18-21 is estimated at $5-7.5 billion, although actual lending volumes will depend on client demand, choice of instrument, overall performance during the CPF, IBRD's financial capacity, and demand from other IBRD borrowing countries.

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 extensive range of knowledge products has started to shift to a more programmatic approach that will include multi-year and multiple output delivery activities. Knowledge services inform policy in various reform areas (education, health, labor, energy) and are the Bank's primary instrument for engaging and broadening ownership through joint preparation and close cooperation with all stakeholders (human development, investment climate, gender certification in employment, sustainable urban development).

5. A key engagement also concerns the Syrian refugees living in Turkey. The WBG is partnering with the EU's Facility for Refugees in Turkey (FRiT) and providing assistance in social support and adaptation, labor markets and the economy, and education, as well as in the crosscutting areas of data collection, measurement, and monitoring. In addition to the FRiT funds, the portfolio is also supported by a broad set of Trust Funds: the most notable being the Clean Technology Fund, EU IPA Funds, and SIDA Gender Funds. The role of Recipient Executed Trust Funds in Turkey portfolio is expected to further grow from its already increased status, due to the active and pipelined EU FRiT projects, in education, labor and other engagement areas.

B. International Finance Corporation

6. Turkey is the second largest country in IFC's global portfolio after India. IFC's investments in Turkey are focused on energy, municipal and transport infrastructure, and financial institutions, with an emphasis on energy efficiency, municipal finance, access to finance for SMEs and women entrepreneurs, deepening capital markets, improved private healthcare and education, and enhanced competitiveness for Turkish firms, including expansion to other emerging markets. Through its investments, IFC continues to offer longer maturity, higher environmental and social standards, better corporate governance, and its considerable global knowledge and experience.

7. Under the new strategy, IFC will strive to address the key binding constraints to the development of Turkey's private sector, with a particular focus on boosting productivity at individual and firm levels through investing in private healthcare, education, municipal services, R&D, sustainable and renewable energy; and through supporting innovative, high-tech and export-oriented companies and SMEs. Given the current macroeconomic backdrop, IFC will place priority on local currency financing and hedging to help mitigate its clients' foreign exchange risks. In addition to bank financing, non-bank financial institutions, and alternative-innovative capital market instruments will be leveraged to help deepen and diversify capital markets, and hence help ensure stable sources of long-term financing and secure sustainable growth. During the previous CPS, IFC invested a record of US$ 4.55 billion—of which US$ 3.58 billion was for IFC's own account and US$ 973 million in mobilization—in 84 projects across sectors.

C. Multilateral Investment Guarantee Agency

8. Turkey is MIGA's largest country by gross exposure, representing almost 14 percent of MIGA's gross portfolio. MIGA's portfolio in the country comprises a number of projects in the infrastructure, financial, and services sectors with gross exposure of US$2.7 billion (as of January 2018). 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 March 5, 2018)

I. Assessment of Data Adequacy for Surveillance
General: Data provision to the Fund is broadly adequate for surveillance purposes, despite some shortcomings especially in national accounts and government finance statistics.
National Accounts: Published data for 2009 onwards adheres to the standards of the *System of National Accounts 2008 (2008 SNA)/The European System of Accounts 2010 (ESA 2010).* The Turkish Statistical Institute (TURKSTAT) compiles and disseminates a comprehensive set of national accounts series, including quarterly Gross Domestic Product (GDP) at current prices and in chain-linked volume terms (production approach and expenditure approach); quarterly and annual GDP at current prices (income approach); financial and non-financial sectoral accounts; regional accounts; and supply and use tables. In December 2016, TURKSTAT published a new series of national accounts, with reference year 2009 and base year 2012. Quarterly national accounts are published with a 2-3 month lag. Since the end-2016 revision, annual GDP is estimated independently from the quarterly estimates and is published with a 9-12 month lag. The end-2016 dissemination of rebased national accounts led to a significant upward revision of GDP. The previous GDP series presented significant weaknesses, and many changes were introduced, including improvements in methodology, the adoption of the *2008 SNA/ESA 2010*, and the use of new data sources. IMF Statistics Department continues to work with TURKSTAT to clarify questions raised on the rebased series. TURKSTAT plans to disseminate a set of rebased high frequency indicators, including the use of new data sources.
Price Statistics: The consumer price index (CPI) and the producer price index (PPI) generally conform to international standards. The CPI has 2003 as base year and the weights are based in Household Budget Survey conducted yearly by TURKSTAT. The PPI is compiled for mining, manufacturing, and utilities. A separate PPI is disseminated for agriculture.
Government Finance Statistics: Coverage of the budget is largely complete. Data for some fiscal operations conducted through extra budgetary funds are available only with some lags. Fiscal analysis is further complicated by some quasi-fiscal operations carried out by state banks, state economic enterprises (SEEs), and other public entities; and technical problems associated with consolidating the cash-based accounts of governmental entities with the accrual-based accounting of SEEs. It is difficult to reconcile fiscal data with monetary and BOP data, especially in the accounting of external debt flows and central government deposits. The latest data available for publication in the *Government Finance Statistics Yearbook* are for 2016 and cover the general government sector and its subsectors with coverage of both stocks and flows, including a full general government balance sheet. Quarterly general government data

