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Reducing Macroeconomic Imbalances in Turkey

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ABSTRACT/RÉSUMÉ

Reducing macroeconomic imbalances in Turkey

Turkey recovered swiftly from the global financial crisis but sizeable macroeconomic imbalances arose in the process. High consumer price inflation and a wide current account deficit are sources of vulnerability. Even though below-potential growth helps rebalancing and disinflation, these imbalances endure. The financial sector still looks resilient thanks to buffers built up mainly prior to the financial crisis. However, private sector balance sheet risks have gained prominence as leverage increased. Macroeconomic and structural policy levers need to steer a passage between robust but externally unsustainable growth and externally viable but low growth. Monetary policy needs to bring inflation and inflation expectations closer to target. Macroprudential policies could more systematically lean against capital inflows and credit cycles to reduce private sector balance sheet vulnerabilities. The fiscal stance is broadly appropriate, but compliance with a multi-year general government spending ceiling would help avoid pro-cyclical loosening in case of revenue surprises and help boost domestic saving. Overall, policies should help reduce the risk of disruptions in capital flows as monetary policy stimulus is being withdrawn in the United States.

This Working Paper relates to the 2014 *OECD Economic Review of Turkey* (www.oecd.org/eco/surveys/economic-survey-turkey.htm).

JEL classification codes: E2; E3; E44; E52; E62; F32; F41; G18; O52

Keywords: Turkey, current account, competitiveness, saving, monetary policy, fiscal policy, financial market policy

Réduire les déséquilibres macroéconomiques en Turquie

La Turquie s'est remise rapidement de la crise financière mondiale, qui a toutefois laissé dans son sillage des déséquilibres macroéconomiques importants. Le niveau élevé de l'inflation des prix à la consommation et l'ampleur du déficit de la balance courante sont des points de vulnérabilité. Même si une croissance inférieure à son potentiel contribue au rééquilibrage de l'économie et à la désinflation, les déséquilibres perdurent. Le secteur financier paraît encore résilient, grâce aux volants de sécurité constitués pour l'essentiel avant la crise financière, mais les risques entourant les bilans se sont accrus dans le secteur privé à mesure que l'endettement se développait. Les autorités devraient faire jouer les leviers macroéconomiques et structurels pour trouver une voie entre les deux écueils que constituent une croissance robuste mais non tenable extérieurement et une croissance extérieurement viable mais faible. La politique monétaire devrait permettre de rapprocher l'inflation et les anticipations d'inflation de l'objectif. Les politiques macroprudentielles pourraient être plus systématiquement orientées à contre-courant des entrées de capitaux et des cycles du crédit, pour réduire les vulnérabilités des bilans dans le secteur privé. L'orientation budgétaire est globalement appropriée, mais un plafonnement pluriannuel des dépenses des administrations publiques contribuerait, s'il était respecté, à éviter un assouplissement procyclique en cas de surprise au niveau des recettes ainsi qu'à doper l'épargne intérieure. Globalement, l'action des pouvoirs publics devrait aider à réduire le risque de ruptures dans les flux de capitaux, dans le contexte de l'abandon progressif de la politique de relance monétaire des États-Unis.

Ce Document de travail se rapporte à l'*Étude économique de l'OCDE de la Turquie 2014* (www.oecd.org/fr/eco/etudes/turquie.htm).

Classification JEL: E2; E3; E44; E52; E62; F32; F41; G18; O52

Mots clés: Turquie, balance courante, compétitivité, épargne, politique monétaire, politique budgétaire, politique des marchés financiers

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REDUCING MACROECONOMIC IMBALANCES IN TURKEY

By

Oliver Röhn, Rauf Gönenç, Vincent Koen and Evren Erdoğan Coşar¹

Introduction

After a vigorous rebound from the global financial crisis, Turkey entered a period of below-potential growth in the past two years. However, consumer price inflation at over 9% (2014Q1) is far above the target and the current account deficit at around 7.5% of GDP (2014Q1) is much too high for comfort. Turkey's growth is too dependent on domestic demand and foreign savings, which mainly come in the form of short-term debt-creating inflows and have pushed up leverage in the economy. This dependence has increased external vulnerabilities, especially after the global crisis (Figure 1). Between mid-2013 and early 2014, the risks were illustrated by the tapering-related financial turmoil. Aggravated by domestic political tensions, the ensuing financial stress was greater for Turkey than for a number of other emerging countries. Risks, including that of a sudden stop in capital inflows, will remain high as monetary policy stimulus is being withdrawn in the United States. If these risks were to materialise, GDP growth and financial stability could be jeopardised.

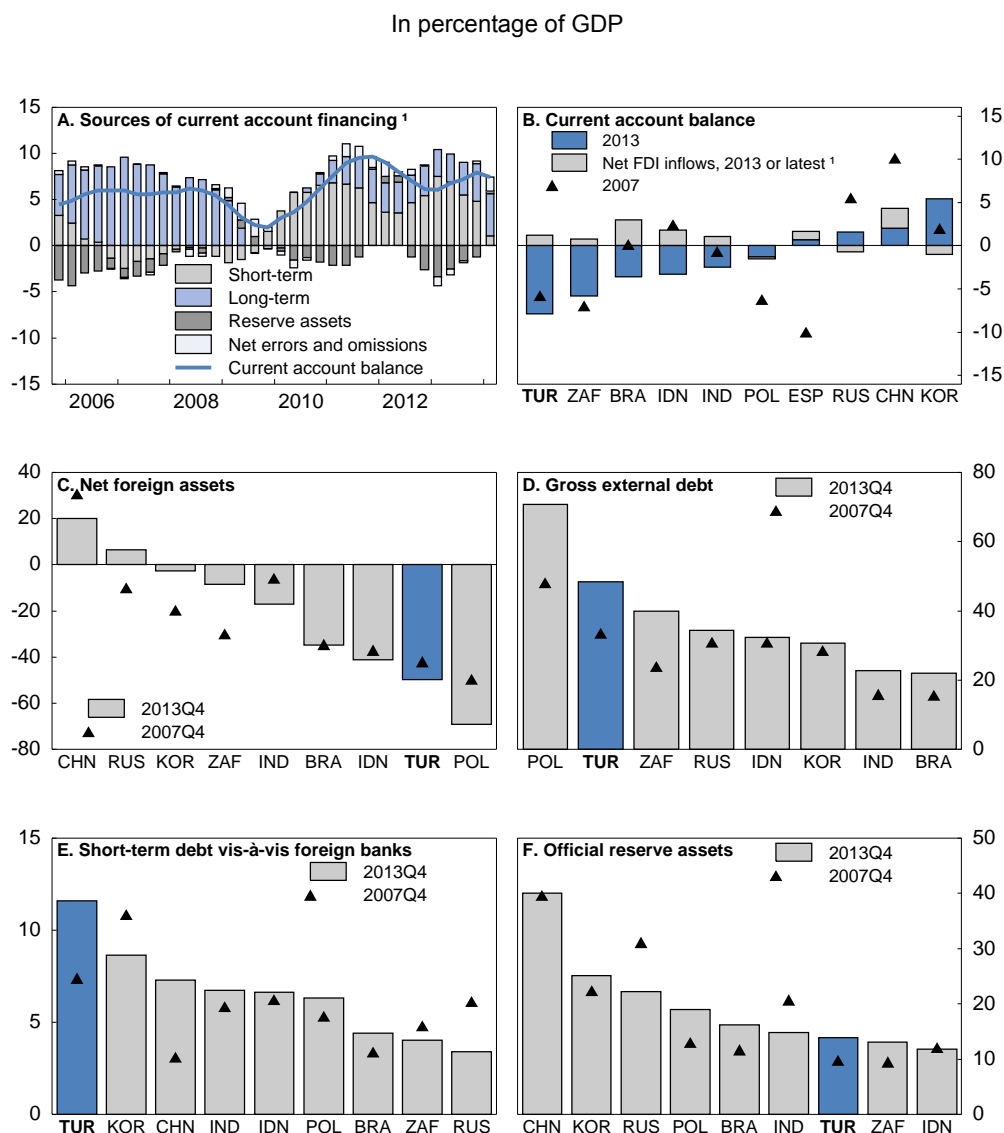
This paper discusses the underlying causes of these imbalances, which include macroeconomic policy settings and more fundamentally a dearth of domestic saving and competitiveness problems. It then turns to discussing policies that can reduce the vulnerabilities and foster more balanced growth. Durably rebalancing the economy requires structural policies to unleash productivity growth in the business sector and necessary reforms are discussed in detail in Gönenç et al. (2014).

Underlying current account pressures persist

Turkey's impressive growth performance in the 2000s was mainly driven by domestic demand, while contributions from net exports remained small or negative, leading to a steadily widening current account deficit (Figure 2). This trend was briefly interrupted during the crisis in 2009, but domestic demand rebounded quickly and the current account deficit in per cent of GDP reached almost double-digit levels in 2011 on the back of strong capital inflows and credit growth. The current account deficit narrowed to around 6% of GDP in 2012 as macro-policies were tightened, capital inflows slowed and one-off factors in the form of exceptional gold exports improved the trade balance. In 2013, the current account deficit widened again to around 8% of GDP, in part due to a restocking of gold inventories. Excluding gold trade, the current account deficit continued to narrow slightly in 2013 (Figure 2).

1 The authors work in the Economics department. This paper was prepared for the OECD *Economic Survey of Turkey* published in July 2014 under the authority of the Economic and Development Review Committee. It has benefitted from background research by Fethi Öğünç. The authors thank Alvaro Pereira, Robert Ford and Jean-Luc Schneider for their valuable comments. Special thanks are due to Béatrice Guérard for statistical assistance and to Nadine Dufour and Mercedes Burgos for technical preparation.

Figure 1. External vulnerabilities are high and have increased since the global financial crisis



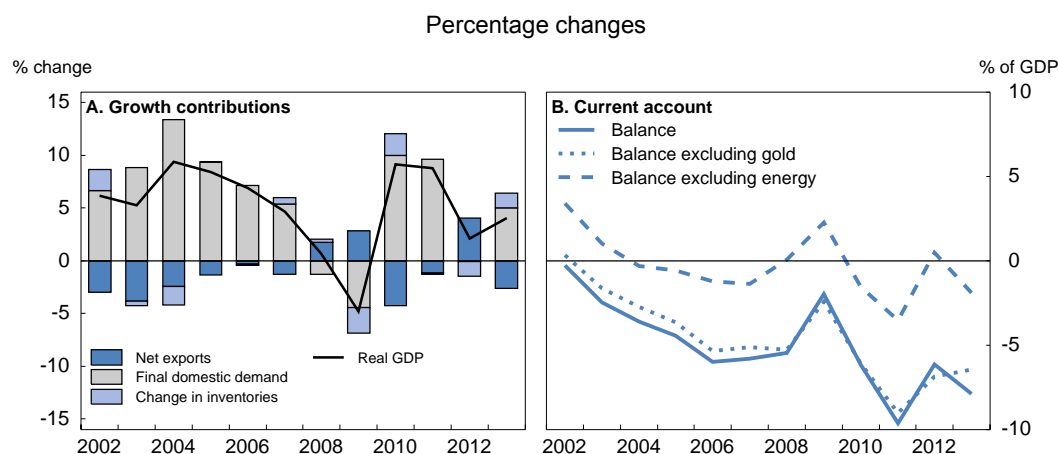
1. Rolling 4-quarter sum as percentage of moving average GDP. Short-term inflows refer to the sum of portfolio investment and short-term other investment net inflows. Long-term inflows refer to the sum of FDI, bond issues and long-term other investment net inflows.

