Executive summary

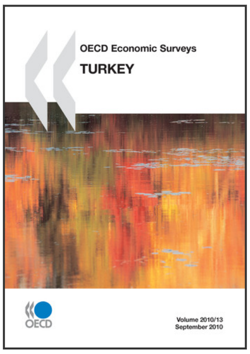
Turkey was directly affected by the global crisis, but showed considerable resilience thanks to important reforms implemented after the 2001 crisis. The adverse external shock originating in financial market turmoil and propagated by a sudden collapse of world trade was amplified by domestic confidence effects. With the experiences of the 2001 banking crisis fresh in mind, companies and households cut investment and durable goods consumption. The strong macroeconomic policy framework provided support for the economy. Moreover, confidence building and credibility were considered more important than a possibly short-lived fiscal stimulus. Now, with the recovery under way, a golden opportunity for structural reforms arises from the sharp drop in real interest rates in the wake of the acknowledgement of Turkey's solid fundamentals by international investors. The government should grasp this opportunity and introduce structural reforms which make most out of this positive shock. Further strengthening the macroeconomic policy environment will be necessary to minimise the risk of a boom-bust scenario.

Potential growth in Turkey is held back by high inactivity and not sufficiently broad-based productivity growth, which is also linked to serious skills mismatches. The low capacity to create new jobs is clearly linked to excessive labour market regulation, which provides incentives for informal arrangements, which in turn hinder productivity growth. Informal firms have less access to finance, cannot efficiently participate in innovation networks and invest less in human capital. Their productivity is therefore much lower than in fully formal, rule-abiding firms. Furthermore, product market regulation is not conducive to market entry and network monopolies have too much pricing power. The fiscal policy framework was successful in bringing down public debt after the 2001 crisis, but became pro-cyclical in the run-up to the crisis and fiscal accounts are not yet fully transparent. Monetary policy succeeded in bringing inflation to single-digit levels but still faces challenges in reaching a lower inflation environment on a sustainable basis.

The recent government initiatives to strengthen the macroeconomic policy framework and advance structural reforms are welcome and should be broadened and accelerated in order to meet the challenge of providing Turkey's rapidly growing population with jobs and accelerate catch-up with the OECD average.

The urgent need for labour market reforms is well known. Turkey should therefore move forward and allow more experimentation with new rules on a voluntary basis. Such measures should be closely monitored and the results used to establish nationwide reformed rules, which can be rigorously enforced without hindering job creation. Simultaneously, product market regulations should be aligned with OECD best practice so as to boost productivity growth and competitiveness. Education policy reforms as outlined in previous Economic Surveys *are necessary to remove widespread skills mismatches.*

The new draft law establishing a fiscal rule is very welcome and has the potential of considerably improving fiscal performance over time, as well as removing the current pro-cyclical bias of fiscal policy. Its discussion in Parliament, initially planned for June, was postponed. In order to allow an effective monitoring of compliance with the rule it will be important to pass the draft law on the Court of Accounts. Turkey's position in international ratings does not fully reflect reformed and sound fundamentals. Making more progress with fiscal transparency, strengthening the inflation targeting framework and preserving financial stability will therefore be important.



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