on an accrual basis, including revenue, expenditure, financing, and balance sheet data, are reported for publication in *International Financial Statistics (IFS)*.	
Monetary and Financial Statistics: The Central Bank of Turkey (CBRT) reports monetary statistics for the central bank, other depository corporations, and other financial corporations, using the standardized report forms (SRFs), which accord with the concepts and definitions set out in the IMF's *Monetary and Financial Statistics Manual*.	
Financial sector surveillance: The Banking Regulatory and Supervision Agency (BRSA) reports all 12 core FSIs and nearly all the encouraged FSIs on a quarterly basis.	
External sector statistics: The CBRT compiles and disseminates balance of payments and international investment positions (IIP) statistics on quarterly basis in broad conformity with the conceptual framework of the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6)*. The CBRT participates in the IMF's surveys on direct and portfolio investments, and reports data template on international reserves and foreign currency liquidity regularly. In addition, the CBRT started reporting the currency composition of IIP to STA recently.	
II. Data Standards and Quality	
Turkey has subscribed to the Special Data Dissemination Standard (SDDS) since 1996.	The latest Data ROSC was published in September 2009.

Turkey: Table of Common Indicators Required for Surveillance
(As of March 5, 2018)

	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	Mar. 2018	03/05/2018	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb. 2018	03/01/2018	W	W	W		
Reserve/Base Money (narrow definition)	Feb. 2018	03/01/2018	W and M	W and M	W and M	O, O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Feb. 2018	03/01/2018	W and M	W and M	W and M		
Broad Money	Feb. 2018	03/01/2018	W and M	W and M	W and M		
Central Bank Balance Sheet	Feb. 2018	03/01/2018	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Feb. 2018	03/01/2018	W and M	W and M	W and M		
Interest Rates[2]	Feb. 2018	03/01/2018	D/W/M	D/W/M	W/M		
Consumer Price Index	Feb. 2018	03/05/2018	M	M	M	O, LO, O, LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2017Q3	Jan. 2018	Q	Q	Q	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Jan. 2018	Feb. 2018	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jan. 2018	Feb. 2018	M	M	M		
External Current Account Balance	Dec. 2017	02/14/2018	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Dec. 2017	02/14/2018	M	M	M		
GDP/GNP	2017Q3	12/11/2017	Q	Q	Q	O, LO, O, O	LO, O, LO, O, LO
Gross External Debt	2017Q3	2017Q4	Q	Q	Q		
International Investment Position[6]	Dec. 2017	02/21/2018	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.

Statement by Mr. Omer Bayar, Alternate Executive Director on Turkey and Mr. Faith Dogan, Advisor to the Executive Director on Turkey
March 30, 2018

On behalf of the Turkish authorities, we would like to thank staff for the comprehensive set of reports which reflect the candid and constructive discussions in Ankara and Istanbul. The authorities appreciate the thorough policy dialogue and staff's assessments.

