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Turkey: Staff Report for the 2010 Article IV Consultation and Post-Program Monitoring—Supplementary Information; Staff Report; Informational Annex; and Public Information Notice on the Executive Board Discussion

The following documents have been released and are included in this package:

- A Supplementary Information of July 27, 2010.
- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 26, 2010, 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 July 13, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- An Informational Annex of July 13, 2010.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 30, 2010 discussion of the staff report that concluded the Article IV consultation.

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

TURKEY

Staff Report for the Article IV Consultation and Post-Program Monitoring—Supplementary Information

Prepared by the European Department
(In consultation with other Departments)

Approved by Ajai Chopra and Aasim Husain

July 27, 2010

1. **This supplement updates economic performance and policy developments that occurred since the staff report was issued**. The thrust of the staff appraisal is not affected. However, with the delay in legislating the fiscal rule, a crucial anchor for fiscal policy and expectations is missing, and staff's updated appraisal in this regard is provided in paragraph 5.

Macroeconomic developments

2. **Recent high-frequency indicators are broadly consistent with staff's current macroeconomic forecasts**. Consumer and commercial loans have maintained their rapid pace and continue to spur domestic demand, while unemployment declined further in seasonally-adjusted terms. Despite the recent drop in headline inflation, medium-term inflation expectations have moderated only slightly.

3. **Recent fiscal developments suggest revenue overperformance is being partially offset by increases in discretionary spending**. Robust activity continues to underpin strong revenue collection relative to the 2009 Medium-Term Plan (MTP) and 2010 budget, consistent with staff's projections. However, on year-to-date trends, discretionary spending looks set to exceed full-year budget appropriations. Therefore, while developments are in line with the 2010 deficit target of 0.3 percent of GDP, they diverge from staff's recommendation to save revenue overperformance in excess of mandatory spending increases (due to higher inflation and revenue sharing) so as to limit pressure on the current account.

Policy developments

4. **In a significant policy shift, the government recently announced it has no specific schedule for bringing the fiscal rule legislation before parliament, and intends instead to continue to follow the September 2009 MTP.** Contrary to previous indications,

parliament's general assembly did not consider the fiscal rule legislation—which has garnered broad political support—during its recently concluded session.[1] Finance Minister Simsek stated on July 15 the government would determine at a later date the timing of parliamentary consideration and the 2011 budget would be drawn up according to the current three-year MTP. In presenting the just-released July inflation report, Governor Yilmaz explained that gradual, modest policy rate increases would be delayed till 2011 owing to moderating price pressures, but that this strategy would be reconsidered if the government failed to adopt the fiscal rule for the 2011 budget cycle.

5. **Staff considers that the fiscal rule is considerably superior to the 2009 MTP and urges passage of the draft rule without further delay**. Under staff's baseline macro scenario but assuming little revenue overperformance is saved this year, the fiscal target in 2011 set by the rule would be broadly similar to the MTP.[2] However, the rule is motivated by longer-term considerations. Specifically, the rule is an explicit binding commitment to a prudent, countercyclical policy. This contrasts with the short-term MTP targets, which are ad hoc and do not automatically adjust to changing cyclical conditions.[3] Moreover, if passed in its current form, the rule would introduce needed enhancements to transparency and public financial management procedures. Finally, although markets have so far taken the postponement in stride, failure to pass the rule quickly may forfeit the window of opportunity that could close ahead of the approaching election cycle, and risk weakening the credibility of the authorities' commitment to fiscal discipline.

[1] The draft law was approved by Parliament's budget committee in June.

[2] By contrast, if, as staff recommends, 2010 revenue overperformance is saved, the 2011 primary balance target under the rule would be about 0.7 percent of GDP, against 0.4 percent of GDP in the MTP.

[3] Recent experience illustrates how quickly the MTP targets can become outdated: the 2009 deficit target (set in the May 2008 MTP) was unachievable and too restrictive because of the deep recession, while the 2010 target (set in the September 2009 MTP) is now insufficiently ambitious due to the much stronger-than-expected growth recovery.

