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TURKEY

2013 ARTICLE IV CONSULTATION

December 2013

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 2013 Article IV consultation with Turkey, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF for the Executive Board's consideration on November 20, 2013, following discussions that ended on October 1, 2013, 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 November 1, 2013.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its November 20, 2013 consideration of the staff report that concluded the Article IV Consultation with Turkey.
- A **Statement by the Executive Director** for Turkey.

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

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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International Monetary Fund
Washington, D.C.

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TURKEY

November 1, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

KEY ISSUES

Context: Economic activity has accelerated, in part thanks to pro-cyclical macroeconomic policies. With domestic demand stronger, the current account deficit is widening again from a high level, and inflation remains well above target.

Challenges: On current policies, Turkey can only sustain high growth at the expense of growing external imbalances. Short- and medium-run policies should focus on reducing external vulnerabilities, so Turkey can break free of its boom and bust cycles.

Key policy recommendations:

- Re-establish a nominal anchor. Despite higher interest rates, monetary policy remains too loose given the inflation target. The policy framework should be normalized with a clearer focus on inflation.

- Tighten the fiscal stance. Expenditures should be reined in and higher-than-expected revenues saved. The 2014 budget should target a primary balance consistent with a 0.7 percent of GDP structural improvement.

- There is room for policy action in case of downside risks, but discretionary stimulus should be applied only if growth is expected to turn negative.

- Increasing national savings and improving competitiveness are central to addressing vulnerabilities. Ambitious medium-term fiscal targets (consistent with a 2 percent of GDP consolidation over the next five years) and deepened structural reforms are needed.

Traction of past Fund advice: The authorities share staff's view on the need to raise savings, as reflected in the 2014 Medium-Term Plan and their 10th development plan. In addition, they introduced macro-prudential measures to address growing leverage by households in line with Fund advice, and more is under consideration. However, they have a more benign view of external vulnerabilities, therefore monetary and fiscal policies are looser than what staff recommends. The authorities also concur that lowering inflation is a key objective, but believe their monetary framework serves them well and intend to continue with the normalization of the policy framework.

Approved By
Philip Gerson and Mark Flanagan

Discussions for the 2013 Article IV consultation were held in Ankara and Istanbul during September 19−October 1, 2013. The mission comprised Messrs. Ramirez Rigo (head), Miniane, Tchaidze, and Tieman (all EUR), Ms. Rial (FAD), Ms. Tambunlertchai (SPR), Mr. Lewis (Senior Resident Representative), and Mr. Cecen (senior economist, Resident Representative Office). Mr. Yalvaç (Alternate Executive Director, OED) joined the meetings. The mission met with Deputy Prime Minister Babacan, Minister of Finance Şimşek, Central Bank Governor Başçı, Treasury Undersecretary Çanakcı, other senior public officials, and representatives from the private sector. Ms. Mahadewa and Mr. Peterson assisted in the preparation of the staff report.

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CONTEXT

1. **Turkey achieved a welcome reduction of imbalances in 2012.** The economy had grown by an average of 9 percent over 2010–11, opening up a positive output gap and bringing the current account deficit to 9.7 percent of GDP. However, monetary tightening starting in the second half of 2011 slowed growth in 2012 to 2.2 percent on the back of a 1.8 percent contraction in domestic demand. Exports were a bright spot however, thanks to successful diversification away from traditional European Union markets and towards MENA as well as one-off factors (see below). The combination of weak imports and strong exports helped narrow the current account deficit to 6.1 percent of GDP. Inflation also decelerated to 6.2 percent at end-2012 versus 10.4 percent a year earlier. Reflecting the reduced imbalances and improved outlook, Turkey has been upgraded by two credit rating agencies to investment grade since the last Article IV consultation.

2. **However, much of the rebalancing was cyclical.** In 2012, staff estimates that about three quarters of the current account adjustment was due to a cyclical compression in imports,[1] as well as exceptionally high net gold exports.[2] Moreover, the adjustment came from a decline in (not particularly high) investment rather than from a needed increase in savings. Staff believes the current account deficit remains 1½–3 percent of GDP higher than warranted by fundamentals and optimal policy settings. Thus, the estimated exchange rate misalignment is 10–20 percent, even after the recent depreciation.

3. **Reducing the still-high vulnerabilities should be the focus of short and medium-term policies.** Notwithstanding the recent adjustment, inflation remains high, and staff projects that the current account deficit will remain in the 7–8½ percent of GDP range on current policies, implying gross external financing requirements exceeding 25 percent of GDP per year. As a result, the net foreign asset position, which has already deteriorated by about 25 percentage points of GDP since 2008, will continue to worsen. These trends are not sustainable, and Turkey could sooner or later suffer a sharp adjustment if they are not redressed.

4. **Turkey is entering a long electoral cycle.** Local elections are currently planned for spring 2014, presidential elections for summer 2014, and parliamentary elections for 2015, with a possible constitutional referendum in between. The Justice and Development Party of Prime Minister Erdoğan has been in power since 2002.

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[1] See 2012 Selected Issues Paper "Turkey's Current Account Rebalancing: Cyclical or Structural?"

[2] Most of the gold exported was obtained by drawing down inventories rather than via imports of gold. This led to a gold surplus in excess of US$10 billion, a one-off occurrence.

BACKGROUND

A. Recent Developments

5. **Growth accelerated significantly in the first half of this year.** In the first two quarters, GDP grew by 1.5 and 2.1 percent q-o-q (seasonally adjusted, non-annualized) respectively, after stagnating in the second half of 2012. The acceleration in activity was led by private consumption and public investment. Despite the impressive pace in sequential terms, GDP in the first half of the year was only 3.7 percent higher than over the same period last year, purely due to weak growth in the second half of last year. More recently, high frequency data suggest that growth slowed down in the third quarter, likely due to the impact of tighter financial conditions, although it remained in positive territory.

6. **Policy stimulus has played a big part in the rebound.** Starting in the third quarter of last year, the central bank lowered the top end of the corridor by more than 500 basis points and the policy rate by 125 bps. The latter was about 2 percent negative in real terms at the end of the easing cycle. As a result of the monetary policy loosening, credit growth accelerated sharply over the last year, reaching peaks of close to 40 percent in annualized terms in mid year. Loose fiscal policy also contributed to aggregate demand, with nominal primary spending growing at more than 15 percent y-o-y for most of the last twelve months. Capital expenditure was the main driver, but other items such as personnel spending are also growing at double digits.

7. **With the rotation back to domestic demand-led growth, external and internal imbalances are widening again.** Last year was unusual for Turkey, as growth was entirely driven by net exports and the positive output gap was reduced significantly without a contraction in overall GDP. But the first half of 2013 saw a more standard growth pattern with domestic demand leading the way, pushing imports up by 10 percent y-o-y. In addition, and despite relatively resilient exports, the current account deficit has been gradually widening, in part due to the normalization in the net gold balance after last year's exceptional surplus. In the year-to-date, the current account deficit has reached US$44.3 billion, compared with US$35.4 billion over the same period last year. The deficit is financed mostly by short term flows, with very little contribution of FDI flows so far in 2013, and a significant increase in portfolio inflows despite some recent pullback. Inflation is also accelerating, reaching 7.9 percent y-o-y in September compared with 6.2 percent at the end of last year. Core inflation measures also accelerated to about 7½ percent.

8. **The emerging market risk episode hit Turkish assets hard and forced some policy tightening on the central bank.** Lower global appetite for emerging market assets following expectations of tapering by the U.S. Federal Reserve exposed Turkey's Achilles heel: its large external financing needs and short term funding composition. Since May, the government benchmark bond rate has increased by some 300 basis points, the exchange rate has depreciated by more than 10 percent against the euro-dollar basket, and stock prices have fallen by close to 20 percent. Concurrent political demonstrations in Turkey added to uncertainty. Pressure on the lira led the central bank to hike the top end of the corridor by 125 basis points, and suspend liquidity provision

at the policy rate (which it has not hiked) during designated exceptional days. This resulted in an average increase of about 200 basis points in interbank rates. In addition, the CBRT intervened in FX markets via auctions by about US$11.5 billion (more than 15 percent of net international reserves) to slow down depreciation. Despite the tightening, the central bank continues to provide liquidity at negative real rates, and fiscal policy has remained expansionary.

B. Outlook and Risks

9. Staff expects growth to reach 3.8 percent this year and 3.5 percent next. Relative to the strong pace of growth in the first half of the year, the current baseline assumes a significant deceleration in the second half, a result of lower confidence due to the recent volatility as well as tighter financing conditions. However, with financial conditions and confidence expected to normalize, and on current policies, growth should re-accelerate into 2014, with the lower annual number purely a matter of base effects. In terms of GDP composition, both 2013 and 2014 are expected to be led by domestic demand. In 2013, domestic demand growth is projected at 4.8 percent, as a result of strong private consumption and public investment, while the net export contribution will swing to -1 percentage points from last year's exceptional 4.1.

10. In this context, imbalances are set to widen. With the strong import pick-up relative to 2012, and with one-off factors that led to large net gold exports last year waning, the current account deficit is forecasted to increase from 6.1 percent of GDP in 2012 to 7.4 percent this year and 7.2 next. This, combined with the short-term nature of the foreign financing, will imply gross external financing needs in excess of 25 percent of GDP annually. Also, with the pick-up in domestic demand and pass-through from the lira depreciation, staff expects inflation of 8 percent at year end (7.7 percent average inflation), well above the central bank's 5 percent target. On current policies, inflation is not expected to return to target next year either.

11. The medium term baseline requires a continued willingness of investors to finance large and growing external deficits, which carries significant risks (see Box 1). On current policies, the baseline projects a gradual convergence towards 4½ percent growth rates in line with the historical trend growth. However, given present levels of savings, such growth would entail a widening of the current account deficit from its already high level, reaching 8¼ percent of GDP in 2018. As such, the medium-term baseline is associated with an increasing vulnerability to capital flow weakening or even a sharp reversal.

12. A sudden stop in capital flows would trigger a significant economic adjustment. The combination of expected monetary policy normalization in the United States and a growth slowdown in emerging economies could result in a sharp and sustained reversal of inflows. Given the size of Turkey's current account deficit, a sudden stop in inflows (one sharper and more sustained than the one seen in recent months) would require a large compression in absorption to close the external deficit, leading to negative GDP growth. The growth path then would look much less benign than in the staff's baseline.

13. Given buffers in the system and the state of balance sheets, a plausible growth and exchange rate shock in line with 2008–09 is unlikely to lead at this stage to a systemic event:

- *Households:* Their net financial asset position is positive at about 20 percent of GDP. Leverage in this sector has increased considerably in recent years, with household debt rising from less than 30 percent of disposable income in 2006 to 50 percent now−still not large by international and peer standards. In addition, debt servicing risks are mitigated by the fact that most loans are at fixed interest rates, although the relatively short maturity of household debt (4.1 years on average) implies principal payments of about 20 percent of disposable income. Crucially, households do not carry foreign exchange (FX) risk, as banks are not allowed to lend to them in foreign currency.
- *Public sector:* government debt remains low at 35 percent of GDP, and in recent years the profile of this debt has improved considerably, both in terms of longer maturities and lower foreign exchange exposure (only a third of public debt carries FX risk). As noted in Annex I, debt sustainability does not represent a risk on current policies and debt is resilient to standard shocks. External financing risk is the most notable public debt vulnerability.
- *Non-financial corporates:* as with households, leverage has increased considerably in recent years. Yet the debt service remains within their capacity to repay at least in the corporates for which data exist: earnings before interest, taxes and depreciation are more than twice debt service payments, considerably higher than only a few years ago. The most concerning aspect is the widening short FX position of the non-financial corporates. This has jumped from US$78 billion in 2008 to US$165 billion now. However: (i) the vast majority of this short FX position is accounted for by long term debt, reducing rollover risks; (ii) only slightly more than half of the corporates' FX liabilities are vis-à-vis the domestic banking system; (iii) by regulation, FX loans can only be granted to large corporates (and only at maturity of more than one year) or to companies with FX receipts; and (iv) the floating exchange regime reduces the probability of a very large and abrupt adjustment in the exchange rate..
- *Banks:* the evolution of banks' balance sheets mirrors that in other sectors, with a significant increase in leverage but not yet reaching alarming levels. The loan-to-deposit ratio has increased sharply from 76 percent in 2009 to around 110 percent now. Capital buffers remain strong, with the capital adequacy ratio at 16 percent. Although there is an FX maturity mismatch, liquid FX assets cover more than 100 percent of the banks' short term FX liabilities. While banks have only a small on-balance sheet FX exposure (about US$20 billion) fully closed via swaps, they do carry indirect FX risk via their lending to corporates. A large devaluation could convey these risks onto banks as increased NPLs. Nevertheless, stress stemming from this channel should be manageable given existing buffers and low levels of NPLs.
- *Foreign reserve buffers:* gross reserves have increased significantly over the last 18 months to reach US$130 billion. They now account for about 115 percent of the Fund's metric versus 98 percent at end 2011. Thus, by this metric, reserves appear reasonable, even if not as ample as those of other emerging markets. However, the reassuring signal of reserve adequacy provided by the Fund metric is largely a result of the interplay between the reserve option mechanism

(ROM) and gross international reserves (see below)[3]. In practice, the increase in gross reserves has not been matched by a corresponding increase in net reserves, which at US$50 billion remain small given Turkey's external financing needs.

Box 1. Turkey: Risk Assessment Matrix[1]

Nature/Source of Risk	Likelihood	Expected Impact	Policy Responses
Domestic, short- to medium-term **Widening external imbalance as a result of excessive policy stimulus.**	*High*	*Medium*	- Tighten fiscal policy to build buffers against potential shocks while creating space for monetary policy maneuver. - Set monetary policy consistent with the inflation target. - Monitor vulnerabilities in the banking and corporate sectors. - Develop contingency plans in case of capital flow reversal (below).
Global, short- to medium-term **Emerging markets capital flow reversal.**	*Medium*	*High*	- Exchange rate flexibility should help buffer BOP pressures, with interventions limited to avoiding excessive overshooting. - Monetary policy should strike a balance between supporting domestic growth and maintaining foreign investor demand. - Macro-prudential measures could be used to ease an excessive impact on credit. - Fiscal stimulus may need to be implemented to mitigate private demand compression.
Global, short- to medium-term **Deeper than expected slowdown in EMs (structurally lower potential growth).**	*Medium*	*Medium*	- Accelerate structural reforms to increase productivity and competitiveness. - Reassess fiscal policy in light of the medium-term impact of slower economic growth on the fiscal structural position.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is staff's subjective assessment of the risks surrounding this baseline. The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities.

[3] Setting aside banks reserves and the corresponding bank's short-term debt, the CBRT international reserves are about 90 percent of the Fund's ARA metric.

Box 2. Medium-Term Program, 2014–16

The macroeconomic assumptions underlying the medium-term program (MTP)[1] are more conservative than last year's. In particular, the growth trajectory has been shifted downwards by 1 percentage point in 2014 and inflation has been revised up for 2013–14. The MTP has placed the emphasis on reducing the current account deficit. The authorities expect that with the policies underlying the MTP, the current account deficit will decline to 5½ percent of GDP by 2016. In particular, the MTP cites higher domestic savings, stimulated through structural and macro-prudential measures, as well as increasing energy efficiency and lower gold imports as the key factors behind the reduction in the current account.

These assumptions are more upbeat than those of staff. Notably: (i) the economy is assumed to grow by 4–5 percent in 2014–16 versus 3½–4½ percent in the staff's scenario; (ii) inflation is projected to fall rapidly and converge close to the central bank's 5 percent target, whereas staff do not expect the target to be reached; (iii) most importantly, the authorities see the current account deficit narrowing despite an acceleration in growth, whereas staff expect the deficit to widen.

The new MTP envisages a slightly more ambitious path for the public sector primary surplus than its predecessor. However, it again allows spending pressures to move in line with higher expected revenues. Relative to the last year's MTP, primary spending will increase by ½ percent of GDP, on account of higher capital spending. For 2014, the new MTP envisages a decline in primary spending of 0.4 percent explained by the unwinding of the previous year's increase in capital expenditures, whereas current spending continues its upward trend.

Staff projects a much less favorable medium-term fiscal outlook. While the authorities expect the central government's primary surplus to reach 1.0 percent of GDP by 2016, staff forecast a primary deficit of 0.1 percent of GDP. About two thirds of the discrepancy between staff's projections and the new MTP are on the spending side, with revenues accounting for the rest. In particular, staff assumes a more modest decline in current spending as a share of GDP and sees risks to the assumed compression in capital spending in 2014.

Turkey: 2014-16 Medium-Term Program

	Old MTP			New MTP				Staff 1/			
	2013	2014	2015	2013	2014	2015	2016	2013	2014	2015	2016
GDP (percent change)	4.0	5.0	5.0	3.6	4.0	5.0	5.0	3.8	3.5	4.3	4.4
CPI (percent change, eop)	5.3	5.0	5.0	6.8	5.3	5.0	5.0	8.0	6.0	6.0	6.0
Current account deficit	7.1	6.9	6.5	7.1	6.4	5.9	5.5	7.4	7.2	7.4	7.7
NFPS primary balance	0.8	1.0	1.1	0.9	1.0	1.2	1.3	0.5	0.2	0.1	0.1
Central government primary balance	0.5	0.6	0.7	0.9	0.5	0.8	1.0	0.4	0.0	-0.1	-0.2
Central government primary revenues	22.8	22.5	22.1	23.7	22.9	22.6	22.3	23.2	22.7	22.2	21.9
Central government primary spending	22.3	21.9	21.4	22.8	22.4	21.8	21.3	22.8	22.7	22.3	22.1
of which current spending	20.2	19.8	19.2	20.2	20.3	19.6	19.1	20.2	20.2	20.1	19.9
of which capital spending	2.1	2.2	2.2	2.6	2.1	2.2	2.2	2.6	2.5	2.2	2.2

Source: Turkish Aurthorities.

1/ Staff data is adjusted to account for expenditure on student loans, which are included in central government spending in the MTP figures.

[1] This plan was announced on October 8th, after the mission's departure. The mission held discussions with the authorities on the broad contours of the MTP.

14. However, external imbalances still need to be addressed quickly. Each year that imbalances (excessive credit growth and large current account deficit) go un-addressed, stock imbalances get worse and balance sheets become more stretched. Over the last three years FX lending of banks to non-financial corporates has grown much faster than exports, representing a growing vulnerability[4]. Turkey's net foreign asset position of close to -50 percent of GDP has also deteriorated noticeably in recent years. This increases the probability that any future sharp economic adjustment could lead to systemic distress. Alternatively, if capital flows simply weaken, and the risk premium demanded by markets rises, investment and GDP could slow significantly.

Authorities' views

15. The authorities broadly share the staff's views on the outlook for 2013 and 2014. However, there is significant disagreement on the medium term forecasts. The authorities are confident that Turkey can grow at 4−5 percent in the medium term and yet achieve a meaningful reduction in the current account deficit, as reflected in their medium-term plan (see Box 2). In their view, Fund staff underestimates the cyclical component of the current account deficit stemming from the impact of slow growth in Europe, Turkey's main trading partner. Excluding gold, they expect the current account deficit to decline this year despite close to 4 percent growth and view the exchange rate as close to equilibrium. Thus, in their opinion, Turkey's external deficit will start closing as Europe recovers even if Turkey's economy grows at close to potential. Regarding risks, the authorities noted that the odds of a market-led adjustment due to weak external financing had receded considerably after the Federal Reserve announced a delay in tapering. Still, they recognize that, sooner or later, monetary policy in advanced economies will be normalized, and that Turkey remains exposed to a reversal in flows. Should one occur, they see the private sector as fully capable of absorbing the shock and recovering quickly as happened in 2008–09, and don't believe such a scenario will lead to any systemic distress. They emphasized that the banks are very well capitalized and have no open FX position. Although acknowledging that non-financial corporate FX liabilities have increased, they take comfort in the long maturity, and that the corporates carrying them either have natural or financial hedges and/or very strong balance sheets. Finally, they pointed out that, even at the peak of the global financial crisis, rollover rates never dipped much below 100 percent, particularly for the banks.

POLICY DISCUSSIONS

The policy priority is clear: large imbalances in a less forgiving global environment call for a more credible monetary anchor and tighter fiscal policy. In the medium term, there is a need to reduce imbalances and gradually break the link between growth, capital inflows and a large and widening current account deficit, which has in the past contributed to economic volatility. This will require a concerted effort to increase national savings and make the economy more competitive.

[4] See Annex II on external debt sustainability.

C. Short Term Policies

C.1 Monetary Policy

16. Staff argued that the monetary policy stance is not consistent with the inflation target and needed to be tightened. The top end of the corridor is at 7.75 percent, the main policy rate (the one-week repo) at 4.5 percent, and the *de facto* average rate at which the central bank is providing liquidity at about 6−6½ percent. The recent tightening has translated into some slowdown in credit growth. Nonetheless, with inflation close to 8 percent, and inflation expectations for end year above 7 percent, this means that policy rates remain negative in real terms (sharply negative in the case of the one-week repo). This is hard to justify in an economy that grew at more than 7 percent annualized in the first half of the year, where credit growth is still running at about 25 percent, and where the 5 percent inflation target is likely to be missed again. Thus, staff called for a significant tightening above and beyond the recent one, specifically: a one step increase of 250bps in the main policy rate (the one-week repo) to reach positive real levels, and a systematic provision of liquidity at this policy rate. In addition, staff argued that the interest rate corridor should be narrowed. While such a move would be equivalent to about 100–150 bps tightening relative to current levels, there would be an important signaling effect coming from increasing the actual policy rate, as opposed to tightening by stealth as is the current practice. Finally, staff argued that foreign exchange intervention cannot substitute for the right monetary stance, and that it should be limited to addressing excessive exchange rate volatility.

17. In addition, staff called for a normalization of the monetary policy framework, which is too complex and has not delivered targeted inflation.[5] The central bank continues to rely on its unorthodox framework, the key elements of which are: (i) a wide interest rate corridor, 425 basis points at present; (ii) a highly variable cost of liquidity within this corridor, as the central bank can suspend its main policy rate (the one week repo) on ad-hoc tightening days and instead provide liquidity at the higher overnight repo rate; and (iii) the reserve option mechanism (ROM, see Box 3),[6] which allows banks to substitute gold and FX for their reserve requirements on TL-denominated liabilities. In addition, the central bank targets *de facto* several concurrent objectives on top of its inflation target, such as financial stability and growth. While the unorthodox policy framework has been praised by some as highly innovative, in the view of staff the combination of multiple instruments and objectives has brought about several adverse consequences:

- *The inflation target has been repeatedly missed:* over the last three years, inflation has been below target in only a few months. Although ignoring financial stability and growth may not be

[5] See Annex III for a summary of the current monetary policy framework.

[6] The ROM gives banks the option to release some of their lira required reserves by depositing foreign exchange or gold instead. The key is that, if *E* is the exchange rate, banks have to deposit more than one dollar to release *E* lira. Using a conversion rate higher than *E* allows the central bank to automatically sterilize a proportionally greater part of the inflows.

the best option for a country constantly buffeted by large capital flows, the Central Bank of the Republic of Turkey (CBRT) has erred on the side of an insufficient focus on delivering the inflation target.

