TURKEY

Highlights

- **The economy has rebounded in 2017.** This is largely due to the impact of various stimuli provided by the government to boost the economy and the strong performance of exports. Measures undertaken by the government to revive consumption include VAT cuts on durable consumer goods and a TRY 250 billion (US$ 70 billion) Credit Guarantee Fund.
- **Monetary policy has been tightened.** This has primarily been achieved by restricting funds available at central bank auctions, requiring banks to borrow through the late liquidity window which has a high rate of interest. As a result, the lira, which had depreciated substantially against the US dollar in the second half of 2016, has recovered in value, reflecting also increased portfolio inflows.
- **There has been some progress in structural reforms.** The government's focus in recent months has been on short-term measures to lift growth. However, the 2016 Action Plan remains valid, and structural reform priorities include increasing labour market flexibility, reform of Turkish Railways, energy security and efficiency, efficient infrastructure financing (for example, public-private partnerships), enhancing private sector competitiveness, deepening local capital markets and promoting regional, gender and youth inclusion.

Key priorities for 2018

- **The government's structural reform agenda needs to be reinvigorated.** The resilience of the economy could be enhanced by further capital market development, in particular by increasing the low domestic savings rate, expanding the small institutional investor base and enhancing foreign participation in the corporate bond market.
- **Enhancing inclusion could increase the competitiveness of the Turkish economy.** Youth unemployment is high, female labour participation is low and there has been a significant influx of refugees from Syria. Their further integration into the economy is important in order to ensure long-term sustainable growth. Regional inclusion would also be helped by a reform and streamlining of the highly complex and costly agribusiness support system.
- **Further infrastructure development is needed.** The current centralised system of investment planning for local infrastructure should be reviewed, and action taken to speed up the delivery of capital investments. Further work is also required to develop a single and overarching public-private partnerships (PPP) law.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	8.5	5.2	6.1	3.2	5.1
Inflation (average)	7.5	8.9	7.7	7.8	10.9
Government balance/GDP	-1.0	-1.1	-1.0	-1.1	-2.1
Current account balance/GDP	-6.7	-4.7	-3.7	-3.8	-4.6
Net FDI/GDP (neg. sign = inflows)	-1.4	-1.4	-2.0	-1.4	-1.3
External debt/GDP	41.1	43.0	46.2	46.9	n.a.
Gross reserves/GDP	13.8	13.7	12.9	12.6	n.a.
Credit to private sector/GDP	60.7	63.8	66.9	70.3	n.a.

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Macroeconomic performance

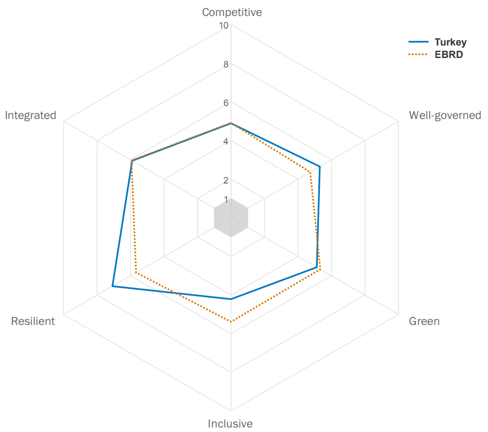
Growth has picked up strongly in 2017. The economy grew by a below-potential 3.2 per cent in 2016. This was due to Russian sanctions on tourism and trade, the decline in agricultural production due to unfavourable weather conditions, along with the negative effect of the failed military coup attempt in July 2016 on consumption and investment and the subsequent state of emergency. Growth has picked up strongly in 2017, reaching 5.1 per cent year-on-year in the first half of 2017, as net exports picked up and domestic demand surged with the help of a series of stimulus measures introduced by the government. These include VAT cuts on durable consumer goods, incentives on payroll taxes and social insurance premiums and an expansion of government-backed credit guarantees to small and medium-sized enterprises under the TRY 250 billion (US$ 70 billion) Credit Guarantee Fund (CGF).

The currency has rebounded. The impact of the failed military coup attempt and the strong performance of the US dollar caused the lira to depreciate substantially against the dollar in the second half of 2016, falling around 27 per cent between July 2016 and the end of January 2017. This, in turn, caused inflation to spike, reaching 12 per cent in April 2017. Actions taken by the central bank to raise the cost of funding to banks (notably restricting availability of funds at its regular auctions, forcing banks to borrow at the high interest rate late liquidity window), and increased portfolio inflows in common with the overall trend in emerging markets, have helped the lira to recover and bring inflation under control. As of October 2017 the lira is around 20 per cent below its July 2016 level against the US dollar, and inflation moved back into single digits in July 2017, although it has risen to double digit figures again since then.