INTERNATIONAL MONETARY FUND

TURKEY

Staff Report for the 2010 Article IV Consultation and Post-Program Monitoring

Prepared by Staff Representatives for the 2010 Consultation with Turkey

Approved by Ajai Chopra and Aasim Husain

July 13, 2010

EXECUTIVE SUMMARY

Past surveillance: During the 2007 Article IV consultation, Directors praised Turkey's progress with reducing imbalances inherited from the 2001 crisis, and urged further efforts to lower public debt and inflation. To achieve this, the authorities maintained a tight monetary stance and high fiscal primary surpluses, but these deteriorated on a cyclically-adjusted basis. As recommended by Directors, a fiscal rule will soon be introduced. However, more effort is needed to remove impediments to employment creation and labor productivity. The authorities have increased gradually the level of international reserves, as supported by Directors.

Context: Earlier strong reforms and solid macro policies supported resilient bank and household balance sheets and made room for decisive policy easing during the crisis. A domestic demand-led rebound is now underway, underpinned by credit growth, and bringing a surging current account deficit and higher inflation, while unemployment remains elevated.

Challenges: Growth is biased toward imports and reliant on foreign saving, reflecting the existence of a competitiveness gap. With low reserve cover and deteriorating quality of external financing, output volatility could increase amid the more unsettled global situation. Persistent inflation differentials could further widen the current account deficit.

Policies and staff views: Rebalancing growth requires domestic demand restraint and decisive structural reforms to lower import dependence. Needed policies include: (i) saving fiscal revenue performance in 2010; (ii) implementing the new fiscal rule from 2011 underpinned by durable fiscal savings; (iii) gradual and modest broad-based monetary tightening while raising daily FX purchases to build reserves; (iv) quickly phasing out financial sector forbearance measures and tightening prudential regulations; and (v) aligning productivity-adjusted employment costs with those of regional peers and strictly adhering to the energy pricing formula. If the recovery stalls, recommendations on fiscal and structural policies remain appropriate, while monetary tightening should be halted or possibly reversed.

Authorities' views: The widening current account deficit reflects structural factors less related to relative prices. While recovery will likely be stronger than originally envisaged in the 2010 budget, external developments are a risk. Therefore, a measured fiscal exit is appropriate, underpinned by a new deficit-based fiscal rule from 2011. Liquidity conditions will be slowly normalized and monetary policy gradually tightened as warranted by domestic and external factors. Relaxed financial sector regulations are still required to encourage rollover of existing loans, and possible risks from banking sector concentration should be addressed. Sustained rapid GDP growth and better training are key to lowering unemployment.

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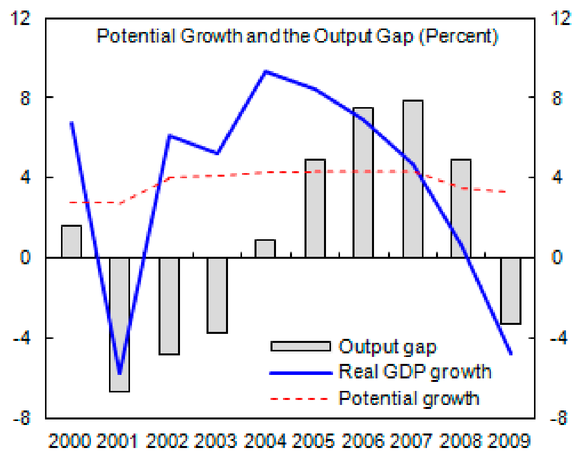
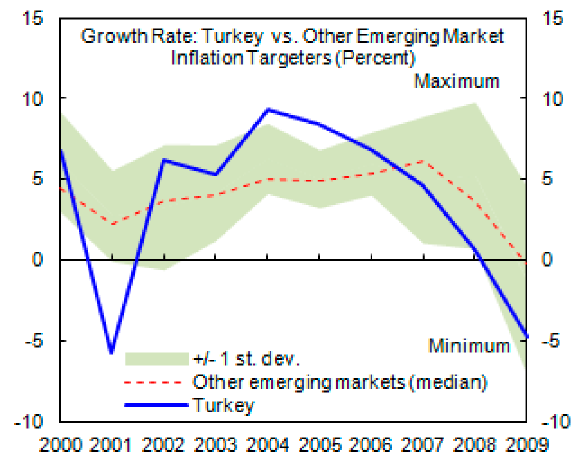
I. Context