- *Communications with market participants have been hampered:* the instruments are complex and too numerous, and the interaction of these tools makes the framework hard to grasp for market participants. To its credit, the central bank has significantly ramped up its communication efforts.

- *The monetary transmission mechanism has been weakened*. While the framework gives the central bank flexibility to adjust rates quickly, the cost of this flexibility is a lower signaled commitment, a critical aspect to manage expectations. Because of this, changes in effective lending rates by the central bank are affecting the short end of the yield curve but less so the long end, where many investment decisions are made. Communication issues only compound the problem.

- *The framework has not prevented a significant increase in private sector leverage*. One of the stated goals of having many instruments is to maintain financial stability in addition to price stability. Yet credit growth in the last three years has exceeded 30 percent on average, and leverage among households, banks, and non-financial corporates has risen significantly. Finally, the framework does not seem to have tamed capital inflows (see Box 4).

With this in mind, staff called for a move towards a more orthodox framework, characterized by a narrower corridor, a consistent provision of liquidity at the main policy rate, and a clearer focus on inflation. This normalized framework should not ignore financial stability concerns, with interest rate policy properly complemented with macro and micro-prudential measures.

18. Staff expressed concerns about whether the reserves accumulated through ROM provide adequate defense against balance of payments pressures. Since early 2012, the central bank has accumulated some US$35 billion in gross reserves through ROM. The central bank has argued that ROM has several distinct advantages over sterilized intervention and indeed in 2012 and through May 2013, ROM proved useful to partially absorb steady inflows. Moreover, swapping the FX with the central bank rather than with private banks lowers counterparty risk. However, during the recent risk episode, the first real test of ROM under stress, the central bank had to resort to straight interventions using scarce net reserves to alleviate BOP pressures. While ROM reserves cover banks' external borrowings, it is clear they do not cover other gaps such as a shortfall of funding for the current account and hence cannot substitute for net reserves. Hence, should inflows resume, staff recommended that the central bank boost net reserves through sterilized intervention.

Box 3. CBRT's Reserve Option Mechanism (ROM)[1]

In late 2011 the CBRT introduced a new tool, the ROM, into its continuously evolving monetary framework. The ROM allows commercial banks to meet their reserve requirements on lira-denominated liabilities by using foreign exchange and gold. Conversion happens at the market exchange rate multiplied by an increasing penalty parameter, the Reserve Option Coefficient (ROC). Currently, banks can convert up to 60 percent of their reserve requirements into FX with ROCs ranging from 1.4 to 2.8 and up to 30 percent into gold with ROCs ranging from 1.4 to 2.5.

The ROM was to help increase the resilience of the economy against external finance shocks and achieve financial stability by (i) limiting fluctuations in the exchange rate; (ii) limiting conversion of FX inflows into bank lending; and (iii) incentivizing banks to accumulate FX for "a rainy day." Existence of the ROM also helped banks reduce costs of fulfilling regulatory obligations. And being a market-driven facility, it was to help the CBRT avoid perceptions of the CBRT targeting the exchange rate.

The ROM was designed so that with strong inflows and costs of FX liquidity declining, banks would voluntarily increase use of the ROM facility, redirecting inflows into the facility while releasing lira and countering appreciation pressures, while the opposite would happen during outflows. With the effective ROC greater than 1, the ROM is a more powerful analog to interventions, yet, reflecting decisions of market participants. Finally, while the ROM has no impact on net international reserves, it does boost gross reserves even though the ROM-part of reserves is not under the CBRT's full control.

The ROM indeed worked as expected during inflows, but its existence did not help sufficiently when inflows weakened in summer of 2013. Release of FX held by the banks in the ROM was limited and did not prevent exchange rate depreciation, forcing the CBRT to *re-introduce the FX sale auctions* and to *tighten TL liquidity*. This happened because outflows were not driven by banks' repayments of their outstanding loans, but by outflows from money, government debt, and equity markets. Under these circumstances, it would not have been rational for banks to sell FX stored in the ROM, as expectations for increases in the costs of TL liquidity and/or nominal depreciation must have been in place, indeed vindicated by subsequent developments. Additionally, sales of FX stored in the ROM, would have opened a short FX position for banks, something restricted by regulations.

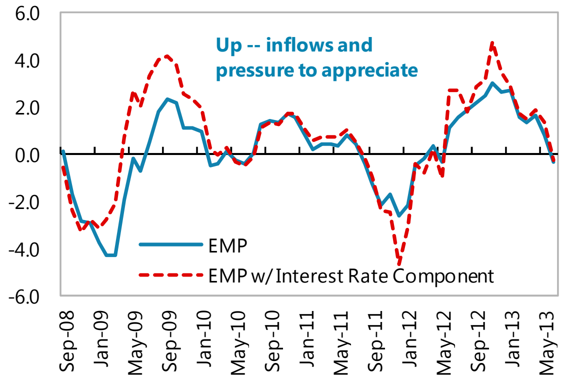
Overall, the ROM has certain limitations. Most importantly, as noted above, it is not a perfect substitute for net international reserves when it comes to the economy's BOP needs. Also, in times of heightened pressures, an increase in the costs of TL liquidity is likely to limit release of FX. Finally, communicating the purpose and mechanics of the ROM to market participants has proved challenging.

[1] See Selected Issues Paper "CBRT's Reserve Option Mechanism."

Box 4. Capital Flows and the Exchange Market Pressure Index[1]

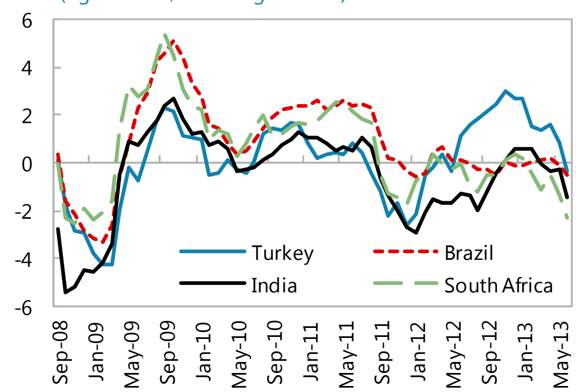
The issue of push and pull factors behind volatile capital flows has been a source of debate in Turkey. The CBRT adopted in late 2010 a new monetary framework, in part to mitigate the impact of these flows. Examining the Turkish experience using the Exchange Market Pressure Index (EMP)—which identifies the factors driving the flows and allows a cross-country comparison with other emerging economies—helps assess the impact the new framework may have had on the flows.

Exchange Market Pressure Index
(Against US$. 6 Rolling Months)



Source: Haver and IMF staff calculations.

Exchange Market Pressure Indices
(Against US$. 6 Rolling Months.)

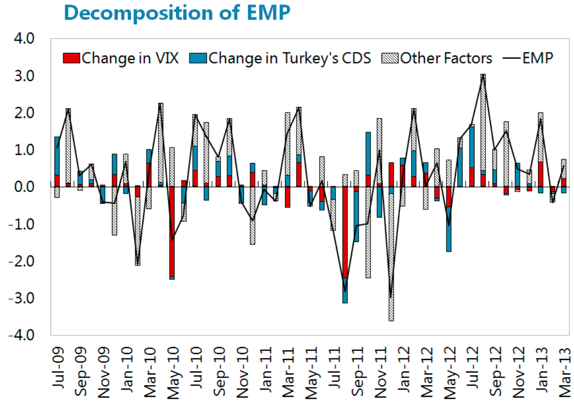


Source: Haver and IMF staff calculations.

Empirical analysis suggests that factors that affect the EMP are: 1) changes in the Turkey-specific risk perceptions, measured by lagged changes in Turkey's CDS spreads, and 2) global conditions measured either by the global volatility index (VIX) or the monetary policy stance of the advanced economies. Specifications with these factors can explain 30–40 percent of movements in the EMP. Surprisingly, there was no statistical evidence of a direct impact of unconventional global monetary policies on Turkey, only of an indirect channel, via global volatility.

More importantly, no evidence of an impact of the CBRT's unorthodox framework was found. Estimations using rolling samples suggest no statistically significant changes in the parameters, raising the question of whether the new framework adopted by the CBRT is more effective than a conventional framework at mitigating inflows. Comparisons with other emerging economies suggest that exchange market pressures in Turkey are to a degree larger than in other countries linked to global and country-specific risk factors, including a noticeably stronger link to interest rates in advanced economies.

Decomposition of EMP



Sources: Haver and IMF staff calculations.

[1] See Selected Issues Paper "Looking at Capital Flows through the Exchange Market Pressure Prism."

Authorities' views

19. The central bank believes the current monetary stance is appropriate. They noted that, although domestic demand grew rapidly in the first two quarters, this came after six quarters of close to zero cumulative growth. Thus, the underlying pace of activity should not be exaggerated, especially given that they still believe there is a negative output gap. In this context, they see their recent interest rate increases as sufficient to bring inflation down to target, pointing to slowing credit growth on a sequential basis, and that financial conditions show a significant tightening. Regarding its framework, the central bank firmly believes that it is superior to a more orthodox inflation targeting one, since in a global economy characterized by large and volatile capital flows, rigid adherence to an inflation target could come into conflict with financial stability. Therefore, they see their framework as consistent with a "flexible inflation targeting" regime that balances other objectives. Moreover, the authorities place great value in the interest rate flexibility afforded by the combination of a wide corridor and the ability to shift within the corridor. In their view, the standard frameworks suffer from significant rate inertia that is not adapted to a volatile world. They agreed with staff that fundamentals should set the level of the exchange rate, but believe the Turkish lira is close to equilibrium. Finally, they concur that ROM cannot cover all balance of payment shortfalls, and agreed that regular interventions had been needed to provide liquidity to the market as a result of weaker BOP financing. Still, they believe the benefits of ROM should not be underplayed, notably its role in ensuring that banks have sufficient liquid FX buffers should roll-over pressures materialize. They added that they are accumulating net reserves via the export/import bank.

C.2 Fiscal Policy

20. The authorities are on track to meet their 2013 budget targets, despite rapid spending growth. The budget contemplates a central government primary surplus of 0.5 percent of GDP, very close to last year's outturn, and the performance to August is consistent with this target. This, however, masks an expansionary fiscal stance as expenditures are growing well above nominal GDP on the back of revenues boosted by one-off factors. Nominal central government revenues grew 17 percent y-o-y in the year to August, compared with 9 percent growth last year. Privatization revenues and repayments of tax arrears by public companies have already exceeded the full year targets.[7] The government has then made use of these windfalls to increase capital spending beyond the budget ceiling. As a result, primary spending grew by 15 percent in the year to August, versus a full year target of 11 percent in the budget.

21. Thus, staff argued that fiscal policy is too loose. The ½ percent of GDP deterioration of the structural primary balance expected for this year, together with high nominal spending growth,

[7] Privatization revenues are below the line and not accounted in the fiscal balances quoted above. However, in Turkey the law allows for excess privatization revenues to be spent freely and hence they are financing sources for additional spending.

is indicative of an expansionary stance.[8] Current levels of spending growth are too high for an economy that expanded at more than 7 percent annualized in the first half of the year, where inflation is at 8 percent, and where the current account deficit is high. Hence, staff advised that, the authorities contain expenditure in the last four months of the year to avoid any further overruns, and that any additional one-off revenues be saved rather than used to add to primary spending.

22. Looking into 2014, staff recommended a significant fiscal tightening. Specifically, staff recommended that next year's central government budget target a 22 percent of GDP expenditure ratio as contemplated in the 2013–15 medium-term plan, and that any revenue over-performance be saved. Such actions would be consistent with a structural tightening of ¾ percent of GDP compared to the baseline. This is appropriate given the very high current account deficit, associated vulnerabilities, and would relieve pressure from monetary policy. However, even this modest structural improvement will be challenging given rapidly growing *non-discretionary* primary spending, whose share in total spending has increased from 47 percent before the crisis to almost 60 percent now. Thus, staff recommended that the fiscal effort focus on containing primary discretionary expenditure growth, notably current spending.[9]

23. Discretionary fiscal stimulus should be reserved for scenarios where growth is expected to turn negative. In the view of staff, given the large current account deficit, and with inflation well above target, there would be little justification to respond with more than the automatic stabilizers to a moderate slowdown in growth. Thus, staff advised that discretionary fiscal policy should not be used to ensure a high "floor" for growth. However, given low public deficits and debt (see debt sustainability analysis), there would be room for discretionary stimulus if growth were projected to turn negative. This policy was adopted by the authorities during 2008–09.

Authorities' views

24. The authorities believe that the 2013 budget headline targets will be met or exceeded, but recognize that there will be expenditure over-runs. Regarding next year, they agreed with the need to respect the primary surplus target set out in the 2013–15 medium term plan. They also share the view that this needs to be achieved primarily via expenditure restraint. Although they see less scope for adjustment at the central government than recommended by staff, they expect some room for gains outside of the central government. Regarding the increase of non-discretionary primary spending, they believe staff should acknowledge that this was allowed for by a permanent decline in debt service costs, thanks to the significant fiscal efforts of the past decade. In addition, some of the large increase in the wage bill reflects the hiring of additional

[8] Staff's measures of the structural fiscal balance suggest a positive fiscal impulse in 2013. However, due to uncertainty over the output gap and structural revenues, this measure is complemented with a spending growth indicator.

[9] Given potential growth of around 4 percent and the central bank's inflation target of 5 percent, nominal spending growth of around 9 percent would be about "neutral" in the sense of being in line with nominal potential growth and would be consistent with the primary surplus target advocated by staff.

teachers, in line with their objectives to reform the education system and increase educational attainment.

C.3 Financial and Macro-prudential Policies

25. **Banks continue to perform well**. Non-performing loan ratios remain low at about 3 percent, although NPLs are slightly higher in more recent loan vintages. Including loans that were restructured before becoming non-performing, the ratio of "problem" loans reaches around 2.84 percent of total loans. With asset quality good, bank profitability was strong in the first half of the year. Even with the recent tightening of monetary policy net interest margins remain at 4 percent, and return on equity close to 17 percent.

26. **Banks' indirect exposure to FX risk has risen rapidly, but prudential regulations provide some comfort.** The banks' own on-balance sheet open FX position is not very large, at slightly below US$20 billion or 2½ percent of GDP, and is hedged off-balance sheet through swaps. However, the indirect FX risk is a growing concern, as lending in foreign exchange to non-financial corporates has increased to some US$130 billion from about US$40 billion in mid-2008 (see Box 5). However, regulations stipulate that FX loans can only be given to companies that can show export receipts, or else be of a minimum US$5 million and at least 1–year maturity. These regulations are aimed to minimize rollover risks, to benefit larger corporates with greater access to financial hedging, and to increase incentives for banks to do proper risk assessment. At present, large corporations account for 84 percent of total FX loans by banks, and the loans are not unduly concentrated in any one sector: the energy sector accounts for 15 percent of the total, and no other sector accounts for more than 10 percent. Still, some US$25 billion in FX indexed loans is not subject to the same regulations, even though it carries similar risks.

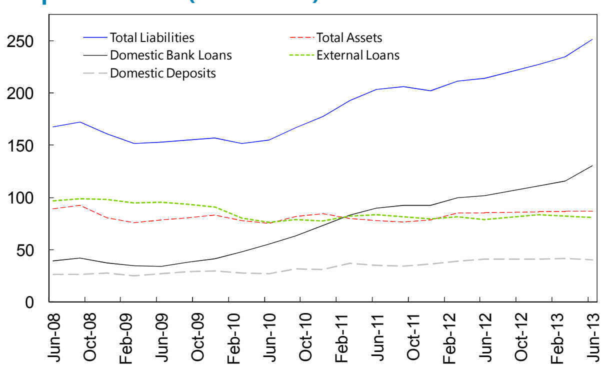
27. **In addition, capital and liquidity ratios appear sufficient to cope with shocks.** The capital adequacy ratio of the system is now at 16 percent (Basel 2.5 definition), still high despite recent marked-to-market losses on the banks' securities portfolios and the impact of a weaker lira on risk-weighted assets. Moreover, capital is almost entirely tier 1. Similarly, the banks' liquidity adequacy ratios (either at one week or one month maturity, total or FX only) show liquid assets cover more than 100 percent of short term liabilities despite conservative assumptions on the amount of deposits "at risk of flight." Recent stress tests by the regulators show that, even under large GDP shocks, the system's CAR would remain above 12 percent, with no bank falling under 8 percent. The models used by the regulator could be further elaborated, in particular focusing on the transmission from GDP shocks into unemployment, credit growth, and the exchange rate, and from there to NPLs. Staff recommended additional calibration of the macro and satellite models regarding unemployment and exchange rate movements.

Box 5. Foreign Exchange Exposure in the Non-Financial Corporate Sector

Recently, attention has focused on the foreign exchange position of Turkey's non-financial corporate sector. Non-financial corporations have substantial foreign exchange (FX) liabilities. As of June 2013, these liabilities stand at US$251 billion, compared to US$87 billion of FX assets, and hence a US$164 billion net position. Since mid 2008, when the net position was US$78 billion, corporate FX liabilities have increased by some 50 percent, while FX assets decreased slightly (Figure). Exports, which are often mentioned in relation to FX liabilities, increased by 17 percent in US dollar terms over the same time period.

Domestic banks' exposure to corporate FX loans has increased sharply over the last half a decade. The domestic banks provide US$130 billion in FX loans, which represents some 52 percent of total FX liabilities of non-financial corporates, compared to just 23 percent in mid-2008. About a third of these loans are to the energy, construction, and real estate sectors. Meanwhile, over the same time frame, external parties (which include foreign subsidiaries of Turkish banks) have scaled back their nominal exposure by US$16 billion (-17 percent). A similar shift can be noted in corporate FX assets: While total corporate FX deposits have remained almost flat at around US$60 billion, the share of these deposits held in the domestic banking system has increased to two-thirds of this total, up from some 42 percent in 2008.

Turkey: Foreign Exchange Exposure of the Non-Financial Corporate Sector (USD billion)



Source: CBRT

This way, risks have transferred to the domestic banking system, and careful monitoring seems warranted. While some of these corporate are hedged – indirectly through export earnings potential or directly using financial hedges,—aggregate data on such hedges is not readily available. Similarly, aggregate information on corporates' FX collateral is not on hand. These data gaps need to be filled to ensure proper regulatory insight into the risks associated with corporate FX exposure at the aggregate level.

28. **Staff is of the view that the macro-prudential tool kit could be used in a more targeted and clear manner for financial stability.**[10] Given that the short FX position of the non-financial corporates constitutes an important vulnerability for the banks, the authorities should consider raising risk weights and provisioning on such loans as was also recommended in the 2012 Financial System Stability Assessment (FSSA). Also, while supervisors have access to data on export receipts, financial hedges, or FX collateral underpinning any single FX loan, the data on these hedges and collateral should be at a minimum aggregated and ideally be made public. Moreover, staff recommended that FX indexed lending be subject to the same prudential measures as FX lending. Separately, while households are not very leveraged relative to peers, debt-to-income ratios have grown rapidly in recent years, and are set to increase even further given the current pace of credit growth. In that context, staff welcomed the measure to link clients' income to credit card limits in line

[10] See Annex IV for a summary of recent macro-prudential measures.

with recommendations from the FSSA. This could be extended to general purpose loans too. Beyond this, a more general consumer debt-to-income limit would be a welcome step. While currently banks use such limits for their internal risk management, the limits are not uniform across banks and cannot be enforced until they are made into a prudential requirement.

29. Staff argued that macro-prudential policies should not be used to stimulate specific credit segments, absent microeconomic distortions. The authorities have recently eliminated loan-to-value ratios for commercial real estate loans. They are also considering changes in micro- prudential regulation for export loans and SMEs. In staff's view, the main role of macro-prudential instruments should be to guarantee financial stability. Thus, absent microeconomic distortions that affect the supply of credit to specific sectors, their use to redirect credit in the economy is not warranted. More generally, staff cautioned that macro-prudential policies should not be a substitute for the proper monetary and fiscal stance.

30. The mission reiterated the importance of addressing deficiencies identified by the Financial Action Task Force (FATF) and the FSSA in Turkey's combating the financing of terrorism (CFT) framework. Turkey is still included on the FATF list of jurisdictions that have not made sufficient progress to address strategic deficiencies in their AML/CFT frameworks, which is leading to heightened due diligence from foreign financial institutions regarding transactions with Turkey. Turkey strengthened its CFT legal framework earlier this year, but the FATF considers that certain concerns nevertheless remain, and these concerns need to be addressed in order to protect Turkey's financial sector.

Authorities' views

31. The authorities believe the regulatory framework is adequate to contain risks. Although they agree that indirect FX risk has increased in recent years, they emphasized prudential regulations that place limits on banks' FX lending. In addition, they are monitoring FX mismatches closely, not least through on site supervisions and a more comprehensive collection of data. Regarding macro and micro prudential measures, they stated that the new regulation linking income to credit card limits is another significant step to contain excessive leverage, and that they will consider extending these limits to other kinds of consumer loans. Unlike staff, they believe that prudential regulation is an important tool to rebalance the economy while not endangering financial stability. In that context, they see scope for some modest changes in prudential regulation to incentivize export and SME loans.

D. Medium Term Policies

32. Turkey needs to raise its savings rate to escape boom-bust cycles. The national saving rate has fallen dramatically over the last fifteen years as improved macroeconomic conditions reduced the need for precautionary savings, while a cleaned up banking system was able to rapidly expand credit. With the savings rate at a low of 15 percent of GDP, the investment rate is determined by the availability of volatile external flows. When these are ample, investment, and consumption expand rapidly. When capital flows contract, they drag the economy down with them. The correlation between GDP growth and capital flows in Turkey is about 80 percent, much higher than in peer countries. With capital flows so volatile, particularly the short term flows that Turkey attracts, output volatility has been high.

33. Without higher savings, Turkey will find it hard to sustain historical trend growth in the future. Turkey's trend growth rate has been remarkably stable at around 4 percent, despite significant output volatility around this trend. Yet this growth rate has not necessarily been consistent with external stability. In fact, staff estimates show that, given current savings and the structure of the economy, the rate of growth consistent with a stable current account is around 2¾ – 3½ percent (see Box 6).[11] Therefore, Turkey can grow sustainably at 4 percent or above only if it manages to raise domestic savings. Otherwise, such growth rates would come at the cost of widening current account deficits (from an already high level), with all the risks attached to them.[12]

34. Staff argued that fiscal policy has a major role to play in raising national savings. The authorities have commendably undertaken a reform of the private pension system, which is proving effective in bringing new people into the savings net. Yet these gains will not be enough given the large savings gap, hence fiscal policy should also play a role.[13] In addition, a tighter fiscal policy would relieve pressure on monetary policy, and contribute to a needed depreciation of the real exchange rate. Thus, staff recommended that the government target a primary surplus of around 2 percent of GDP in the medium term, which would be akin to targeting a 1 percent of GDP structural primary surplus by 2018, about 2 percent more than under the current policies baseline. To initiate the adjustment, staff proposed that the 2014 MTP (which covers the period 2014–16) target a central government primary balance of 1.2 percent of GDP by 2016 (consistent with an increase in the structural primary balance relative to baseline of 1.1 of GDP over three years). Staff welcomed the recently adopted development plan for 2014–18 which contemplates a 1 percent of GDP primary balance in the medium term, although more is needed.