Source: IMF, *International Financial Statistics*; IMF, *Balance of Payments*; OECD *Economic Outlook Database*; World Bank, IMF, BIS, OECD, *Joint External Debt Hub*.

Cyclical conditions played a role in Turkey’s current account developments. In particular the sharp deterioration in 2010-11 reflected the swift rebound in domestic activity fuelled by capital inflows on the back of highly expansionary monetary policy in advanced economies. External demand especially in Europe, Turkey’s largest export market, remained subdued and the terms-of-trade deteriorated as commodity prices increased. Since then, cyclical conditions have normalised as domestic demand slowed in 2012 and external demand picked up somewhat in 2013. Abstracting from cyclical factors, estimates of a structural current account suggest a sizeable deficit of around 5% of GDP in 2012 (IMF, 2013a; Kara and

Sarikaya, 2013). In addition, Kara and Sarikaya (2013) find that the structural current account deficit has widened slightly over the last decade, from below 4% until about 2005 to around 5% in recent years.

Figure 2. Domestic demand driven growth has led to imbalances



Source: OECD Economic Outlook Database and Central Bank of Republic of Turkey.

Current account deficits are to be expected in catching-up emerging markets with a young population. However, estimates relating the current account to fundamentals such as demographics, GDP per capita and natural resource abundance and policies such as fiscal, social and financial policies indicate that Turkey's structural current account deficit in 2012 may have been 1.5-3% of GDP larger than implied by fundamentals and desirable policy settings (IMF, 2013a; Philips et al., 2013). Policy or market distortions may therefore account for at least part of Turkey's current account deficit.

In addition, the financing structure of the current account deteriorated after the crisis, with a growing share of more volatile short-term debt-creating inflows, which are more prone to sudden reversals. Since 2012, the share of long-term inflows has increased again somewhat, helped by policy measures, but the share of FDI inflows remains low. The banking sector channelled part of the short-term inflows into long-term loans to finance productive capacity enhancing investments and there are no clear signs of asset price bubbles (see below). However, the banking sector faces a maturity mismatch and leverage has built up swiftly in the non-financial private sector, which may raise financial stability concerns.

External debt, which is almost entirely foreign-currency denominated, stands slightly below 50% of GDP. Some simple calculations, based on the methodology outlined in Röhn (2012), can illustrate the implications of the current account deficit and composition of inflows for the evolution of external debt. For example, assuming 4% real GDP growth, 5% inflation (measured by the GDP deflator), no nominal depreciation and debt-creating inflows of around 7% of GDP (as observed in late 2013), the gross external debt-to-GDP ratio would rise, converging to around 80%, with half of the adjustment completed after eight years. Under the same assumptions for real GDP growth and inflation, but assuming that debt-creating inflows were reduced by 3 percentage points to 4% of GDP, both by raising domestic saving and by attracting more FDI, the gross external debt-to-GDP ratio would stabilise at the current level of around 50%.

To achieve more balanced and socially inclusive growth, Turkey needs to tackle the underlying current account pressures. Recent IMF research estimates that *ceteris paribus* – holding the real exchange rate, terms-of-trade and structural determinants of saving constant – GDP growth in excess of 2¾ per cent to 3½ per cent has been historically associated with a deteriorating current account in Turkey (IMF 2013b).

While growth in the vicinity of 3% may lead to more balanced growth, it is unlikely to create enough jobs to absorb an expanding workforce (due to rural migration, demographics and increasing female labour force participation) and to reduce unemployment in line with targets. To overcome this “speed limit”, Turkey needs to durably strengthen competitiveness and raise private saving as analysed in detail in the previous *Economic Survey* (OECD, 2012a) and revisited in this one. In addition, improving energy efficiency and reaping the full potential of renewable energy resources will not only reduce Turkey’s reliance on energy imports and foreign saving but will also promote greener growth.

Competitiveness

Turkey’s price and cost competitiveness has come under pressure over the past decade mainly owing to higher average inflation and unit labour cost growth compared to trading partners and competitors (OECD, 2012a). The trend real exchange rate (both in CPI and unit labour cost terms) appreciation has been steeper than in most peers notwithstanding temporary bouts of depreciation driven by the nominal exchange rate in times of financial turmoil (Figure 3). This has hurt export growth while boosting imports and domestic demand, leading to a deterioration of the trade deficit and hence the current account. Turkey successfully improved non-price competitiveness and diversified its export portfolio towards medium-to-high technology sectors, but the export share of low- and low-to-medium technology sectors, which are more vulnerable to deteriorations in price and cost competitiveness, is still high (see Table 1). These sectors employ a large share of the workforce in manufacturing and the bulk of Turkey’s low-skilled workers (Figure 3 and Gönenç et al., 2014). Therefore, maintaining price and cost competitiveness is not only essential to rebalance the economy but also to foster inclusive growth.

Table 1. Revealed comparative advantage in manufacturing

In 2009

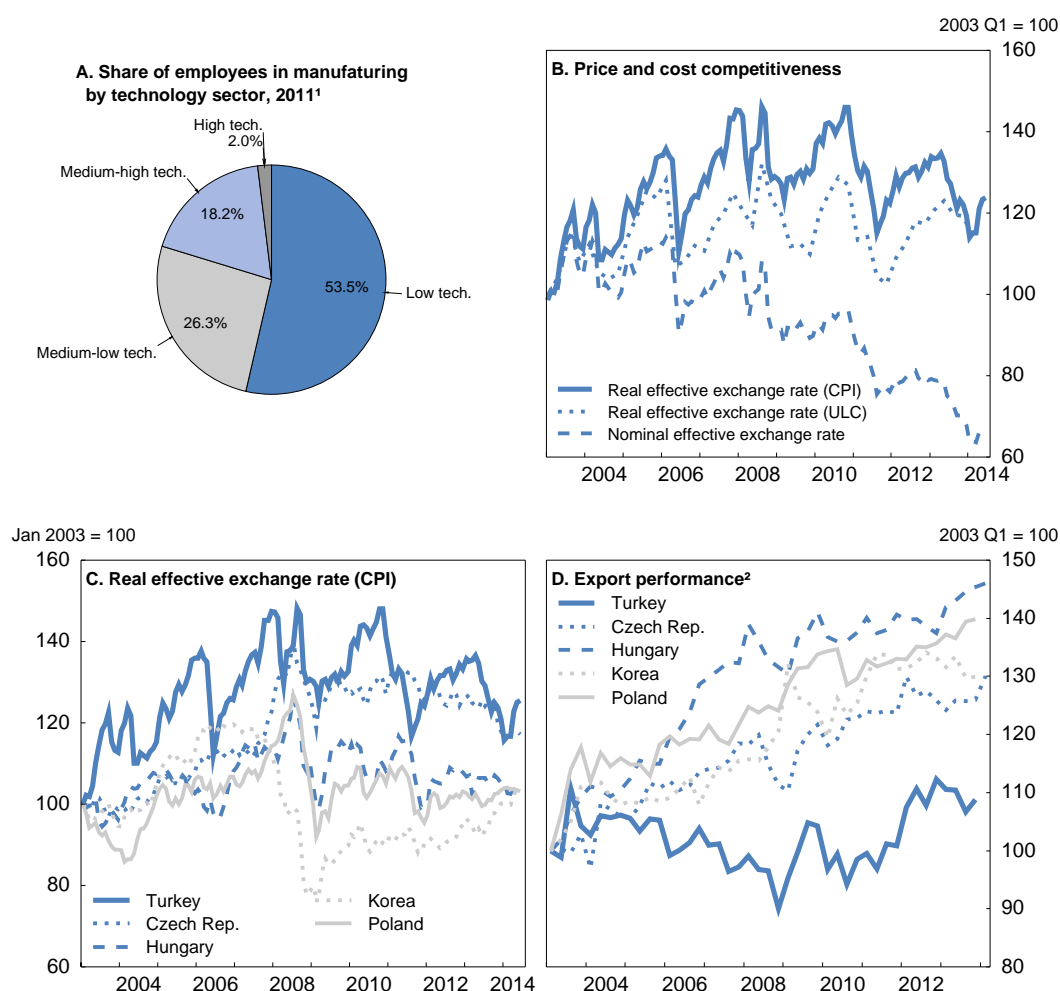
	Based on gross exports	Based on value-added exports
Food products, beverages and tobacco	0.82	0.84
Textiles, textile products, leather and footwear	3.03	3.14
Wood, paper, paper products, printing and publishing	0.34	0.32
Chemicals and non-metallic mineral products	0.70	0.68
Basic metals and fabricated metal products	2.10	1.94
Machinery and equipment (not elsewhere classified)	0.80	0.78
Electrical and optical equipment	0.30	0.31
Transport equipment	1.27	1.24
Other manufacturing; recycling	0.71	0.67

Note: Revealed comparative advantage is calculated as the share of exports of a certain industry by a specific country and the world in relation to the total exports of that country and the world. A value greater than 1 indicates a comparative advantage by a country in a certain industry.

Source: OECD-WTO-TIVA Database, June 2013.

Swings in the real exchange rate affect economic performance. After a sharp appreciation driven by strong capital inflows during the rebound from the global financial crisis, the real exchange rate depreciated over the course of 2011 as the central bank took measures and concerns over an intensifying euro area crisis adversely affected risk sentiment. This lowered import demand, helped exporters recoup market shares and contributed to rebalancing the economy in 2012 (Figure 3). From 2012 until mid-2013, the real exchange rate appreciated again. Nevertheless, Turkey continued to gain export market share. Following heightened domestic and international uncertainty since May 2013, the real exchange rate (CPI based) has depreciated again, by about 9%, despite some recent appreciation. This more competitive real exchange rate will help further rebalance demand.