Large external imbalances remain. The current account deficit has been declining in recent years, from 6.7 per cent of GDP at the end of 2013 to around 4.1 per cent of GDP at the end of the second quarter of 2017, as lower oil prices have given rise to a declining energy import bill and exports picked up. However, gross external financing needs to cover the current account deficit and external debt repayments due within a year are estimated at around 25 per cent of GDP in 2017, leaving the country exposed to global liquidity conditions.

Short-term growth is expected to remain robust. Thanks to the stimulus provided by the government, growth is expected to recover to around 5.1 per cent in 2017. However, credit has been growing at a rate of around 20 per cent year-on-year since January 2017 and the loan-to-deposit ratio in lira has exceeded 140 per cent. Thus, the limits to credit-driven growth will likely soon be reached, and the CGF is almost exhausted. In this context, withdrawal of the stimulus is expected to cause growth to weaken in 2018 to around 3.5 per cent. Furthermore, the stimulus has increased the budget deficit from 1.1 per cent of GDP at the end of 2016 to around 2.0 per cent in June 2017, giving rise to concerns about the government's hitherto-strong reputation for fiscal prudence.

Assessment of transition qualities (1-10)



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Major structural reform developments

There has been some progress in structural reforms in the past year. Economic policies have primarily focused on providing short-term fiscal stimulus. Nonetheless, the government remains committed to implementing the reforms outlined in the 2016 Action Plan, which aims to improve the business environment and growth. Transforming the legal framework to comply with the constitutional amendments adopted in the April 2017 referendum has occupied an important part of the legislature's agenda, while the executive branch has focused on countering the short-term impact of the failed coup attempt in July 2016.

Measures to improve infrastructure quality and private sector participation in the sector have advanced. Secondary legislation to liberalise rail transport was introduced in August 2016. Preparations to privatise highways, bridges and ports have continued, and large public transport and infrastructure projects are ongoing. However, investment planning for local infrastructure remains highly centralised and delivery of capital investments is slow. Despite a good track record of PPP deals, Turkey lacks a single PPP law, which limits the reach of this financing mechanism.

Reforms continue in the banking sector. Turkey continues to move towards full implementation of Basel III, and the Turkish banking legislation has been fully compliant with Basel III risk-based capital and liquidity coverage requirements since March 2016. Net stable funding ratio regulations and IFRS 9 will be enforced from January 2018. A new resolution framework has been drafted based on recommendations by the Financial Stability Board (FSB) and the IMF in line with the Bank Recovery and Resolution Directive (BRRD). The Banking Regulatory and Supervisory Authority (BRSA) is also working on the requirements for systemically important banks, due to be effective from 2019.

Improvements to the capital markets continue but the pace is uneven. In February 2017 the Capital Markets Board (CMBT) amended issuance regulations to improve reporting and transparency, following some near-defaults in the corporate bond market. Several steps have been taken to improve the transparency of the interest rate-setting process. New money market instruments have been launched on Borsa Istanbul but the take-up has been slow among banks and investment funds. As of October 2017, the CMBT is drafting complementary regulations on mutual recognition of foreign central counterparty clearing houses (CCP) in Turkey as part of the process to achieve recognition by the European Securities and Markets Authority (ESMA) under the European Market Infrastructure Regulation (EMIR). This is essential to facilitate cross-border trading and enhance integration with European entities in Turkey.

The severance pay system and private pension scheme are being reformed. These ongoing reforms should help increase domestic savings. In January 2017 the law for auto-enrolment to private pension schemes was implemented, although the government is now working on updating the regulations as opt-outs have been higher than expected. Efforts to update the existing severance pay system to include a severance pay fund are ongoing.

Measures to improve competitiveness in the manufacturing sector have been introduced. In June 2017 the government adopted a reform package that aims to reduce operational and investment costs for manufacturing companies. The package should ease access to, and lower the cost of, land in organised industrial zones. It also slashes certain fees and taxes on production and investments. The package also contains clauses aimed at improving industry-university cooperation and the quality and governance of universities and higher vocational education institutions.

Legal reforms are continuing. In the first half of 2017 new regional courts were established and the law and regulations for court experts were enacted. Progress has been made in finalising the draft law for employment tribunals, which increases the role of arbitration in labour disputes. A comprehensive new intellectual property rights law has been adopted which restructures the national patent agency and aims to improve the protection of designs, patents, brands and geographic indications.