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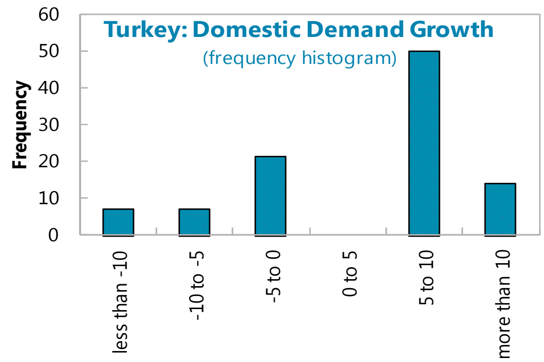
[11] Average growth of 4 percent over the last fifteen years has been associated with a *trend* deterioration in the current account of about 7 percentage points of GDP.

[12] Turkey was able to grow at 4 percent per year on average in the past because it started with a low current account deficit and a low stock of external liabilities. Now, with much higher external liabilities and current account deficit, the external financing constraint is more likely to become binding.

[13] The Ricardian offset coefficient is estimated to be around 0.5 in Turkey. The government has recently undertaken other measures to boost savings, such as the reform of the private pension system. See the 2012 Article IV Staff Report for details on this reform.

Box 6. Output Volatility and Externally Sustainable Growth[1]

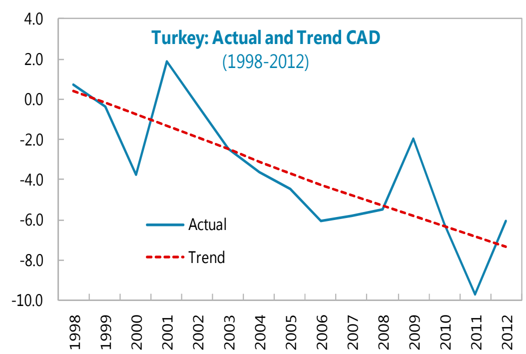
Among large economies, Turkey stands out for its volatility. Over 1998–2012, the period for which complete national accounts exist, GDP either contracted or grew faster than 6 percent in more than 70 percent of the observations. Domestic demand was even more volatile, either contracting or growing faster than 5 percent in every single year. In the G-20+Poland space, only Argentina has experienced more volatility over this period.



Source: Haver; WEO; IMF staff calculations.

Low domestic savings, and policy pro-cyclicality, are key reasons behind this volatility. Turkey has a low national savings rate, hence at the margin investment is financed by foreign flows: when these are ample, investment and the current account deficit expand, and when flows recede so does investment, dragging the economy with it. The correlation between GDP growth and capital flows in Turkey is 0.8, much higher than in peer countries. In addition, flows into Turkey have been more volatile than elsewhere, because Turkey attracts relatively little FDI and more short-term flows. Beyond the low savings-volatile flows nexus, fiscal policy has been pro-cyclical in Turkey, exacerbating the effect of capital flows.

Standard estimates of potential growth have limitations. Turkey's trend growth has been stable at 4 percent despite high volatility. It is thus no surprise that most estimates of potential growth are close to this trend, in the 4−4½ percent range. The problem then is that potential is unrepresentative of historical experience, as the economy has seldom grown in the neighborhood of such rates. More importantly, 4 percent average growth in the last decade and a half has been associated with a sharp trend deterioration of the current account.



Source: Haver; WEO; IMF staff calculations.

Given the high current account deficit, it is important to estimate the highest rate of growth consistent with no deterioration in this deficit. Formal regressions show that: (i) growth is the main correlate of the current account, more so than other variables like oil prices; (ii) the highest growth rate consistent with no deterioration in the current account deficit is in the 2¾−3½ percent range; and (iii) every year that growth exceeds this ± 3 percent speed limit by one percentage point, the current account deteriorates by 0.3−0.4 percent of GDP. Thus, were the economy to grow consistently at the consensus potential rate, the current account deficit would gradually deteriorate from its already high level.

[1] See Selected Issues Paper "Turkey: Output Volatility and Externally Sustainable Growth."

35. Tighter monetary and fiscal policies, as recommended by staff, would deliver a reduction in imbalances. While a tighter monetary stance and fiscal adjustment as recommended above could have costs in terms of growth, the current account deficit and associated external financing needs would also be lower and on a *declining* trend (see text table for details). In the active scenario, the current account deficit could be reduced by 2¾ percent of GDP by the end of the projection period relative to the baseline; gross financing needs could be some 6 percent of GDP lower, too. In turn, the reduction in the external imbalance, coupled with a commitment to strong policies, could materially reduce the probability of an abrupt, market-led adjustment. Staff argued that the gains from slightly slower growth but with less risk of a sudden stop (which would produce a sharp growth slowdown) would far outweigh the costs. Structural reforms could complement macro policies, helping to boost growth in the outer years.

Turkey: Comparison of Baseline and Active Policies' Scenarios 1/

	2013	2014	2015	2016	2017	2018
Central government primary balance (percent of GDP)						
Baseline	0.5	0.1	0.0	-0.1	-0.2	-0.3
Active policies	0.5	0.8	1.1	1.4	1.6	1.8
Current account deficit (percent of GDP)						
Baseline	7.4	7.2	7.4	7.7	7.9	8.3
Active policies	7.4	6.5	6.2	6.1	5.8	5.6
Gross external financing needs (percent of GDP)						
Baseline	25.3	27.5	26.4	26.9	27.8	29.5
Active policies	25.3	27.4	25.6	24.9	24.1	23.6
REER (year average)						
Baseline	115.0	112.1	116.2	120.3	124.5	128.8
Active policies	115.0	110.4	112.1	113.7	115.2	116.6
CPI inflation (average)						
Baseline	7.7	6.5	6.0	6.0	6.0	6.0
Active policies	7.7	5.0	4.0	4.0	4.0	4.0
GDP growth (percent)						
Baseline	3.8	3.5	4.3	4.4	4.5	4.5
Active policies	3.8	2.2	3.6	4.0	4.1	4.1

1/ The active scenario is predicated on a 2 percent of GDP structural fiscal adjustment spread over five years, and an immediate (i.e., Jan 2014 for the purpose of the scenario) monetary tightening equivalent to 150 basis points. The fundamental assumptions are: (i) the fiscal multiplier is 1; (ii) the impact of a 100 basis points monetary tightening is a contraction of 0.6 percent of GDP at peak, dissipating after two years; (iii) a 1 percentage point reduction in growth is associated with a reduction in the current account deficit of 0.4 percent of GDP; (iv) the Ricardian offset of fiscal policy is 0.5; and (v) the elasticity of the current account to the REER is set at 0.15

Source: IMF staff calculations.

36. To increase public savings, budget rigidities must be addressed (see Box 7). Even though interest spending has declined by more than 2 percent of GDP relative to the 2005–07 average, total spending has increased by some ¾ percentage points of GDP because of non-discretionary primary spending items such as salaries and pensions. The rising spending, however, has not led to deterioration in the fiscal balance as revenues, largely dependent on consumption and import taxes, have compensated spending increases. Nevertheless, non-discretionary primary spending items now account for close to 60 percent of total spending compared to 47 percent five years ago. In staff's view, the creep up of non-discretionary primary spending has brought about several undesirable consequences: (i) it has squeezed investment spending, which at least until this year has remained below 3 percent of GDP, not enough given the country's infrastructure needs; (ii) it will render even a 2 percent consolidation spread over five years difficult (though not unrealistically so), as such a consolidation would require very low *nominal* growth in discretionary spending, and in particular personnel costs; and (iii) it will limit the room for fiscal policy to respond quickly to shocks, exacerbated by the fact that 75 percent of central government revenues are directly linked to domestic demand and import growth.

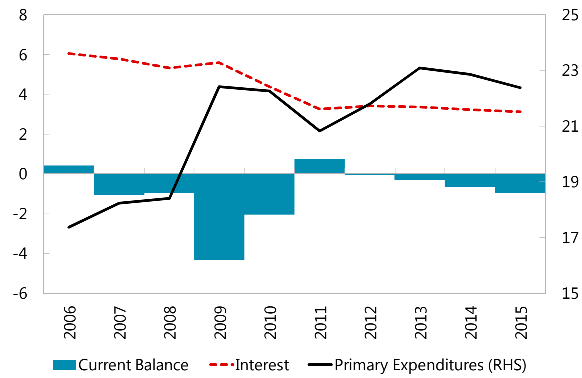
37. Beyond low savings, Turkey has a broader competitiveness challenge (see Box 8) that requires action on the structural front. In addition to the estimated current account gap and real effective exchange rate overvaluation, low inward FDI flows relative to peers, limited export sophistication (about 75 percent of exports are concentrated in agriculture and low- and medium-tech manufacturing), and fast wage growth are among the indicators that point to a competitiveness challenge. The government has put in place various measures to address this gap, such as last year's package of investment incentives to help companies move into advanced technology sectors and lower the import content of production. It is too early to gauge the success of the plan, but whatever its success more will be needed on various fronts to address Turkey's competitiveness gap:

- **Attracting FDI:** Turkey's FDI stock, at slightly more than 20 percent of GDP, is one of the lowest among emerging market peers. This is disappointing considering the potential offered by the country's location, as well as its large and growing domestic market and favorable demographics. Low FDI not only limits transfer of know-how, it also means that external imbalances are financed with less stable sources of funds contributing to the boom-bust pattern of growth. While the new commercial code introduced in 2012 is widely thought to represent major progress, foreign investors often complain of a slow and inconsistent judiciary, cumbersome licensing and regulations, and a costly tax policy and administration. High wage costs also are a problem.
- **Reducing energy dependence:** historically, more than two thirds of the country's current account deficit has been accounted for by the net energy import bill. The authorities' have undertaken large-scale privatizations of the energy distribution system, are encouraging expansions of renewables, and have signed a tender for a second nuclear plant as part of an ambitious agenda to limit energy dependence. However, these gains will only be felt in the medium-term.

Box 7. Budget Rigidities in Turkey[1]

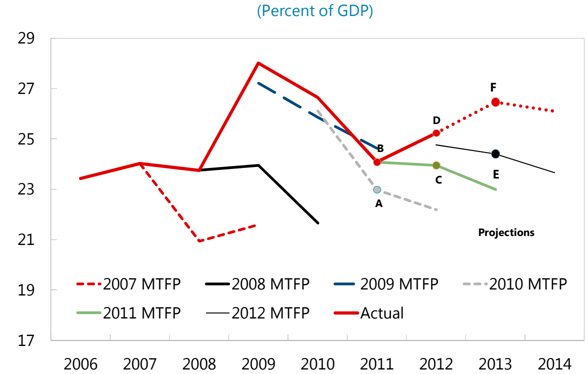
Turkey's fiscal effort over the last ten years brought about an impressive reduction in debt and interest costs. However, in recent years the share of non-discretional primary spending has grown too rapidly. Unaddressed, it could become a source of concern from a macroeconomic and budgetary perspective. In the medium-term, fiscal policy should play a significant role in aggregate demand management and contribute to higher and stable national savings. For such purposes, the budget should remain flexible to be able to accommodate potential shocks.

Central Government Expenditure and Primary Balance
(In percent of GDP)



Budget rigidities are linked to the rapid increase in primary spending and low public savings. From 2005 to 2012, central government primary spending increased by 4.4 percent of GDP. The impact on total spending was partially compensated by the decrease in interest payments of almost 3.6 percent of GDP in the same period. While the share of interest payments in total spending was cut by half, non-discretional spending quickly accommodated to fill the gap. In particular, salaries increased from 23 percent to almost 28 percent of spending, while transfers to the social security institutions and subnational governments showed a similar path.

Performance of MTP Expenditure Ceilings 2006-2012
(Percent of GDP)



Sources: Staff estimates based on official data.

Rigidities in the composition of primary spending can undermine hard-won fiscal discipline and the credibility of the overall budgetary framework. Spending rigidities limit the space for reallocation of budget resources in response to changing needs, perpetuating budget allocations on the basis of historical levels and making it difficult to meet MTP targets. This is illustrated by Turkey's substantial slippage translating MTP targets into reality. Despite the over-performance in terms of overall balance observed in recent years, spending ceilings have been systematically exceeded during the whole period.

Key features of the MTP do not facilitate compliance with spending ceilings. The MTP remains focused on the annual budget process, with little emphasis given to its medium-term component. In particular, spending ceilings for the outer years are not binding and are updated every year, systematically allowing for spending levels to accommodate past deviations. This practice creates a built-in bias towards

[1] See Selected Issues Paper "Budget Rigidities in Turkey."

Box 7. Budget Rigidities in Turkey (concluded)

higher spending and therefore reduces the government's capacity to comply with spending ceilings, ultimately putting at risk fiscal discipline.

Given current budget rigidities, achieving spending priorities set in the MTP may prove challenging. While overall Turkey has managed to meet overall balance targets in the past, the consequences of spending rigidities for fiscal discipline are far reaching. A comprehensive solution would require a combination of spending rationalization and improvement in current public financial management practices. Based on international best practice, options regarding the latter include: (i) gradually move to a more binding medium-term spending ceilings; (ii) introduce mechanism to adjust for past deviations; (iii) save over-performance in revenues; and (iv) report a detailed reconciliation between budget realizations and MTP spending.

- **Efforts to address the large informal sector have had some success in recent years and need to be sustained.** According to some estimates, the informal sector now accounts for a quarter of GDP, some 7 percentage points lower than ten years ago. This is good progress, but the informal sector remains large and there is evidence that firms in this sector are more liquidity constrained, invest less, and have a harder time growing. Current plans to double the number of tax inspectors are welcome. In this context, the proposed PIT/CIT reform is a step in the right direction, although further rationalization of the tax structure could increase incentives for formal labor market participation[14].
- **The labor market needs to become more attuned to economic conditions:** the national employment strategy aims to address obstacles to the use of part-time and temporary labor in the formal market (which will also help increase female participation rates), in particular the high cost of pension and severance premia relative to part time wages. These reforms go in the right direction.

Authorities' views

38. The authorities are well aware of the competitiveness challenge. Nonetheless, they believe that staff underestimates Turkey's capacity to adjust and maintain high growth rates while reducing external imbalances. In their view, staff's estimates of the growth rate consistent with no deterioration of the external balance over-emphasize the role of growth in the trend deterioration of the current account over the last ten years. Related to this, they gauge Turkey's competitiveness gap to be smaller than in the staff's estimates, with the current account deficit about 1 percent above its sustainable norm, and the real exchange rate close to equilibrium. Nonetheless, they remain

[14] The proposed CIT/PIT reform aims at simplifying and harmonizing income taxation. The purpose is to ensure that different types of income are subjected to similar tax rates, while improving the progressivity of the system. The income tax base will be broadened by reducing exceptions. Overall, the authorities expect that the reform will have a positive fiscal impact on revenue collections.

committed to tackling Turkey's low savings problem, pointing to the fact that the reform of the private pension scheme had attracted a considerable number of new entrants. In addition, the 10th National Development Plan provides tangible proof of their commitment to reducing energy dependence, increasing labor force participation and labor market flexibility, and reducing informality.

Box 8. Turkey's External Competitiveness[1]

In 2012, Turkey achieved a welcome reduction in external imbalances, thanks in large part to export diversification to the MENA region and strong gold exports. The trade diversification resulted in a growth of Turkey's export share to the MENA region of 37 percent. Penetration into traditional EU markets has remained constant, allowing for an overall growth in world market share of 12 percent. At 6.1 percent of GDP however, the current account deficit remained high, and is now expected to widen again to 7.4 percent of GDP in 2013 due to stronger domestic demand and gold re-stocking. On trend, Turkey has been running a current account deficit since 2002, with an average deficit of 4.7 percent of GDP.

Real effective exchange rates, based on consumer and producer prices, rose by 8 and 5 percent, respectively, in 2012 and have remained relatively constant in the first half of 2013. The nominal exchange rate against the euro-dollar basket was relatively flat in 2012, and has been on a depreciating trend since the second quarter of 2013.

The IMF's 2013 External Balance Assessment (EBA), which relies on end-2012 outturns, shows that Turkey's current account deficit is 4 percentage points of GDP higher than levels suggested by fundamentals (e.g., demographic factors and level of economic development) and desirable policy settings. On this basis, assessments of the real effective exchange rate (REER) show an overvaluation of 20-30 percent. However, the EBA model in which only 0.7 percentage point of the current account gap is explained by the specified policy variables, delivers a poor fit for Turkey.

A 10-20 percent overvaluation of the REER— based on a current account gap in the range of 1½– 3 percentage points of GDP —is likely a more appropriate estimate. This gap reflects the improvement in the 2012 current account balance vis-à-vis the 2011 outturn, and is in line with the assessment contained in the 2011 Article IV Consultation Staff Report. Moreover, in the context of strong capital inflows up until the first half of 2013, an improving share of exports in GDP, and a stable share of FDI into the tradable industrial sector, it is possible that standard REER assessments may overstate the extent of the overvaluation. Still, Turkey's current account deficit continues to be weaker than the estimated norm, and the trend thus far in 2013 does not point to any improvement.

The real exchange rate overvaluation is driven by positive inflation differentials with trading partners and trade competitors. In particular, the recent nominal exchange rate depreciation has not been enough to offset domestic price increases. This has encouraged imports while hurting the competitiveness of Turkish exports, around 1/3 of which are price-sensitive primary and low-technology products. The high relative

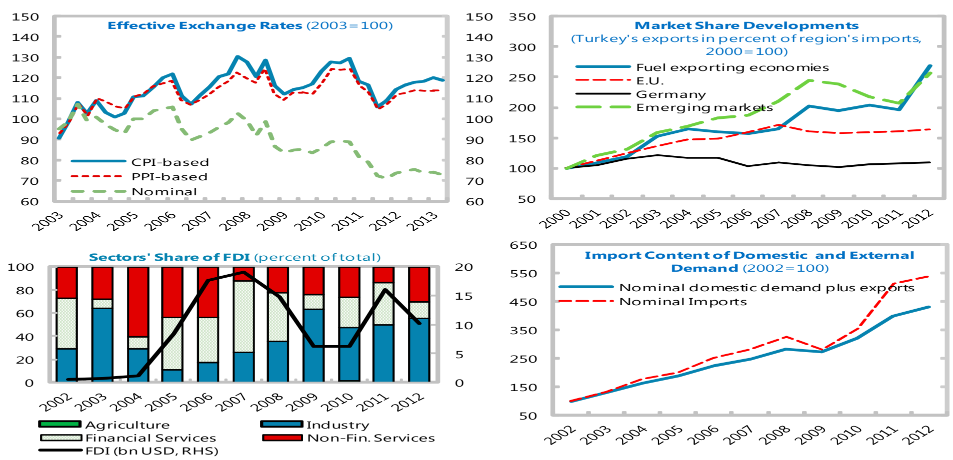
[1] See Selected Issues Paper "Turkey's External Competitiveness."

Box 8. Turkey's External Competitiveness (concluded)

inflation also feeds into the country's wage dynamics, creating nominal and real wage rigidities, which in turn feed back into broader price developments.

FDI continues to make up only a small part of total capital flows into Turkey, and presents another view on Turkey's competitiveness challenges. In 2012, an FDI flow of 1.6 percent of GDP was below the average of 2.2 percent of GDP for G-20 emerging-market peers. There has been an improvement in the composition of FDI, with the share in tradable sectors increasing to 55 percent of total in 2012 from 50 percent in the previous year. Still, greater effort is needed to attract more FDI, and firmly tilt it towards the tradable sector. The country's volatile economy, dependence on imports, and overvalued exchange rate likely weigh on its attractiveness as an investment destination. But cross-country comparisons suggest that other structural bottlenecks may also be at play. According to the 2013 Global Competitiveness Report, Turkey continues to rank poorly in terms of labor market efficiency and quality of education. The World Bank's Doing Business Report also point to the high cost of starting a business as a potential constraint.

Shifts in global conditions highlight the importance of reforms to raise Turkey's competitiveness. The large capital flows into emerging markets in recent years may slow significantly in the period ahead. At the same time, improving economic conditions in Turkey's trading partners also point to better prospects for exports. These conditions underscore the need to raise domestic savings while boosting exports' short-term price competitiveness. Public savings must contribute as much as possible. Over the medium term, steady rises in real per capita income will hinge on sustained productivity gains, notably by increasing the technical capacity of its workforce, encouraging investment, and improving the functioning of labor markets. The recent investment incentive scheme and education reform show that the Turkish authorities are aware of these issues. Such policies will help close the competitiveness gap by improving the overall productivity of the country, moving Turkish products up the value chain, and reducing the reliance on imports.



Sources: Central Bank of Turkey; IMF Direction of Trade Statistics, Turkstat, and IMF staff estimates.

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39. The authorities' policies delivered a welcome rebalancing in 2012 while maintaining low unemployment. This set the stage for the acceleration of economic activity in 2013. The rebound, led by private consumption and public investment, was driven by the policy stimuli since the second half of 2012. Unemployment stayed low, while household balance sheets remained relatively healthy, as leverage increased from a low base. With domestic demand gathering strength, full year growth is expected to come in at 3.8 percent. Under current macroeconomic policies, next year's growth is forecast at 3½ percent.

40. The domestic demand-led recovery is exerting upward pressures on the current account deficit and inflation. The current account deficit is projected to widen to above 7 percent of GDP this year, in part on account of an increase in gold imports, and is likely to stay close to that level next year. Inflation trends and the currency depreciation are likely to result in inflation again above the central bank's target of 5 percent both this and next year.

41. The authorities' immediate priority should be to reduce imbalances. The market reappraisal of advanced economies' monetary policies has exposed Turkey's main vulnerability—its sizable external imbalance. While the timing and magnitude of the normalization of interest rates is uncertain, the recent portfolio rebalancing has led to a re-pricing of Turkish assets and caused lira depreciation. In this context and with gross external financing needs projected to remain high over the next few years, a weakening or a reversal of capital flows presents a major challenge for the Turkish economy. Therefore, policies need to focus on mitigation of these risks.

42. The monetary stance needs to be tightened to be consistent with the inflation target. High credit growth, inflation (both headline and core) well above the end-year target of 5 percent, and the high and widening current account deficit, all warrant positive real policy rates, in particular the one week repo rate. Without this, it would be hard to bring inflation and expectations in line with the authorities' target, and to establish a strong nominal anchor.

43. The CBRT should re-consider its monetary policy framework. Ultimately the success of a monetary policy framework is tied to its ability to achieve the inflation target and anchor expectations. The current framework might not be helping to deliver the authorities' inflation target and may have weakened the monetary transmission mechanism. It is complex and has too many objectives. With a more unforgiving external environment, the framework is increasingly questioned by markets and complicates the communication of policies. Normalizing the framework would boost policy credibility and simplify communication.