Figure 3. Recent competitiveness gains need to be preserved



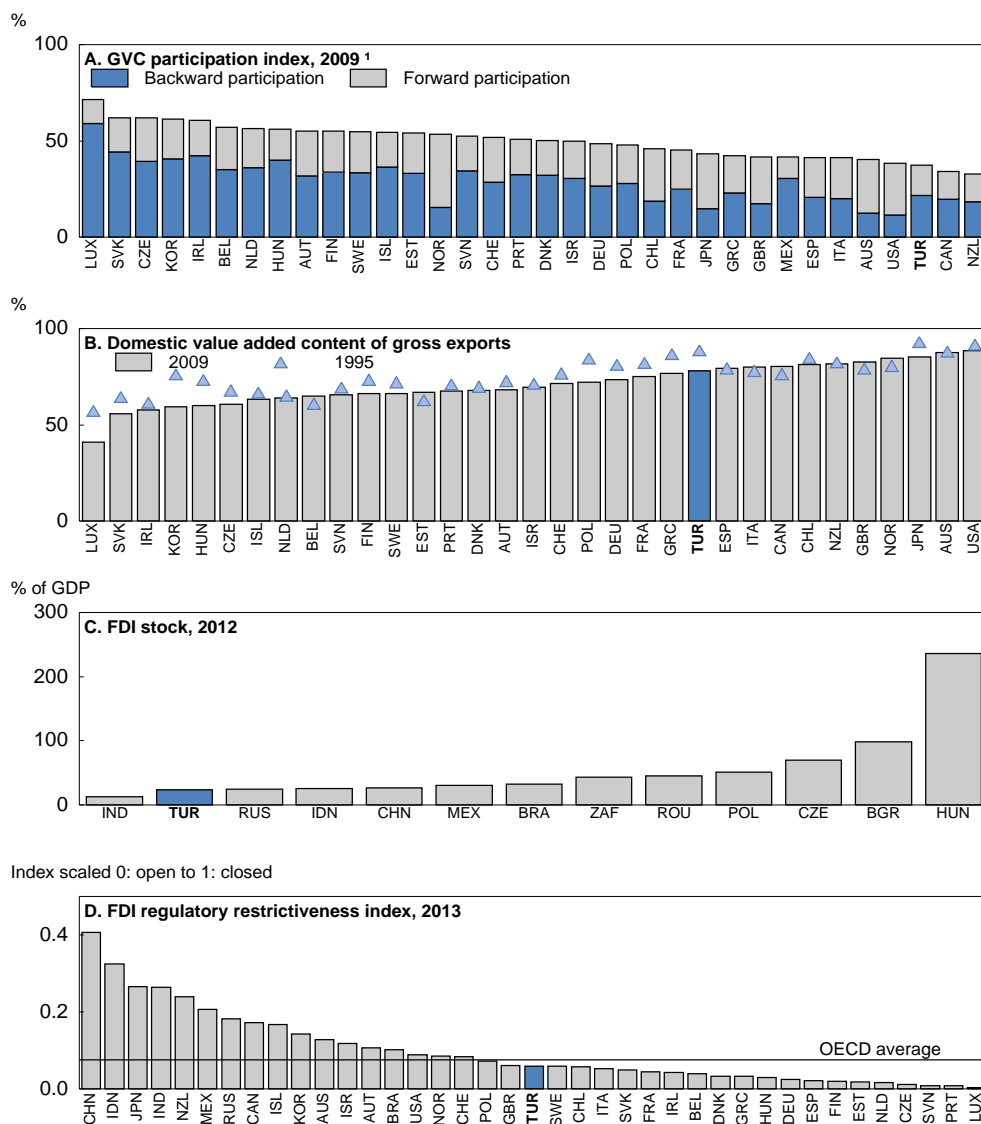
Notes:

1. Based on full-time equivalents. Sectoral classification based on OECD technology classification.
2. "Export performance" measures export market share developments and is calculated as actual volume growth in exports relative to the growth of the country's export market, which represents the potential export growth for a country assuming that its market shares remain unchanged at their 2005 level. An adjustment is made for Turkey to exclude gold exports.

Source: OECD calculations based on Turkstat data; *OECD Economic Outlook Database*.

Exports could be boosted by better integrating Turkey into global value chains (GVC). Firms especially in the textiles, wearing apparel, basic metal, rubber and plastic, automotives and construction sectors managed to successfully integrate into GVCs in the past two decades. However, Turkey's economy-wide participation appears rather low, also relative to comparable countries such as Poland and Chile (Figure 4), even if the underlying data may not adequately capture recent structural changes. Recent OECD research (OECD, 2013) highlights that to remain competitive in a world dominated by GVCs, firms require efficient access to imports of intermediate goods and to services. Since GVCs involve activities within and between multi-national enterprises and independent suppliers, the ability to enforce contracts is crucial. Countries with sound business structures and legal systems tend to export more in more complex industries. Tasks that require more complex contracts (e.g. R&D, design, branding) are also more easily carried out in countries with well-functioning business sectors and contract enforcement (OECD, 2013).

Figure 4. Participation in global value chains and FDI should be strengthened



1. Backward participation shows the use of foreign intermediates in a country's exports and forward participation the use by other countries of a country's inputs in their exports.

Source: OECD (2013), *Interconnected economies: Benefiting from global value chains*; OECD-WTO Trade in Value Added (TiVA) Database; IMF, *International Financial Statistics*; www.oecd.org/investment/index.

Attracting FDI is also essential to better integrate into GVCs as multi-national enterprises are crucial players in GVCs. FDI inflows to Turkey have been low (Figure 4) and mainly concentrated in the non-tradable sector, notwithstanding a more recent increase in inflows into the tradable sector. FDI inflows picked up in the second half of the 2000s but slowed during the crisis in 2008-09. They started to increase again but have not yet reached pre-crisis levels. This partly owes to the sluggish recovery in the European Union, Turkey's main source of foreign investment. But structural problems may also be responsible. Formal FDI restrictions are below the OECD average (Figure 4), suggesting that improvements in the broader business environment are key for Turkey to attract FDI (Gönenç et al., 2014).

Durably preserving Turkey's competitiveness requires structural reforms to unleash long-term investment and productivity growth in the business sector, including by improving the regulatory

framework in product and labour markets as suggested in Gönenç et al. (2014). This would allow Turkish firms to better compete in export markets and at home, and may help attract more FDI. The authorities have introduced many schemes to improve external competitiveness. These schemes may help mitigate some of the excess costs and barriers to resource reallocation created by weak regulatory product and labour market settings. But they support only parts of the economy comprising eligible regions and sectors. Instead, Turkey should align its regulatory settings for the entire business sector with OECD best practices to facilitate a shift of resources to the most productive businesses.

These structural reforms face political economy obstacles and may take time to implement. In the meantime, a larger burden will fall on macroeconomic policies to preserve competitiveness and prevent Turkey from being trapped between two equilibria with either high but externally unsustainable growth or externally viable but low growth.

Saving

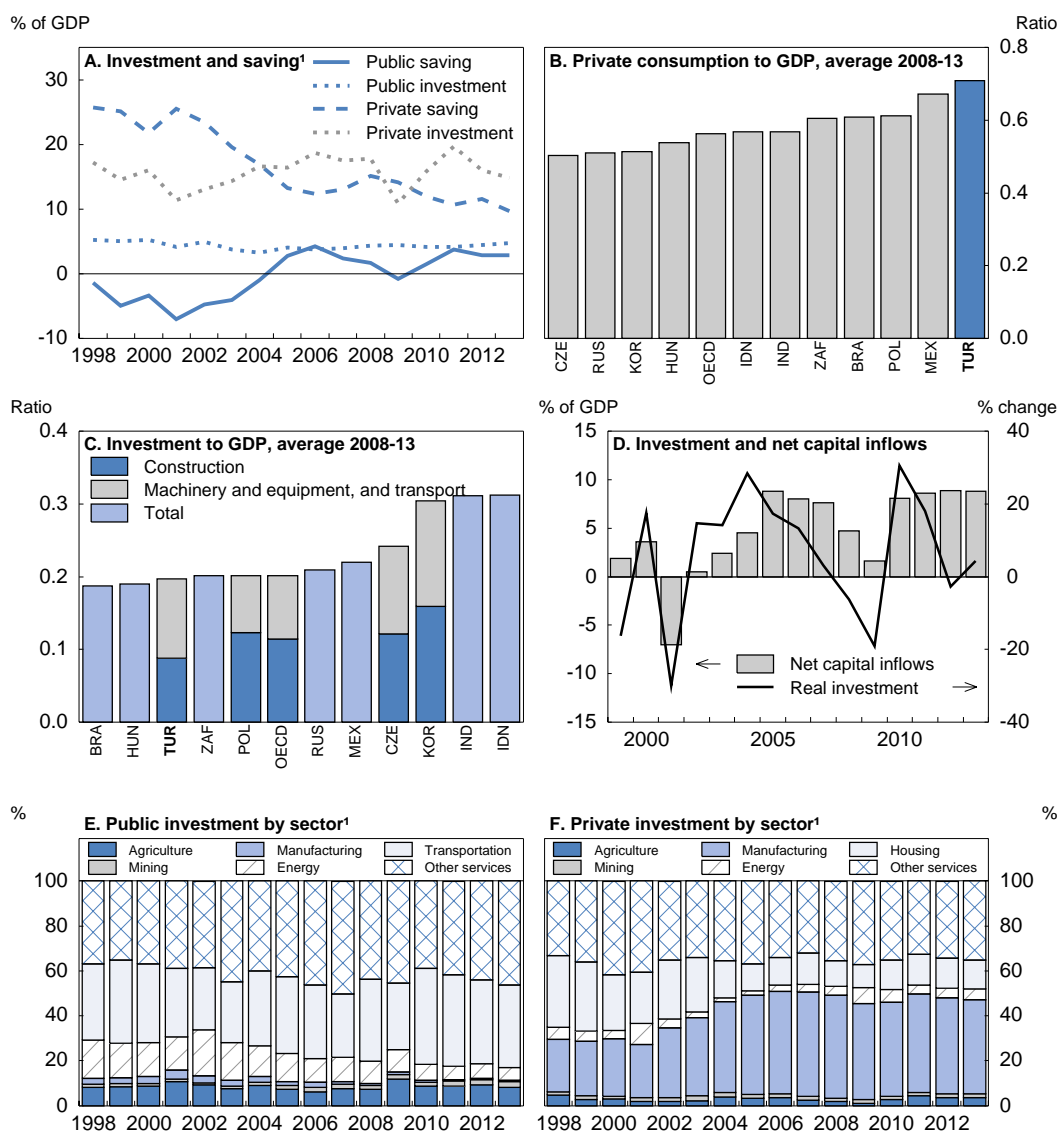
As discussed in the previous *Economic Survey* (OECD, 2012a), the corollary of the widening trade deficit was the opening up of a domestic saving-investment gap since 2001. This gap reflected both a secular decline in private saving and a surge in private investment (Figure 5). In contrast, public saving increased. After a temporary increase during the crisis years 2008-09, private saving continued to decline.

The surge in private investment appears to have been mainly channelled into machinery and equipment and directed towards manufacturing sectors. In addition, investment in transportation and communication remained high. Construction investment expanded moderately and was mainly driven by public investment to enhance transport infrastructure. The share of private residential investment in total private investment was on a declining trend until the crisis after which it picked up again slightly. Overall, the ratio of investment to GDP is low in international comparison, especially compared to fast-growing Asian economies, and the rebalancing observed in 2012-13 was mainly due to falling private investment rather than increasing private saving (Figure 5). Thus, if anything, investment needs to be strengthened and closing the saving-investment gap requires boosting domestic saving.

Boosting domestic saving would not only reduce Turkey's dependence on foreign saving, and hence volatile capital inflows, but could also foster more inclusive growth. First, with low domestic saving, investment is at the margin financed through foreign saving, thus making investment dependent on capital inflow cycles and external conditions. This contributes to the traditionally high volatility of investment and GDP growth in Turkey (Figure 5). More stable output growth would especially benefit low-skilled people who are usually the first to lose their jobs in recessions. Second, higher domestic saving may be needed to sustain higher growth rates which are needed to absorb new entrants into the labour force and reduce unemployment. Third, domestic saving can help domestic banks co-finance foreign investments. FDI is facilitated through domestic co-finance as domestic banks can directly monitor local projects to which the technology must be adapted (Aghion et al., 2006). A higher share of FDI would reduce dependence on more fickle types of inflows. FDI may also spur productivity growth through technology spillovers, though this effect appears to depend on the sectoral allocation and the capacity to absorb foreign technology, which in turn depends for example on human capital endowment (Leshner and Miroudot, 2008).² Hence, FDI may contribute to less volatile and higher GDP growth.

2. The empirical evidence of technology spillovers from FDI in Turkey is rather mixed (Erdoğan, 2011; Sönmez and Pamukçu, 2011).

Figure 5. Saving-investment gap



1. Data for 2013 are Ministry of Development estimates.

Source: Ministry of Development; OECD Economic Outlook Database; Central Bank of the Republic of Turkey.

