TURKEY

Highlights

- **The economy risks a hard landing.** Measures undertaken by the government to revive consumption and investment led to a surge in domestic demand in 2017 and early 2018, but overheating concerns became evident as inflation surged to 15-year highs in 2018 and the current account deficit expanded to over 6 per cent of GDP.
- **The lira has depreciated substantially and remains volatile.** Concerns over macroeconomic imbalances and geopolitical tensions led the lira to depreciate by over 40 per cent at one point since the start of 2018. While aggressive monetary tightening has reversed some of the depreciation, the currency has remained volatile.
- **There has been limited progress in structural reforms.** Over the past year, economic policy has mainly focused on reviving consumption and investment. The recent New Economic Programme (NEP) sets out credible proposals for structural reform for the coming three years, but the government's commitment to implementation remains to be seen.

Key priorities for 2019

- **Efforts to achieve macroeconomic stability and rebalance the economy need to be sustained and structural reforms prioritised.**Coordination between fiscal, macroprudential and monetary policies needs to be ensured and structural reforms aiming to increase domestic savings, productivity and exports need to be reinvigorated.
- **Competitiveness of the private sector needs to improve.** Despite increasing resources being devoted to research and development, the innovative capacity of the private sector remains moderate. Designing policies and devoting more resources to improve commercialisation, strengthen access to finance and train and retain qualified research personnel would increase the competitiveness of the private sector.
- **Labour market reforms should be reinvigorated, in particular those promoting regional, gender and youth inclusion.** Turkey's young, entrepreneurial population is an unexploited asset. It has large geographic disparities, high numbers of refugees, low female labour force participation and high youth unemployment. Expanding education and training opportunities and access to finance would enhance long-term growth prospects and inclusion.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	5.2	6.1	3.2	7.4	3.6
Inflation (average)	8.9	7.7	7.8	11.1	15.0
Government balance/GDP	-1.1	-1.0	-1.1	-1.5	-3.4
Current account balance/GDP	-4.7	-3.7	-3.8	-5.6	-5.7
Net FDI/GDP [neg. sign = inflows]	-1.4	-2.1	-1.5	-1.3	-1.3
External debt/GDP	43.5	46.7	47.8	53.3	n.a.
Gross reserves/GDP	12.9	12.6	13.7	13.0	n.a.
Credit to private sector/GDP	59.9	62.9	65.7	66.5	n.a.

CONTINUES

Macroeconomic performance

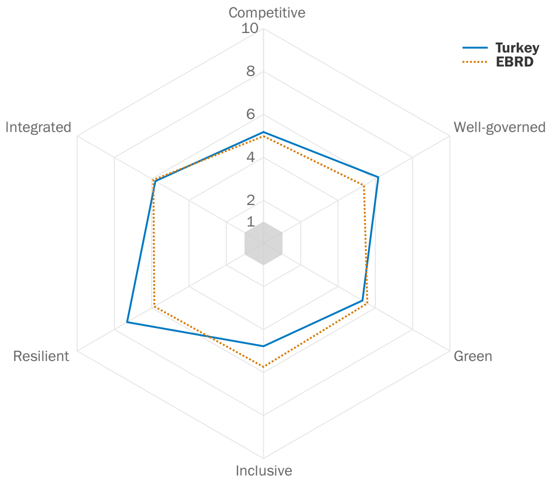
The economy grew rapidly in 2017 and early 2018 through stimulus measures. The Turkish economy grew by 7.4 per cent in 2017 and by 6.2 per cent in the first half of 2018, on the back of various stimuli provided by the government, including an expansion of government-backed credit guarantees to small and medium-sized enterprises (SMEs) under the TRY 250 billion (US$ 40 billion) Credit Guarantee Fund (CGF) and major public infrastructure projects. This led to a surge in private consumption and investment, raising overheating concerns as inflation rose to a 15-year high of almost 25 per cent in September 2018 and surging imports drove a steep decline in net exports.