44. The authorities should use sales of foreign exchange reserves only to address excessive volatility, as foreign exchange rate interventions cannot substitute for the right monetary stance. This would preserve limited net foreign exchange reserves, which should be increased through sterilized intervention if inflows resume.

45. The authorities are on track to meet the fiscal targets for 2013, but the fiscal stance is expansionary and should be reined in. Revenue performance year-to-date has been strong, with some help from one-off effects. As a result, the authorities are broadly on track to meet their 2013 budget deficit target, further reducing public debt from already modest levels. However, buoyant revenues have allowed large nominal expenditure increases. Therefore, the government will exceed the approved 2013 budget expenditure ceilings, notably due to investment spending.

46. Fiscal policy has a critical role to play in reducing external vulnerabilities. Thus, the 2014 budget should target the primary spending levels set by the government in the 2013–15 medium-term fiscal plan and save any revenue over-performance. Such a policy objective—which implies a 0.7 percent of GDP improvement of the structural deficit—would make a critical contribution to the envisaged gradual reduction of Turkey's macroeconomic imbalances and reassure markets that fiscal discipline is intact.

47. It will also be important to revisit the structure of the budget to prevent it from becoming more rigid. Non-discretionary primary spending has been allowed to grow to more than half of total expenditure, which limits the ability of the authorities to target spending to priority areas, especially as this change over time. In particular, containing current expenditure would increase room for public investment. At the same time, it would increase flexibility and buffers in the budget, enabling fiscal policy to better respond if unexpected adverse shocks were to occur. The welcome ongoing efforts to broaden the tax base and improve tax administration will further enhance the structure and resilience of the budget.

48. The Turkish financial system continues to perform well, although risks remain. Banks' leverage and the level of non-performing loans are low relative to peers; the capital adequacy ratios remain high; loans are largely funded by deposits; and their open FX positions are not large.

Still, risks are being taken in this period of rapid credit expansion, and so continued careful monitoring is needed. In particular, more attention to FX credit to corporate clients is warranted, as FX-induced liquidity or solvency problems in the corporate sector can quickly lead to rising non_performing loans. On the other side of the banks' balance sheets, keeping an eye on the amounts and structure of FX funding of the sector remains important, especially given the current external environment.

49. Prudential policies should be targeted at the household credit and corporate FX lending segments. Data gaps with respect to all aspects of FX lending to the non-financial corporate sector need to be addressed. Increasing risk weights or reserve requirements for such loans could be considered. Prudential regulations on FX-indexed lending should be brought in line with regulation of FX loans. In the rapidly growing household credit segment, the authorities' measure to link clients' credit cards exposure limits to income is welcome and could be helpfully extended to general purpose consumer loans. Meanwhile, in the absence of microeconomic distortions, use of prudential policies to stimulate credit to specific sectors is not warranted.

50. In the medium-term, the challenge is to boost growth without increasing imbalances. Turkey's demographic structure, strategic geographical location, and dynamic economy present many opportunities. However, it will be difficult for Turkey to sustain an average growth of 4 to 5 percent per year while continuing to accumulate large external liabilities year after year. The present low level of domestic savings implies that investment is determined by the availability of volatile external inflows. Without structural reforms, growth would have to be below the historical trend to avoid increases in external imbalances and accompanying bouts of instability.

51. The authorities have correctly identified the need to increase domestic savings. Last year's private sector pension reform has started to bear some results and is a positive initial step. However, the public sector must also lead the way with a sizeable contribution to raise savings. In that sense, the 1¼ percent of GDP increase in public savings envisioned in the 10th development plan is commendable. Nevertheless, the authorities are encouraged to target over the medium-term a more ambitious primary surplus in line with the levels observed before the onset of the global financial crisis.

52. Structural reform should further boost competitiveness and growth. The Turkish private sector has demonstrated an ability to adapt to shocks. Further improvements in the business climate could enhance this resilience further and would attract more foreign direct investment—a stable source of external funding. Increasing educational outcomes to boost productivity should be another priority. Reducing energy dependence further—in line with government policies and recent reforms—would help decrease the energy import bill, which represents a significant part of Turkey's trade deficit. Efforts to address the large informal sector have met with some success and need to be sustained. Lastly, reforms to improve the functioning of the labor market could boost productivity and employment.

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

Table 1. Turkey: Selected Economic Indicators, 2008–14

Population (2012): 74.9 million
Per capita GDP (2012): $10,527
Quota (2012): SDR 1,455.8 million

	2008	2009	2010	2011	2012	2013	2014
						Proj.	
				(Percent)			
Real sector							
Real GDP growth rate	0.7	-4.8	9.2	8.8	2.2	3.8	3.5
Contributions to GDP growth							
Private domestic demand	-1.8	-8.3	12.6	9.5	-2.9	3.3	2.7
Public spending	0.6	0.8	0.9	0.4	1.0	1.5	0.7
Net exports	1.9	2.7	-4.4	-1.1	4.1	-1.0	0.1
GDP deflator growth rate	12.0	5.3	5.7	8.6	6.8	6.9	6.9
Nominal GDP growth rate	12.7	0.2	15.4	18.1	9.1	11.0	10.6
CPI inflation (12-month; end-of period)	10.1	6.5	6.4	10.4	6.2	8.0	6.0
PPI inflation (12-month; end-of-period)	8.1	5.9	8.9	13.3	2.5	6.9	6.0
Unemployment rate	11.0	14.0	11.9	9.8	9.2	9.4	9.5
Average nominal treasury bill interest rate	19.2	11.6	8.5	8.7	8.8	...	...
Average ex-ante real interest rate	12.3	2.8	1.9	1.0	1.7	...	...
				(Percent of GDP)			
Nonfinancial public sector							
Primary balance	1.7	-0.9	0.9	1.9	0.9	0.6	0.3
Net interest payments	4.3	4.5	3.7	2.7	2.8	2.7	2.5
Overall balance	-2.6	-5.4	-2.3	-0.8	-1.9	-2.0	-2.2
General government structural primary balance 1/	0.4	1.0	0.5	-0.6	-0.7	-1.2	-1.2
Debt of the public sector							
General government gross debt (EU definition)	40.0	46.1	42.3	39.1	36.2	35.4	34.4
Nonfinancial public sector net debt	34.5	39.5	36.8	33.3	30.2	29.8	29.3
External sector							
Current account balance	-5.5	-2.0	-6.2	-9.7	-6.2	-7.4	-7.2
Nonfuel current account balance	0.0	2.2	-1.8	-3.6	0.6	-0.9	-0.7
Gross financing requirement	16.8	18.1	18.9	24.6	21.7	25.2	28.0
Foreign direct investment (net)	2.4	1.2	1.0	1.8	1.1	0.8	1.4
Gross external debt 2/	38.5	43.8	39.9	39.3	43.0	46.4	47.7
Net external debt	21.3	24.2	23.8	23.9	24.0	28.3	31.1
Short-term external debt (by remaining maturity)	13.7	15.5	16.1	16.0	18.4	21.5	21.8
Monetary aggregates							
Nominal growth of M2 broad money (percent)	27.5	12.9	19.0	11.5	10.3	...	...
GDP (billions of U.S. dollars) 3/	730.3	614.6	731.1	774.8	788.3	...	...
GDP (billions of Turkish lira)	950.5	952.6	1,098.8	1,297.7	1,415.8	1,571.0	1,737.6

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

1/ The structural balance is estimated using the absorption gap method and excludes one-off operations.
2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the
3/ GDP in U.S. dollars is derived using the average exchange rate (consolidated from daily data published by the CBRT).

Table 2. Turkey: Medium-Term Scenario, 2008–18

(Percent change, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2003–12	2013–18
								Proj.				Average	Average
Real GDP	0.7	-4.8	9.2	8.8	2.2	3.8	3.5	4.3	4.4	4.5	4.5	5.1	4.2
Real domestic demand	-1.2	-7.4	13.5	9.5	-1.8	4.8	3.3	5.1	5.2	5.2	5.2	5.5	4.8
Private consumption	-0.3	-2.3	6.7	7.7	-0.6	3.8	3.1	3.8	4.2	4.2	4.2	5.0	3.9
Private investment	-9.0	-22.5	33.6	22.3	-4.8	1.4	1.3	9.6	8.8	8.9	8.6	11.3	6.5
Public spending	12.7	-0.6	17.7	-2.2	9.3	17.5	2.5	5.0	5.0	5.0	5.0	4.9	6.7
Exports	2.7	-5.0	3.4	7.9	16.7	5.2	5.9	5.7	5.7	5.9	6.0	6.6	5.7
Imports	-4.1	-14.3	20.7	10.7	-0.3	8.7	5.2	8.3	8.2	8.2	8.1	8.7	7.8
Contributions to GDP growth (percent)													
Real domestic demand	-1.2	-7.6	13.5	9.9	-1.9	4.8	3.3	5.2	5.3	5.4	5.4	5.6	4.9
Private consumption	-0.2	-1.6	4.7	5.3	-0.4	2.5	2.1	2.5	2.8	2.8	2.8	3.5	2.6
Private investment	-2.0	-4.4	5.4	4.4	-1.1	0.3	0.3	1.9	1.8	1.9	1.9	1.8	1.4
Public spending	0.6	0.8	0.9	0.4	1.0	1.5	0.7	0.7	0.7	0.7	0.7	0.6	0.8
Net exports	1.9	2.7	-4.4	-1.1	4.1	-1.0	0.1	-0.8	-0.9	-0.9	-0.9	-0.5	-0.7
Exports	0.7	-1.3	0.9	1.9	4.0	1.4	1.6	1.6	1.6	1.7	1.8	1.6	1.6
Imports	-1.2	-4.0	5.2	3.0	-0.1	2.4	1.5	2.4	2.5	2.6	2.7	2.1	2.4
Saving-investment balance (percent of GDP)	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018		
Public saving-investment balance	-3.1	-5.6	-3.2	-0.8	-1.4	-1.4	-1.7	-1.7	-2.0	-2.1	-2.1	-3.1	-1.8
Private saving-investment balance	-2.4	3.6	-3.0	-8.8	-4.6	-6.0	-5.5	-5.7	-5.7	-5.8	-6.3	-2.0	-5.8
Employment rate	41.7	41.2	43.0	45.0	45.4	...	...	...	...	...	...	42.6	...
Unemployment rate (percent)	11.0	14.0	11.9	9.8	9.2	...	...	...	...	...	...	10.8	...
Consumer prices													
Period average	10.4	6.3	8.6	6.5	8.9	7.7	6.5	6.0	6.0	6.0	6.0	10.1	6.4
End-period	10.1	6.5	6.4	10.4	6.2	8.0	6.0	6.0	6.0	6.0	6.0	9.3	6.4
Output gap (percent of potential GDP)	1.2	-6.6	-1.6	2.4	0.4	0.2	-0.5	-0.4	-0.2	0.0	0.4	0.2	-0.1
Nonfinancial public sector (percent of GDP)													
Primary balance	1.7	-0.9	0.9	1.9	0.9	0.6	0.3	0.2	0.2	0.0	-0.2	2.7	0.2
Overall balance	-2.6	-5.4	-2.8	-0.8	-1.8	-2.0	-2.2	-2.1	-2.1	-2.3	-2.4	-2.7	-2.2
Primary revenue of central government	20.4	21.0	21.9	22.2	22.4	23.2	22.7	22.2	21.9	21.6	21.5	21.5	22.2
Primary expenditure of central government	18.5	22.4	22.3	20.8	21.8	22.7	22.6	22.2	22.0	21.8	21.9	19.4	22.2
Rest of the public sector, primary balance	-0.2	0.5	1.3	0.5	0.5	0.2	0.2	0.2	0.2	0.2	0.2	0.6	0.2
Net interest expenditure	4.3	4.5	3.7	2.7	2.8	2.7	2.5	2.3	2.3	2.3	2.2	5.4	2.4
General government structural primary balance (percent of GDP) 1/	0.4	1.0	0.5	-0.6	-0.7	-1.2	-1.2	-1.1	-1.0	-1.0	-1.0	1.7	-1.1
General government gross debt (percent of GDP, EU definition)	40.0	46.1	42.3	39.1	36.2	35.4	34.4	33.2	32.6	32.0	31.6	47.0	33.2
External indicators													
Current account (percent of GDP)	-5.5	-2.0	-6.2	-9.7	-6.2	-7.4	-7.2	-7.4	-7.7	-7.9	-8.3	-5.2	-7.7
Gross external debt (percent of GDP) 2/	38.5	43.8	39.9	39.3	43.0	46.4	47.7	47.9	48.1	49.2	50.3	40.6	48.3
Real effective exchange rate (CPI-based, level, average)	123.2	114.6	127.0	112.2	116.7	115.0	112.1	116.2	120.3	124.5	128.8	114.7	119.5

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

1/ The structural primary balance is estimated using the absorption gap method and excludes one-off operations.

2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).

Table 3. Turkey: Summary of Balance of Payments, 2008–18

(Billions of U.S. dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Proj.					
Current account balance	-40.4	-12.2	-45.4	-75.1	-48.5	-60.7	-61.5	-69.7	-80.0	-91.3	-106.8
Trade balance (incl. shuttle trade), net	-53.0	-24.9	-56.4	-89.1	-65.3	-78.4	-81.8	-92.9	-106.3	-121.4	-138.4
Exports of goods	140.8	109.6	120.9	143.4	163.2	167.9	174.9	182.6	191.7	202.4	214.0
Imports of goods	-193.8	-134.5	-177.3	-232.5	-228.6	-246.3	-256.7	-275.6	-298.0	-323.8	-352.4
of which Fuel imports	-48.3	-29.9	-38.5	-54.1	-60.1	-60.3	-64.1	-68.7	-73.7	-79.1	-84.9
Services, net	18.8	18.6	16.7	20.1	22.6	26.0	30.4	35.1	40.3	46.2	52.9
Credit	37.0	35.7	36.3	40.7	43.2	48.3	52.1	56.7	61.9	68.0	75.0
of which tourism receipts	23.4	23.0	22.6	25.1	25.3	29.4	32.1	34.2	36.4	38.9	40.2
Debit	-18.2	-17.1	-19.6	-20.5	-20.6	-22.4	-21.7	-21.6	-21.6	-21.8	-22.0
Income, net	-8.4	-8.3	-7.2	-7.8	-7.2	-9.6	-11.8	-13.6	-16.1	-19.0	-24.2
Credit	6.9	5.2	4.5	4.0	5.0	4.6	5.1	5.7	6.3	7.5	9.2
Debit	-15.3	-13.5	-11.7	-11.8	-12.2	-14.2	-16.9	-19.3	-22.4	-26.5	-33.4
of which interest	-15.1	-13.3	-11.5	-11.6	-11.9	-13.9	-16.5	-18.8	-21.9	-25.9	-32.9
Private transfers, net	1.4	1.2	1.0	1.0	0.8	0.8	1.0	1.1	1.4	2.1	2.1
Official transfers, net	0.7	1.2	0.6	0.8	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Capital and financial account balance	36.4	9.4	56.9	63.9	68.2	72.2	61.5	69.7	80.0	91.3	106.8
Direct investment, net 1/	17.2	7.1	7.6	13.7	9.0	6.8	11.7	17.2	20.9	23.6	26.4
Portfolio investment, net	-5.0	0.2	16.1	22.0	40.8	28.2	19.3	26.7	29.9	34.8	33.2
of which government eurobonds, net	0.6	1.8	4.1	2.5	4.8	4.2	4.5	4.5	4.5	4.5	4.5
Other investment, net	24.2	2.1	33.2	28.2	18.5	37.3	30.6	25.7	29.1	32.8	47.2
of which short-term borrowings	2.9	-3.5	13.4	9.6	7.5	1.9	-1.7	0.3	-0.3	3.4	6.5
of which banks	2.3	-2.8	12.0	6.9	4.9	0.8	-2.4	-1.1	-2.1	0.0	2.0
of which other sector	0.5	-0.7	1.4	2.7	2.6	1.1	0.6	1.5	1.8	3.4	4.5
Errors and omissions	3.0	2.9	1.4	9.4	1.2	-5.1	0.0	0.0	0.0	0.0	0.0
Overall balance	-1.1	0.1	12.8	-1.8	20.9	6.5	0.0	0.0	0.0	0.0	0.0
(percent of GDP)											
Current account balance	-5.5	-2.0	-6.2	-9.7	-6.2	-7.4	-7.2	-7.4	-7.7	-7.9	-8.3
Nonfuel current account balance	0.0	2.2	-1.8	-3.6	0.5	-0.9	-0.7	-1.0	-1.5	-1.9	-2.5
Trade account balance (incl. shuttle trade)	7.1	-4.0	-7.7	-11.5	-8.3	-9.5	-9.6	-9.9	-10.2	-10.5	-10.8
Capital and financial account balance	4.9	1.5	7.8	8.3	8.7	8.8	7.2	7.4	7.7	7.9	8.3
Overall balance	-0.1	0.0	1.8	-0.2	2.7	0.8	0.0	0.0	0.0	0.0	0.0
(percent year-on-year)											
Export volume growth	4.0	-5.4	3.4	5.5	17.1	5.3	5.9	5.7	5.7	5.9	6.0
Export value growth	22.4	-18.3	8.2	17.1	12.3	4.6	5.0	5.4	6.0	6.6	6.9
Import volume growth	-2.0	-15.5	20.3	10.0	-0.1	8.8	5.1	8.3	8.2	8.2	8.1
Import value growth	19.0	-28.5	29.9	28.5	-1.6	7.9	3.6	6.8	7.6	8.1	8.4
Change in terms of trade	-3.1	2.1	-3.1	-4.9	-2.7	0.2	0.5	1.1	0.8	0.7	0.6
Gross foreign reserves (CBRT) 2/											
In billions of U.S. dollars	74.0	74.8	86.1	88.4	119.4	128.0	128.0	128.0	128.0	128.0	128.0
Net international reserves	57.1	57.3	63.4	51.9	53.4	48.4	48.4	48.4	48.4	48.4	48.4
Debt service ratio 3/	29.6	39.7	34.8	26.5	24.6	25.8	22.2	20.3	19.7	21.8	23.4

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

1/ Including privatization receipts.

2/ The change in gross reserves in 2012 is likely to significantly exceed the overall BOP surplus, due to gold transactions between domestic banks and the central bank which are not recorded in the BOP.

3/ Interest and amortization payment of medium- and long-term debt in percent of export receipts.

Table 4. Turkey: External Financing Requirements and Sources, 2008-18

(Billions of U.S. dollars)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
						Proj.					
Gross external financing requirements	122.7	111.4	138.4	190.3	170.7	207.4	238.5	255.4	281.3	315.2	356.8
Current account deficit	40.4	12.2	45.4	75.1	48.5	60.7	61.5	69.7	80.0	91.3	106.8
Amortization of government eurobonds	3.4	1.9	2.6	1.8	2.3	1.5	1.2	1.2	1.2	1.2	1.2
Medium- and long-term debt amortization	35.7	44.7	41.3	36.1	38.0	44.4	39.1	36.6	35.2	38.3	42.6
Government 1/	3.5	3.2	3.2	2.9	2.9	4.1	4.4	4.4	4.4	4.4	4.4
Banks	7.2	7.6	6.7	6.9	9.4	8.0	6.3	6.8	7.9	9.5	11.9
Other sectors	25.0	33.9	31.4	26.3	25.7	32.3	28.4	25.4	23.0	24.4	26.2
Short-term debt amortization	43.2	52.5	49.0	77.3	81.9	100.8	136.8	147.9	164.9	184.5	206.2
Government 1/	2.3	1.9	1.8	1.6	1.2	1.0	1.0	1.0	1.0	1.0	1.0
Banks	18.3	26.8	25.2	50.9	52.2	68.2	93.6	100.8	111.6	123.8	135.7
Other sectors	22.5	23.8	22.0	24.9	28.4	31.6	42.2	46.0	52.3	59.6	69.5
Available financing	122.7	111.4	138.4	190.3	170.7	207.4	238.5	255.4	281.3	315.2	356.8
Sale of assets 2/	-13.3	8.3	3.5	13.8	2.1	5.7	21.3	4.9	4.5	-2.1	1.1
Foreign direct investment (net)	17.2	7.1	7.6	13.7	9.0	6.8	11.7	17.2	20.9	23.6	26.4
Portfolio flows	-0.4	4.9	20.9	18.1	30.2	13.8	9.7	15.3	14.3	18.3	19.4
Government eurobonds	4.0	3.8	6.7	4.3	7.1	5.7	5.7	5.7	5.7	5.7	5.7
Equity and domestic government issuance (net)	-4.4	1.1	14.2	13.8	23.1	8.1	4.0	9.6	8.6	12.6	13.7
Banks (net)	0.0	0.0	1.1	2.9	9.0	9.0	8.0	8.0	10.0	10.0	10.0
Medium and long-term debt financing 3/	59.8	34.3	39.6	46.2	40.2	43.7	40.1	45.2	47.3	59.2	67.8
Government 1/	3.8	4.1	6.4	3.3	0.8	2.1	3.6	4.0	4.0	4.0	4.0
Banks	8.1	6.0	7.6	12.6	9.5	11.7	7.6	12.9	15.7	23.7	29.9
Other sectors	47.9	24.2	25.5	30.4	29.9	29.9	29.0	28.3	27.6	31.5	33.9
Short-term debt financing 3/	54.1	50.9	77.3	85.8	108.2	148.2	155.1	172.0	193.6	215.4	241.4
Government 1/	1.9	1.8	1.6	1.2	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Banks	26.8	25.2	50.9	52.2	68.2	93.6	100.8	111.6	123.8	135.7	150.0
Other sectors	25.4	24.0	24.8	32.3	39.0	53.5	53.3	59.5	68.8	78.6	90.4
Official transfers	0.7	1.2	0.6	0.8	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Other 4/	3.4	4.8	1.9	10.0	1.3	-4.8	0.0	0.0	0.0	0.0	0.0
GIR change (- denotes increase)	1.1	-0.1	-12.8	1.8	-20.8	-6.5	0.0	0.0	0.0	0.0	0.0
of which IMF (net)	1.7	-0.7	-2.2	-2.8	-2.0	-0.9	0.0	0.0	0.0	0.0	0.0
Purchases	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-1.9	-0.7	-2.2	-2.8	-2.0	-0.9	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Net public sector financing (incl. IMF, excl. reserves)	5.2	5.0	7.3	2.1	2.3	2.9	5.4	5.9	5.9	5.9	5.9
Government's loan rollover rate (in percent)	82	94	88	80	84	99	100	100	100	100	100
Banks' loan rollover rate (in percent)	146	94	202	103	131	137	108	111	111	110	111
Corporates' loan rollover rate (in percent)	106	93	113	114	111	134	109	114	114	117	117
Gross external financing requirements (percent of GDP)	16.8	18.1	18.9	24.6	21.7	25.2	28.0	27.1	27.0	27.3	27.9
International Investment Position (percent of GDP)	-27.4	-45.0	-49.5	-40.5	-53.2	…	…	…	…	…	…

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

1/ Includes the general government and the Central Bank of the Republic of Turkey; excludes eurobonds and IMF purchases and repurchases.
2/ Includes sale 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, 2008–18