Macroeconomic Context

Growth regained momentum with strong employment generation. In the wake of a period of significant headwinds, the authorities entered 2017 with a recalibrated policy mix to stave off emerging contractionary pressures, and buttress lingering confidence. As such;

- Fiscal policy was used judiciously and on a strictly measured basis to preserve the production and employment base via targeted transfers, investment and employment incentive schemes, temporary tax breaks, and an emphasis on key public investment programs upgrading the education, health, energy, transportation and telecommunications infrastructure – including through public-private-partnerships (PPPs). All in all, the drag on Turkey's public indebtedness is estimated to be very limited as the general government debt to GDP ratio is expected to remain at around 28.5 percent as of end-2017.

- The Credit Guarantee Fund (CGF) was restructured and scaled up to provide Treasury guarantees to a portfolio of TL 250 billion (about USD 65 billion) for a period of 3 years. In designing the CGF, the authorities (i) aimed to support the ailing credit market against the backdrop of substantial economic and non-economic uncertainties, (ii) uphold the market dynamics as key marketing, due diligence, and liquidity decisions are retained within the banking system, and (iii) carefully contain the contingent fiscal liabilities by imposing a 7 percent ceiling on the possible Treasury assumptions of problematic loans, which effectively limits the maximum fiscal burden to about USD 4.5 billion over a three-year period. The authorities appreciate the analyses by the staff on the CGF and its impact on various macroeconomic indicators, and see these analyses broadly in line with their own assessments, particularly as regards the contributions to 2017 growth. Beyond being an effective anti-recessionary tool, the CGF is also seen by the authorities as an instrument to address the inherent market failures owing to the prevailing uncertainties and information asymmetries stemming from a conflux of shocks in 2016, including a failed coup attempt.

Buoyed by these supportive policies as well as a more favorable external backdrop, the Turkish economy rebounded very strongly last year with an estimated growth of around 7 percent, placing Turkey among the top performers among major economies. Continuing its impressive track record post-global recession, employment generation was robust again in 2017 as 1.6

million new jobs were added throughout the year. Notwithstanding these impressive outcomes, the magnitude and pace of the economy's response went beyond what the authorities had envisaged as growth targets in their initial (i.e. covering 2017 – 2019) and revised Medium-Term Programs (i.e. covering 2018 – 2020) - which are 4.4 percent and 5.5 percent, respectively.

Despite the strong export performance and rapid recovery in the tourism sector, the current account deficit has widened from 3.8 percent in 2016, to an estimated 5.5 percent of the GDP in 2017. Exports (fob) increased by 10.2 percent, driven among other factors by the firm recovery in trading partners, notably in the EU; and net tourism receipts soared by 26 percent, reflecting mainly a significant improvement in broader security and geopolitical conditions. Nevertheless, imports (cif) inched further by an increase of 17.7 percent, on account of buoyed domestic demand, deteriorating terms of trade and a significant uptick in net gold imports - reaching USD 10 billion (more than 1.1 percent of GDP) last year. On the financing side, solid investment appetite towards Turkish equities and bond markets bore the brunt of net external funding needs.

Consumer prices edged up by 11.9 percent (y-o-y / end-2017), while recent inflation readings show signs of moderation. In view of the rising inflationary pressures, the Central Bank of Republic of Turkey (CBRT) tightened the monetary stance, and the weighted average funding cost has risen by almost 500 bps throughout 2017. Despite this substantive policy tightening, the exchange rate pass-through of previous bouts of Turkish lira depreciation, recovering global energy commodity prices and continued pressures from food prices have fueled inflation up. Headline CPI inflation recently lost momentum, as the y-o-y inflation receded to 10.3 percent in February 2018 on account of favorable base effects, and dissipating first-round pressures from FX pass-through.

Outlook and Policies

The Medium-Term Program[1] 2018-2020 (MTP), announced in October 2017, is appropriately geared towards promoting strong and inclusive growth while ensuring macroeconomic stability, taming inflation, and reducing external imbalances.