Survey evidence suggests that the drop in private saving stemmed mainly from a broad-based fall in household saving, encompassing all income groups (see below), rather than in corporate saving (World Bank, 2012). The empirical literature has identified a set of reasons for this decline after the crisis in 2001: *i*) higher public saving, which may have induced forward-looking agents to expect lower taxation in the future; *ii*) greater macroeconomic stability; *iii*) the expansion of the social security system, which may have reduced the need for precautionary saving; *iv*) lower real interest rates, which reduced incentives to save; and *v*) better access to credit after the stabilisation of the banking sector, which reduced precautionary saving further and allowed private agents to better smooth consumption over time. Looking ahead, none of these drivers is likely to reverse in the future, nor does it appear desirable to counteract any of the developments through policy measures, with the exception of credit expansion because it has arguably been excessive (see below). Demographic developments are also unlikely to boost saving substantially in the future. While the youth dependency ratio is projected to decline, which should support saving, this could be at least partly offset by the projected increase in the old-age dependency ratio.

The authorities have identified the need to increase domestic saving as one of their priorities, as reflected in their 2014-16 Medium-Term Programme and the 10th Development Plan. An important measure has been the reform of the voluntary private pension system (see also OECD, 2012a). Existing tax advantages were replaced with matching government contributions in January 2013, which tilted incentives towards participation of lower income households and non-taxpayers. The uptake has been strong, with the number of participants increasing by 33% to 4.2 million from January to December 2013 (Pension Monitoring Centre, 2013). However, the amount of funds in the system remains small at around 1.7% of GDP. In addition, it remains unclear whether the reform fosters additional saving or merely shifts funds from other private saving vehicles. Investigating the international experience with similar reforms, Özel and Yalcin (2013) estimate only modest additional saving potential of about 1.5% of GDP. However, 63% of the respondents in a May 2014 survey conducted by the Turkish Treasury and the Pension Monitoring Centre indicated that they would not have used other saving vehicles absent the pension reform.

Labour market reforms may help reduce the saving-investment gap. Employment rates, especially those of women, are low in Turkey. Increasing them could boost saving both through higher household income and lower dependency ratios. Several empirical studies for Turkey show that income and saving are positively correlated (World Bank, 2012; Pirgan-Matur et al., 2012). Empirical evidence suggests that structural labour market reforms along the lines suggested in Gönenç et al. (2014) could improve the current account. The findings in Kerdrain et al. (2010) and Jaumotte and Sodsriwiboon (2010) suggest that high labour costs due to strict employment protection and high minimum wages relative to firm productivity levels may induce firms to substitute capital for labour. Hence, reducing labour costs could reduce investment, at least temporarily. Kerdrain et al. (2010) also find that lower employment protection is associated with higher saving rates if unemployment benefits are low possibly due to higher precautionary saving. However, this latter effect may be offset if unemployment benefits are simultaneously increased. To the extent that the suggested labour market reforms shift more people into the formal labour market, household income and saving potential may be boosted given the sizable wage gap between formal and informal jobs (Baskaya and Hülügü, 2011). Finally, labour market reforms could help foster resource reallocation and productivity growth, which could positively affect firm profitability and hence corporate saving.

Renewable energy and energy efficiency

Turkey's energy deficit accounted for about 6 percentage points of the 8% of GDP current account deficit in 2013. In contrast to Turkey's lack of fossil fuels, renewable energy resources are relatively abundant. In addition, the scope to improve energy efficiency is considerable. This suggests there is ample room to both reduce the current account deficit and to "green" growth. In this context, Turkey has set itself targets to raise the share of renewable energy in electricity generation to 30% by 2023, from currently slightly above 25%, and improve energy efficiency by 20% by 2023 compared to 2011.

There are favourable conditions for renewable energy, in particular wind and solar, in Turkey, and generating capacity is expanding rapidly. In 2012, natural gas accounted for 44% of total electricity generation followed by coal, hydropower and wind with shares of 28%, 24% and 2.4%, respectively. Solar capacity is under construction but it is not yet operational on a significant scale. The main policy instruments to spur the deployment of renewable capacity include feed-in tariffs with extra bonuses depending on the share of domestically-manufactured generating equipment, VAT and customs exemptions for equipment, preferential allocation of land to renewable energy producers and licence exemptions for generation facilities up to 1 MW. In a recent assessment, the IEA (2013) identified the comparatively low level and duration of feed-in-tariffs, the licensing and permission procedures for medium to large-scale projects, grid connection for wind capacity and the cost and availability of financing as potential bottlenecks hampering a swifter expansion of renewable energy.

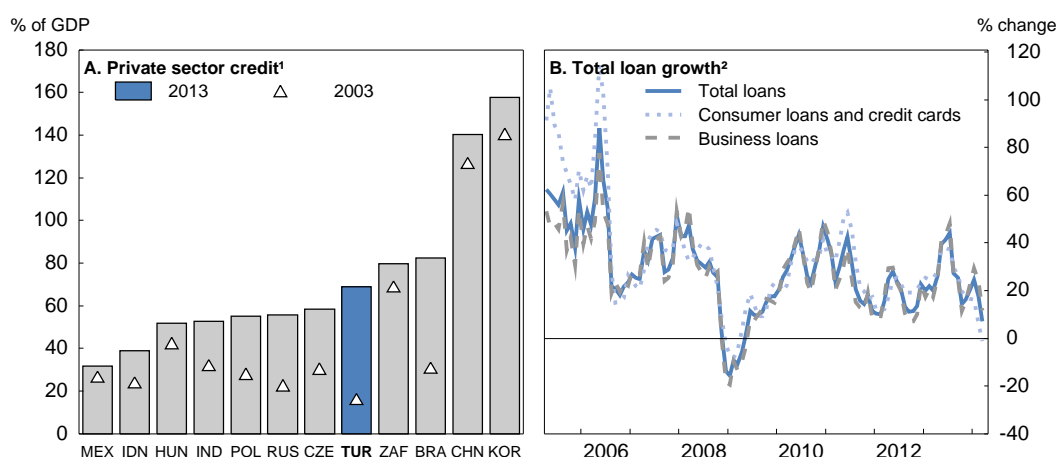
Although the energy intensity of the economy is below the OECD average, large potential exists to increase energy efficiency and progress over time has been limited. A wide range of energy efficiency projects appear profitable for investors even without any energy and climate policies given high energy prices, especially in the area of residential and commercial buildings (EBRD, 2011). Stricter enforcement of existing policies such as minimum standards and required energy performance certificates, central heating and metering systems for new buildings, and mandatory energy audits for public buildings exceeding a certain size, would complement private incentives to seek efficiency gains.

Macroeconomic policy to tackle imbalances

Financial market policies

Over the past decade leverage has increased rapidly in the private sector, although from a low base. Growing availability of credit enabled low-income households and small and medium enterprises to increase borrowing and expand consumption and investment. While this has supported inclusive growth and living standards, it may raise concerns related to some debtors' capacity to repay debt. Although the level of financial intermediation is not particularly high (Figure 6) and has not surpassed levels that recent research has identified as possibly detrimental to growth (Cecchetti and Kharroubi, 2012; Law and Singh, 2014), periods of strong credit growth have been associated with higher probabilities of financial crisis (Kaminsky and Reinhart, 1999; OECD, 2012b; Schularick and Taylor, 2012).

Figure 6. Leverage has increased substantially but remains moderate



Notes:

1. 2004 figure instead of 2003 for Poland.
2. Annualised growth rate of the loan stock, calculated as the 12th power of 3-month moving average of monthly growth rates. For total and commercial loans, growth rates are foreign exchange rate adjusted using a basket consisting of 70% US dollar and 30% euro.

Source: IMF, *International Financial Statistics*, and Banking Regulation and Supervision Agency (BRSA).

After the global crisis, Turkey faced strong capital inflows, which translated into domestic loan growth that far outstripped that of other emerging markets, averaging 25% per year. These developments prompted the central bank in late 2010 to adopt an innovative monetary policy framework which puts greater weight on financial stability (see below), and, subsequently, the Banking Regulation and Supervision Agency (BRSA) tightened macroprudential measures. These measures helped curb loan growth from the second half of 2011. After accelerating again sharply in the first half of 2013, loan growth moderated anew.

Since May 2013, financial conditions in Turkey deteriorated, notwithstanding the more recent stabilisation. Capital inflows slowed, the currency depreciated sharply and in January 2014 the central bank hiked interest rates. Partly as a result, the domestic economy is projected to slow somewhat in 2014. These factors may put pressure on private balance sheets. The following sections describe developments in different sectors, highlight vulnerabilities and suggest policy options.

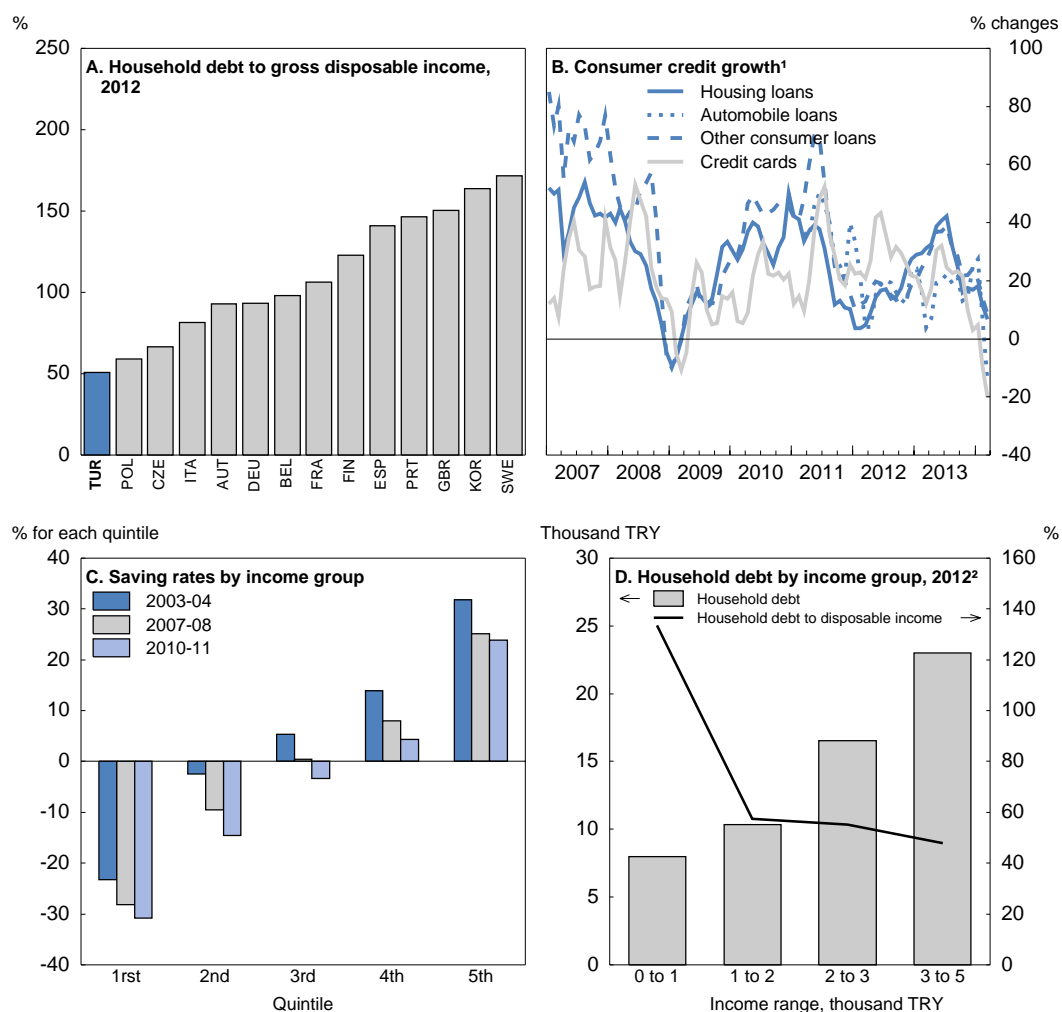
Household sector

Household debt has risen sharply over the past decade but remains moderate in international comparison (Figure 7). Household liability ratios have doubled since 2006, reaching about 23% of GDP and 50% of disposable income by mid-2013. Debt service costs have also increased but remained manageable at 5.4% of disposable income in late 2013 (CBRT, 2013b). Interest rate and foreign currency risks are limited as most loans are fixed-rate (except for a small share of housing loans) and lending in foreign currency (as well as in foreign currency indexed loans) has been forbidden since June 2009. Indeed, the household sector holds a sizeable long position in foreign currency, which amounted to around USD 191 billion (23% of GDP) as of early 2013 (CBRT, 2013a).