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
								Proj.			
Nonfinancial public sector primary balance	1.7	-0.9	0.9	1.9	0.9	0.6	0.3	0.2	0.2	0.0	-0.2
Central government	1.9	-1.4	-0.4	1.4	0.4	0.5	0.1	0.0	-0.1	-0.2	-0.3
Primary revenue	20.4	21.0	21.9	22.2	22.4	23.2	22.7	22.2	21.9	21.6	21.5
Tax revenue	17.7	18.1	19.2	19.6	19.7	20.5	20.1	19.6	19.4	19.1	19.0
Personal income taxes	4.0	4.0	3.7	3.8	4.0	4.0	4.0	3.9	3.9	3.9	3.8
Corporate income taxes	1.8	1.9	1.9	2.1	2.0	1.9	1.8	1.7	1.7	1.7	1.8
VAT	4.9	4.9	5.7	6.1	5.8	6.2	6.1	6.1	6.0	5.9	5.9
SCT	4.4	4.6	5.2	4.9	5.1	5.5	5.2	4.9	4.8	4.7	4.6
Other	2.6	2.7	2.7	2.7	2.8	3.0	3.0	2.9	2.9	2.9	2.9
Nontax revenue 1/	2.7	2.9	2.7	2.7	2.7	2.6	2.6	2.5	2.5	2.5	2.5
Primary expenditure	18.4	22.4	22.3	20.8	21.8	22.7	22.6	22.2	22.0	21.8	21.9
Personnel	5.8	6.6	6.7	6.6	7.1	7.2	7.6	7.7	7.6	7.5	7.5
Goods and services, *of which* :	2.6	3.1	2.7	2.5	2.3	2.1	2.0	2.0	2.0	2.0	2.0
Transfers, *of which* :	8.1	10.6	10.6	9.3	10.1	10.7	10.5	10.4	10.2	10.2	10.2
Social security institutions	3.7	5.5	5.0	4.1	4.5	4.6	4.7	4.7	4.7	4.7	4.7
Agricultural subsidies	0.6	0.5	0.5	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Transfers of revenue shares	2.1	2.3	2.4	2.4	2.4	2.6	2.7	2.7	2.6	2.6	2.5
Capital transfers	0.3	0.5	0.6	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Capital expenditure	1.9	2.1	2.4	2.4	2.4	2.6	2.5	2.2	2.2	2.2	2.2
Rest of the public sector	-0.2	0.5	1.3	0.5	0.5	0.2	0.2	0.2	0.2	0.2	0.2
Extrabudgetary funds	-0.1	-0.1	-0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds 2/	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	0.4	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Local governments 2/	-0.6	-0.4	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	-0.1
State economic enterprises 3/	0.0	0.6	0.7	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Nonfinancial public sector overall balance 4/	-2.6	-5.4	-2.8	-0.8	-1.8	-2.0	-2.2	-2.1	-2.1	-2.3	-2.4
Interest expenditure (net)	4.3	4.5	3.7	2.7	2.8	2.7	2.5	2.3	2.3	2.3	2.2
Memorandum items:											
General government primary revenue	30.7	31.3	32.4	34.0	34.0	35.4	35.0	34.4	34.2	34.0	33.9
General government primary expenditure	29.1	32.8	32.2	31.9	32.9	34.6	34.6	34.2	34.1	34.0	34.1
General government primary balance	1.7	-1.5	0.2	1.9	0.9	0.7	0.3	0.2	0.2	0.0	-0.2
General government overall balance	-2.7	-6.1	-3.5	-0.7	-1.9	-2.1	-2.2	-2.0	-2.2	-2.4	-2.5
General government structural primary balance 5/	0.4	1.0	0.5	-0.6	-0.7	-1.2	-1.2	-1.1	-1.0	-1.0	-1.0
General government gross debt	40.0	46.1	42.3	39.1	36.2	35.4	34.4	33.2	32.6	32.0	31.6
Nominal GDP (billions of Turkish lira)	951	953	1,099	1,298	1,416	1,571	1,738	1,922	2,128	2,358	2,612

Sources: Turkish authorities; and IMF staff estimates.

1/ Excluding privatization proceeds, transfers from CBRT, and interest receipts.
2/ Excluded from consolidated government sector.
3/ Excluding severance payments for retirees.
4/ 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.
5/ The structural primary balance is estimated using the absorption gap method and excludes one-off operations.

Table 6. Banking System at a Glance, 2008–13

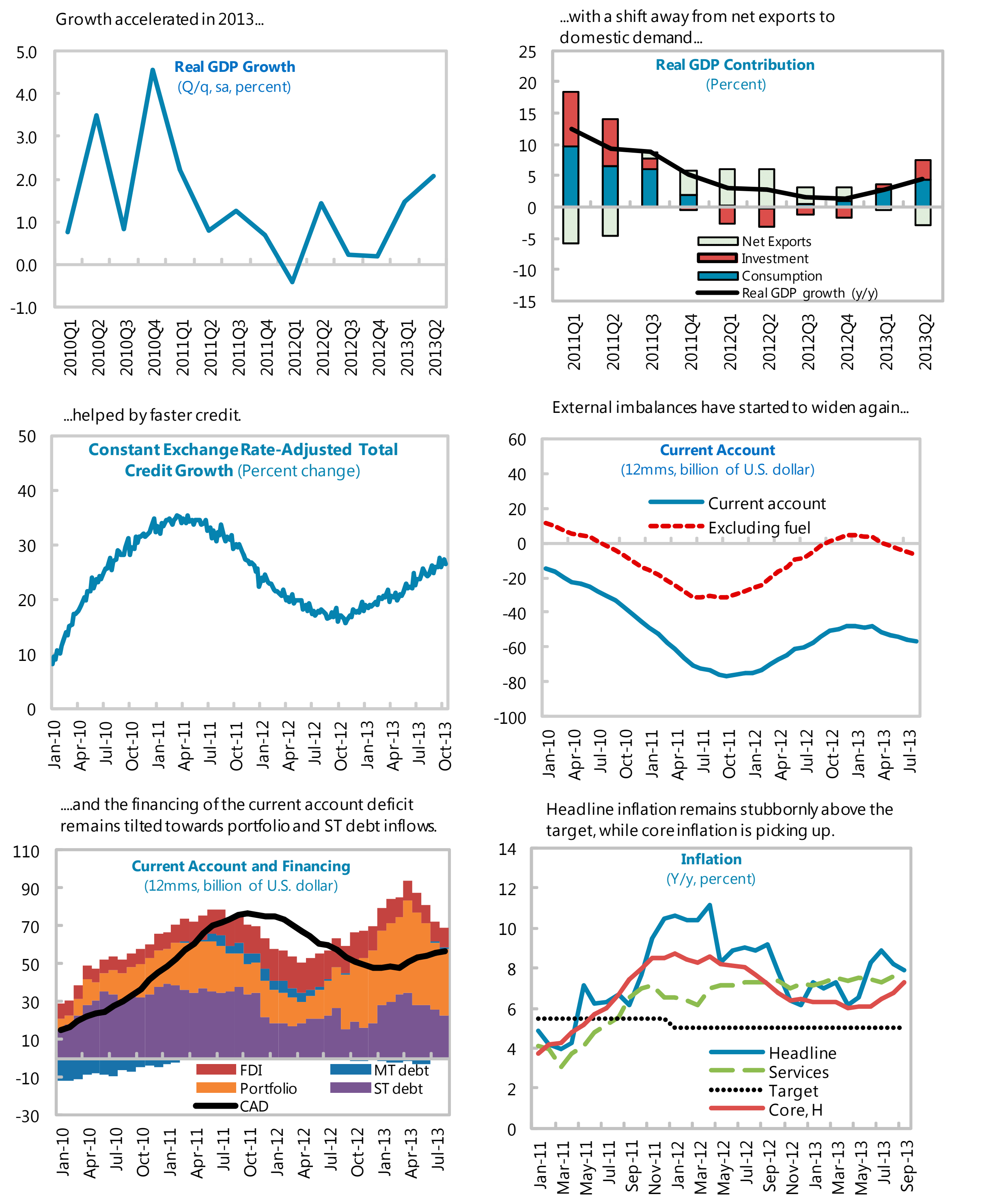
(Percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013 1/
Balance sheet and loan quality						
Assets (percent of GDP)	77.1	87.6	91.6	93.8	96.8	99.5
Loans / total assets	50.2	47.1	52.2	56.1	58.0	60.6
Government securities / total assets	26.5	31.5	28.6	23.4	19.7	18.1
Loan-to-deposit ratio	80.8	76.3	85.2	98.2	102.9	108.7
Year-on-year loan growth	28.6	6.9	33.9	29.9	16.4	27.5
NPLs (gross, percent of total loans)	3.6	5.4	3.7	2.7	2.9	2.8
Provisioning ratio (percent of NPLs)	79.8	83.6	83.8	79.4	75.2	74.8
FX exposure						
FX assets / FX liabilities (on-balance sheet only)	86.9	84.7	84.0	83.7	85.9	83.0
FX loans / total loans	28.7	26.6	27.0	29.0	26.0	26.4
FX deposits / total deposits	35.3	33.7	29.7	33.9	32.6	33.4
Capital ratios						
Capital adequacy ratio	18.0	20.6	19.0	16.5	17.9	15.9
Shareholders' equity / total assets	11.8	13.3	13.4	11.9	13.3	11.9
Profitability and liquidity ratios						
Return on assets	2.5	3.3	3.0	2.2	2.4	2.5
Return on equity	18.7	22.9	20.1	15.5	15.7	16.0
Liquid assets / total assets 2/	23.7	29.4	27.7	24.7	21.6	20.0

Sources: BRSA; and IMF staff calculations.

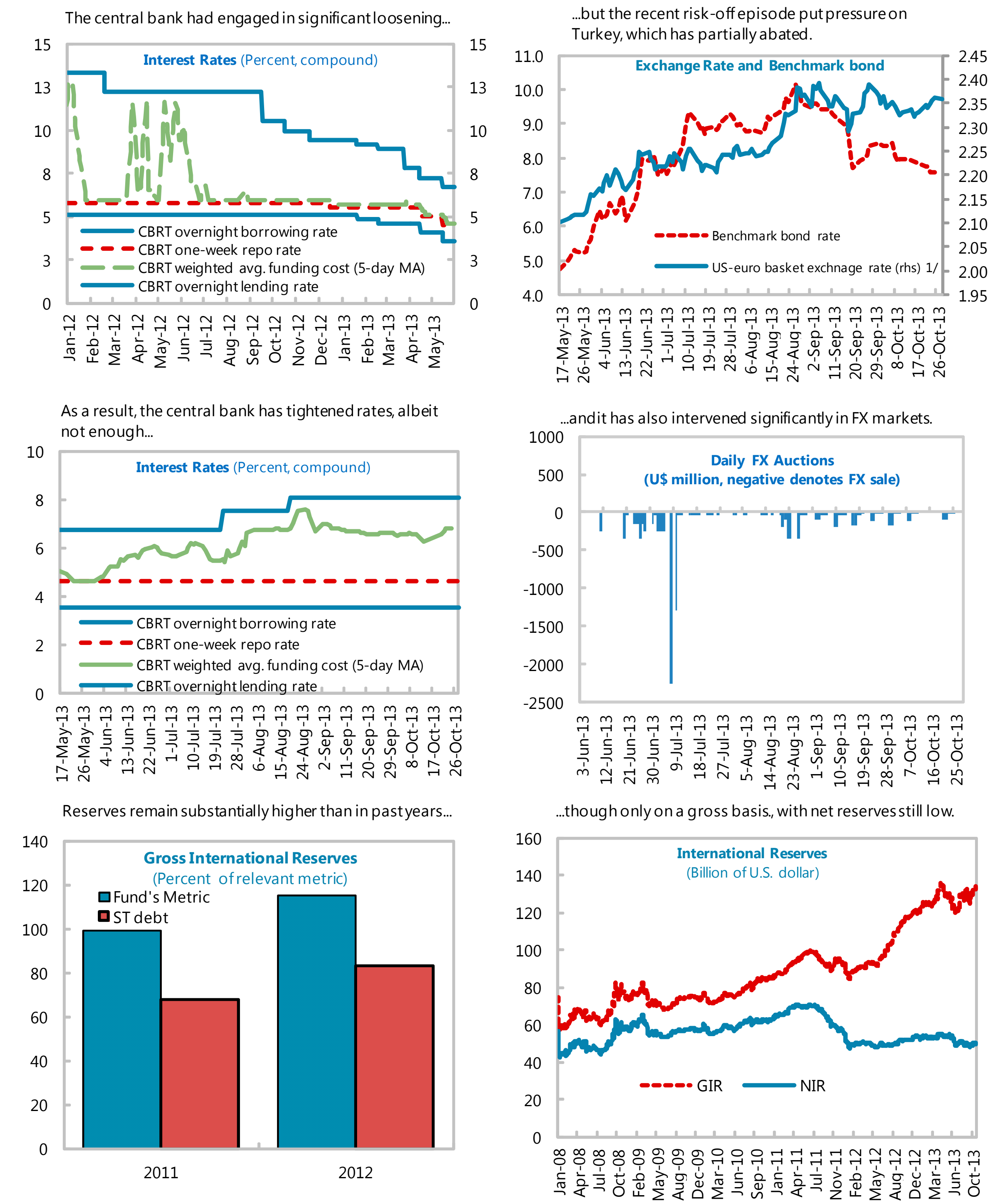
1/ Based on data through July 2013. Return on assets/equity is annualized.
2/ Liquid assets include cash, receivables from the CBRT, money markets, and banks, and securities held for trading and sale.

Figure 1. Turkey: Recent Developments



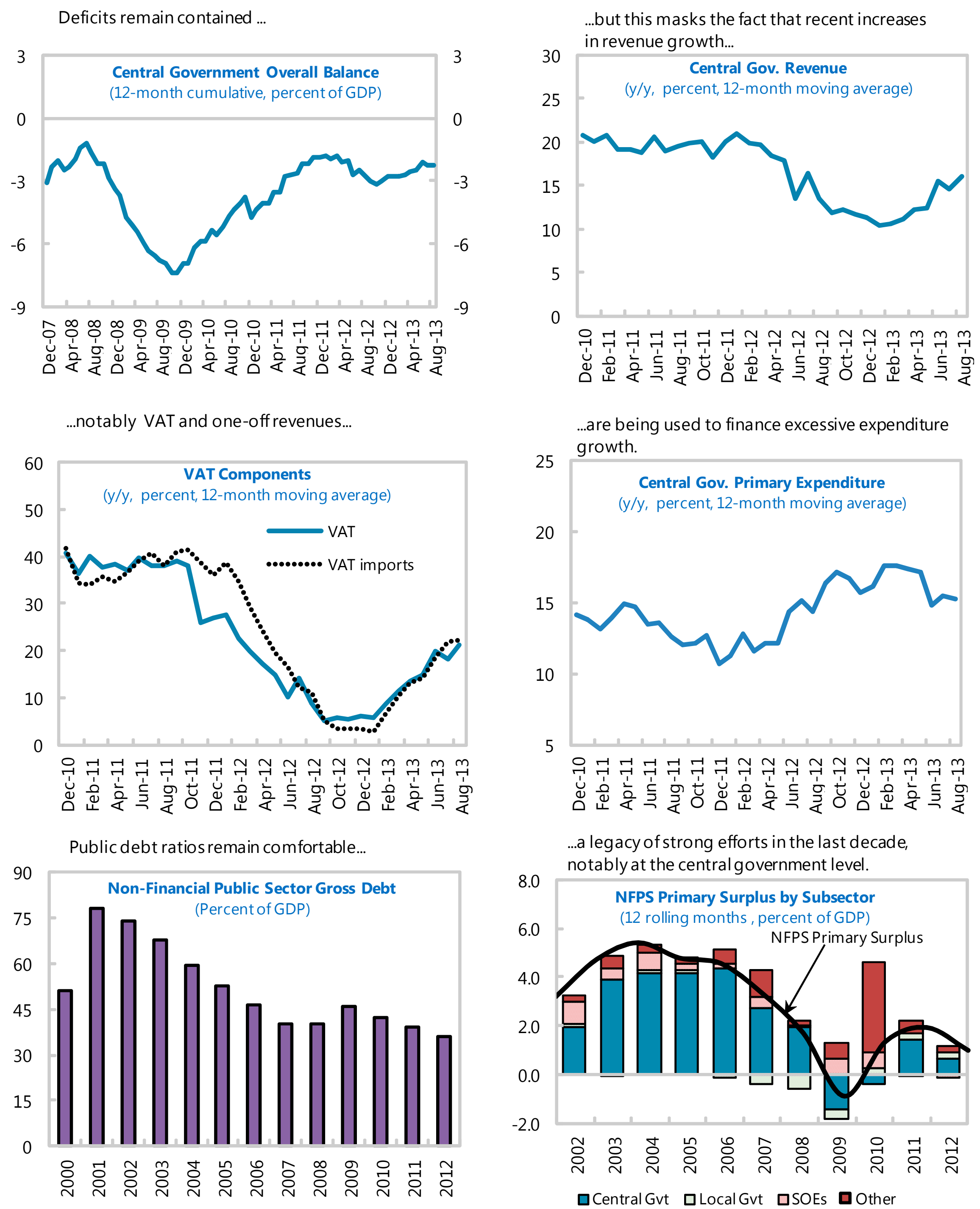
Source: CBRT; Turkstat; and Haver

Figure 2. Turkey: Monetary Policy and Financial Markets



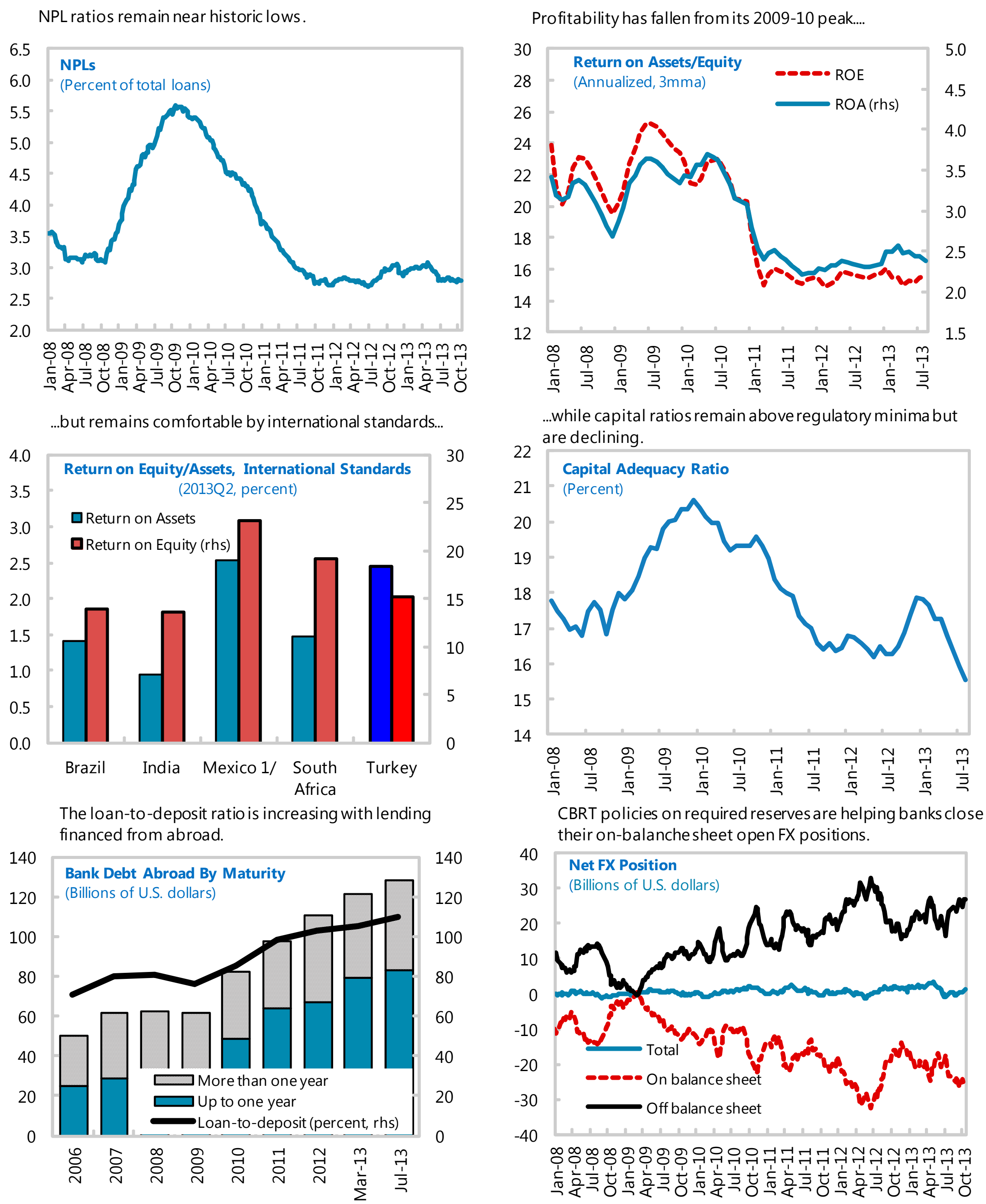
1/ Lira per equal-weight euro/dollar basket.
Source: Haver; CBRT; BRSA; and IMF staff estimates.

Figure 3. Turkey: Fiscal Stance



Source: Fund's estimates based on official data.

