This report was prepared by Roger Kelly and Ali Sokmen with contributions from Sector Economics Pillar, Governance and Political Affairs, Country Economics Pillar, Local Currency and Capital Markets Development, Treasury
Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank’s strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD’s policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank’s mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the International Monetary Fund, World Bank, and World Economic Forum. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD’s Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

For more information, go to: https://www.ebrd.com/publications/country-diagnostics

Or: www.countrydiagnostics.com
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The political environment has deteriorated in recent years

2.2 Economic context
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Annex: QUALITIES OF A SUSTAINABLE MARKET ECONOMY
1. EXECUTIVE SUMMARY

- This report assesses the progress in Turkey towards developing a well-functioning, sustainable market economy, and the challenges ahead. It focuses on the role of the private sector. It also benchmarks Turkey against its EBRD peers in terms of its transition progress, within the ‘Six Qualities’ framework.
- The report identifies a number of key constraints that are holding back private sector development in Turkey, and proposes ways in which these constraints can be addressed.
- The underdeveloped nature of local capital and financial markets is identified as a major issue which has given rise to a significant dependence on foreign capital in recent years, which in turn has caused external imbalances to develop, impacting macroeconomic stability. The lack of depth of local capital markets has also resulted in problems relating to access to finance. Addressing this issue would make the economy more resilient.
- Removing impediments to innovation is identified as a priority that would help Turkey become more competitive, reverse the recent stagnation in its productivity and help the country avoid getting caught in a middle-income trap. This is vital at the current conjuncture, when the existing economic model which involves using foreign capital to support domestic demand is proving to be unsustainable.
- Turkey’s industrial policies have resulted in a complex web of protection designed both to support domestic industries and to address the large current account deficit. At the same time, they are found to have given rise to significant distortions, and it is far from clear that the objectives have been achieved. Rethinking the role of industrial policies – in particular vertical policies – would help address the distortions created, and help the economy become more competitive. Lifting those policies that are not achieving their objectives would also reduce the burden on the state budget.
- Due primarily to inefficiencies in the labour market, the participation rate of women in the workforce is extremely low, and youth unemployment is high, while skills mismatch is widespread. Taking action to resolve this issue would help improve economic inclusion and competitiveness, allowing the country to tap into a significant underutilised resource, and also help bolster the resilience of the economy by potentially increasing the domestic savings rate, an issue which is at the heart of the country’s macroeconomic instability.
- Turkey is dependent on imported energy for 75% of its energy needs. In order to improve the resilience of the economy, the authorities have plans to reduce its reliance on imported energy through increased localisation. However, this involves a significant increase in the use of fossil fuels, which will impact the country’s carbon footprint. Increasing the use of renewable energy and further developing energy efficiency would improve the sustainability of the economy.
- As regards Turkey’s progress along the transition road, the report indicates that it is well advanced in some areas, including well-governed and resilient, while in other areas, notably inclusive, there is still significant room for improvement. Annex 1 of the report provides scores, along with insights into the relative strength of development of Turkey along these six dimensions.
2. POLITICAL AND ECONOMIC CONTEXT
2.1 POLITICAL ECONOMY
The political environment has deteriorated over the past years

- The past four years have been a very challenging period for Turkey. The country was traumatised by the putsch attempt of July 2016 and it is struggling to come to terms with the aftermath.

- A state of emergency, imposed after the failed coup, was in force for two years.

- Constitutional changes, narrowly approved in the referendum of April 2017, introduced an executive presidential system, with the office of the prime minister abolished and all executive authority transferred to the president. The system entered into force after parliamentary and presidential elections that took place in June 2018. The elections resulted in the re-election of President Erdogan and a more diverse parliament in which the president’s AKP partners joined with the smaller MHP to achieve a parliamentary majority. Local elections took place in March 2019.

- The number of terrorists attacks, which claimed many lives throughout 2016 and in the first months of 2017, has diminished. Turkey continues to host around 4 million refugees, making it the largest host country under the UNHCR’s mandate.

- International organisations raised concerns about respect of the rule of law and fundamental freedoms following a massive crackdown against suspected coup plotters as well as the concentration of powers in the new system.

- Overcoming the political divide and steering politics in a more inclusive direction will be one of the main challenges in the period to come, as will making sure that independence of institutions relevant for economic governance and successful policy making is preserved.

- Domestic political and security issues will continue to shape Turkey’s actions in the foreign policy sphere, with the country’s relations with other international actors, including its traditional EU and NATO partners, being transactional rather than strategic. With Turkey's accession negotiations effectively at a standstill, the country has been deprived of its external reform anchor. This may change if the work towards the modernization of the EU – Turkey Customs Union resumes.
2.2 ECONOMIC CONTEXT

Turkey has grown rapidly in the years since the 2001 crisis but external vulnerabilities have increased.