Since the crisis, the authorities have taken a number of macroprudential measures to rein in consumer debt. The introduction of loan-to-value ratios for housing loans (at 75%), higher risk weights on consumer loans and increased provisioning requirements helped curb consumer loan growth in 2011. However, it rebounded in early 2013, mainly driven by housing and general purpose consumer loans (Figure 7). Low interest rates, as well as relatively strong increases in house prices and one-off effects due to anticipated regulatory changes in residential real estate taxation, which may have pulled forward demand (see below), have contributed to the pick-up in housing loan growth through the end of 2013. At the same time, improved consumer confidence pushed up demand for general-purpose loans. In October 2013, the BRSA linked credit card limits to income, increased card payments and risk weights and extended loan provisioning regulations to credit cards, overdrafts and vehicles loans. This, together with the substantial hike in interest rates (see below), has helped slow consumer loan growth.

Survey data suggests that the lowest-income groups continuously and increasingly dissaved during the 2000s (Figure 7), despite significant income gains. Credit growth for these groups picked up strongly after the crisis. This has helped lower-income groups catch up to consumption levels of higher-income groups. However, it also entails financial stability risks, as the debt-to-income (DTI) ratios of the lowest-income group have increased (Figure 7). So far the share of non-performing loans (NPLs) in total consumer loans (including credit cards) has remained low at around 3% at the beginning of 2014, notwithstanding some deterioration in credit card and other personal finance loans observed in recent months. However, with economic growth projected to slow somewhat in 2014, upward pressure on NPL ratios in particular from low-income groups can be expected. DTI ratios should be implemented more broadly across the banking sector and consumer loan types. This would increase household balance sheet resilience, even if it comes at the price of constraining poorer families disproportionately. In addition, recent empirical research suggests that DTI ratios are effective macroprudential tools to restrain credit growth and housing boom-bust cycles (Claessens et al., 2013).

Figure 7. Household leverage



Notes:

1. The annualised growth rate of the total loan stock is calculated as the 12th power of 3-months moving average of monthly growth rates. Includes loans from finance companies.
2. Household debt is per capita annual total consumer and housing credit in 2012. Income estimate is the annualized mid-point of monthly income bracket.

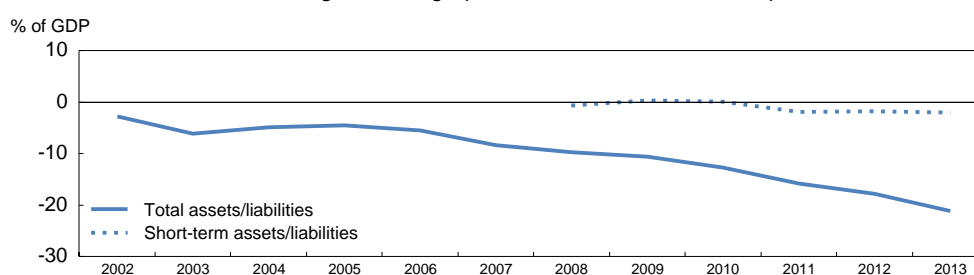
Source: OECD Economic Outlook Database; Turkstat, Household Budget Surveys; Central Bank of the Republic of Turkey; OECD calculations; and Banks Association of Turkey.

Non-financial corporate sector

Leverage in the non-financial corporate sector has also increased substantially in recent years and corporate financial debt now exceeds 50% of GDP. The share of external debt in total corporate debt has been falling to about 20% and there are no signs that the corporate sector faces difficulties rolling over external debt, despite tightening global credit conditions. Domestic commercial loan growth picked up again in the first half of 2013, with loans to small and medium sized enterprises (SMEs) expanding particularly rapidly. SMEs borrow predominantly in Turkish lira but at comparably shorter maturities. They are thus less exposed to foreign currency risk but may be hit harder by the recent interest rate hikes. The BRSA recently reduced general provisioning requirements on SME loans, which may give a boost to bank lending to SMEs.

The main risk facing the non-financial corporate sector stems from its widening net foreign currency liability position (Figure 8). With a depreciating currency, debt servicing costs increase and put pressure on corporate profits. Foreign currency liabilities have more than quadrupled since 2004 and reached around USD 265 billion (32% of GDP) by January 2014. As foreign currency assets did not grow at the same pace, a short position in foreign currency opened up of about USD 170 billion (21% of GDP). A growing share (now about 65%) of foreign currency loans has been extended by domestic banks after the easing of foreign currency lending regulations in 2009. While this allows for better monitoring of foreign currency risks and increases the traction of macroprudential tools, it has shifted foreign currency related credit risk to the domestic banking sector.

Figure 8. Corporate non-financial sector debt developments
Net foreign exchange position of non-financial companies



Note: The net foreign exchange position is the difference between foreign-currency-denominated assets and liabilities.

Source: Central Bank of Turkey.

The foreign currency risks of the corporate sector are mitigated by several factors. First, most of the foreign currency liabilities are long term, which reduces rollover risks. The short-term net foreign currency liability position amounts to only about USD 17 billion (2% of GDP). Second, regulations stipulate that domestically operating banks are only allowed to lend in foreign currency if the borrower has income in foreign currency or else loans must be of at least USD 5 million with at least one-year maturity. The latter regulation favours larger firms, which are likely to have better access to financial hedging and increases incentives for banks to carry out proper risk assessments.

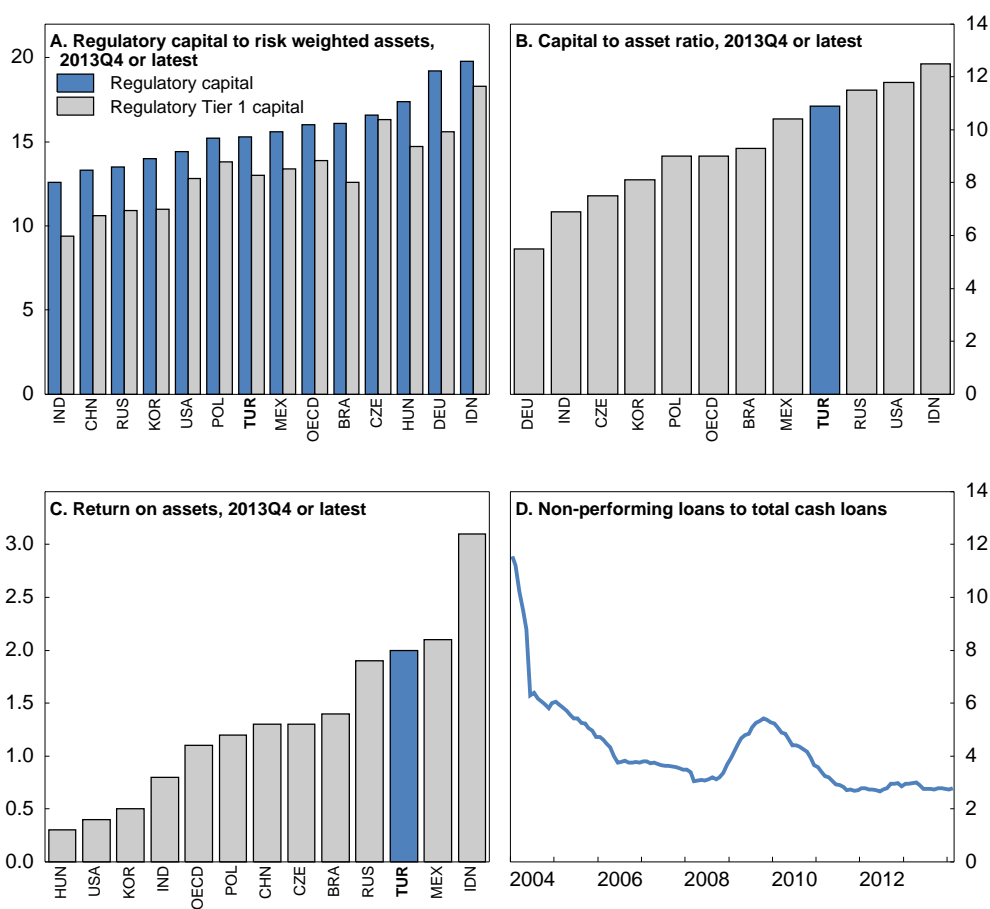
Data gaps hamper the assessment of the corporate sector's foreign currency risks. Aggregate data on financial hedges is not publically available, nor is information on foreign currency collateral. Firm-level data provided by the Turkish central bank provide some insights, even if the firms covered in the database only account for about 40% of the loans granted by domestic and foreign banks. The data suggests that most firms have either no foreign currency loans or at least a partial natural hedge from export income. Only about 12% of the firms have foreign currency loans but no foreign currency income. In addition, foreign currency exposures are smaller in SMEs, with over 65% of them having no foreign exchange loans (CBRT, 2014). Furthermore, information on direct foreign loans by non-resident banks suggests that professional services (mainly R&D), transport and storage, electricity and gas and the construction sector are most heavily exposed to foreign currency loans, and a large share of these loans are extended to finance privatisations and public infrastructure investments (CBRT, 2014a).

To counter risks from foreign currency exposure, the authorities could hike their risk weights and provisioning requirements for foreign currency loans extended to firms without revenues in the same currency, bearing in mind the provisions of the OECD Code of Liberalisation of Capital Movements. However, such measures may encourage domestic corporates to increase their borrowing from abroad. Further efforts to develop domestic corporate bond and equity markets could help reduce corporates' reliance on bank loans including foreign currency loans.

Banks

The increasing leverage in the economy is mirrored in the growth of the banking sector. Banking assets doubled from about 50% of GDP in 2003 to over 100% in 2013Q4, mainly reflecting the rapid expansion of loans. Loans have strongly outpaced deposits and the loan-to-deposit ratio reached 110% by the end of 2013. The funding gap has been plugged by stronger reliance on wholesale funding from abroad. The banking system’s foreign liabilities reached USD 150 billion (18% of GDP) by late 2013, accounting for about 21% of the banking sector’s funding sources (CBRT, 2013b). While these liabilities are predominantly short term, banks have had no problems so far rolling them over as capital inflows into the banking sector continued.

Figure 9. The banking sector remains robust
In percentages



Note: The OECD average is calculated as an arithmetic average of available countries.

Source: IMF, *Financial Soundness Indicators*; Banking Regulation and Supervision Agency (BRSA).