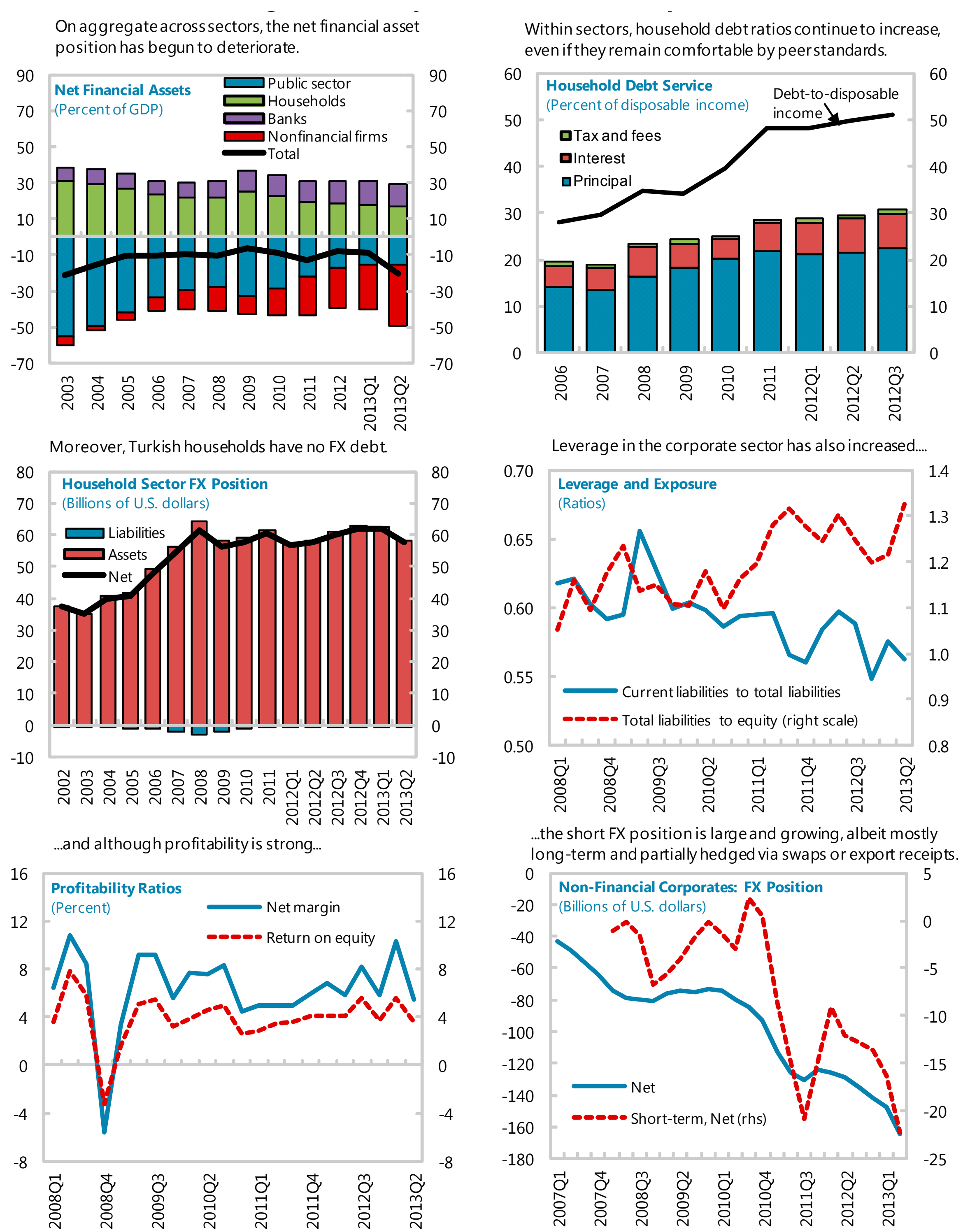
Figure 4. Turkey: Financial Sector



1/ 2013Q1.

Sources: Haver; CBRT; BRSA; and FSI.

Figure 5. Turkey: Households and Corporates



Sources: CBRT; Treasury; BRSA; TBA; and IMF staff estimates.

Figure 6. Turkey vs. Peers

1/ 2013Q1.
Source: World Economic Outlook; IMF Financial Soundness Indicators and Corporate Vulnerability databases.

ANNEX I: PUBLIC DEBT SUSTAINABILITYANNEX I: PUBLIC DEBT SUSTAINABILITY

At close to 35 percent of GDP, Turkey's public debt ratio is well below its historical ten-year average. Gross financing needs are slightly above 10 percent of GDP, and are expected to rise to around 11 percent of GDP over the medium term. The DSA suggests that Turkey's government debt is sustainable even under different shock scenarios. Given the debt structure (average maturity of 5 years and 60 percent of total debt at fixed interest rates) the direct interest pass-through to the budget is relatively slow. Only the impact of lower GDP growth rates represents a significant threat to debt dynamic. While all public debt profile indicators are below early warning benchmarks, the high external financing requirements point to risks arising from the external debt position.

Baseline and Realism of Projections[15]

- ***Debt-levels***. Turkey's favorable debt dynamics are underpinned by a primary surplus and trend GDP growth above the real interest rate. A higher fiscal effort in 2012 than projected a year ago, along with higher privatization proceeds and the impact of higher growth, are forecast to push down the debt-to-GDP ratio relative to previous estimates. Staff forecast that the former will continue its declining path from already moderate levels reaching 31.6 percent in 2018—down by 8.4pp since end-2008. Staff projects that gross financing needs will be 10.4 percent of GDP in 2013—down from 19.7 percent on average for 2002–2010—and will reach 11.4 percent at the end of the projection period.
- ***Growth.*** Past projections of growth outcomes show high forecast errors, possibly due to high volatility of GDP in Turkey, but don't seem to have a systematic bias that undermine the assessment of sustainability. The current growth projections are slightly above those of one year ago, yielding a positive impact in reducing the level of debt. In the medium term, the output gap is expected to close after a being slightly negative in the next two years. Nonetheless, Turkey's debt is highly sensitive to big swings in GDP growth, highlighting the relevance of growth shocks in the stress tests.
- ***Sovereign yields***. Despite the volatility observed in recent months, Turkey' yields on public sector debt have returned to historical values at around 9.0 percent. The spreads against the US bonds in the last three months remained on average at 213 bps, close to trend but higher than its lowest value of 118 bps observed in May 2013. The effective interest rate is forecast to rise from 9.8 percent in 2012 to 10.3 percent in 2013, returning to 2012 values at the end of the forecast period.

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

- ***Fiscal adjustment.*** In the baseline the structural primary balance deteriorates due to lower structural revenues and the primary spending drift linked to increasing budget rigidities. The maximum projected 3-year adjustment of the cyclically-adjusted primary balance is close to zero.

- ***Maturity and rollover***. Given current debt structure (average maturity just under 5 years, 60 percent share of fixed interest debt to total debt, and only 30 percent denominated in foreign currency), the direct interest pass-through to the budget is very slow. A 100 basis points shock to the yield curve is estimated to raise the interest bill by just 0.1 percent of GDP. Similarly, a 5 percent shock in real exchange rate impacts gross public debt stock by just 0.5 pp. During the whole period, only 30 percent of marketable debt is held by non-residents, which keeps the rollover risks at a reasonable level.

Shocks and Stress Tests

- ***Primary balance shock***. A deterioration of 1.0pp of GDP in the primary balance delays by 2 years the downward trend of debt-to-GDP ratio relative to the baseline. Sovereign borrowing costs are pushed up (25 bps for each 1 percent of GDP worsening in the primary balance). The debt-to-GDP ratio and gross financing needs end up at similar levels compared to the baseline by 2018.

- ***Growth shock***. Real output growth rates are lowered by 1 standard deviation, or 4.6 percentage points, for 2 years starting in 2014. The decline in growth leads to lower inflation (0.25 percentage points per 1 percentage point decrease in GDP growth). The nominal primary balance deteriorates significantly compared to the baseline as nominal revenues fall against unchanged expenditure plans, reaching -3.9 percent of GDP by 2015. The deterioration in primary balance leads to higher sovereign borrowing costs (see above). The debt-to-GDP ratio increases to about 43 percent during the growth shock and then stabilizes around 39 percent at the end of the projection period. Gross financing needs climb toward 15 percent of GDP at the end of period.

- ***Interest rate shock.*** Market concerns about medium-term debt sustainability intensify increasing spreads by 525 bps. The government's interest bill climbs reaching an implicit average interest rate of almost 11.1 percent by 2018. The debt-to-GDP ratio remains at low levels reaching just 32.3 percent in 2018, and gross financing needs reach around 12 percent of GDP by 2018.

- ***Contingent liability shock***. A one-time bail out of the financial sector increases non-interest expenditures by 10 percent of banking sector assets. This is combined with real GDP growth shock (1 standard deviation for 2 years). Sovereign borrowing costs are pushed up (25 bps for each 1 percent of GDP worsening in the primary balance) while inflation declines (0.25 percentage points per 1 percentage point decrease in GDP growth). Debt rises to 44 percent of GDP in 2015 and stabilizes at 39 by 2018. Gross financing needs jump to about 17 percent of GDP in 2014 and come down to 14 percent by the end of the period.

- ***Combined 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).

In the case of Turkey, a combined shock would increase debt to around 45 percent of GDP, still below Turkey's average debt of 52.1 percent of GDP between 2002 and 2010.

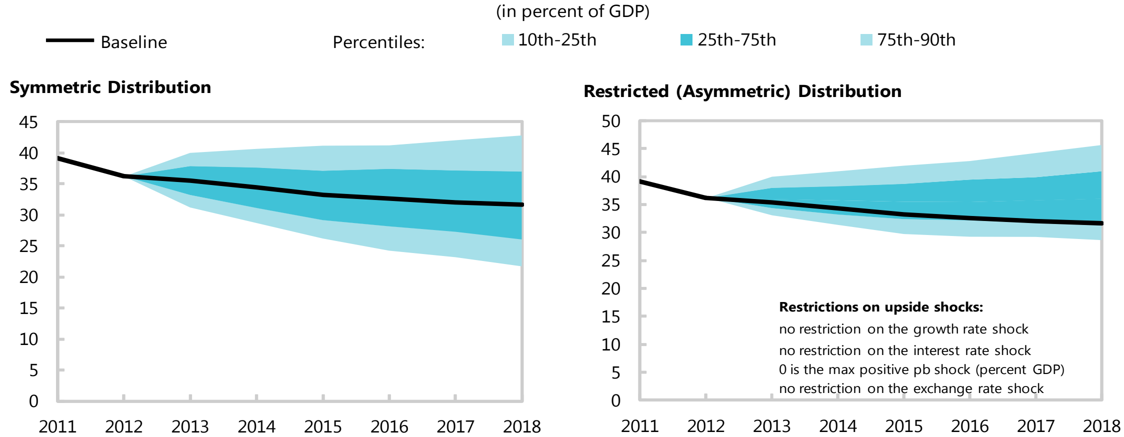
Turkey Public DSA Risk Assessment

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

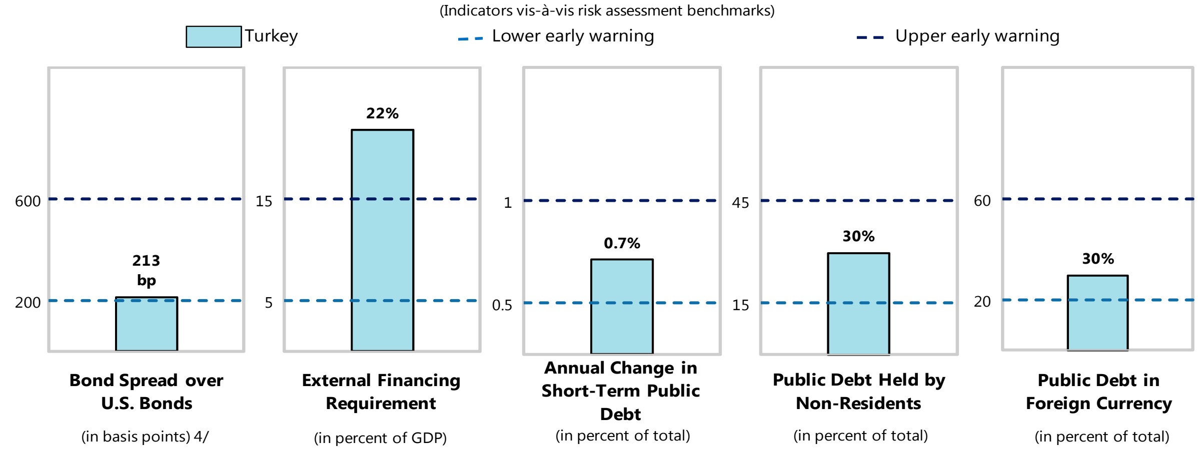
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

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

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

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

Lower and upper risk-assessment benchmarks are:

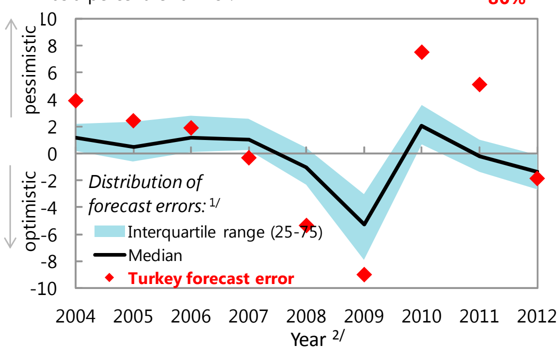
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for total external financing requirement (public and private); 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency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

4/ An average over the last 3 months, 01-Jun-13 through 30-Aug-13.

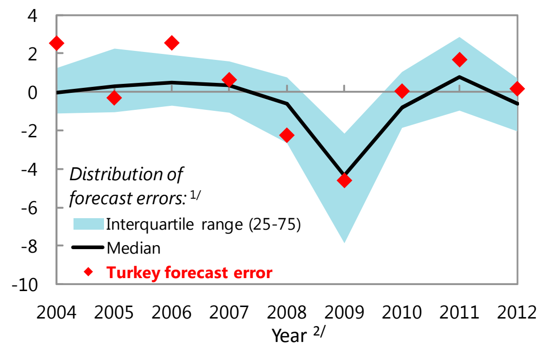
Turkey Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

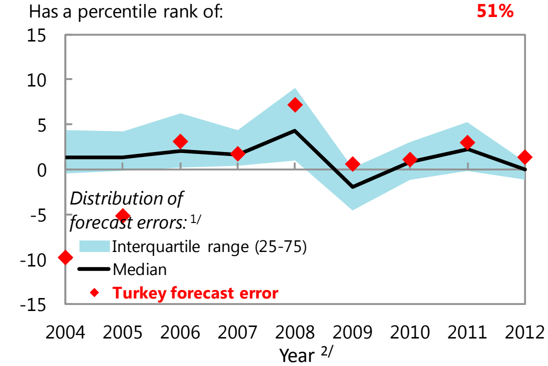
Real GDP Growth
(in percent, actual-projection)
Turkey median forecast error, 2004-2012: **1.89**
Has a percentile rank of: **86%**



Primary Balance
(in percent of GDP, actual-projection)
Turkey median forecast error, 2004-2012: **0.17**
Has a percentile rank of: **59%**

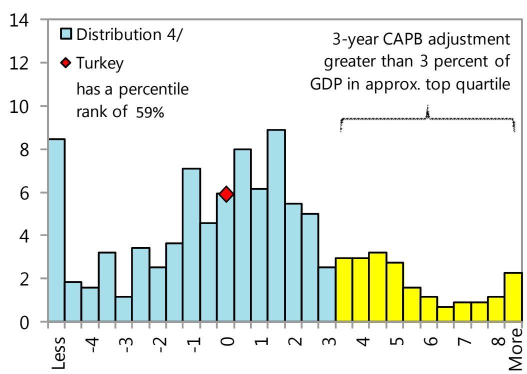


Inflation (Deflator)
(in percent, actual-projection)
Turkey median forecast error, 2004-2012: **1.35**
Has a percentile rank of: **51%**

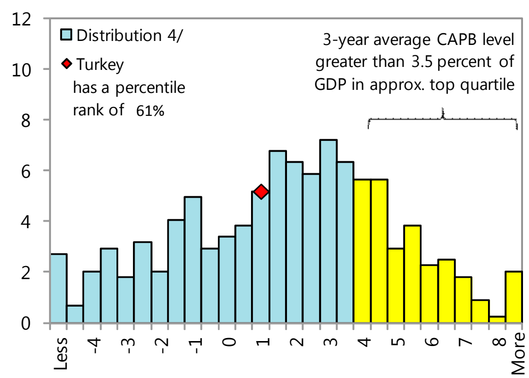


Assessing the Realism of Projected Fiscal Adjustment

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

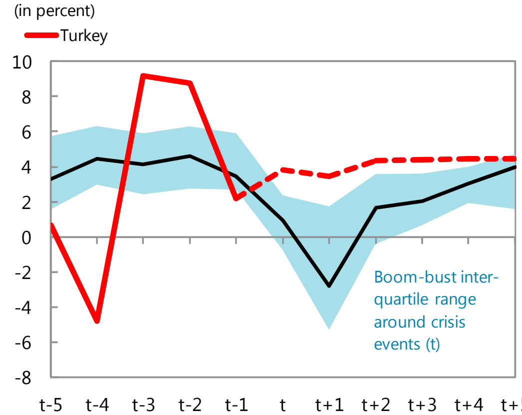


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Turkey has had a positive output gap for 3 consecutive years, 2010-2012 and a cumulative increase in private sector credit of 18 percent of GDP, 2009-2012. For Turkey, t corresponds to 2013; for the distribution, t corresponds to the t
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 Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

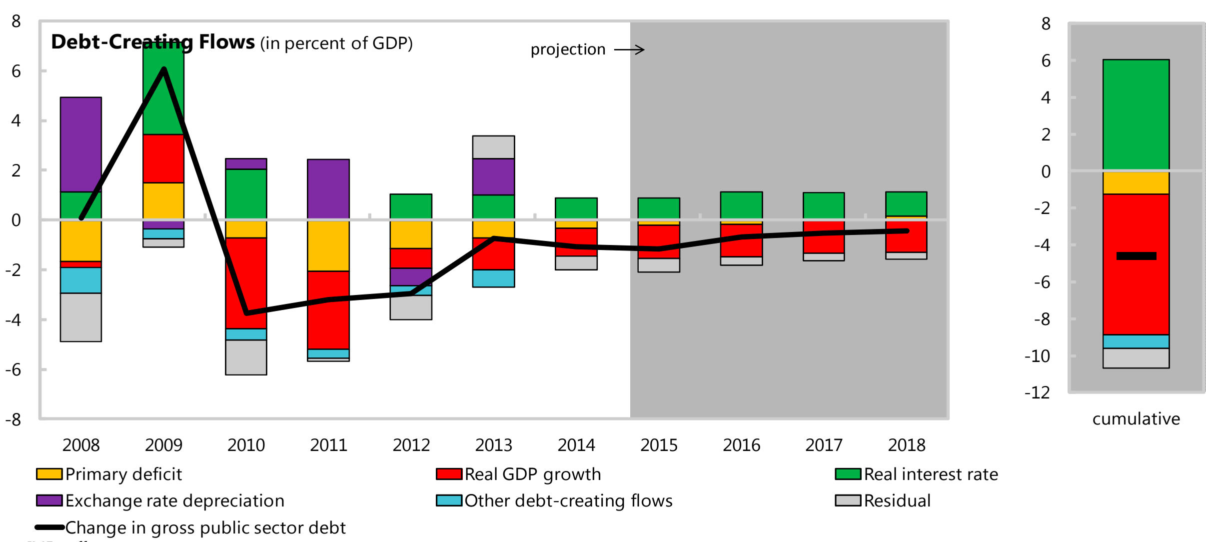
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	52.1	39.1	36.2	35.4	34.4	33.2	32.6	32.0	31.6
Public gross financing needs	19.7	10.2	9.3	10.4	9.8	9.0	11.3	11.0	11.4
Real GDP growth (in percent)	5.1	8.8	2.2	3.8	3.5	4.3	4.4	4.5	4.5
Inflation (GDP deflator, in percent)	13.2	8.6	6.8	6.9	6.9	6.0	6.0	6.0	6.0
Nominal GDP growth (in percent)	19.0	18.1	9.1	11.0	10.6	10.6	10.7	10.8	10.8
Effective interest rate (in percent) [4/]	17.9	9.4	9.8	10.3	10.0	9.2	10.1	10.1	9.7

As of August 30, 2013		
Sovereign Spreads		
Spread (bp) 3/		300
CDS (bp)		240
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BB+	BBB
Fitch	BBB-	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-4.0	-3.2	-3.0	-0.7	-1.1	-1.2	-0.7	-0.5	-0.4	-4.6	
Identified debt-creating flows	-4.2	-3.1	-2.0	-1.7	-0.5	-0.6	-0.3	-0.2	-0.2	-3.5	
Primary deficit	-2.7	-2.0	-1.1	-0.7	-0.3	-0.2	-0.2	0.0	0.2	-1.2	-0.3
Primary (noninterest) revenue and grant	30.7	34.0	34.0	35.4	35.0	34.4	34.2	34.0	33.9	206.9	
Primary (noninterest) expenditure	28.0	31.9	32.9	34.6	34.6	34.2	34.1	34.0	34.1	205.7	
Automatic debt dynamics [5/]	-0.8	-0.7	-0.4	-0.2	-0.2	-0.4	-0.2	-0.2	-0.3	-1.6	
Interest rate/growth differential [6/]	-0.8	-3.1	0.3	-0.2	-0.2	-0.4	-0.2	-0.2	-0.3	-1.6	
Of which: real interest rate	1.7	0.0	1.0	1.0	0.9	0.9	1.1	1.1	1.0	6.1	
Of which: real GDP growth	-2.5	-3.1	-0.8	-1.2	-1.1	-1.3	-1.3	-1.3	-1.3	-7.6	
Exchange rate depreciation [7/]	0.0	2.5	-0.7	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.7	-0.4	-0.4	-0.7	0.0	0.0	0.0	0.0	0.0	-0.7	
Public Sector: Privatization Proceeds (n	-0.7	-0.4	-0.4	-0.7	0.0	0.0	0.0	0.0	0.0	-0.7	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
(Specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.2	-0.1	-1.0	0.9	-0.5	-0.5	-0.3	-0.3	-0.3	-1.1	



Source: IMF staff.