Domestic and external imbalances have increased. The current account deficit grew despite the depreciating currency, as stimulus-driven domestic demand and rising oil prices pushed up imports. Gross external financing needs are around 25 per cent of GDP in 2018, leaving the country exposed to changing global liquidity conditions. Fiscal loosening in the run up to the elections in June 2018 caused concern among investors, so it is important that the significant tightening proposed in the NEP is implemented.

The Turkish lira has been extremely volatile in 2018. A heavy dependence on foreign capital, a wave of tightening monetary policy in advanced economies, a lack of domestic policy clarity and geopolitical tensions all led to rapid depreciation of the lira, which at one point lost around 40 per cent of its value against the dollar since the start of 2018. Stock markets have also taken a hit, with the BIST 100 index at one stage falling 25 per cent below the record highs attained earlier in 2018.

Growth is expected to slow down in the short term and a hard landing is increasingly likely. The lira's depreciation and interest rate hikes are likely to impact consumption and investment, despite some positive contribution from net exports. A sharp slow-down in the second half is expected to bring growth in 2018 down to 3.6 per cent, followed by 1.0 per cent in 2019. The key risk to the outlook is uncertainty regarding the banking sector but other risks include the direction of economic policy, the ongoing moderation in global liquidity and further depreciation of the lira. Important and long-overdue structural reforms need to be undertaken to improve competitiveness and to achieve external rebalancing to generate sustainable growth.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Reform progress has been limited, but new measures are in the pipeline. The government has been preoccupied with bureaucratic reorganisation amid the transition from a parliamentary to presidential system following the June 2018 elections, while economic policies have focused on containing the impact of the currency crisis. In September the government announced the NEP, which outlined reforms for increasing flexibility and inclusion in the labour market, improving the stability of the financial system and the efficiency of the justice system.

The government is taking steps to improve the business environment. A reform bill focusing on improving elements of the business environment, such as starting a business, enforcing contracts, paying taxes and resolving insolvency, was introduced in early 2018. This has helped Turkey improve its ranking in World Bank's *Doing Business 2019* report by 17 places to 43rd out of 190 countries compared with the previous year. Meanwhile, the government announced plans to considerably expand the scope of e-government applications by the end of 2018.

The government has introduced targeted incentives to the manufacturing sector. In March 2018 the government introduced a comprehensive incentives package for 23 investment projects in sectors or products with high trade deficits, in order to reduce the current account deficit in the medium term. The supported projects are in metallurgy, defence, petrochemicals, renewable energy and machinery and are eligible for a large range of support measures including tax exemptions, interest rate subsidies and land allocation support.

Employment incentives have been expanded. The government has increased the social security and tax incentives provided to firms for new hires, with an emphasis on female, young or disabled employees, in an effort to promote inclusion of vulnerable groups. Meanwhile, efforts to increase labour market flexibility and domestic savings by updating the existing severance pay system have run into problems with labour unions and are currently stalled.

The regulatory framework on foreign exchange borrowing has been tightened and the government has introduced a number of restrictive measures to address currency instability. The government has adopted a more restrictive approach in order to address potential risks arising from foreign currency mismatch of SMEs borrowing in currencies other than Turkish lira. The regulatory agency has introduced regulations to limit short-selling of the lira by investors. Legislation requiring exporters to convert transaction revenues into lira was introduced. Lastly, a presidential decree aiming to reduce dollarisation has introduced significant restrictions to foreign currency-denominated contracts between Turkish residents.

Reforms of the banking sector and capital markets continue. Regulation has been introduced to allow publicly owned banks to sell non-performing loans to asset management companies. Also, the Capital Markets Board reduced the minimum share of stocks required to be offered to institutional investors in initial public offerings, which is expected to encourage companies to list domestically instead of listing abroad in countries with more flexible regulations. Moreover, the government has also presented plans to set up a higher agency for financial regulation in the new parliamentary term starting in October 2018.