- Between 2001 and 2017, Turkish real GDP grew on average 5.2% pa.
- Growth received a significant boost from IMF-driven reforms following the crisis of 2001, and subsequently the EU accession process provided an important policy anchor.
- However, growth has been more volatile in the period since the Global Financial Crisis, and productivity has stagnated.
- Increasingly growth has been driven by credit-fuelled domestic demand, notably for consumption and construction.
- Low domestic savings combined with rising consumption-driven credit demand has resulted in an economy heavily reliant on external debt.
- Expansionary macroeconomic policies since the coup attempt resulted in significant economic imbalances.
- Expansionary policies since the coup attempt resulted in significant economic imbalances.
- Concerns about the sustainability of the situation in the context of domestic and geopolitical issues impacted investor confidence and pushed the economy into recession.
- Private sector deleveraging and economic rebalancing will mean slower growth in the coming period.
3. PRIVATE SECTOR AND BUSINESS ENVIRONMENT
3. PRIVATE SECTOR AND BUSINESS ENVIRONMENT

The manufacturing sector has undergone a transformation but there is a risk of being caught in a middle income trap.

- Services dominate the Turkish economy but the share of manufacturing is increasing.
  - Services provide 65% of GDP and employ 54% of the labour force, and investment into non-tradables, in particular financial services boomed following the IMF-imposed reforms to the financial sector in 2002.
  - The manufacturing sector has undergone an important transformation since the creation of the Customs Union with the EU in 1996. There has been a shift from traditional sectors such as textiles and food processing to medium/high tech industries such as automotive and electronics.

- The manufacturing sector attracted significant shares of FDI in the 2000s, helping increase productivity.
  - This can be seen in the shift from low to medium technology exports, although there has not been a shift to high technology exports. Although Turkey has moved from 51st place to 40th place in the Economic Complexity Index during this period, innovation remains limited.

- The agricultural sector is characterised by a complex and costly support system.
  - The share of agriculture in output is falling but its share in employment remains high. The Customs Union does not cover agriculture at present. The sector is inefficient, characterised by small, family-owned farms, an undersupply of capital and a lack of long-term financing options.

Source: Turkstat, Ministry of Trade
Trade as a share of GDP is relatively low in Turkey. Although the large domestic market compensates somewhat, international trade is more productive.

The EU remains Turkey’s principal trading partner although the share has declined from 62% to 47% over the past decade in favour of MENA countries.

Turkey imports 93% of its oil and 99% of its gas; energy imports account for a significant share of the CAD. Efforts are being made to expand domestic sources of supply including renewables and increase energy efficiency.

Participation in GVCs remains below potential. Forward integration in value chains is limited, while backward integration is increasing, which reflects the expansion of manufacturing into more complex areas. Moreover, the omission of services from the EU Customs Union means that the integration of this sector into GVCs is relatively weak.

Source: World Bank, Ministry of Trade, UNCTAD, EBRD calculations
Competitiveness is affected by macroeconomic and political instability, the large size of the informal sector, and labour market inefficiencies.

- Through an investment environment reform package introduced in January 2018, the government has successfully moved the economy up the World Bank Doing Business Rankings from 60th to 43rd place.
- Competition from the large informal sector is the biggest obstacle affecting business competitiveness, according to the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS). Informal firms face lower regulatory and labour costs, giving rise to an uneven playing field. Other significant obstacles include political instability and access to finance.
- Labour market efficiency is weak as measured by most metrics, but in particular female participation and skill levels.

Turkey ranks 61st in the WEF’s Global Competitiveness Index. Strengths are the large size of the domestic market, infrastructure and innovation capability. However, weaknesses include macroeconomic instability driven by the high inflation rate and declining credit ratings. The relatively poor performance of the financial system reflects the lack of development of local capital markets.

Productivity is below the EU average and has stagnated since the Global Financial Crisis

- The large size of the informal sector (30% of GDP) is an important reason for Turkey’s low productivity relative to the EU.
- TFP levels have declined despite a surge in R&D spending and capacity. There are several possible explanations:
  - Excess global liquidity has enabled inefficient ‘zombie’ firms to survive
  - A decline in governance protects incumbents and impedes the allocation of capital to more productive firms
  - A decline in the volume and quality of FDI: as FDI has declined, the share going to the non-tradable sector, particularly unproductive real estate, has increased.

Source: WEF, World Bank, Ministry Economy.
3. PRIVATE SECTOR AND BUSINESS ENVIRONMENT

Private sector characteristics reflect business environment challenges

SMEs dominate the economy but lag behind in productivity

<table>
<thead>
<tr>
<th>Business demography indicators</th>
<th>Micro (&lt;10)</th>
<th>Small (10-49)</th>
<th>Medium (50-249)</th>
<th>Large (&gt;250)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>2.0%</td>
<td>45.2%</td>
<td>12.7%</td>
<td>97.0%</td>
</tr>
<tr>
<td>Employment</td>
<td>0.8%</td>
<td>24.5%</td>
<td>17.6%</td>
<td>46.1%</td>
</tr>
<tr>
<td>Value added</td>
<td>0.2%</td>
<td>20.6%</td>
<td>20.5%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Small enterprises (<50 employees)
Drive the economy but are less productive than larger firms

- 58% of the labour force
- 99% of total number of companies
- 33% of GVA; GVA per employee significantly below that of larger firms.
- Concentrated in the informal sector
- SMEs are predominately domestically owned and focused on the local market

FDI has predominantly gone to the manufacturing and financial sectors

<table>
<thead>
<tr>
<th>FDI by sector, 2002-2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
</tr>
<tr>
<td>Manufacturing</td>
</tr>
<tr>
<td>Communications &amp; Transport</td>
</tr>
<tr>
<td>Utilities</td>
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<tr>
<td>Other</td>
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<tr>
<td>Trade</td>
</tr>
<tr>
<td>Construction</td>
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<tr>
<td>Mining</td>
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<tr>
<td>Agriculture</td>
</tr>
</tbody>
</table>