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

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

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

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

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

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

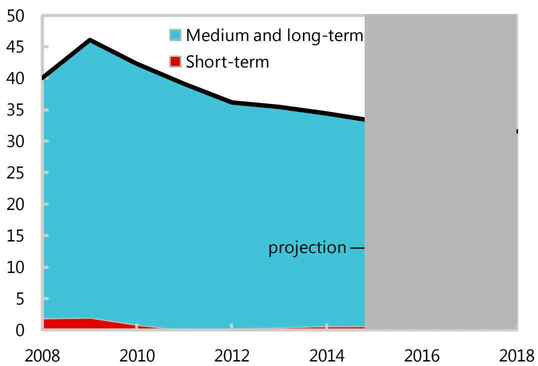
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Turkey Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

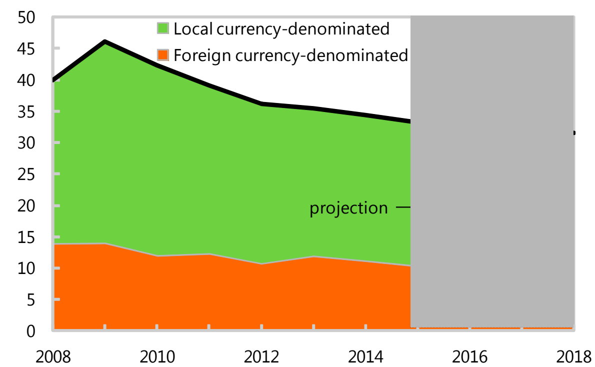
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

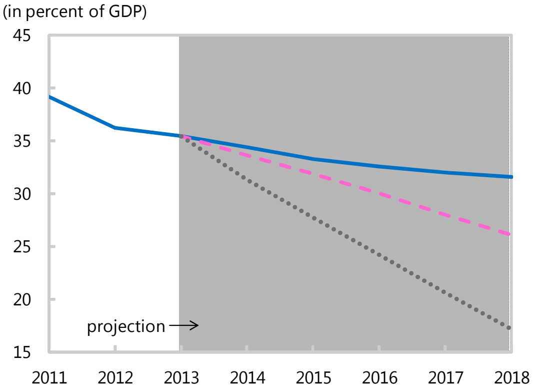


Alternative Scenarios

Baseline — Historical — Constant Primary Balance

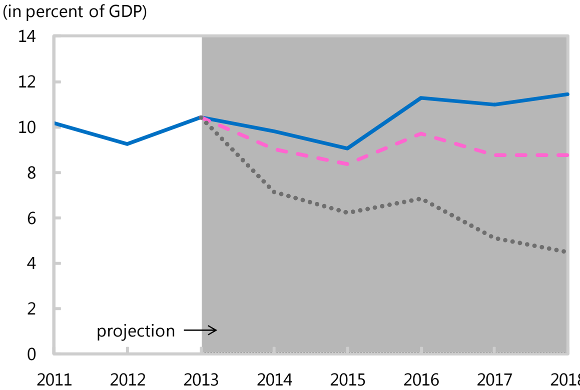
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

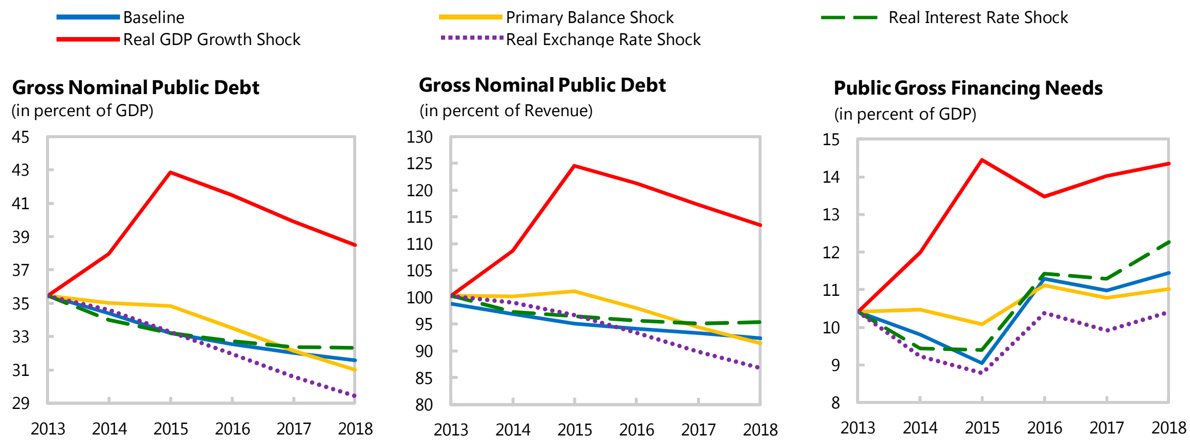
Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	3.8	3.5	4.3	4.4	4.5	4.5
Inflation	6.9	6.9	6.0	6.0	6.0	6.0
Primary Balance	0.7	0.3	0.2	0.2	0.0	-0.2
Effective interest rate	10.3	10.0	9.2	10.1	10.1	9.7
Constant Primary Balance Scenario						
Real GDP growth	3.8	3.5	4.3	4.4	4.5	4.5
Inflation	6.9	6.9	6.0	6.0	6.0	6.0
Primary Balance	0.7	0.7	0.7	0.7	0.7	0.7
Effective interest rate	10.3	8.8	9.0	8.0	7.1	7.1

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	3.8	5.1	5.1	5.1	5.1	5.1
Inflation	6.9	6.9	6.0	6.0	6.0	6.0
Primary Balance	0.7	2.5	2.5	2.5	2.5	2.5
Effective interest rate	10.3	8.8	9.3	8.6	7.8	7.5

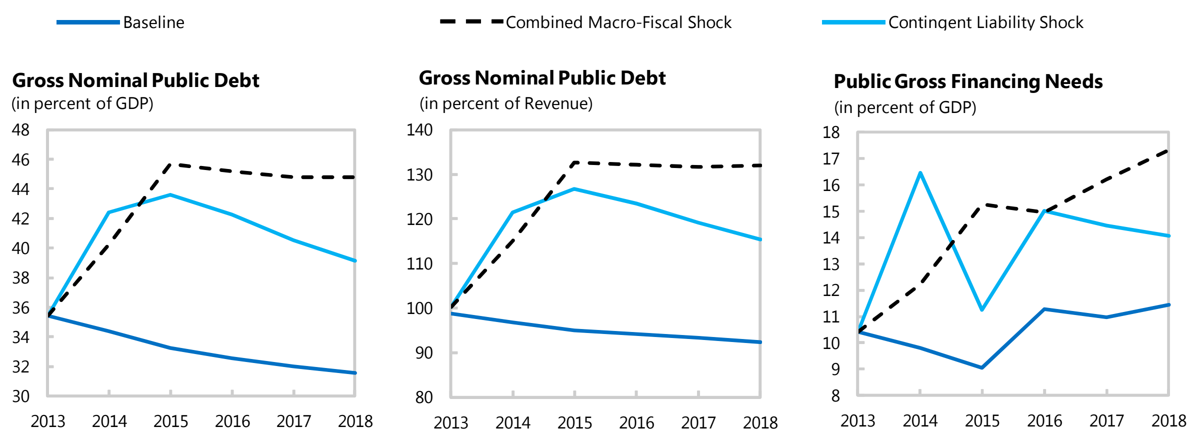
Source: IMF staff.

Turkey Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2013	2014	2015	2016	2017	2018
Primary Balance Shock						
Real GDP growth	3.8	3.5	4.3	4.4	4.5	4.5
Inflation	6.9	6.9	6.0	6.0	6.0	6.0
Primary balance	0.7	-0.7	-0.8	0.2	0.0	-0.2
Effective interest rate	10.3	8.8	9.0	8.2	7.3	7.2
Real Interest Rate Shock						
Real GDP growth	3.8	3.5	4.3	4.4	4.5	4.5
Inflation	6.9	6.9	6.0	6.0	6.0	6.0
Primary balance	0.7	0.3	0.2	0.2	0.0	-0.2
Effective interest rate	10.3	8.8	10.4	10.8	10.7	11.1
Combined Shock						
Real GDP growth	3.8	-1.1	-0.3	4.4	4.5	4.5
Inflation	6.9	5.7	4.9	6.0	6.0	6.0
Primary balance	0.7	-1.7	-3.9	0.2	0.0	-0.2
Effective interest rate	10.3	9.1	10.3	10.9	10.7	11.1

	2013	2014	2015	2016	2017	2018
Real GDP Growth Shock						
Real GDP growth	3.8	-1.1	-0.3	4.4	4.5	4.5
Inflation	6.9	5.7	4.9	6.0	6.0	6.0
Primary balance	0.7	-1.7	-3.9	0.2	0.0	-0.2
Effective interest rate	10.3	8.8	9.1	8.5	7.5	7.3
Real Exchange Rate Shock						
Real GDP growth	3.8	3.5	4.3	4.4	4.5	4.5
Inflation	6.9	11.6	6.0	6.0	6.0	6.0
Primary balance	0.7	0.3	0.2	0.2	0.0	-0.2
Effective interest rate	10.3	9.1	8.7	7.9	7.1	7.1
Contingent Liability Shock						
Real GDP growth	3.8	-1.1	-0.3	4.4	4.5	4.5
Inflation	6.9	5.7	4.9	6.0	6.0	6.0
Primary balance	0.7	-5.6	0.2	0.2	0.0	-0.2
Effective interest rate	10.3	10.3	9.5	8.6	7.2	7.4

Source: IMF staff.

ANNEX II: EXTERNAL DEBT SUSTAINABILITY

Turkey's gross external debt is sustainable under the baseline scenario, but the rising path points to increased vulnerabilities (see external DSA table). External debt is projected to rise to 50 percent of GDP by 2018 reflecting the large and widening current account deficit and reliance on debt-creating inflows. In 2012, despite improvements in the current account balance, external debt-to-GDP ratio deteriorated on account of slower growth and a continued buildup of external liabilities. These liabilities continued to grow in the first half of 2013, but the pace has since moderated due to changing external funding conditions.

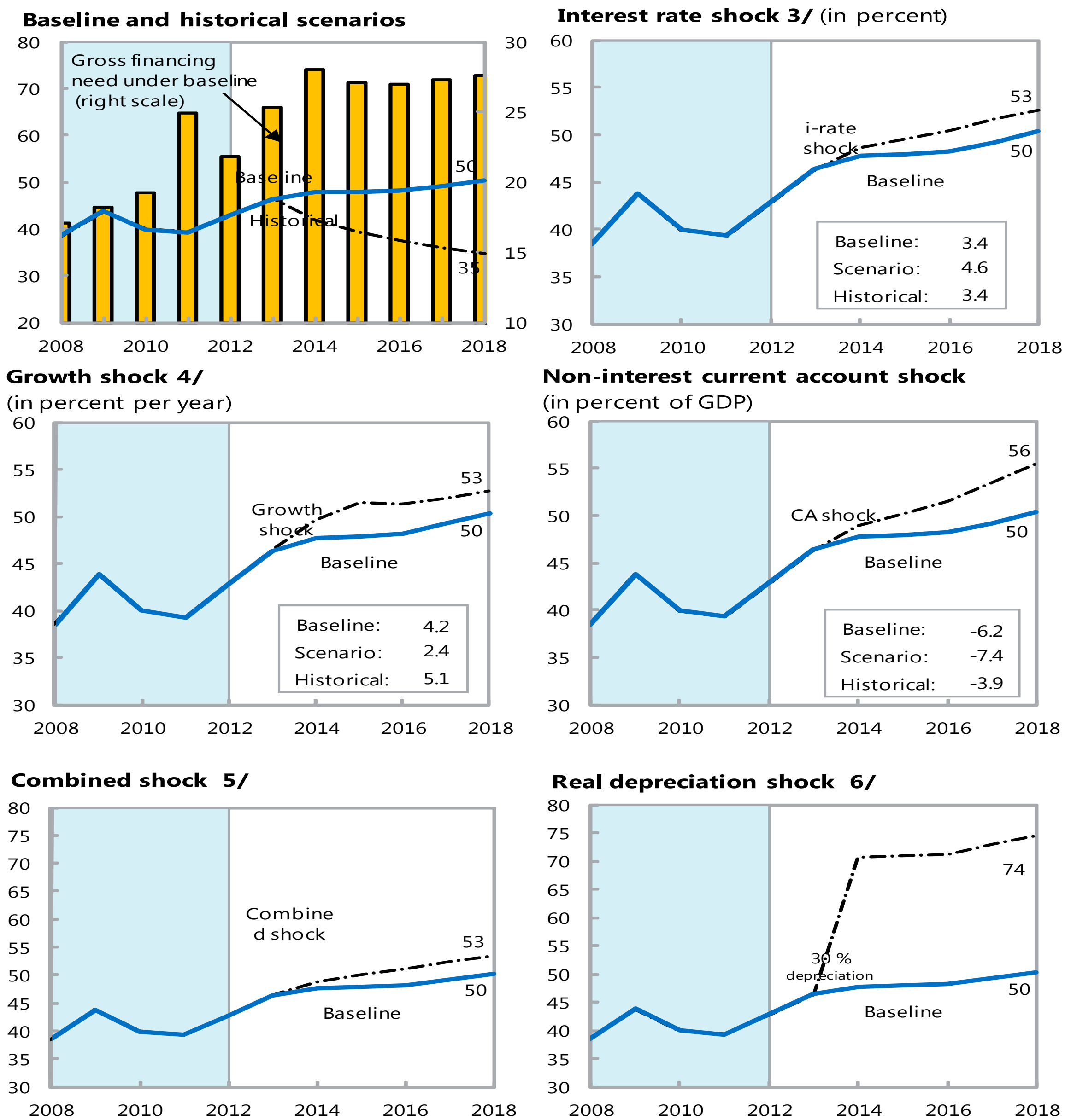
Most of the external debt is long term although the share of short-term debt has been rising. At 34 percent of total, the share of short-term debt has almost doubled since end-2009. Financial institutions account for roughly 70 percent of short-term borrowings. In terms of sector exposure, two thirds of the total external debt are held by the private sector, with an even split between financial and non-financial institutions.

The external debt is relatively robust to interest rate, growth, and current account shocks. To be conservative, the standardized growth shock of one-half standard deviation was replaced with a one standard deviation shock equivalent to a 4.6 percentage-point reduction in growth. In the same vein, the interest rate shock was customized to mirror the large increase in spreads experienced in 2008. Under these scenarios, the standardized current account balance shock, or a combination of the three shocks, external debt would remain below 60 percent of GDP (see external DSA figure). Turkey's external debt sustainability, however, is vulnerable to large exchange rate depreciations. A one-time depreciation of 30 percent would cause the external debt stock to rise above 70 percent of GDP. It should be noted that individual shock scenarios assume that all other variables follow their baseline paths. In practice, a real exchange rate shock of this magnitude would precipitate adjustment in the current account that would help mitigate the impact on external debt.

Given the large external financing requirements, liquidity and rollover risks are the most pertinent concerns for debt sustainability. Annual gross external financing needs are large at 25 percent of GDP and are forecast to remain elevated over the medium term. The high current account deficit and the reliance on short-term financing are the main culprits behind the persistently large external financing needs. Turkey's debt sustainability therefore remains susceptible to sudden and sustained shifts in international investors' risk appetite, which could trigger a simultaneous increase in both borrowing cost and exchange rate pressure. **Turkey made its last repurchase to the Fund in May 2013.**

Turkey: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks, unless otherwise specified. 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/ Interest rate rises to the maximum rate experienced over a ten-year history.

4/ Real GDP growth is reduced by 1 standard deviation for 2 consecutive years.

5/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

6/ One-time real depreciation of 30 percent occurs in 2010.

Turkey: External Debt Sustainability Framework, 2008-2018

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	38.5	43.8	39.9	39.3	42.8			**46.4**	**47.7**	**47.9**	**48.1**	**49.2**	**50.3**	**-5.1**
2 Change in external debt	-0.2	5.3	-3.9	-0.6	3.5			3.6	1.4	0.1	0.3	1.0	1.1	
3 Identified external debt-creating flows (4+8+9)	-1.3	7.6	-2.3	5.8	3.5			4.8	3.8	3.3	3.3	3.5	3.9	
4 Current account deficit, excluding interest payments	4.0	0.3	5.1	8.7	5.0			6.3	6.0	6.3	6.4	6.2	6.1	
5 Deficit in balance of goods and services	4.7	1.0	5.4	8.9	5.4			6.4	6.0	6.1	6.3	6.5	6.7	
6 Exports	24.3	23.6	21.5	23.8	26.2			26.3	26.7	25.4	24.3	23.4	22.6	
7 Imports	29.0	24.7	26.9	32.7	31.6			32.7	32.7	31.6	30.7	29.9	29.3	
8 Net non-debt creating capital inflows (negative)	-2.5	-1.6	-1.5	-1.6	-1.9			-1.0	-1.8	-2.3	-2.4	-2.5	-2.5	
9 Automatic debt dynamics 1/	-2.8	8.9	-5.8	-1.2	0.4			-0.5	-0.4	-0.7	-0.6	-0.3	0.2	
10 Contribution from nominal interest rate	1.6	1.7	1.2	1.0	1.1			1.1	1.2	1.1	1.3	1.7	2.2	
11 Contribution from real GDP growth	-0.2	2.2	-3.4	-3.3	-0.8			-1.6	-1.6	-1.9	-1.9	-1.9	-2.0	
12 Contribution from price and exchange rate changes 2/	-4.2	5.0	-3.6	1.1	0.2			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.1	-2.3	-1.6	-6.5	0.0			-1.3	-2.5	-3.1	-3.0	-2.5	-2.8	
External debt-to-exports ratio (in percent)	158.1	185.2	185.8	165.4	163.3			176.3	179.0	188.3	197.9	210.2	222.7	
Gross external financing need (in billions of US dollars) 4/	124.7	112.0	140.6	193.1	172.0			208.3	238.5	255.4	281.3	315.2	352.5	
in percent of GDP	17.1	18.2	19.2	24.9	21.8	10-Year	10-Year	25.3	28.0	27.1	27.0	27.3	27.5	
Scenario with key variables at their historical averages 5/								**46.4**	**41.8**	**39.4**	**37.4**	**36.0**	**34.6**	**-5.3**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	0.7	-4.8	9.2	8.8	2.2	5.1	4.6	3.8	3.5	4.3	4.4	4.5	4.5	
GDP deflator in US dollars (change in percent)	12.1	-11.6	9.0	-2.6	-0.4	8.2	10.9	0.4	0.1	6.0	6.0	6.0	6.0	
Nominal external interest rate (in percent)	4.6	3.7	3.2	2.8	2.8	3.4	0.6	2.7	2.6	2.6	3.0	3.9	5.0	
Growth of exports (US dollar terms, in percent)	22.4	-18.3	8.2	17.1	12.3	15.0	13.7	4.6	5.0	5.4	6.0	6.6	6.9	
Growth of imports (US dollar terms, in percent)	19.0	-28.5	29.9	28.5	-1.6	18.5	20.1	7.9	3.6	6.8	7.6	8.1	8.4	
Current account balance, excluding interest payments	-4.0	-0.3	-5.1	-8.7	-5.0	-3.9	2.4	-6.3	-6.0	-6.3	-6.4	-6.2	-6.1	
Net non-debt creating capital inflows	2.5	1.6	1.5	1.6	1.9	2.2	1.2	1.0	1.8	2.3	2.4	2.5	2.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

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

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

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

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

ANNEX III: THE CBRT'S NEW MONETARY FRAMEWORK

Adoption Date	Description
October 2010– August 2011	The interest rate corridor is opened downwards. *The CBRT varies volumes of TL-liquidity provided via quantity-based repo auctions*. Volatility of the overnight interbank rates is increased but, on average, they are kept close to the policy rate. The CBRT purchases FX via regular auctions. Reserve Requirement Ratios are differentiated and gradually tightened.
August 2011– October 2011	The interest rate corridor is narrowed from below. *The CBRT initiates FX selling auctions.* ROM is introduced in September.
October 2011– January 2012	The interest rate corridor is opened upwards. *The CBRT starts additionally providing TL liquidity via price-based repo auctions.* Effective cost of TL liquidity provided by the CBRT and the interbank rate decouple from the policy rate and from each other. FX selling auctions continue and the CBRT conducts several direct interventions in December-January. RRRs are lowered, put on hold, and, effectively, dropped from the toolbox.
January 2012– June 2012	The interest rate corridor remains wide. *The CBRT provides TL liquidity via various repo-facilities with highly-variable effective cost, which depends on local and global circumstances.* The CBRT conducts no FX auctions or interventions. Reserve Option Coefficients (ROCs) are introduced in March and are gradually increased. So is the Reserve Option Ratio.
June 2012– September 2012	*The CBRT sharply lowers the effective cost of liquidity it provides to the markets*.
September 2012– May 2013	*The CBRT in several steps narrows the interest rate corridor from above*. The CBRT shifts the whole corridor down. The cost of liquidity is now close to the policy rate and the interbank rates.
May 2013 onward	The CBRT increases cost of TL liquidity it provides. Effective cost of TL liquidity provided by the CBRT and the interbank rate again decouple from the policy rate. *The CBRT reintroduces FX selling auctions*. The CBRT *increases reserve requirements (RRR)* on ST FX but suggests ROCs and FX-RRRs could be decreased.

Sources: Turkish authorities; and IMF staff.

ANNEX IV: RECENT MACRO-PRUDENTIAL MEASURES

Measure	Description	Adoption Date
Loan-to-value (LTV) ceilings	Implements loan-to-value ceilings on housing loans to consumer (at 75 percent) and on purchases of commercial real estate (at 50 percent).	December 2010
Implicit Nominal Credit Growth Target	The authorities provided guidance to banks that credit growth (adjusted for FX movements) in 2011 should not exceed 25 percent.	Spring 2011
High risk weights for consumer loans	Higher risk weights introduced for fast growing consumer loans. For new general purpose loans with maturities below two years, the risk-weighting increased to 150 percent (from 100 percent). For new general purpose loans with maturity greater than two years, the risk-weight increased to 200 percent (from 100 percent).	June 2011
Increased provisions for consumer loans	For new (performing) general purpose loans, general provisions were increased from 1 percent to 4 percent. Specific provisions for (pre-nonperforming) loans increased from 2 percent to 8 percent. The higher provisioning requirements are conditional on banks having a consumer loan portfolio exceeding 20 percent of total loans or having a general purpose loan NPL greater than 8 percent.	June 2011
Limits to credit card payments	If three or more monthly payments within a calendar year are less than half of the outstanding balance for the period, the individual credit card limits cannot be increased and cash advances for such credit cards cannot be permitted, unless the outstanding balance for the period is fully covered.	June 2011

Interest Rate Risk	Announced by the Banking Regulation and Supervision Agency (BRSA) to contain interest rate risk through capital charges on large maturity mismatches, discouraging duration gaps. Effective from 2012.	August 2011
Changes to minimum Capital Adequacy Requirements	Amended by the BRSA in September 2011 to apply to banks with foreign strategic shareholders as of January 2012. The minimum ratio would depend on various factors such as the CDS spread of the parent and its sovereign, EBA stress test results and the public debt ratio in the country of origin.	September 2011
Changes to deposit insurance premiums	The deposit insurance fund introduced a premium surcharge for large banks and a new factor to calculate the banks' score for the deposit premium determination.	September 2011
Abolition of loan to value ratios for commercial real estate loans	Loan to value ratios for loans financing commercial real estate were abolished.	April 2013
Credit card limits introduced	Consumer credit card limits were tied to incomes. Minimum payment limits and risk weights were increased.	October 2013
Changes to provisioning rate	Increased general provisioning rates for uncollateralized consumer loans to 4 percent from 1 percent; Decreased general provisioning rates on export and SME loans to 0 percent and 0.5 percent respectively from previous 1 percent.	October 2013

Sources: Turkish authorities; and IMF staff.

INTERNATIONAL MONETARY FUND

TURKEY

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 1, 2013

Prepared By European Department

CONTENTS

FUND RELATIONS

(Data as of September 30, 2013)

A three-year SDR 6.7 billion (559 percent of quota) **Stand-By Arrangement** was approved in May 2005 and expired on May 10, 2008. Cumulative purchases amounted to SDR 6.7 billion.

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 September 30, 2013.

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	1,455.80	100.00
Fund holdings of currency	1,343.03	92.25
Reserve position in Fund	112.78	7.75

SDR Department

	SDR Million	**Percent Allocation**
Net cumulative allocation	1,071.33	100.00
Holdings	966.20	90.19

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	12/20/01	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				
	2013	2014	2015	2016	2017
Principal	--	--	--	--	--
Charges/Interest	0.02	0.08	0.08	0.08	0.08
Total	0.02	0.08	0.08	0.08	0.08

[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:

The last Article IV staff report (IMF Country Report 12/338) was issued on December 21, 2012. Board discussion took place on November 16, 2012.