Despite some erosion in financial soundness indicators in recent years, the banking sector still appears robust in international comparison. The Basel II (2.5 principles) framework was fully adopted by mid-2012 and the BRSA has completed most of the draft regulations pertaining to Basel III. These efforts should be maintained. Both capital and leverage ratios remain high in international comparison and the regulatory capital-to-risk-weighted asset ratio well exceeds legal and target ratios of 8% and 12%, respectively

(Figure 9). Scenario analysis conducted by the BRSA and the central bank in September 2013, which simulated simultaneous shocks to the exchange rate, eurobond returns, interest rates and NPLs revealed that the capital adequacy ratio of the banking system drops to 7% (slightly below the legal ratio) only in the most adverse scenario (CBRT, 2013b). To build in further safeguards, the authorities recently introduced leverage-based reserve requirements: an additional reserve requirement of 1 to 2% is now imposed on banks that had an average 3 to 3.5% leverage ratio in the last quarter of 2013, and the upper limit of this leverage ratio is to be gradually raised to 5% by 2015.

Asset quality also remains high with the overall NPL ratio below 3% at the beginning of 2014 (Table 2). In addition, banks' liquidity adequacy ratios for total and foreign exchange liquidity have been well above the legal thresholds of 100% and 80% respectively. The banking system's foreign exchange liquidity buffers have been strengthened through the introduction of the Reserve Option Mechanism (ROM) at the end of 2011, which allows banks to hold a certain portion of their lira reserve requirements in foreign exchange (see below). Banks have actively used this facility.

The banking sector faces several risks at the current juncture. Maturity mismatch may hurt profitability in the near term, as surging external and domestic funding costs cannot readily be passed on to customers. Furthermore, even though banks' direct exchange rate risk is low, as banks' net foreign currency liability position is almost fully closed by off-balance sheet transactions, mostly swaps, they are indirectly exposed through their lending to the non-financial corporate sector. Finally, banks with heavy exposure to SMEs and/or consumer or credit card loans to low-income households may face deteriorating asset quality.

Table 2. Bank loan portfolio

As of the end of 2014Q1

	Share in total bank loans in %	Non-performing loans in % of total loans in category
Consumer and credit card loans	31	3.3
Housing loans	10	0.6
Vehicle loans	1	3.2
Credit card loans	8	6.0
Other loans	12	3.7
Business loans	69	2.6
Sectors:		
Agriculture, hunting, forestry, fishing	3	3.6
Mining and quarrying	1	3.0
Manufacturing	19	2.5
Electricity, gas and water	5	0.1
Construction	7	4.1
Wholesale and retail trade	12	3.6
Other services	22	2.0
SME loans	26	3.2

Source: Banking Regulation and Supervision Agency (BRSA).

As noted, the BRSA has applied a range of macroprudential tools to rein in credit growth in recent years. Its toolbox is being strengthened further, notably through countercyclical capital requirements. It could be reinforced even more via dynamic provisioning. Coordination with other agencies has also been strengthened with the establishment in 2011 of the Financial Stability Committee (FSC) – which comprises the CBRT, the BRSA, the Treasury, the Savings Deposit Insurance Fund and the Capital Market Board. However, macroprudential measures could be more proactively used to lean against capital inflow and loan growth cycles. Credit growth had reached almost 40% between late 2010 and early 2011 before the BRSA took measures to slow loan growth in June 2011. Credit growth accelerated again sharply in the first half of 2013, far exceeding the central bank's 15% reference rate. But it was only in October 2013 that the BRSA tightened macroprudential measures. As a result, credit, and especially consumer loan growth slowed (Figure 6).

Asset markets

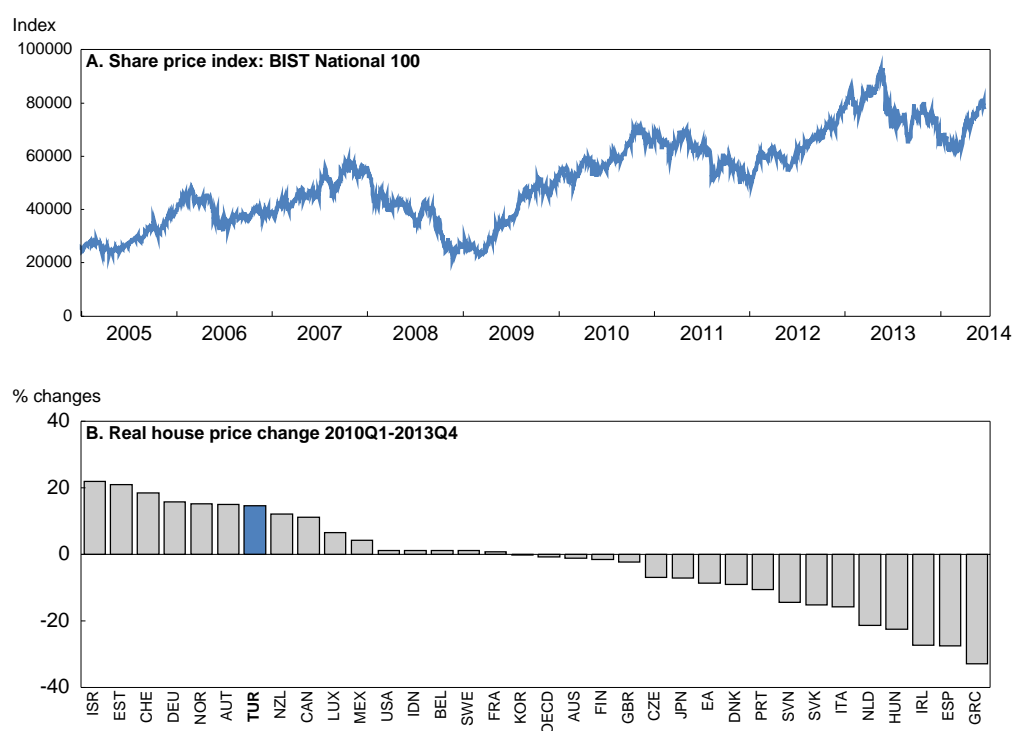
After the capital inflow driven rally from early 2009 to May 2013, during which the Istanbul stock exchange index almost quadrupled, the Turkish stock market dropped by more than 30% by March 2014 after which it started to recover (Figure 10). The drop reflected mostly a sell-off by domestic residents as foreign investors mostly stayed put. The impact on financial stability and the real economy from the equity market is likely to be limited, as stock market capitalisation is still low and households only hold a small portion of their assets in stocks.

House prices have increased rapidly and may have significant macroeconomic effects. Deflated by the CPI, they increased around 6% in 2013, one of the fastest rates in OECD countries. In Istanbul, they jumped by 12%. Since the start of the official data series in January 2010, real house prices in Turkey have risen by about 14%, a robust increase in international comparison but slower than for example in Norway, Germany, Austria and Switzerland (Figure 10). House prices have grown faster than rents and in line with disposable income between 2010 and 2013. Household survey data suggest that the home ownership rate is around 67% in Turkey.

The number of house sales jumped by almost 65% in 2013, after rising on average by around 13% between 2008 and 2012. About 40% of house sales have been mortgage financed. The surge in house sales is likely due to a change in the VAT regime of newly-built property, which pulled forward demand for already built and licenced residential housing. Under the new system, the VAT rate depends on a set of factors including the land value rather than only the size of the property. But the surge in sales may also be due to pent-up supply. After growing sharply in 2010-11, particularly because of increased supply by the Housing Development Administration of Turkey (TOKİ) and urban transformation projects in a number of metropolitan municipalities, building construction output stagnated in 2012-13. Building permit growth (by number of dwelling units) also slowed in 2013 and remained below the long-term average growth rate.

The shortness of most official series makes it hard to assess the housing market. The authorities should continue to monitor developments closely and stand ready to tighten macroprudential measures if needed, for example through a decrease in loan-to-value ratios. Increasing land supply, as advocated in the 10th Development Plan, may also ease pressures on house prices in the medium term.

Figure 10. Asset market developments



1. Over 2010Q1-2013Q3 for Belgium and Japan.

Source: Datastream and OECD House Price Database.

Monetary policy

Given Turkey's open capital account, the CBRT faces the difficult task of taming inflationary pressures while avoiding potentially destabilising capital inflow surges. Other things equal, raising policy interest rates to contain inflation encourages capital inflows, which push up the exchange rate, harming competitiveness, and fuel domestic credit booms, inducing a build-up of foreign currency liabilities that weakens balance sheets. The same challenge arises when global liquidity expands and global rates decline, but high domestic inflation calls for tight monetary policy.

As discussed in detail in the previous *Economic Survey* (OECD, 2012a), in dealing with this “trilemma”, the Turkish central bank (CBRT) shifted from a pure inflation targeting approach introduced in 2006 towards a more unconventional approach in late 2010. While preserving price stability as the main monetary policy goal, financial stability has been adopted as an additional objective.

In this context, the central bank has targeted inflation, while monitoring credit growth and the exchange rate. It began to set a medium-term inflation target with a $\pm 2\%$ uncertainty band in 2006. The target is set at 5% for 2014, 2015 and 2016. In addition, the central bank views annual nominal credit growth of about 15% in the short term as a prudent benchmark based on historical international experience. As credit deepening advances, credit growth should follow a gradual downward path (Kara et al., 2014). Finally, the CBRT has explicitly aimed to avoid excessive exchange rate misalignments. In its view, a trend real effective exchange rate appreciation is consistent with a catch-up process and measurement bias due to quality improvements (Alper et al., 2013), and sharp or persistent deviations from this path should be avoided due to feedback effects from exchange rates to credit growth. For example, rapid lira

appreciation improves the balance sheets of firms, which are typically net borrowers of foreign currency. This, in turn, may lead to excessive lending appetite by banks and thus may feed into rapid credit growth and systemic risk. Rapid credit growth, in turn, may lead to a relative rise of non-tradable prices, further increasing real appreciation pressures. This feedback loop between exchange rates and credit growth can become a source of vulnerability and eventually end in a sudden reversal of capital flows (Alper et al., 2013).

This multiple-objective approach has necessitated the use of a variety of policy instruments. A key one has been the asymmetric and relatively wide interest corridor (in contrast to a symmetric and narrow corridor in conventional inflation targeting regimes), delineated by overnight (O/N) borrowing and lending rates together with a one-week repo lending rate. Through active liquidity management via open market operations, the CBRT has been steering interest rates within this corridor on a daily basis. The CBRT has valued this flexibility as it allows to react quickly to volatile capital inflows. According to the CBRT (Alper et al., 2013), the impact of sharp changes in capital flows on exchange rates can be smoothed through active liquidity policy, thereby reducing the need for more costly direct foreign exchange intervention. The interest rate corridor may also be used to change the composition of inflows during capital inflow surges. By creating short-term interest rate volatility at the lower end of the interest rate corridor via liquidity management, short-term inflows are discouraged, while this volatility is less relevant for long-term investors.

In late 2011, the CBRT added the Reserve Option Mechanism (ROM) to its monetary toolbox. The ROM allows banks to meet their lira reserve requirements with foreign exchange or gold up to a limit. Presently banks are allowed to hold up to 60% of their lira reserve requirements in foreign currency and 30% in gold. Conversion occurs at the market exchange rate multiplied by an increasing penalty parameter, the Reserve Option Coefficient (ROC), which currently ranges from 1.4 to 3.2 for foreign exchange and from 1.4 to 2.5 for gold. The ROM aims to support the foreign currency liquidity management of the banking system, to increase the CBRT's foreign currency reserves, to reduce the need for costly sterilized interventions in the foreign exchange market and to limit the adverse effects of excess capital flow volatility on macroeconomic and financial stability. Utilisation of the ROM depends mostly on the relative costs of domestic versus external funding. The ROM acts as an automatic stabiliser. At times of strong inflows, costs of foreign currency liquidity decline and banks seek to increase the use of the ROM, thereby redirecting inflows into the facility while releasing lira and countering appreciation pressures. The opposite should happen during outflows. With the effective ROC greater than 1, part of the inflows will be automatically sterilized. Since its inception the ROM has been intensively used by commercial banks with the utilisation rate consistently above 80%.