- The private sector constitutes 98% of Turkey’s top 500 firms in terms of turnover and accounts for 78% of investment.
- The economy is characterised by a small number of large, innovative and internationally integrated firms, a growing number of medium sized family firms with limited innovation and international presence, and a large tail of small firms.
- Privatisation is well advanced. Energy and telecoms are largely privatised although state regulators play an important role. The government aims to increase private sector participation in various sectors, notably healthcare and utilities, via PPPs and BOTs. There are plans to privatise a number of assets including further power plants, port operating rights, shares in toll roads and bridges.
- The authorities have intervened in private sector activities at times, via the use of industrial policies and interventions to incentivise bank lending. More controversial was the seizure of US$ 11 billion of assets purportedly having connections to the Gulenist movement.
- Foreign ownership remains low outside the manufacturing and financial sectors, which accounted for 60% of FDI inflows since 2002.

Source: OECD, Ministry of Economy.
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.1 Underdeveloped local capital and financial markets

Developing domestic capital and financial markets would improve macroeconomic stability and the resilience and competitiveness of the Turkish economy.
4.1 Underdeveloped local capital and financial markets

A reliance on foreign capital has seen Turkey’s external vulnerability increase in recent years

The large current account deficit is increasingly financed with ‘hot’ money.
- The counterpart of Turkey’s low domestic savings rate is the large current account deficit.
- As FDI has fallen in recent years, Turkey has had to rely on short term portfolio flows to finance the CAD, increasingly debt flows, the financing of which increases the deficit. These flows are quick to reverse in response to global or domestic developments, increasing the volatility of the lira.
- CBRT reserves are very low, insufficient to cover short term financing needs in case of a restriction of access to international capital.

Turkey’s strong growth has come at a cost in terms of external vulnerability

Turkey has faced a tradeoff between strong growth and external sustainability for a number of years.
- Foreign capital inflows in the years after the IMF programme resulted in a significant increase in external debt.
- 90% of the debt is denominated in foreign currency and 60% is variable rate, leaving borrowers vulnerable to a tightening of global liquidity and changes in investor sentiment towards emerging markets.
- 38% of external debt is due within a year. Including the CAD, this amounts to annual external refinancing needs of around 25% of GDP.
- Evidence of the external vulnerability has been seen in the recent past, manifested in a depreciation of the lira, during the European sovereign debt crisis of 2013, the “Taper Tantrum” of 2015, and more recently the summer of 2018.

Source: CBRT.
4.1 Underdeveloped local capital and financial markets
Increase in external debt driven by demand from corporates and banks in the face of an inadequate domestic capital market.

Corporates’ FX borrowing has resulted in a large open FX position
- Corporates have seen a strong build up of debt with liabilities increasing from 30% to 60% of GDP since 2007.
- Following a relaxation of Decree 32 in 2009, FX loans increased tenfold, driven by corporate demand.
- Only around 40% of NFC FX liabilities are covered by FX assets, giving rise to an open position of around USD 220bn, 25% of GDP.
- Around 80% of NFC FX borrowing is from Turkish banks, exposing them to counterparty risk. The implications of this were seen in the crisis of 2018, when several high-profile corporate restructurings were requested, causing ongoing concerns about bank asset quality, which will impact banks’ ability to lend.

Banks have increasingly resorted to FX borrowing in the face of high loan to deposit ratios
- Banks are predominantly (60%) deposit funded but credit growth has seen increased recourse to wholesale funding.
- Wholesale funding constitutes around 32% of non-equity funding and 75% of this is FX denominated.
- Funding short in FX is an attractive option for banks due to the high inflation rate, exchange rate volatility and absence of a term premium for FX funds. However, it gives rise to a refinancing/rollover risk.
- Around 53% of bank liabilities are FX denominated, against 38% of assets. The open position is typically closed using swaps, but these are short term so this is another source of refinancing risk for banks.
- Recently, the lira loan to deposit ratio has reached almost 150% due to the rapid increase in lending associated with the CGF. Concern about the Turkish banking sector has resulted in swap lines being cut, contributing to a credit crunch.

Decree 32
- Introduced in 1989 to protect value of the currency
- Limited ability of entities without FX income to access FX loans
- The regime was loosened for NFCs in 2009 but tightened for consumers
- Tightened again in 2018 to address the vulnerabilities associated with the growing unhedged FX positions.

Source: BRSA, EBRD calculations.
4.1 Underdeveloped local capital and financial markets

Access to finance is impeded by the poor development of local capital markets

- Lira capital markets are underdeveloped. High inflation rates mean individuals prefer to save in the form of hard currency (hard currency deposits make up 50% of total deposits) or assets. As a result, the lira yield curve is short.
- The resultant short tenor of lira credits tends to be unsuitable for project financing. Domestic funds tend to be used to finance working capital rather than investment, meaning many firms are reliant on retained earnings to finance their development.
- Alternative sources of financing are limited; 90% of assets remain in the hands of banks, with non-bank financing limited.
- Stock market capitalisation is low as institutional investors are inactive – pension funds only allocate 12% of their portfolio in domestic equities.
- Private equity is limited; according to the GCI 2017, Turkey ranks 82nd of 137 countries for venture capital availability.