The authorities, while envisaging a gradual moderation in the program period, are more sanguine on the growth outlook. GDP growth is expected to moderate to 5.5 percent in 2018 and onwards – slightly higher than staff's forecast – more in line with the potential of the economy. In view of the rising inflationary pressures and widening current account deficit, the authorities see a gradual moderation in growth, conducive to the rebalancing of the economy. That said, the authorities disagree with the staff on the estimate of the potential growth rate and thus, the precise cyclical position of the Turkish economy. While acknowledging the fact that estimating potential output is a daunting task and that pinpointing a precise number is not possible, the authorities see the discussion on potential growth as a crucial one that would underpin the direction of the entire policy debate. Particularly at the current juncture, where widening imbalances have accompanied a year of very strong growth, identifying the dynamics

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

at play and putting forward an accurate diagnosis could not be more important. The authorities see the current staff range estimate of 3.5 – 4.0 percent for potential growth as too conservative, in light of the following considerations:

- Historically, since the establishment of the Republic, the Turkish economy has managed to record an average real growth rate of about 4.8 percent per annum. More recently, in the period 2011 – 2016, the average growth rate of the economy soared above 6.4 percent per annum. While acknowledging the forward-looking nature of potential output estimates, the authorities see a disconnect between the staff projections and Turkey's past growth trajectory.

- Methodologically, the authorities concur that the recent episode of growth in Turkey relied primarily on factor (i.e. capital and labor) accumulation, and that the non-factor residual (a.k.a *Solow residual*) remained subdued, at times negative. The authorities, however, attribute the recent subdued trend of the *Solow residual* to a number of economic and non-economic shocks that have hindered effective allocation and utilization of resources in the economy, and thus, argue that this phenomenon is transitory and could not be extrapolated to a negative long-run total factor productivity (TFP) contribution to growth. The authorities further believe that an adjustment to staff's negative TFP growth estimates that would simply take into account Turkey's past 15 years' TFP growth average (i.e. close to 1 percent per annum) or an international benchmark based on peer countries with similar convergence potential could materially raise staff's potential output estimates.

- Judgmentally, the authorities observed that some of the assumptions by the staff on the respective contribution of labor to output were too conservative and in particular, failed to duly incorporate a sustained increase in the female labor force participation and thus, the active population growth rate. Reflecting the facts that (i) average years of schooling in Turkey are fast converging to the OECD average on the back of 12-year compulsory schooling, (ii) at all levels of education, female students now constitute about half of the student cohorts, and (iii) female labor force participation is strongly correlated with educational attainment – reaching above 70 percent among university graduates; the authorities envisage a higher path for labor contribution to long-run output. Staff assumptions on population and labor also beset the calculated optimal investment rate.

The current account deficit will be contained. The authorities closely monitor the developments on the current account and put external rebalancing as one of the key policy objectives. The MTP set the official target for the current account deficit at 4.3 percent of GDP in 2018. Under a set of assumptions that would include (i) moderation of growth from its current levels, (ii) a reversion of net gold trade towards its historical averages (USD 1.5billion), (iii) no material terms of trade shock, (iv) continued recovery of the tourism sector and shuttle trade, (v) continued export performance underpinned by *inter alia* firm trading partner growth and increased competitiveness, the authorities see the MTP target attainable.

The authorities also concur with the staff on the need to accumulate international reserves towards more comfortable levels, as financing conditions permit.

Monetary Policy

Inflation is projected to moderate. The authorities appreciate the staff's work on re-estimating the Philips Curve for the Turkish economy. They see that the rise in the headline inflation in Turkey can be mainly attributable to core inflation – which *inter alia* reflects pass through pressures from previous bouts of lira depreciation, and to exogenous supply-side issues epitomized by Turkey's structural reliance on energy imports, and inherent inefficiencies in the food supply-chains. The CBRT estimates the output gap to move towards negative territory in the second half of 2018 and assumes continued moderation of credit growth as the CGF gradually tapers, implying limited inflationary pressures from the demand side. The authorities also see the strong monetary-fiscal policy coordination help keeping administered price inflation at low levels.