A. The Growth Surge (2002–07)

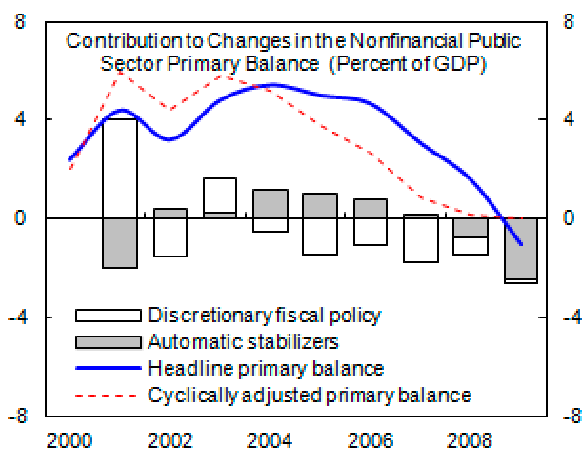
1. **On the eve of the global financial crisis, the Turkish economy had just concluded a six-year growth surge, spurred by policy reforms and favorable external and domestic conditions**. Greater political stability, policy reforms in the context of Fund-supported programs (including overhaul of financial sector supervision, introduction of inflation targeting, and conservative fiscal targets), and initiation of EU accession negotiations improved confidence in economic management and strengthened fundamentals. Together with strong world growth and bounce back from the 2001 crisis, these factors propelled GDP growth to 6¾ percent on average during 2002–07. The combination of rapid growth and sound macro policies produced large fiscal primary surpluses, rapid retreat of public debt, moderate inflation, and strong bank and household balance sheets (Box 1).



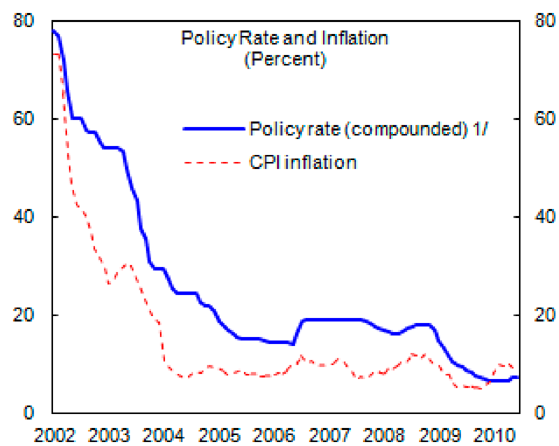
Sources: Turkstat; and IMF staff estimates.



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.



Sources: Turkish authorities; and IMF staff estimates.

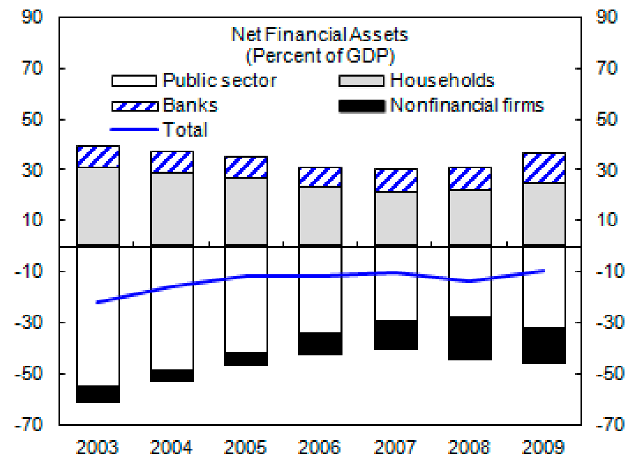


Sources: CBT; and Turkstat.
1/ The increase in May 2010 corresponds to the switch from the CBT overnight borrowing rate to the 7-day repo as the policy rate.

Box 1. Turkey's Net Financial Asset Position by Sector, 2003–09

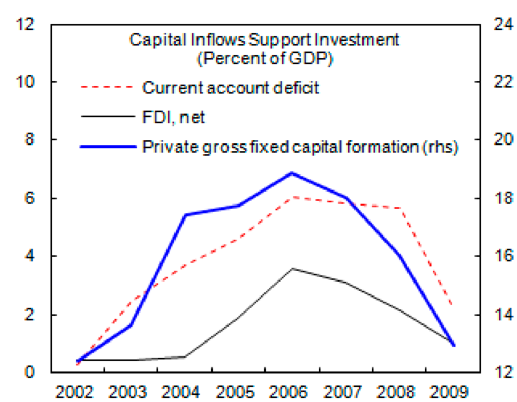
As a share of GDP, Turkey's net financial asset (NFA) position improved during 2003-2007 by 11 percent of GDP as the reduction in public sector (government and central bank) net indebtedness (by some 26 percentage points) more than offset increased leverage by households (10 percentage points) and nonfinancial firms (5 percentage points). Both the public sector and firms have a net financial liability position, while households and banks have a positive position, but with a net liability position for the economy overall (8 percent of GDP).