Developing local capital markets would reduce the dependence on external debt, increasing the economy’s resilience

- Development of lira capital markets would reduce the dependence of banks and corporates on external debt and enable the development of nonbank financing. A reduction in dollarisation would help improve the effectiveness of the monetary transmission mechanism. And by allowing the development of long-term lira savings instruments, saving would increase, and the current account deficit would decrease.
- A key prerequisite is policy action to achieve macroeconomic stability, in particular to address high inflation rates.
- In order to attract investors and generate liquidity, reliable money market indicators need to be developed further and the local central clearing counterparty needs to achieve international recognition to enable further integration into capital markets.
- Support also needs to be provided on the demand side to address the low propensity of firms to seek financing through capital markets.
- Alternative sources of funding need to be developed, beyond banks. Leasing and factoring have grown in importance in recent years, but insurance penetration remains low, at around 1.5% of GDP. The long investment horizons of insurance companies make them ideal for project financing that requires patient capital. There is scope to address the undersupply of sukuk financing and to encourage long-term risk capital through tax incentives.
- With an anticipated increase in NPLs in Turkey, the development of an NPL resolution mechanism may help attract international funding (in particular PE) to the predominantly domestically-funded AMCs currently operating, which may face liquidity issues.

Source: CBRT.
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.2 Impediments to innovation

Addressing impediments to innovation would help Turkey avoid getting caught in a middle income trap, and would help make the economy more competitive.
4.2 Impediments to innovation
There are several factors behind Turkey’s mediocre innovation performance, which impede forward integration into GVCs.

- Turkey imports innovation from abroad; in order to continue the process of economic convergence action needs to be taken to encourage firms to innovate themselves.
- In order to fully benefit from advantages offered by GVC linkages, firms need to work on increasing forward integration – produce more competitive intermediate goods for export.
- Turkey’s innovation performance is mediocre, 19th among 37 countries in the 2018 EBRD Knowledge Economy Index. ICT infrastructure has improved in recent years but although skills for innovation have improved, institutions for innovation have worsened.
- European Innovation Scoreboard 2018 also highlights deficiencies in Turkey’s innovation performance, noting that although Turkey’s employment in manufacturing is higher than the EU average, its employment share of medium- and high-tech manufacturing is significantly lower.
- An EBRD-commissioned report notes four key areas that limit the ability of Turkish firms to innovate their way up GVCs:
  1. Deficiencies in the education and training system, resulting in severe skills mismatches. There have been some actions in this area, e.g., the number of researchers has increased, but more efforts are needed to improve innovative capacity and foster adaptation to industry 4.0 applications.
  2. Weaknesses in ability to commercialise research and innovation. Although incubators (TEKMERS) Tech Development Zones and Tech Transfer Offices have been established, the level of interaction between university and industry remains limited.
  3. Lack of appropriate financing mechanisms to support innovative entrepreneurship. Risky, early stage investment typically requires equity capital from VC or business angels but such finance is underdeveloped in Turkey.
  4. There has been a lack of coordination between governmental bodies concerned with STI activity (Ministry of Industry, Ministry of Development, TUBITAK, KOSGEB). However, this is changing with the merger and reorganisation of government agencies and ministries as a part of the transition to the presidential system.
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.3 Distortions created by Turkey’s industrial policies

*Addressing the distortions created by Turkey’s industrial policies would help the economy become more competitive and resilient*
4.3 Turkey’s industrial policies create distortions
Turkey has increasingly turned to vertical measures in its conduct of industrial policy

Industrial policy has shifted from horizontal to vertical in recent years

- The country’s approach to industrial policy was mainly horizontal until 2012, with measures aimed at improving the business environment and promoting trade integration.

- Most significant was the Investment Incentives Regime, introduced 2004, which aimed to increase investment, employment and eliminate regional imbalances.

- Subsequently policy became more vertical, with a series of selective and sectoral policy measures becoming prevalent.

- The 10th Development Plan (published 2014) focused on policy tools such as public procurement, land allocation and government-funded R&D, with the aim of increasing domestic technological content of particular industries.

- Recently the government launched a project-based TRY 135 billion package, a highly selective vertical industrial policy instrument targeting specific companies selected in a rather opaque manner. The aim is to create jobs and address the current account deficit.

- Public procurement has become an important tool of industrial policy in recent years with the introduction of various forms of local content requirements and localisation schemes. Turkey has not signed the WTO Government Procurement Agreement.

- The government has resorted to trade measures to protect industries in recent years, albeit within WTO rules. Since 1995, anti-dumping investigations by Turkey have resulted in 174 anti-dumping measures being introduced.

Example: Renewables
Turkish authorities have introduced measures to support the development of renewable energy through two schemes, which also seek to boost local component production. YEKDEM offers a feed-in tariff with a local content premium commensurate with the intensity and complexity of local equipment used in a particular project. YEKA, an auction system that became operational in 2017, defines localisation minimum requirements for large scale investments, on the assumption that such projects will create economies of scale for localisation of certain renewable technologies in Turkey.