Against this backdrop, the authorities see their current monetary policy stance tight enough to contain broad inflationary pressures and allow for a gradual easing of the inflation to single-digit levels this year (with the current end-year inflation estimate standing at 6.5 – 9.3 percent). Recent developments in exchange rates and oil prices have led to upside risks to this forecast, but the monetary policy maintains a tightening bias and is ready to further tighten policy stance if needed. The authorities also pursue a gradual shift towards a simpler policy framework, with all funding executed from a single facility, implying an effective policy rate of 12.75 percent. Interbank rates have converged to CBRT funding rate and the predictability of monetary policy has improved considerably. In broad agreement with the staff assessment that the cost of disinflation in Turkey has recently edged higher, and taking into account the nature of the shocks to the economy, the authorities opt for a more gradual, but steady convergence towards the target inflation.

Beyond the cyclical drivers of inflation, the authorities are determined to continue to address the root causes of the supply-side hindrances to price stability, notably from energy and food. With respect to energy, in line with the Development Plan objectives, measures to break structural dependence on energy imports continue. As for example, the share of renewable sources (including hydro) in electricity generation in Turkey has already surpassed 30 percent of the energy mix, with further significant investments in generation capacity in the pipeline. Beyond their obvious climate-related benefits, these steps will also help alleviate inflationary inertia and current account pressures. On a similar note, the Food and Agricultural Products Markets Monitoring and Evaluation Committee continues to monitor food prices and take necessary measures to curb undue price changes, including by selective relaxation of import quotas.

Fiscal Policy

The fiscal policy stance will be growth-friendly, and fiscal prudence - the linchpin of the Turkish economy's resilience - will be maintained. Fiscal policy, which was at the forefront of the supportive policies in 2017, was gradually recalibrated in lockstep with the strength of the economic activity. In addition to the time-bound elements of the fiscal stimulus that expired in the second half of 2017, the authorities also took steps to restrain expenditure growth, while windfall revenue gains improved the year-end central government budget deficit - expected to be realized as 1.5 percent of GDP - below the official estimates of the revised MTP (i.e. 2 percent).

Consequently, the public debt-to-GDP ratio in EU definition is estimated to remain broadly stable at around 28.5 percent, putting Turkey among the top performers in its peer group.

Even though debt sustainability is not a source of concern, fiscal discipline will remain intact to complement the monetary policy's efforts to tame inflation. The 2018 central government budget, adopted by the Parliament, aims to strike a delicate balance between bolstering growth potential and allowing for a gradual rebalancing of the economy. The budgetary emphasis on capital spending, SME incentive schemes, and R&D expenditures will support growth. The authorities were puzzled about the specific staff recommendation to refrain from backward wage indexation, as in a year when nominal GDP is expected to grow by about 19 percent, the public sector wage bill has contracted in nominal terms, limiting the relevance of such an emphasis. Given the declining share of labor in the overall output of Turkey, they also could not reconcile this advice with the emerging emphasis of the Fund on income inequalities.

On the quasi-fiscal activities and contingent liabilities, the authorities closely monitor the developments on the state loan guarantees, including under the portfolio guarantee scheme (CGF), and do not expect a material impact on the fiscal balances. Under the portfolio guarantee scheme, they see the existing safeguards, particularly the loan assumption ceiling of 7 percent of the portfolio, as sufficiently prudent. For transparency purposes, the authorities also budgeted a contingency (i.e. about 0.1 percent of GDP) for fiscal year 2018 to cover potential assumptions by the Treasury. On PPPs, the authorities appreciate the analyses by the staff as well as a very productive TA mission in December 2017. The authorities will continue to improve assessment, monitoring, reporting and management of the PPP portfolio, including by improving the legal framework, as needed. On the Sovereign Wealth Fund (SWF), the authorities assured staff that they will adhere to the international best practices in accounting of its activities once it will become operational.

Financial Sector

The Turkish banking system is well-capitalized with strong liquidity buffers and asset quality. The capital adequacy ratio of 16.8 percent (latest data - as of January 2018) remained well above the regulatory minimum. The total non-performing loan ratio was stable around 3 percent, thanks to robust economic activity, momentum in credit growth and portfolio guarantees by the CGF. As an early indication of the asset quality of the CGF-backed loans, the NPL ratio currently stands at less than 0.5 percent. By regulation, banks are not allowed to carry net open FX positions and therefore, the balance sheet of the banking system is effectively immune from direct effects of currency valuation, including through appropriate hedging. The 13-week annualized rate of credit growth has slowed down to 12.9 percent recently, signaling a moderation.