The global financial crisis interrupted the improvement in aggregate NFA in 2008, largely reflecting the valuation increase in firms' liabilities from depreciation of the lira. Aggregate NFA resumed improving in 2009—despite a deterioration in the public sector position from the widening fiscal deficit—mainly due to increased household saving, repayment of FX loans by firms, appreciation of the lira, and strong bank profits. For both households and firms, deposit accumulation exceeded new borrowing.

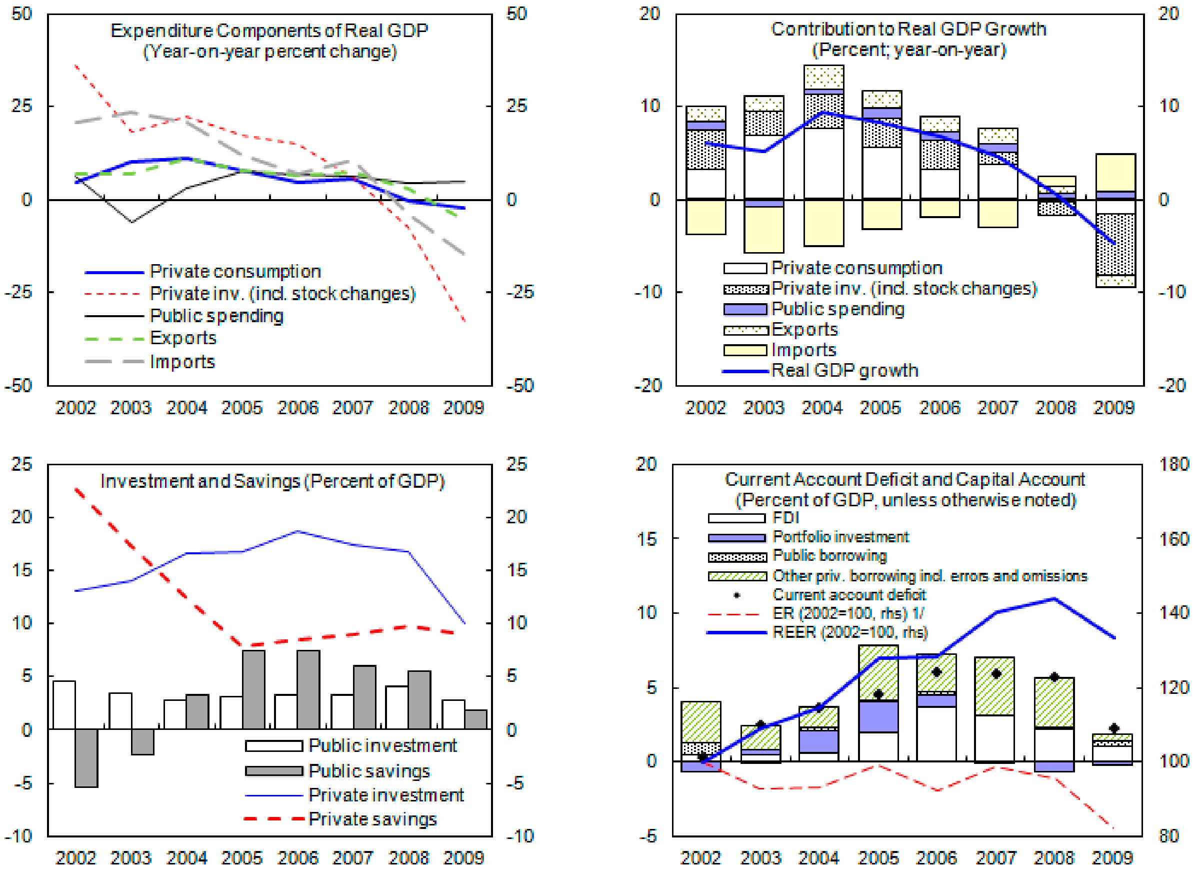


Sources: CBT; and IMF staff estimates.