As described in the previous *Survey* (OECD, 2012a), more standard reserve requirements, differentiated by maturity and currency denomination, have also been part of the new monetary framework. These reserve requirements have not been changed since May 2013.

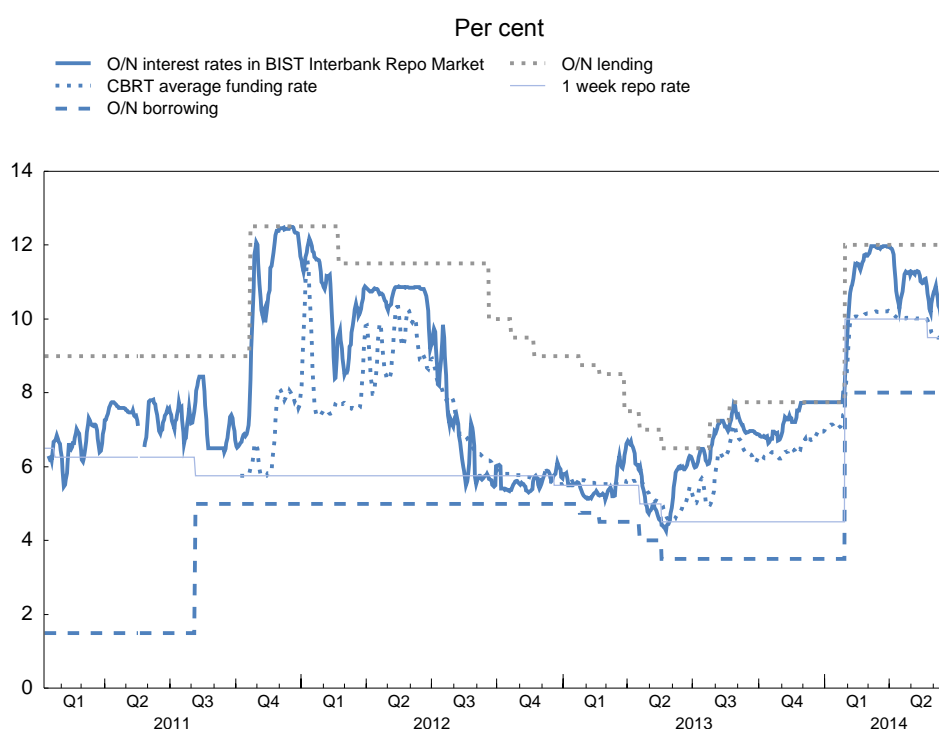
The new framework has undergone different phases (Figure 11):

- Late 2010 to July 2011 (US Federal Reserve quantitative easing QE2 and surging capital inflows): the CBRT cut the lower bound of the interest rate corridor (O/N borrowing rate) and increased interest rate volatility to discourage short-term capital inflows; reserve requirements were hiked and differentiated by maturity to influence the composition of flows; the CBRT also carried out sterilised foreign exchange purchase auctions.
- August 2011 to mid-2012 (intensification of the euro area debt crisis): in order to avoid a sudden stop due to the reversal in risk sentiment, to contain depreciation pressures and faced with surging inflation, the CBRT widened the interest rate corridor by increasing the upper bound

(O/N lending rate) and provided less liquidity at the one-week repo rate, pushing up market rates; from August 2011 to January 2012, the CBRT also sold around USD 15 billion worth of foreign exchange via auctions and outright interventions.

- Mid-2012 to mid-2013 (diminished tail risks associated with a possible break-up of the euro area): the CBRT responded to the resurgence of capital inflows by increasing liquidity and thus lowering short-term market rates; the O/N lending rate was gradually cut; instead of resorting to foreign exchange buying auctions, the CBRT fine-tuned the ROM facility to mop up excess foreign exchange liquidity.
- May 2013 to January 2014 (Fed tapering discussion and domestic political tensions): the CBRT successively hiked the O/N lending rate to 7.75% and provided less liquidity to steer market rates towards the upper bound of the corridor. Since August 2013 the goal of the CBRT has been to increase the predictability of monetary policy and to reduce interest rate uncertainty (notably through more information on liquidity management operations). Between June 2013 and end-January 2014 the CBRT provided foreign exchange of over USD 23 billion through outright sales and auctions.³

Figure 11. The monetary policy stance

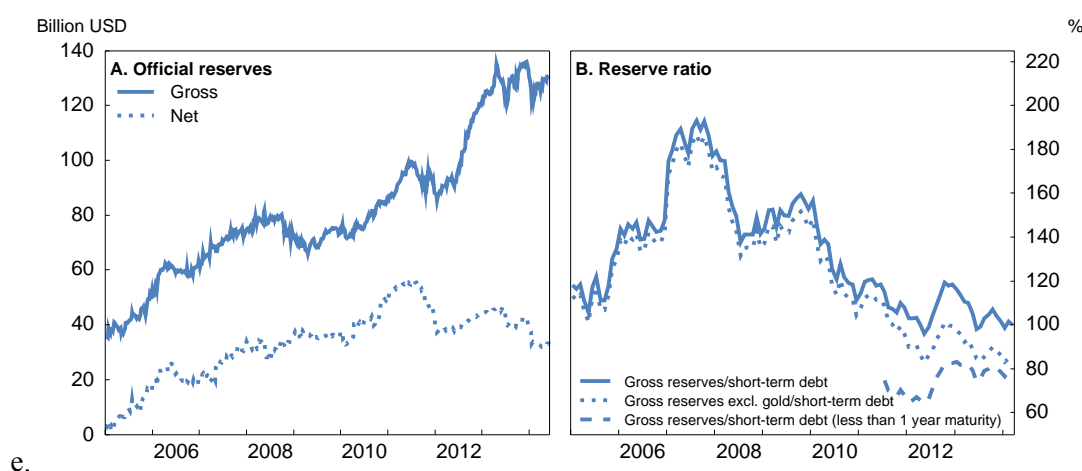


Source: Central Bank of the Republic of Turkey.

3. On 23 January 2014, the Central Bank sold foreign currency worth more than USD 3 billion in one day.

The record of this policy framework is mixed. On the positive side, the interest rate corridor, active liquidity management and the ROM have been shown to reduce exchange rate volatility (Akçelik et al., 2012; Ermişoğlu et al., 2013; Oduncu, et al., 2013a). Değerli and Fendoğlu (2013), in addition, find that the ROM reduced volatility, skewness and kurtosis of exchange rate expectations, implying that tail risks of large exchange rate swings associated with sharp movements in capital flows have diminished. However, developments in late 2013 and early 2014 put these findings into perspective. Empirical results suggest that the new monetary policy framework significantly contributed to the decrease in credit growth volatility (Oduncu et al., 2013b) and reduced the sensitivity of capital inflows to global conditions (Aysan et al., 2014). A drawback of the above mentioned studies is that their assessment is confined to a period of relatively benign external conditions.

Figure 12. Official reserves

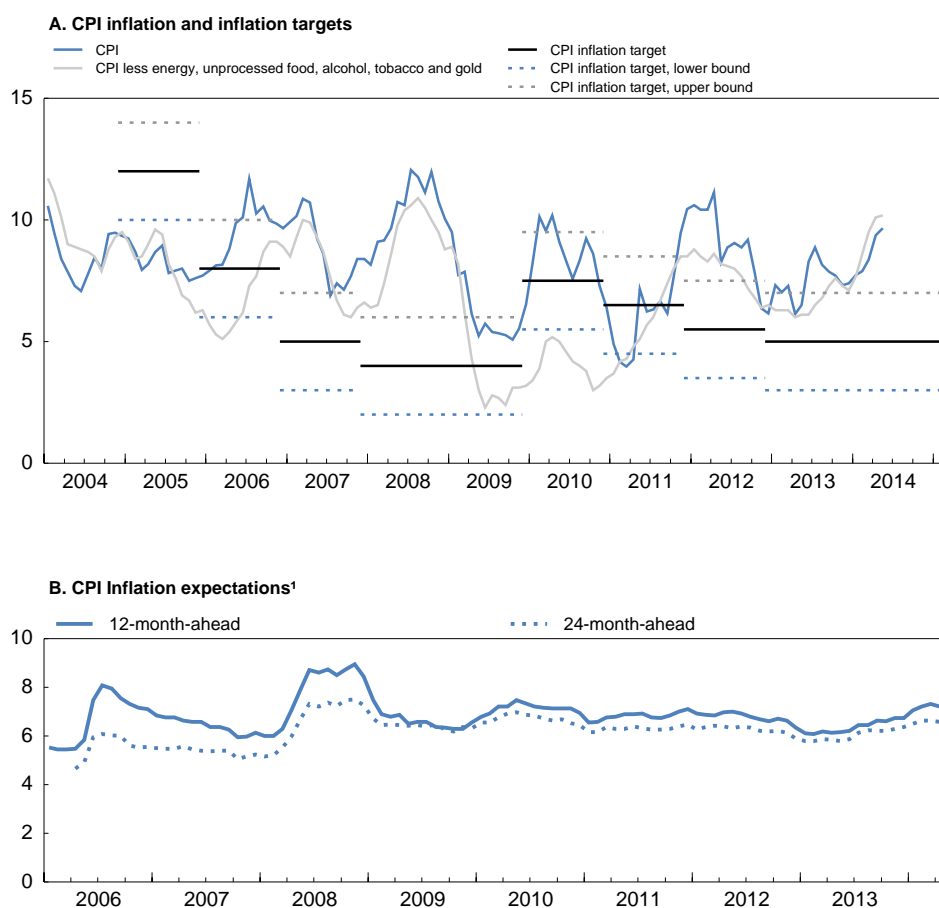


Source: Central Bank of the Republic of Turkey.

The ROM has also contributed to the build-up of banks' foreign exchange liquidity buffers and central bank gross reserves, with banks accumulating around USD 50 billion through the ROM at the central bank in the first two years after the ROM's inception. However, gross reserves still appear relatively low compared to the external short-term debt of the economy (Figure 12). Moreover, reserves accumulated through the ROM are not under the full control of the central bank. Net reserves have recently been strengthened by extending export rediscount credits, but these reserves did not match the increase in gross reserves and remain at a moderate level.⁴ Since the beginning of the financial market turmoil in May 2013, the CBRT was forced to resume foreign exchange selling auctions to stem depreciation pressures since banks' release of foreign exchange from the ROM was only limited. This partly reflects the fact that capital outflows mainly concerned portfolio flows, while inflows into the banking sector remained relatively stable. Thus banks did not experience any funding problems and were not forced to draw down their foreign currency reserves. However, the limited release from the ROM may also reflect a more general design issue. During outflow periods banks may expect currency depreciation and higher domestic funding costs, expectations that were vindicated by events following both May and December 2013. Both factors provide incentives to banks to hold on to their foreign currency reserves.

4. Export rediscount credits are extended to firms in Turkish lira to facilitate and reduce the costs of export financing, and are paid back in foreign exchange. Eligibility has been eased in August and November 2013 and the central bank estimates that this has increased net foreign exchange reserves by USD 8 billion in 2012 and USD 13 billion in 2013 (CBRT, 2013b).

Figure 13. Inflation and inflation expectations are high
Year-on-year percentage changes



1. Based on the Central Bank of Turkey's Survey of Expectations Descriptive Statistics.

Source: OECD, *OECD Economic Outlook database* and Central Bank of the Republic of Turkey.