ROSCs

Standard or Code Assessed	Date of Issuance	Document Number
Fiscal Transparency	June 26, 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. 03/353
Fiscal ROSC	March 24, 2006	Country Report No. 06/126
FSSA and Related ROSC	May 7, 2007	Country Report No. 07/361
Data ROSC	September 3, 2009	Country Report No. 09/286
BCP	*Forthcoming*	*Forthcoming*
IAIS	*Forthcoming*	*Forthcoming*

Recent Technical Assistance

Dept.	Timing	Purpose
FAD/MFD	February 2005	Treasury cash management and state bank reform
MFD	2005–06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May 2005	Investor relations office
FAD	July 2005	Income tax reform
FAD	2005–08 (numerous 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

WORLD BANK RELATIONS

1. **Turkey and the World Bank Group have a strong partnership, which continuously deepened over the last twelve years.** Country Partnership Strategies (CPSs) form the basis of the partnership between Turkey and the World Bank. The Country Partnership Strategy FY12–15 envisages financing levels of around US$4.5 billion; the increased provision of analytical and advisory services as well as new services and instruments—including fee-based services. The CPS has three main strategic objectives and pillars: (i) enhance competitiveness and employment; (ii) improve equity and public services; and, (iii) deepen sustainable development. Turkey's development success and a number of its economic and social reforms have attracted international interest and recognition. Together, Turkey and the World Bank are exploring avenues to collaborate in sharing Turkey's experience abroad.

2. **Turkey is the IBRD's second largest borrower in terms of debt outstanding**. The active portfolio of investment projects with World Bank financing includes 11 projects with total net commitments of US$4.6 billion. The investment portfolio supports financial and private sector development, urban development, the energy sector, transport, and health and education.

3. **Turkey is the IFC's second largest exposure in terms of committed portfolio with more than US$3 billion.** Fiscal year 2013 was a record year for the IFC in Turkey with US$985 million of investments in 20 projects. During the FY12–15, IFC is expected to invest US$1.7–2 billion in Turkey. So far, it is ahead of this plan and has invested about US$1.8 billion. The IFC is helping Turkey to address the increasing demand for energy in the country, is contributing to the development of its domestic capital markets, and is supporting under-served sectors of the economy such as SMEs and the agribusiness sector. The IFC is also helping Turkey to become a regional leader. It has invested $580 million in 23 private sector projects with Turkish companies investing outside Turkey. The establishment of the IFC's Istanbul Operations Center (IOC) has been a successful development for IFC and supports the government's goal of establishing Istanbul as an international finance center. Today, IOC has about 200 staff serving 52 countries in Europe, the Middle East, and North Africa region (EMENA).

4. **The World Bank Group is engaged in Turkey with its full range of financing as well as analytic, knowledge, and advisory services.** Recent analytic, knowledge, and advisory activities have included (i) a Programmatic Jobs Series covering the labor market through the economic cycle, activation of low-skilled youth and women, and the creation of good jobs; (ii) a Country Economic Memorandum on foreign trade following the previous on savings and sustainable growth; (iii) a Programmatic Education Series covering quality and basic education, improving early childhood education and efficiency of delivery of education; (iv) a Programmatic Health Series covering family medicine, pharmaceuticals and universal health coverage; (v) an investment climate assessment; (vi) a roadmap for the development of a corporate bond market; (vii) a Transport Public Expenditure Review; and (viii) technical assistance on food safety, sustainable development, watershed management and promoting gender equity in the private sector and entrepreneurship. Much analytic and advisory work is carried out together with the Turkish authorities, the private sector,

academia, or civil society stakeholders. The World Bank Group engages with civil society in the preparation and implementation of projects and collaborates closely with other development partners such as the IMF, the EU, UN organizations, and other key bilateral partners.

STATISTICAL ISSUES

1. **Data provision to the Fund is broadly adequate for surveillance purposes, despite certain shortcomings.** Turkey subscribes to the Special Data Dissemination Standard (SDDS).

Real Sector Statistics

2. **Data on producer and consumer prices are published monthly, with a short lag. Monthly data on industrial production are published with a lag of five to six weeks**. The CPI and the PPI generally conform to international standards. The methodology of the CPI was improved with the introduction of a 2003-based index, and this new CPI has been in effect since 2005. The methodology of the CPI was further improved in 2009 regarding the collection of telecommunication services prices. The new CPI does not cover owner-occupied housing, commodities produced by households for own consumption, and expenditures on commodities obtained through in-kind payments. The PPI is compiled according to NACE Rev. 1.

3. **Quarterly national accounts are published with a 2–3 month lag**. The Turkish Statistical Institute (Turkstat) publishes national accounts in current and constant prices for the production and expenditure approaches to gross domestic product (GDP). Only quarterly GDP data are presented on a seasonally adjusted basis.

4. **In March 2008, revised annual and quarterly estimates were released for 1998 onwards following the introduction of *ESA 1995* in Turkish National Accounts**. However, GDP time series have not been constructed for years prior to 1998. Work is underway aiming at incorporation of data from annual collections, the development of independent estimates of household consumption, and further enhancement of estimates for the non-observed economy. A project recently initiated aims at extending the scope of the accounts to a full sequence of accounts for the total economy, annual supply and use tables, and institutional sector accounts.

5. **There is a wide range of data on labor market developments, with the biannual Household Labor Force Survey (HLFS) replaced with a monthly survey at the beginning of 2000**. These data have been published annually until 2005 and from 2005 are published quarterly with a three months lag. Coverage of wage developments in the private sector has improved through the use of quarterly surveys of the manufacturing sector.

Government Finance Statistics

6. **Budgetary data are published monthly, with a lag of 15 days**. Coverage of the budget is incomplete, with some fiscal operations conducted through extra budgetary funds, for which data are available only with long lags. Fiscal analysis is further complicated by the omission of certain transactions from the fiscal accounts, 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 authorities have requested technical assistance to improve these and other statistical issues.

7. **Turkey reports fiscal data for publication in the *Government Finance Statistics Yearbook***. The latest data available are for 2012 and cover the general government sector and its subsectors. Monthly data are reported on an irregular basis for publication in *International Financial Statistics*, starting from September 2009.

Monetary and Financial Statistics

8. **Data on the central bank balance sheet, and provisional data on the main monetary aggregates and total domestic credit, are published weekly, with a one- and two-week lag, respectively**. Data on the monetary survey and deposit interest rates are published monthly, with a one month lag, except for year-end data, where the lag is two months. The CBRT reports to STA the Standardized Report Form (SRF) 1SR for the Central Bank on a monthly basis with a one month lag and SRF 2SR for the Other Depository Corporations with a one month lag, except for year-end data, where the lag is two months.

9. **Public data on banks' external funding could be improved**. The CBRT reports data on banks foreign assets and liabilities. However, this includes data on transactions with banks' branches abroad that are classified as non-residents from the BOP perspective. The BRSA maintains data on the consolidated banking sector with more accurate information on the true foreign assets and liabilities; however, this data is not currently disseminated in a public report.

External Sector Statistics

10. **The central bank reports quarterly BOP data to STA with about two months lag; in May 2012, it started reporting quarterly IIP data from 2006 onwards**. The CBRT participates in the Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct investment Survey (CDIS). External sector statistics are compiled in broad conformity with the conceptual framework of the fifth edition of the *Balance of Payments Manual* (*BPM5).*

Turkey: Table of Common Indicators Required for Surveillance (As of October 16, 2013)							
	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]	Data Quality Accuracy and reliability[9]
Exchange Rates	Oct. 2013	10/16/2013	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct. 2013	10/10/2013	W	W	W		
Reserve/Base Money (narrow definition)	Oct. 2013	10/10/2013	W and M	W and M	W and M	O,O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	Oct. 2013	10/10/2013	W and M	W and M	W and M		
Broad Money	Oct. 2013	10/10/2013	W and M	W and M	W and M		
Central Bank Balance Sheet	Oct. 2013	10/10/2013	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	Oct. 2013	10/10/2013	W and M	W and M	W and M		
Interest Rates[2]	Oct. 2013	10/16/2013	D/W/M	D/W/M	W/M		
Consumer Price Index	Sept. 2013	10/3/2013	M	M	M	O,LO,O,LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2 2013	9/30/2013	M	M	M	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug. 2013	9/16/2013	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2 2013	9/30/2013	M	M	M		
External Current Account Balance	Aug. 2013	10/16/2013	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	Aug. 2013	10/16/2013	M	M	M		
GDP/GNP	Q2 2013	9/10/2013	Q	Q	Q	O, LO,O, O	LO, O, LO, O, LO
Gross External Debt	Q2 2013	9/30/2013	Q	Q	Q		
International Investment Position[6]	Jul. 2013	9/19/2013	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 assets and liability positions vis-à-vis nonresidents.
[7] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC published in September 2009 and based on the findings of the mission that took place during November 3-17, 2008. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and valid.

Press Release No. 13/476
FOR IMMEDIATE RELEASE
November 27, 2013

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

IMF Executive Board Concludes 2013 Article IV Consultation with Turkey

On November 20, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Turkey.[1]

The Turkish economy achieved a welcome reduction of imbalances in 2012. In 2013, growth has accelerated significantly on the back of a monetary and fiscal policy stimulus. The economy is projected to expand by 3.8 percent this year with private consumption and public investment as the main contributors. With this rotation back to domestic demand-led growth, the current account deficit is widening again, while inflation remains above target.

The authorities are on track to meet their 2013 budget targets, despite rapid spending growth. As one-off factors boosted revenues beyond projection, the government made use of these windfalls to increase capital expenditure significantly beyond the budget ceiling, while maintaining its overall deficit targets. The banking system remains well capitalized, with capital ratios well above regulatory minima and non-performing loans (NPLs) remaining subdued, despite some uptick over the last year.

Executive Board Assessment[2]

Executive Directors noted the faster growth of the Turkish economy this year, due in part to policy stimulus. Nonetheless, they observed that the domestic demand-led growth is leading to a renewed deterioration in inflation and the current account deficit. In the period ahead, Directors encouraged the authorities to tighten their macroeconomic policies and step up structural reforms to strengthen external performance and bolster economic growth.

[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.

[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 considered a less accommodative monetary stance to be more appropriate in light of still-high inflation. Most Directors agreed that normalizing the monetary policy framework would help improve communications and strengthen monetary transmission. Some Directors noted the challenge faced by the monetary authorities in dealing with volatile capital flows and noted the improvements in inflation relative to the past. Directors suggested building up net foreign reserves through sterilized intervention when capital inflows resume.

Directors generally agreed that a tighter fiscal policy would help reduce external vulnerabilities and relieve pressure on monetary policy. They encouraged the authorities to contain current spending and save any revenue overperformance. They cautioned that discretionary stimulus should be reserved for a scenario of potential negative economic outturn. Over the medium term, fiscal consolidation would raise public saving and contribute to real exchange rate depreciation. Greater budgetary flexibility would be needed to allow greater spending on priority areas such as education and infrastructure.

Directors expressed satisfaction that the Turkish financial system is generally sound. They noted, however, that banks' indirect exposure to foreign exchange risk requires careful monitoring. They considered that macroprudential measures should be targeted at household credit and corporate foreign exchange lending. Directors encouraged further efforts to address the deficiencies in the regime for anti-money laundering and combating the financing of terrorism identified by the Financial Action Task Force.

Directors noted the Turkish economy's low saving rate and reliance on external financing. They underscored the importance of raising both private and public saving and stepping up structural reforms to raise competitiveness, attract foreign direct investment, and enhance growth while reducing external imbalances. The authorities' efforts to decrease energy dependence, increase labor market flexibility, reduce the informal sector, and reform private pension are in the right direction. Further efforts to improve the business climate will also be important.

Turkey: Selected Economic Indicators, 2008−14

Population (2012): 74.9 million

Per capita GDP (2012): $10,527

Quota (2012): SDR 1,455.8 million

	2008	2009	2010	2011	2012	2013	2014
						Proj.	
				(Percent)			
Real sector							
Real GDP growth rate	0.7	-4.8	9.2	8.8	2.2	3.8	3.5
Contributions to GDP growth							
Private domestic demand	-1.8	-8.3	12.6	9.5	-2.9	3.3	2.7
Public spending	0.6	0.8	0.9	0.4	1.0	1.5	0.7
Net exports	1.9	2.7	-4.4	-1.1	4.1	-1.0	0.1
GDP deflator growth rate	12.0	5.3	5.7	8.6	6.8	6.9	6.9
Nominal GDP growth rate	12.7	0.2	15.4	18.1	9.1	11.0	10.6
CPI inflation (12-month; end-of period)	10.1	6.5	6.4	10.4	6.2	8.0	6.0
PPI inflation (12-month; end-of-period)	8.1	5.9	8.9	13.3	2.5	6.9	6.0
Unemployment rate	11.0	14.0	11.9	9.8	9.2	9.4	9.5
Average nominal treasury bill interest rate	19.2	11.6	8.5	8.7	8.8	…	…
Average ex-ante real interest rate	12.3	2.8	1.9	1.0	1.7	…	…
				(Percent of GDP)			
Nonfinancial public sector							
Primary balance	1.7	-0.9	0.9	1.9	0.9	0.6	0.3
Net interest payments	4.3	4.5	3.7	2.7	2.8	2.7	2.5
Overall balance	-2.6	-5.4	-2.3	-0.8	-1.8	-2.0	-2.2
General government structural primary balance 1/	0.4	1.0	0.5	-0.6	-0.7	-1.2	-1.2
Debt of the public sector							
General government gross debt (EU definition)	40.0	46.1	42.3	39.1	36.2	35.4	34.4
Nonfinancial public sector net debt	34.5	39.5	36.8	33.3	30.2	29.8	29.3
External sector							
Current account balance	-5.5	-2.0	-6.2	-9.7	-6.2	-7.4	-7.2
Nonfuel current account balance	0.0	2.2	-1.8	-3.6	0.6	-0.9	-0.7
Gross financing requirement	16.8	18.1	18.9	24.6	21.6	25.2	28.0
Foreign direct investment (net)	2.4	1.2	1.0	1.8	1.1	0.8	1.4
Gross external debt 2/	38.5	43.8	39.9	39.3	43.0	46.4	47.7
Net external debt	21.3	24.2	23.8	23.9	24.0	28.3	31.1
Short-term external debt (by remaining maturity)	13.7	15.5	16.1	16.0	18.4	21.5	21.8
Monetary aggregates							
Nominal growth of M2 broad money (percent)	27.5	12.9	19.0	11.5	10.3	…	…
GDP (billions of U.S. dollars) 3/	730.3	614.6	731.1	774.8	788.3	…	…
GDP (billions of Turkish lira)	950.5	952.6	1,98.8	1,297.7	1,415.8	1,571.0	1,737.6

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

1/ The structural balance is estimated using the absorption gap method and excludes one-off operations.

2/ The external debt ratio is calculated by dividing external debt numbers in U.S. dollars based on official Treasury figures by GDP in U.S. dollars calculated by staff using the average exchange rate (consolidated from daily data published by the CBRT).

3/ GDP in U.S. dollars is derived using the average exchange rate (consolidated from daily data published by the CBRT).

Statement by Mr. Omer Yalvac, Alternate Executive Director for Turkey and Mr. Cem Gokcen, Advisor to Executive Director
November 20, 2013

We thank staff for a very productive Article IV mission and comprehensive set of papers. Although there were several points where the authorities and staff held differing opinions, the meetings were very fruitful for exchanging views. My authorities appreciated the candid interaction with staff.

Economic Outlook

Following the policy-induced slowdown in 2012 in an effort to rebalance the economy, growth gained momentum in the first half of 2013. Figures for the third quarter suggest that the economy grew more moderately compared to the second quarter. The latest PMI indicators also confirm this trend. However, the main confidence indicators provide mixed signals regarding the economic outlook for the remainder of 2013. Bearing in mind the policy-induced slowdown to 2.2 percent in 2012, which was more effective than the initial plan of a slowdown to 3.2, the authorities are closely monitoring the upside and downside risks.

In order to further strengthen the economy's resilience and break the vicious cycle of growing external weaknesses, the authorities have focused on a comprehensive plan. The 10th Development Plan has specified the underlying factors of the Turkish economy's structural weaknesses. The Plan has put forward medium- and long-term policy targets for improving domestic savings and transforming the economy into one that is more productive and competitive. The authorities have prepared the Medium-Term Program in line with the priorities listed in the 10th Development Plan. The Program's main goals are: (1) putting the current account on a sustainable path; (2) lowering the inflation rate; (3) maintaining a strong fiscal stance; and (4) boosting growth potential and creating jobs.

Focusing on the root causes of the problem, the Medium-Term Program provides a multi-faceted response to external imbalances with the support of well-calibrated monetary, fiscal, as well as macroprudential and structural policies. First and foremost, measures that promote domestic private and public savings will be at the core. As a consequence of targeted policies coupled with the introduction of new measures in the private pension system, the domestic savings rate is projected to reach 16 percent in 2016, implying an increase of 3.4 percentage points in the following 3 years.

Fiscal Policy

The authorities have continued to maintain a cautious fiscal stance. In order to contribute to domestic savings, the central government's budget deficit target in 2013 was revised down from 2.2 percent to 1.2 percent in the Medium-Term Program. This has been one of the lowest central government budget deficit figures in the last three decades. The over-performance in revenues stemming from acceleration of growth, one-off revenues from energy state-owned enterprises (SOEs), and last year's administered price hikes were partially saved.

The 2014 budget was also formulated with the same cautious approach. Budget revenues were assumed to increase by approximately 7.1 percent in parallel with the nominal increase in the domestic demand. Budget expenditures were expected to increase by about 7.3 percent, which is in line with the nominal growth rate. As a result, the central government budget deficit is projected to be around 1.9 percent in 2014.

The strong budget performance has helped to further lower the EU-defined public debt-to-GDP ratio to around 35 percent in 2013 and this downward trend is expected to continue in the coming years. The low level of public debt, coupled with improvements in its composition, has established an important buffer for the coming period.

While formulating fiscal policies, the authorities have taken into consideration both global uncertainties and the economy's domestic needs. They have tried to strike the right balance between saving and spending prudently to improve the current account deficit. In parallel with the priorities listed in the 10th Development Plan, the expenditure policy in the Medium-Term Program has been geared towards improving structural deficiencies. In this vein, the largest share has been allocated to education, which has been a very important bottleneck for improving competitiveness. The ratio of education expenditures to GDP has been increased to 4.6 percent in 2014. In order to improve infrastructure, the investment allocation has been raised to 2.6 percent of GDP. Although the increase in current expenditures via recruiting more teachers, social security, and tax inspectors could lead to higher budget rigidities, the benefit from improving the educational system and reining in the unregistered economy would be higher than the costs incurred in the short term.

Financial and Corporate Sector

The Turkish banking sector has gone through another significant stress test during the latest market turmoil. Despite the recent mark-to market losses on banks' balance sheets, the system's capital adequacy level is approximately 16 percent, according to the Basel 2.5 definition. Non-performing loan ratios remain low and bank profitability has been strong. The corporate sector's FX loans have increased the banking system's indirect exposure to FX risk. However, the authorities have taken several measures to reduce risks. These loans are extended mostly to large corporations, which have FX income. Additionally, they are not concentrated in a few sectors. Nevertheless, the authorities are closely following the developments.

Despite the banking sector's strength, the authorities are working proactively on additional macroprudential measures that target credit cards as well as SME and export loans. In line with staff's recommendation, they are keen on not creating any distortions. These measures are also expected to support the economy's resilience and improve the current account balance in line with the Medium-Term Program targets. In particular, the measures associated with credit cards could maintain the household sector's strength and rein in private consumption.

The corporate sector's FX borrowing from Turkish banks and abroad has been striking. Nevertheless, the rollover ratio of the corporate sector has been very high, even in the wake of the Lehman Brothers crisis. The latest figures also show that despite higher costs, the rollover ratio has exceeded over 120 percent. The high level of rollover ratios is due to strong collaterals. As discussed during the mission, more data and information are needed to ensure proper regulatory insight regarding the risks stemming from this area.

Monetary Policy

The Central Bank has continued to implement the new policy framework with additional adjustments. Similar to what many central banks around the world did, the main aim was to adapt the monetary policy to the ever-changing and unconventional global liquidity conditions and to serve the needs of the economy.

The developments in 2012 have illustrated that the new policy framework has contributed positively to the achievements in inflation and financial stability. The consumer price index has reached 6.2 percent, the lowest year-end figure in 44 years. With regard to financial stability, the annual rate of credit growth has declined from around 35 percent at the end of 2010 to around 18 percent at the end of 2012. The current account balance has also improved. The current account deficit-to-GDP ratio has come down from 9.7 percent in 2011 to 6.1 percent at the end of 2012. Overall, growth slowed down to 2.2 percent despite the high level of liquidity in the global markets.

2013 was a critical year as the resilience of many emerging market countries was tested. Financial market volatility was mostly a result of repricing of risks and reallocation of funds. In response to heightened global risks, the authorities started to implement a cautious monetary policy taking into consideration inflation indicators and macro-financial risks. Liquidity policy, macroprudential policy and, to a more measured extent, fiscal policy were tightened. Regarding inflation dynamics, a weaker Turkish lira led to a limited rise in the annual consumer price inflation. The inflation forecast for 2013 was revised upwards by 0.6 percent. The 0.4 percentage points of revision was due to exchange rate developments, and 0.1 percent was coming from the change in the average oil price assumption.

In terms of financial stability, the cautious monetary policy and rising loan rates under the current monetary framework have helped rein in strong credit growth which was observed in the first half of 2013. Regarding the external balance, the current account deficit has started to deteriorate to some extent since January. Nevertheless, this deterioration stemmed mainly from gold trade, which was a temporary but sizable factor (about 1 percent of GDP). The improvement in the non-gold current account balance, which started in 2012, has continued in 2013. The authorities also expect the real exchange rate and credit developments to support the continuation of the improvement in the current account balance in the coming period as well.

So far, the new policy framework has positively contributed to the efforts in rebalancing the economy and in preserving financial stability. The historically low inflation level in 2012 and the resilience shown in the second half of 2013 also prove that the macroprudential measures in the new policy framework have been helpful. The authorities are closely following global and domestic developments and are adjusting the policies accordingly. We should bear in mind that all central banks are strengthening their toolkits and policy strategies to cope with the new global challenges due to high volatility in capital flows.

The new three-year Medium-Term Program, which was published recently, relies mainly on structural and macroprudential measures in order to boost the private savings rate in Turkey. This will contribute to a more balanced and sustainable growth prospect, while enabling the Central Bank to focus fully on the price stability objective.

Structural Policy

The Medium-Term Program puts forward priority areas that will be closely followed to improve domestic savings and reduce the current account deficit. In particular, energy imports are an important drag on the current account deficit. With an import dependency rate of over 70 percent in the energy area, Turkey needs to diversify its energy sources and lower energy intensity so as to contain the energy import bill. To this end, the authorities have put strong emphasis on utilizing domestic sources, resorting to renewable and nuclear energy, improving energy efficiency and stepping up exploration efforts both in Turkey and overseas.

Last but not least, the authorities are aware of the need for more efforts to improve the business and investment environment, and to boost competitiveness in order to increase Turkey's share in Foreign Direct Investment. This could also positively contribute to the financing of the current account deficit. Nevertheless, the ongoing economic and financial problems in European countries (which have been an important source of FDI) are not supporting the current initiatives.