2. **Improved growth prospects, amid abundant global liquidity, attracted strong capital inflows that fueled the economic expansion but also widened the current account deficit**. Capital inflows—direct private external borrowing, FDI, and portfolio flows—spurred private investment which, in turn, supported rapid GDP growth. Alongside a cumulative 40 percent appreciation of the CPI-based real exchange rate from 2002 to 2007, imports consistently grew faster than exports, and the current account deficit widened from balance in 2002 to a deficit of 5¾ percent of GDP in 2007.

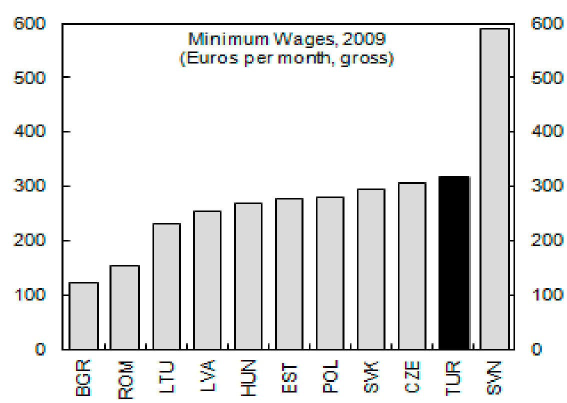


Source: Turkish authorities.

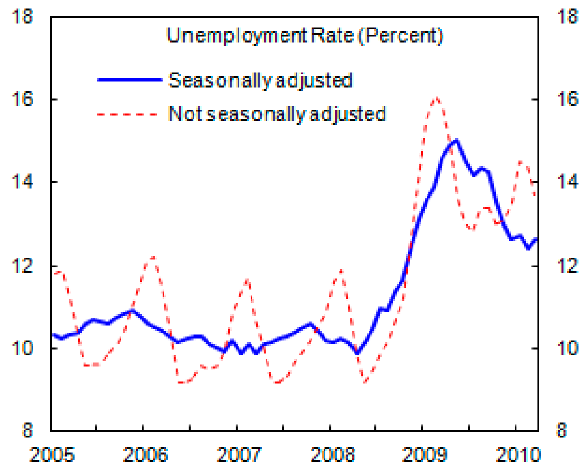


Sources: Turkstat; CBT; and IMF staff estimates.
1/ 50-50 dollar-euro basket.

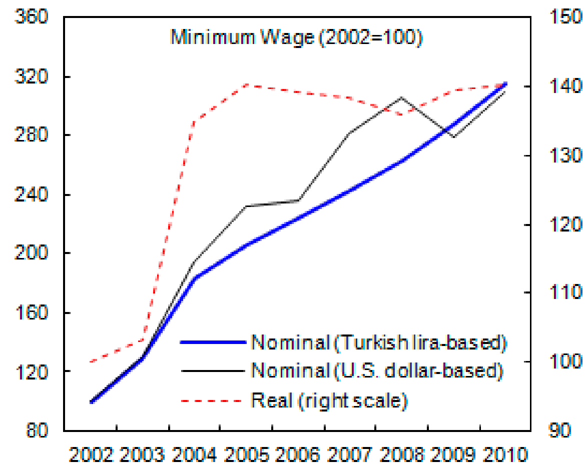
3. **Nonetheless, the unemployment rate remained stuck around 10 percent, with a high share of unofficial or semi-official employment**. This may reflect significant inefficiencies in the formal sector labor market, including a minimum wage that was increased substantially (tripling in U.S. dollar terms since 2002), is now higher than in almost all new EU member countries, and is binding in lower-income regions of Turkey. Also, Turkey's severance pay scheme is among the most generous in the OECD (one month per year of tenure), while its regulations on short-term contracts are the most restrictive. As a result, jobs have been squeezed from the formal to the informal sector (wages reported to the Social Security Institution are less than 20 percent of GDP and more than 40 percent of private-sector wage earners report only the minimum wage—also representing a significant tax leakage), or job creation has been discouraged altogether.



Source: Eurostat.



Sources: Turkstat; and IMF staff calculations.

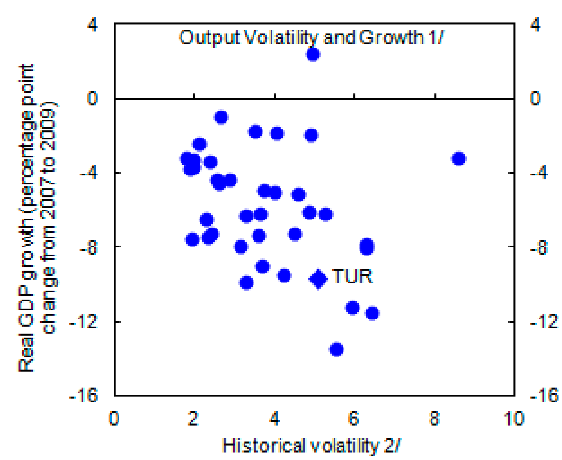


Sources: Turkstat; and IMF staff calculations.