LCR schemes are not WTO-compliant and the EU and EU IFIs argue for their rapid phase-out in Turkey. Beyond these legal concerns, the effectiveness of such schemes is in question as they face challenges relating to currency fluctuations, as most tariffs under the schemes are in US dollars, and declining prices of most components due to Asian competition.
4.3 Turkey’s industrial policies create distortions
There is little evidence to show that Turkey’s industrial policies have achieved their objectives in a cost-effective way

Achievement of industrial policy has been mixed
- Support to investment has increased steadily in recent years, both in terms of number and value of projects supported.
- The country has increased its industrial depth: manufacturing as a share of GDP as increased from 16.2% to 17.6%, higher than the EU 28 average of 16.4%.
- R&D expenditure has almost doubled since 2002 to around 1% of GDP thanks to various incentives and TUBITAK grant programmes. Although slightly above the EBRD average, it remains below the EU average of 2%.
- Share of the private sector in Turkey’s R&D spending has increased to 54%, approaching the EU average of 57%.
- Economic complexity has increased, with Turkey moving from 51st in 2001 to 40th in 2016 in the Harvard/MIT Index.
- However, the share of high-tech products in exports remains very low in Turkey, at 3.6% compared to 24.4% globally.
- It seems that the drivers of Turkey’s productivity growth over the medium term have been urbanisation and integration into EU production networks rather than industrial policy.
- There is little evidence that industrial policy has alleviated regional imbalances or created jobs in underdeveloped regions.

The distortionary impact is high
- Four policy tools in particular stand out in terms of their distortionary impact:
  - Strategic investments components of investment
  - Local content policies and requirements that favour domestic production
  - The project-based incentive scheme
  - Use of temporary trade barriers

And the economic costs of industrial policies has been high
- As of 2017, the direct costs of Turkey’s industrial policy programmes is around US$ 1.2 billion.
- This does not take include foregone tax revenues, which could be as high as US$ 3 billion only for firms in technology development zones. And there is no reliable estimate for tax incentives under the general incentive scheme.
- The economic costs arising from market distortions through limited competition and trade restrictions are also potentially high but there is limited empirical research on this topic for Turkey.
4.4 Labour market imperfections

Addressing labour market imperfections would not only help improve economic inclusion, but also increase the economy’s competitiveness and resilience.
4.4 Labour market imperfections
The labour market is characterised by low participation rates, particularly among women and youth, due to legislation and cultural factors.

Participation rates are low, particularly among women and youth, and unemployment is high
- The overall labour force participation rate is 52.8% compared to OECD average 64%.
- There is a significant gap between male (72.5%) and female (33.5%) participation rates. Furthermore, there is a 47.5% employment gap between prime age men and disadvantaged groups.
- The economy is characterised by high informality rates and vulnerable employment conditions, particularly for women and youth, the latter facing an unemployment rate in excess of 20%. Moreover, restrictive labour regulations and language barriers hinder formal employment of Syrian refugees.
- This represents a significant underutilisation of a valuable resource which could improve the county’s competitiveness in the face of severe labour market shortages being faced in neighbouring countries in south-eastern Europe.
- It would also help address the structural savings deficit, which has resulted in a large current account deficit.

Low participation among women is a by-product of well-intended legislation and cultural factors
- Some of the differences are enforced by well-meaning legislation:
  - Article 50 of the constitution: ‘no one shall be required to perform work unsuited to his/her age, sex and capacity’
  - Labour law 4857 bans women from underground work and restricts involvement in night shifts and heavy/dangerous work.
- More significant is the tendency towards women taking on unpaid care responsibilities, driven by cultural factors. Women on average take on 5.5 hours of unpaid work daily compared to 1.5 hours for men.
- Female participation reduces from 34% to 24% after childbirth, with the difference even greater when skill levels are factored in.

Benefits intended to support female participation have the effect of pushing them towards jobs in the less productive, more precarious informal sector.
- Legislation intended to support participation, such as a requirement for employers to provide maternity benefits, seems to discourage employment of women in the formal sector and helps explain why 46% of the female workforce is engaged in the informal sector compared to only 28% of the male workforce.
- Working in the informal sector is more precarious, with limited job security and lower pay.
- At the same time, if such legislation encourages firms to operate informally or semi-formally in order to avoid such obligations, this has a negative impact on overall productivity of the economy.
- In order to address these issues, transferability of maternity-related benefits should be promoted, and care should be taken in not linking specific requirements to female workers.
### 4.4 Labour market imperfections

The labour market faces significant skills gaps which may impact its ability to avoid getting caught in a middle income trap.

**Skills mismatches are a serious concern**
- According to Manpower group, 66% of employers have difficulty filling jobs in Turkey, with medium sized companies faring worst.
- BEEPS survey finds that workforce skills is one of employers’ top 10 concerns in Turkey.
- Vocational education and skills are high on the policy agenda of the Turkish Government Skills Vision 2020.
- However, the topic receives only a light treatment in the draft 11th Development plan 2019-2023.