However, the policy framework did not deliver low and stable inflation and inflation expectations have become increasingly de-anchored from the inflation target (Figure 13). After reaching double-digit levels in late 2011, consumer price inflation abated but remained volatile. It increased again in the course of 2013, reaching 7.4% in December, and further increased to above 9% in early 2014. Core inflation also started to veer up in the second half of 2013, partly due to pass-through from lira depreciation. Import price increases and exchange rate depreciation are estimated to have added 1.5 percentage points to year-end inflation in 2013. Furthermore, inflation expectations have trended up since mid-2013 and have become increasingly de-anchored from the target, possibly due to the repeated overshooting. Shifts of the inflation target in the past, especially in 2009 and 2010 when its mid-point was temporarily raised, may have also weakened the anchoring power of the target. In May 2014, 12- and 24-month ahead expectations stood at 7.2% and 6.7% respectively. This may raise inflation through wage and price setting mechanisms going forward and lead to real exchange rate appreciation pressures and competitiveness losses. The central bank expects inflation to remain high until mid-2014 and then to gradually fall to about 7.6% by end-2014 and 5% by end-2015. Tax hikes in January and lagged effects from the exchange rate depreciation between October 2013 and March 2014 are estimated to respectively contribute 0.5 and 0.8 percentage points to year-end inflation (CBRT, 2014).

In January 2014 the CBRT tightened the monetary stance sharply and streamlined its operating framework. In the face of persistent inflation overshooting, rapid depreciation and after having spent a sizeable chunk of its foreign exchange reserves, the CBRT decided in an emergency meeting to hike the marginal O/N lending rate from 7.75 to 12% and the borrowing O/N rate from 3.5 to 8%. The one-week repo rate was increased from 4.5 to 10% and central bank liquidity will henceforth be provided primarily via one-week repos. Then, in a context of benign global liquidity conditions and improvement in Turkey's risk premia, the one-week repo rate was cut in May and June, by respectively 50 and 75 basis points.

A restrictive monetary stance is needed, and may need to be stiffened further, to ensure inflation and inflation expectations fall back closer to the target. To this end, it may also be advisable to narrow the interest corridor to strengthen the commitment to higher interest rates which would help better manage inflation expectations. While a tight monetary stance may adversely affect growth in the short term, credibility is crucial for monetary policy and macroeconomic stability. Without a credible inflation target, inflation expectations may become more backward-looking and monetary policy may be forced to react more to temporary inflation shocks, causing greater volatility in output and unemployment. Once disinflation is on track, the remaining room for manoeuvre can be used to help smooth exchange rate and capital flows. The authorities could also use foreign exchange purchases to build up reserves, which are not particularly high. However, if used over an extended period, such purchases may run into the "trilemma" and thereby undermine inflation targeting. In this environment, preserving trust in the independence of the central bank is essential.

Fiscal policy

Turkey has not yet caught up with OECD norms on fiscal transparency, notwithstanding improvements, such as better reporting of general government cyclically-adjusted balances. Annual Programmes, Pre-Accession Economic Programmes and Public Debt Management Reports contain relevant information but accrual-based consolidated general government accounts need to be published timely and aligned further with international standards. There are plans to report general government accounts according to accrual-based ESA-95 consolidation norms with shorter time lags from 2015, which would be welcome.

As discussed in the previous *Economic Survey* (OECD, 2012a), fiscal analysis would also be considerably facilitated if all one-off and cyclical revenue and spending items were better identified. A more detailed structural analysis of the general government budget should be included in Turkey's Pre-Accession Economic Programmes and other policy and budget documents, according to international standards. Investment and debt of public entities, such as the public housing agency (TOKI) and municipally-owned enterprises, should also be better monitored. Recently, the Ministry of Finance started to collect financial information from 378 local government-owned corporations affiliated to 250 municipalities, which will form the basis of future systematic reporting. There are also plans to more comprehensively account for government liabilities which arise in the context of expanding public-private partnerships (Box 1). The prospective financial costs of the expanding social security system also call for close scrutiny. This is particularly important as health and pension costs have started to increase rapidly.

A regular *Fiscal Policy Report* (similar to the central bank's *Inflation Report*) containing a full set of cyclical adjustments and relevant information on the long-term balances of the social security system and on the activities of public entities not included in the general government sector would improve fiscal transparency. An independent Fiscal Council, along the lines of those existing in a number of OECD countries, could draw on the work of the Court of Accounts, which has been vested with wider auditing powers by a 2010 Court of Accounts Law. These powers extend to the entire general government sector. However, a number of provisions of this law, including the examination of an in-depth annual report by the

Court by a specialised Commission of the Parliament, have not yet been implemented. These institutional innovations would help Turkey's plans to reform spending and revenue structures (World Bank, 2014).

Notwithstanding these caveats, Turkey's overall public finance position appears to remain robust. Fiscal policy continues to outperform the objectives published in the successive medium-term programmes mainly thanks to stronger-than-projected revenue growth, which offset the surge in public infrastructure investment in the first half of 2013. According to authorities' estimates, the general government deficit stood at 1.6% of GDP in 2013 and the debt-to-GDP ratio, at 36.3%, stay on a downward trajectory. In addition, the composition of debt has improved considerably over the past decade. The share of foreign-currency-denominated debt has fallen to about one third, debt maturities have lengthened and the majority of debt has been issued as fixed rate bonds. This will reduce the immediate impact on public finances of the recent depreciation and hike in risk premia compared to the past.

Box 1. Fiscal management of expanding PPPs

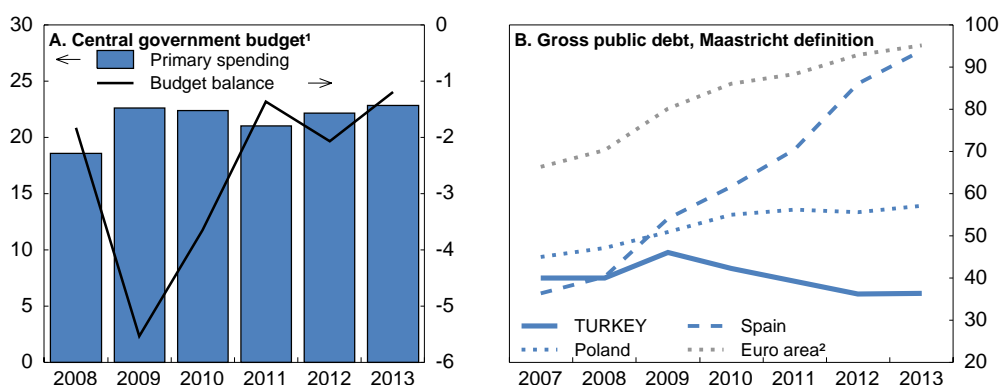
Turkey has been an emerging market pioneer in public-private partnerships (PPPs) for infrastructure development since the mid-1980s. Since then, implementation contracts of 180 PPP projects have been signed, through Build-Operate-Transfer (BOT), Build-Operate (BO), Build-Lease-Transfer (BLT) and Transfer of Operating Rights (ToR) arrangements, including electricity power plants, harbours, motorways, hospitals and airports. These projects were generally technically successful, but created fiscal surprises. In particular, public purchase guarantees at pre-determined prices have been activated more often than expected. After a Court of Accounts review in the mid-2000s, which concluded that government losses from energy PPPs alone (reflecting the gap between purchase and resale prices of electricity) had reached USD 2.3 billion after only a few years of operation (Sayıştay, 2004), qualms about adequate public/private risk sharing in these contracts led to some slowdown in new arrangements. Between 2000 and 2010 several airport, marina and border facility projects were realised under the BOT schemes. After 2010, implementation contracts of major transportation projects such as the Gebze-Izmir Motorway and the third bridge over the Bosphorus have been signed. BLT healthcare projects have also been implemented.

The magnitude of Turkey's infrastructure needs and plans – and the government's objective to limit government borrowing and debt – will nonetheless make additional recourse to PPPs necessary in the period ahead. The 10th Development Plan projects government infrastructure spending of USD 250 billion during 2014-18 and complementary PPP investments of USD 100 billion. Although these preliminary estimates may change after "value for money" analysis, around 30% of total infrastructure spending is expected to be privately financed. During this period PPP projects will include nuclear power plants, harbours, hospitals, marinas, border facilities, schools, dormitories and motorways.

In order to draw on past experiences and more effectively manage these projects, a "Special Ad-Hoc Committee on PPPs" was recently created, with representatives from all ministries and agencies, lenders, contractors and lawyers. The Committee analysed the main governance issues faced in PPP projects, and plans to prepare a strategy paper outlining best practice guidelines for implementation agencies. Accurately accounting for fiscal implications and risks was also high on its agenda. In May 2014, the Treasury formally clarified the procedures and caps on the debt assumption commitment to the creditors of PPP contractors. This is an area prone to "too important to fail" syndromes. More comprehensively, the Treasury and the Ministry of Finance are working on a method to quantify total fiscal commitments related to PPPs, including purchasing guarantees. A full report on Turkey's PPP-related fiscal liabilities is planned for 2015. Finally, the PPP Committee suggested drafting a new Framework Law on PPP agreements.

The government targets set out in the *Medium-Term Programme* published in October 2013 foresee further reductions in the general government budget deficit and debt to 0.7% and 30% of GDP respectively by 2016 (Government of Turkey, 2013). These targets imply a tightening of the fiscal stance in the context of below-potential growth. Such a prudent fiscal stance appears appropriate amid the current electoral cycle and political tensions to preserve credibility and confidence. Should downside risks materialise, such as a sudden stop in capital inflows, room for a discretionary stimulus exists.

Figure 14. The fiscal position is strong
In percentage of GDP



1. Data for 2013 are estimates from the 2014-16 Medium Term Programme.
2. 15 first members of the euro area.

Source: Undersecretariat of Treasury and OECD Economic Outlook database.

Primary spending, in particular for personnel, education, health and pensions, increased rapidly in recent years and could only partly be offset by reductions in interest spending. Infrastructure investment has also increased, funded partly through public-private partnerships and state-owned enterprises. Demographic trends, active social policies and large infrastructure projects will put additional pressure on public spending. General government primary spending is to be restrained at around 36% of GDP according to latest *Medium-Term Programme*. However, these spending targets, based on *ex ante* budget appropriations, have repeatedly been breached in the past – though usually not by much. The spending targets of the general government should become hard spending ceilings, even if implementation may be constitutionally challenging. Outcomes should be reported transparently so as to improve compliance. In the event of revenue windfalls, keeping to such a spending ceiling would help preserve a tight fiscal stance and boost national saving. In addition, in periods of strong capital inflows, a tight fiscal stance would help monetary policy restrain domestic demand and hence inflationary pressures. This would also allow building-up sufficient buffers to counteract a possible capital flow reversal.

Box 2. Macroeconomic and financial policy recommendations

Monetary and financial market policy

- Ensure the monetary policy stance is sufficiently restrictive to better align inflation and inflation expectations with the inflation target.
- Consider introducing dynamic provisioning, debt-to-income caps across more loan types, and higher risk weights or provisioning requirements on foreign currency loans extended to companies without revenues in the same currency.
- Further encourage the development of savings and long-term investment.

Fiscal policy

- Continue the ongoing fiscal consolidation. Provide discretionary stimulus should downside risks materialise.
- Further improve fiscal monitoring by publishing general government accounts according to international standards as well as a comprehensive report on fiscal policy covering all fiscal and quasi-fiscal activities.
- Adopt a multi-year general government spending ceiling and report outcomes transparently to improve compliance.

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