4. **While the growth surge created some new vulnerabilities, Turkey entered the global crisis in a stronger position than many other countries in emerging Europe**. Standard indicators suggest Turkey's fundamentals were not as strong as those typical in emerging Asia and Latin America, but vulnerabilities (particularly the current account deficit, external debt, and the cyclically-adjusted primary fiscal deficit) were generally well below levels present in emerging Europe (Figure 1). This reflects the more restrained size of the foreign credit-induced boom, better focus of macro policies on leaning against the cyclical upswing, and the more restrictive regulatory environment for credit.

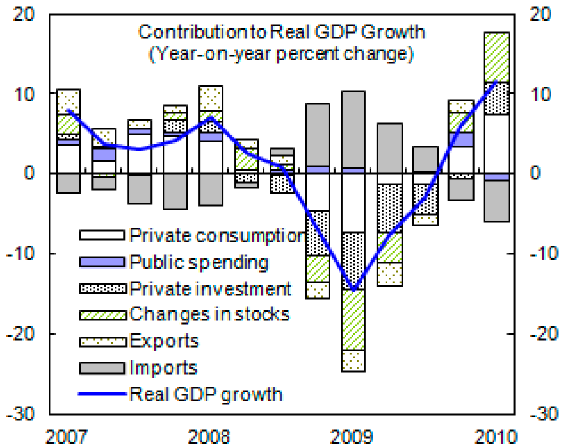
B. Crisis and Recovery (2008–mid 2010)

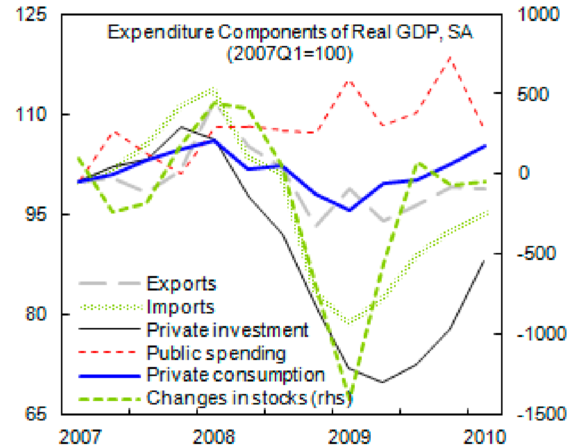
5. **Turkish GDP was hit hard by the onset of the global financial crisis, but quickly retraced its losses** (Figure 2). Capital flight, seizing up of bank lending, and collapse of external demand—together with a history of output volatility that was compounded by domestic political turbulence in mid-2008—caused domestic confidence to quickly erode. As a result, investment, including inventories, dropped sharply, with a smaller decline in exports (Box 2). Seasonally adjusted output plummeted 12 percent during Q4 2008 and Q1 2009. However, domestic demand revived strongly beginning in Q2 2009 on improving global sentiment and the consequent reflow of capital, combined with an effective domestic policy response (temporary cuts in consumption taxes and relaxed monetary policy). More recently, inventory restocking



Source: IMF, *World Economic Outlook*.
1/ Sample includes all emerging market countries included in the IMF Vulnerability Exercise. Countries with any missing value during the 1980–2009 period were excluded.
2/ Historical output volatility is measured as the standard deviation of output growth over the 1980–2006 period.

abroad has buoyed Turkish exports. The steep recovery cushioned the GDP decline to 4¾ percent for 2009 as a whole and led to a 11¾ percent year-on-year rise in output during the first quarter of 2010.

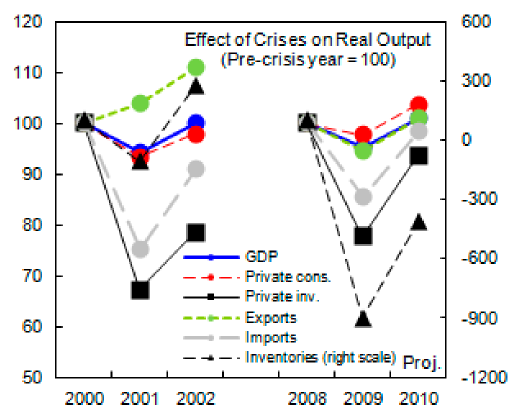




Sources: Turkstat; and IMF staff estimates.