**The changing nature of work means the problems are likely to get worse without action being taken.**
- The changing nature of work, in particular the implications of automation, is a widely recognised policy issue, and the focus of EBRD’s 2018-19 Transition Report
- Although education and skill levels are high among the young, they often do not have the skills needed by employers.
- At tertiary level there is a tendency to favour subjects such as business administration and law over science and technology.
- Less than 20% of new university entrants are engaged in STEM subjects, compared to an OECD average of 30%. This means the share of professionals in this area is low, despite high demand.
- This limits Turkey’s capacity for innovation and industry 4.0 activities, with implications for the country’s ability to avoid a middle income trap.
- A recently-announced Digital Transformation Map from the Ministry of Science and Technology is a positive step, but the EIU finds that there is a lack of coordinated policy action by the Turkish authorities to plan for the challenges of automation and its impact on the future of work and skills in Turkey.

**Action needs to be taken to expand vocational training opportunities and employment support services**
- In the short to medium term there is a need to address the skills shortages of the existing labour force, particularly new entrants including Syrian refugees, whose employment prospects are impeded by limited recognition of existing qualifications.
- ISKUR, the Turkish Employment Agency, plays a key role in this regard by providing vocational training and other employment support services.
- But Turkey needs to consider the longer term and invest more in planning in order to align education and training policies with the medium and longer term needs of the labour market.
- A robust policy on skills for the future of jobs in Turkey is needed.
4. OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

4.5 Dependence on imported energy
Moving away from dependence on imported energy will improve the resilience of the economy, but in order to improve green credentials, the focus should be on renewable alternatives.
4.5 Dependence on imported energy

Attempts to reduce reliance on imported energy are important but the environmental implications of increased dependence on coal need to be considered.

Incentives are being provided to increase the share of the coal sector in the future energy mix, including BOT rights for coal power generation which include a 15 year power purchase agreement.

In addition to the existing 67 units of coal-fired power plants, six more are under construction and 73 more are planned.

This will result in at least a 40% increase in emissions from the Turkish power sector as a whole.

Taking into account the wider costs, including subsidies and environmental externalities, studies indicate that the real cost of coal is much higher than renewable sources such as wind and solar.

The cost of renewable technologies is decreasing rapidly every year. Recent auctions in Turkey have included ceiling prices for onshore wind and solar PV that suggests future costs will be significantly cheaper than the cost of coal (IEA).

As the average lifespan of a coal power station is 40 years, there is a significant risk of stranded assets.

Public investment in, and subsidies to, the coal sector amounts to 0.2% of GDP p.a. If this were passed on to consumers and businesses, this would raise the market price of electricity by 29%, significantly impacting the competitiveness of businesses.

Turkey’s goal is that two thirds of its installed capacity will be through domestic sources by 2023.

Turkey’s energy demand is likely to grow at 4-6% pa until 2023 due to growing population, rising living standards and industrialisation. This impacts the current account, as 75% of energy needs are imported.

To address this challenge, actions are being taken on both the supply and demand side:

- Efforts are being made to increase energy produced domestically. According to Vision 2023, by 2023 two thirds of installed capacity will be through domestic sources – renewables, coal and nuclear.
- On the demand side, the National Energy Efficiency Action Plan (NEEAP) 2017-2023 aims to reduce the primary energy consumption of Turkey by 14 per cent by 2023.

Source: Ministry of Energy.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY
EBRD methodology for measuring transition gaps is based on the following six desirable qualities of a sustainable market economy: competitive, well-governed, green, inclusive, resilient and integrated. Progress on a transition path is measured on a continuous scale of 1 to 10, where 10 is the best possible score and denotes the frontier. The composite indicators at quality level aggregate a wide range of sub-indicators.

**Turkey ranks a little above the EBRD regional average in terms of progress towards a sustainable market economy.** Based on a simple average of the six scores, it ranks 15th out of 37 countries in the region. Within this average it performs significantly worse for the inclusion quality, ranking 36th out of 37 countries, and significantly better that its peers in resilience, where it ranks 7th. The country also shows a strong relative performance in the well-governed (25th) and competitive (17th) indicators. Compared to the EU 11 the difference is more pronounced, and significant gaps can also be seen in terms of the competitive, green and integrated qualities. The following sections consider each quality separately and the main factors underlying the scores in Turkey.

* Score for advanced comparator economies is a simple average of scores for Canada, Czech Republic, France, Germany, Japan, Sweden, United Kingdom and United States.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Competitive

Turkey ranks 17th out of 37 CoOs in the competitive quality index. While the country visibly performs better in the ATQ score than EBRD average, it still lags behind the 8 OECD comparator countries. Turkey’s convergence is constrained, among others, by weaknesses in the education system and relatively weak innovation eco-system.

Market structures and institutions that facilitate competition

- Trade has strongly contributed to economic growth over the past 20 years, driven by the liberalisation of tariffs on most industrial products as a part of the customs union with the EU and the negotiation of several FTAs, which has translated into relatively low weighted average of applied tariff rates. Nonetheless, Turkey’s (tariff) protection remains high for agricultural commodities, and non-tariff barriers together with recent macroeconomic developments may also slow down further trade integration.
- Small and medium-sized enterprises play a substantial role in Turkey’s industry. A positive environment for SMEs is reflected in its above-average EBRD SME Index score. SMEs in Turkey face some of the lowest financing constraints in EBRD region. Nevertheless, strong reliance on family members in management and weak governance may prevent mature SMEs from further expansion.
- Despite the large share of services in the economy, Turkey is among the EBRD CoOs with the lowest share of advanced business services (finance, accounting, communications, etc.) in total services exports. These services amounted to 15.7% of total services exports in 2016, compared to over 50% in some EBRD CEB and SEE countries (e.g., Romania and Hungary).