The authorities have announced a new protocol for the use of remaining CGF-backed loans (TL 55 billion), with a new set of criteria ensuring a more selective targeting towards mostly manufacturing and export-oriented companies – to account for about ¾ of the new loans, and female and young entrepreneurs.

The corporate sector has weathered well the impacts of the Turkish lira depreciation. There are a number of factors mitigating the FX risk of the corporate sector: (i) Most firms with FX liabilities are either hedged or have a natural hedge in the form of FX revenues or FX receipts from other group of firms in a holding company. (ii) FX loans are concentrated in large companies with the capacity to absorb the impacts of large FX depreciation. (iii) The corporate sector has its net FX long position in the short term. (iv) Offshore FX assets held by firms act as a buffer in times of stress. (v) The share of FX loans in corporate loan volume fell as companies shift to TL financing in the face of FX depreciation.

Nevertheless, with an eye on the macro stability implications, the authorities are determined to use macroprudential measures to curb FX borrowing by non-financial corporates. As a first step in this direction, the authorities put in place a new regulation effective as of May 2, 2018 that will introduce a ceiling (i.e. equivalent to the total of preceding 3 years' FX receipts) to the FX borrowings of small- and medium- sized enterprises. Although these enterprises account for less than 20 percent of the FX-denominated loan stock, they were deemed as a priority group, given their limitations for effective corporate risk management. To supplement these efforts, the authorities are now working on a more comprehensive prudential framework for containing large corporates' FX exposures, which is expected to be announced this year. Following these steps, the macroprudential framework on FX borrowing will cover all major balance sheets of the economy – banks, households, and non-financial corporates.

Structural Reforms

There is strong political ownership and resolve to implement comprehensive structural reforms in an effort to improve the Turkish economy's competitiveness, strengthen its resilience to external shocks, and address impediments to job creation and investments. Against a very challenging backdrop, authorities managed to secure progress in labor market, business environment, public administration and finance, and judicial and education systems through their reform steps in the last couple of years. Authorities acknowledge the need for renewed reform momentum and have identified *inter alia* the following as their reform priorities:

- Labor Market: Severance pay reform, enhancing active labor market programs, boosting on the job training

- Public Finance: Income Tax Code, Tax Procedures Code, VAT reform, extending the Treasury single account coverage, public expenditures reform

- Capital Markets: Capital Markets Law, Istanbul Finance Center reform, restructuring the private pension system, introduction of new savings and investment instruments (e.g. housing accounts, and gold lease certificates)

- Public Personnel Reform: Civil Service Code

- Education: Increasing share of private sector, lifelong education centers, prioritization of foreign language learning, establishing an academy for teachers, introducing compulsory pre-school education, improving vocational and technical education

- Investment Climate and Competitiveness: Boosting R&D and innovation, easing regulatory burden, access to finance, improving logistics, establishing the Localization Board, restructuring the Scientific and Technological Research Council of Turkey (TÜBİTAK) and the state-owned development bank

International Development Efforts and Refugees

Turkey, reflecting its growing economy and connectivity, has been an important cornerstone of stability in its region and beyond. Turkey has also significantly ramped up its global humanitarian outreach in support of the UN Sustainable Development Goals, with its total development assistance reaching USD 7.9 billion in 2016, making it one of the most generous countries globally.

Turkey continues to host about 4 million refugees and caters to more than 600,000 beyond its borders, making it the largest refugee-hosting and supporting country. Significant efforts and funding were mobilized to establish high-standard refugee camps along with essential public services, including education and health. The authorities continuously take measures to integrate refugees to social and economic life, including through granting work permits. Authorities, while recognizing the challenges facing Syrian refugees in the labor market, see those mostly stemming from market dynamics, rather than administrative restrictions. Turkey and the EU continue to cooperate on the refugee matters.

Final Remarks

The Turkish authorities are grateful for the analytical depth and rigor of the Article IV consultations and associated policy advice, which will carefully be assessed. Authorities will continue to work closely with the Fund, including through targeted Technical Assistance that would support key policy and reform initiatives.