Capacity to generate value added and to innovate

- Improvement of Turkey’s education system is a precondition for the country’s convergence towards more advanced economies. As evidenced by the quality of education score, the country falls slightly below the average of the EBRD countries while the gap vis-à-vis Central European and Baltics countries and OECD comparators is non-negligible.
- Turkey’s performance in moving towards a knowledge intensive economy, as measured by the EBRD Knowledge Economy Index score, has improved significantly since 2010. Although it is now in line with the EBRD region, there is much further potential for scaling up R&D, commercialising innovations and promoting progress towards the research frontier.

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Well-governed

- Turkey performs fairly well according to the most recent results of the ATQ (2018) for governance vis-à-vis other EBRD countries of operations. However, the country’s performance is weak relative to EU 28 and EU 11 countries, and has shown a deterioration in recent years (chart). It should also be noted that these indicators do not reflect the significant worsening of the quality of governance in Turkey over the past two years.

- Quality of institutions scores are low in several sub-indicators, especially in the freedom of media, government effectiveness, private property protection and regulatory quality. Political instability is the second most significant obstacle facing businesses, according to the latest round of the BEEPS. This has likely become even more significant in the period since the BEEPS survey, which has seen an attempted military coup in July 2016 a two-year state of emergency; a referendum to create an executive presidency; and parliamentary and presidential elections.

- On the rule of law, Turkey is scoring low and well behind the frontier group on most indicators, including judicial independence, framework for challenging regulations, and enforcement of contracts.

- Competition from the informal sector is perceived as the biggest obstacle facing businesses in Turkey, according to the latest round of the BEEPS.

- The regulatory and institutional framework supporting good corporate governance in Turkey is relatively advanced. However, implementation of the modern best practices is strongest in the large listed companies, while in the majority of the companies which are SMEs, dominated by family-owned businesses, it’s lagging behind. The EBRD’s assessment of corporate governance legislation and practices in Turkey (2016) points to lack of gender diversity on the boards, potential dominance by the executive board members of the committee work and lack of disclosure regarding board evaluation. Another notable weakness is the absence of cumulative voting in the law which prevents the minority shareholders.

- On business integrity and the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) side, Turkey scores quite low on both the ethical behaviour of the firms and the implementation of frameworks.

- Turkey ranks 81st out of 180 countries in Transparency International’s 2017 Corruption Perceptions Index.
- Turkey ranks 58th out of 180 countries in Index of Economic Freedom 2018 (The Heritage Foundation), with low scores in government integrity and judicial effectiveness indicators.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Green

- With projections indicating that the primary energy demand in Turkey will continue to increase between 4-6% annually, the Energy Strategy 2015-2019 envisages a significant increase in the use of domestically available coal, renewables and nuclear sources.

- There is significant energy efficiency potential across all sectors of the economy, including in buildings. The National Energy Efficiency Action Plan (NEEAP) 2017-2023 aims to reduce the primary energy consumption of Turkey by 14% by 2023 through 55 actions focusing on 6 categories.

- Renewable Energy (RE) share ambitions should be scaled up as Turkey has already surpassed its goal of 30% RE share in total electricity generation by 2023. Recent auctions in wind and solar have shown that its potential can be exploited at a competitive cost. Legislation and financial incentives for RE are advanced in the country. In addition, the buildings and services sector has significant potential for using renewable energy resources and on-site generation.

- Waste management have been recognised as a priority for Turkey and policies should be developed and implemented to overcome existing obstacles and help Turkey advance towards a more competitive and resource-efficient circular economy. As of 2016, the municipal recycling rate was 1% compared to an EU-28 average of 29%. Given the right legislation and incentives, the private sector may be able to participate in the resource efficiency and waste minimisation initiatives.

- Water shortage due to climate change and growing demand is a pressing concern, which produces knock-on effects in sectors such as agriculture, which uses 73% of available water resources for irrigation and takes up 19 per cent of the labour force. Turkey is not rich in water resources and is expected to be among the countries facing extremely high water-stress by 2040. This may also pose issues for future power generation, as up to 22% of electricity is currently produced by hydroelectric sources. The government has set targets to decrease annual water loss to 30%.

Source: International energy Agency, World Bank WDI.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Inclusive

- Equitable access to economic opportunity and particularly employment remains a key issue for women, young people and populations living in underserved regions in Turkey. Although employment rate has been steadily increasing over the past decade, this trend is slowing down and unemployment has been picking up.
- Additionally, Turkey continues to experience low rates of labour market participation, high informality and precarious and vulnerable employment, which disproportionately affect women and young people.

- There is evidence of sex-segmentation in the labour market, with women continuing to be mostly employed in health, education and care sectors, and this is becoming more pronounced. Overall, women are overrepresented among low skilled workers, informal employees and contributing family workers.

- Inequalities in the labour market start at a young age with 33% of young women not in education, training or employment compared to 14% of young men.
- Women still represent just over a quarter of total entrepreneurs/firm owners in Turkey and gender gaps in access to finance continue to exist with 65% of women compared to 77% of men owning a bank account.

- For women who remain in the labour force, unpaid care responsibilities appear to affect the nature of the work they engage in.

- Skills gaps remain an issue. Although vocational education and skills are high on Turkey’s policy agenda, skills forecasting and skills matching policies remain insufficient. There is no thorough evidence and no robust policy on the skills for the future of jobs.

- Regional disparities and inequality levels remain large. Economic activity is heavily concentrated in Istanbul plus Turkey’s Western provinces which, together, produce 81% of Turkey’s GDP. Consequently, Turkey ranks 28th out of 32 countries in the OECD’s Gini index of inequality of GDP per capita across regions.

- Per capita GDP is more than three times higher in Istanbul than in South-eastern provinces of Turkey which are facing additional social and economic strain following the recent influx of refugees from Syria and elsewhere.

- The approximately 10,000 Syrian-owned firms in Turkey face their own challenges, notably in terms of language skills, limited familiarity with business laws and government incentives, and access to finance.

5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Resilient

**Financial Resilience**

- Turkey’s financial sector is built on a foundation of prudent policies and competent skills present since the 2001 crisis, as evidenced by the country’s relatively quick recovery after the 2008 global financial crisis and sustained growth until YE2017. Credit to private sector as percentage of GDP has risen from around 18% in 2000 to more than 70% as of 2017, and the sector’s capital adequacy ratio (CAR) has not dipped below 15% in the past decade, standing at 17% as of YE 2017.

- Nevertheless, Turkish banks are facing an imminent rise in non-performing loans (NPLs), albeit from a low base of 3% as of end-2017. Corporates may face difficulties with servicing their debts due to the weaker TRY, shortened tenors, rising TRY and FX interest rates, and subdued demand, which may translate into higher NPLs and call for stronger turnaround skills in the country. To prevent a bigger rise in NPLs, the government introduced a new form of bankruptcy protection (“concordat”) as well as a sector-wide financial restructuring framework for large credit exposures, and forbearance towards loans under the CGF. The existence of an active retail NPL market and private AMCs, which resolve c. 1.5% of NPLs annually, is a supportive factor.

- The recently announced New Economic Programme (NEP) should further help alleviate the rising risks. Alongside measures to rein in inflation and tighten fiscal policies, NEP includes financial health assessment studies of the banks, which may lead to new measures to safeguard the banking system, and help restore confidence amidst global pressures on emerging markets and domestic challenges. Banks traditionally rely on foreign wholesale funding to a significant extent and have so far achieved rollovers, albeit at an increased cost. The government has also announced plans to strengthen the capital of public banks and create bad asset resolution vehicles in April 2019.

**Energy Resilience**

- Turkey continues to meet its energy needs primarily through imports (Chart 31) – which reached 75% of net primary energy use in 2015. Dependence on imported energy has increased significantly in recent years. Since the enactment of the Natural Gas Market Act in 2001, Turkey’s net imports of natural gas have grown significantly from 15 bcm to 46 bcm in 2016, accounting for 99% of its total gas usage. Domestic gas production is negligible.

- The growing import dependence has left Turkey severely exposed to commodity price and exchange rate fluctuations, and drives a significant share of Turkey’s current account deficit. When energy prices peaked in 2014, Turkey’s energy import costs reached US$53 billion. In 2017, import costs declined to US$36 billion following the decline in global energy prices. The rapid depreciation of the lira in 2018 has led to significant price increases for industrial and household consumers in the country.

- Turkish energy policy is now heavily focused on lessening dependence on external suppliers and diversifying import sources. This includes reducing the share of natural gas in the power generation sector and substituting it with locally produced energy resources such as coal and renewables. Renewable energy now accounts for nearly 30% of Turkey’s electricity generation. Two new international pipeline projects—TANAP and TurkStream – are expected to further Turkey’s supply security and allow the Petroleum Pipeline Corporation (BOTAŞ) to receive and transmit extra gas through its system and help meet demand surges when required.

Source: National statistical authorities and central banks, ECB.
5. QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Integrated

**External Integration**

- **Trade environment:** Turkey has a low number of non-tariff measures (209, compared to 821 in EBRD and above 2,000 in comparator countries). However, trading partners face a relatively high degree of uncertainty regarding the applied tariffs.

- **Investment environment:** Turkey ratified 93 bilateral investment agreements (EBRD average: 65, OECD comparator average: 116). FDI inflows have declined in recent years due to political and financial instability.

- **Non-FDI environment:** Portfolio inflows as a share of GDP are similar to the EBRD average, but lagging behind the OECD comparator average. The level of restrictions on cross-border financial transactions is higher than in the EBRD and OECD averages.

**Internal integration**

- **Domestic transport:** Turkey is one of the top EBRD countries in terms of logistics competency and domestic infrastructure quality as measured by the GCI.

- **Cross-border integration:** Turkey enjoys a high quality international logistics sector and transport infrastructure. However, the cost and time burden of trading across borders, especially for imports is higher than the EBRD and OECD averages.

- **Energy and ICT:** The quality of electricity supply is low. Furthermore, the ICT infrastructure is lagging behind EBRD and OECD levels: only 58% of people are using the internet, compared to 63 per cent in the EBRD and 87% in OECD comparator countries; broadband subscriptions are low (13% of households).

Source: WB WDI, WEF GCI, EBRD calculations.