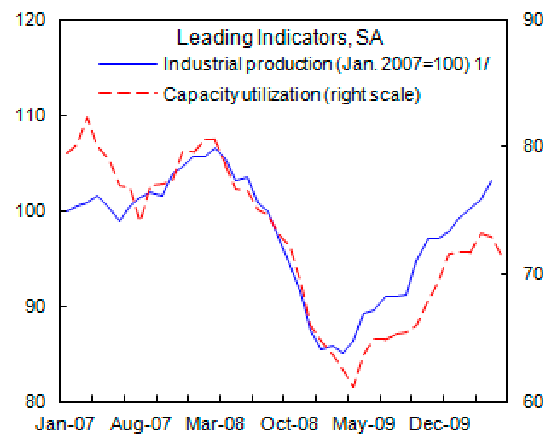
Box 2. Composition of GDP During the Crisis—This Time *IS* Different

A comparison of Turkey's GDP collapse during the 2009 global crisis and Turkey's 2001 financial crisis indicates that, while the overall GDP decline was of a similar magnitude, the underlying expenditure composition was quite different. The global nature of the current crisis made exports much less supportive in 2009 than in 2001, when export growth was even positive. Inventory drawdown was also much deeper in 2009 than in 2001, as the widespread nature and expected long duration of the current crisis at its onset caused firms to run down inventories. Consequently, with the global recovery occurring sooner and stronger than initially anticipated, inventory restocking has been an important driver of growth since Q2 2009.

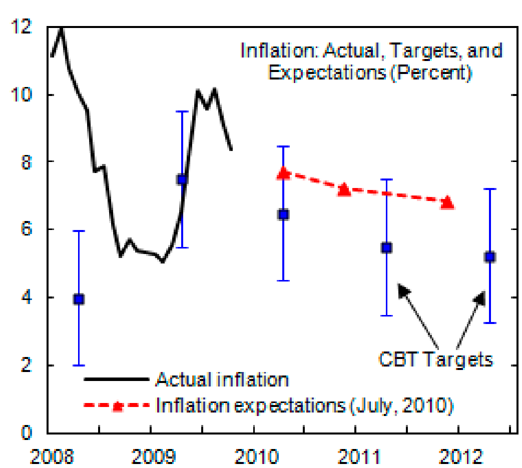


Sources: Turkstat; and IMF staff estimates.

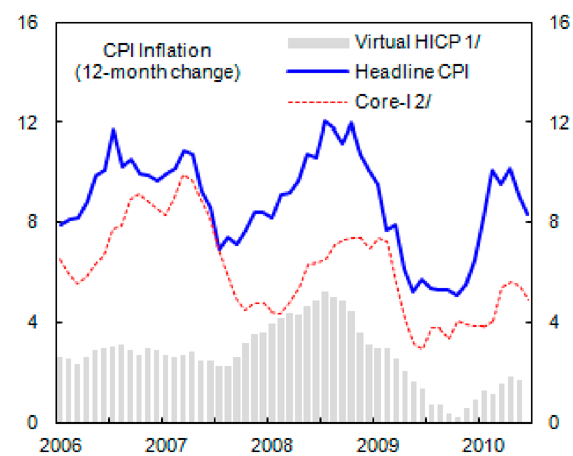
6. **The output gap—while still negative—is closing, and underlying inflation pressures appear contained**. Capacity utilization picked up in tandem with the very strong rebound in industrial production. Seasonally adjusted unemployment moderated from a peak of 15 percent in early 2009 to 12½ percent in March 2010. With the negative output gap currently around 1-2 percent, headline and core inflation recently resumed their downward path after being pushed up temporarily in early 2010 on large excise hikes and food price shocks (Figure 3). Inflation expectations are also moderating, but remain near the top of the Central Bank of Turkey's (CBT's) uncertainty band around the point target for 2010 and 2011.[1]



Sources: Central Bank of Turkey; Turkstat; and IMF staff estimates.
1/ Both seasonally adjusted and working-day adjusted.



Source: CBT.

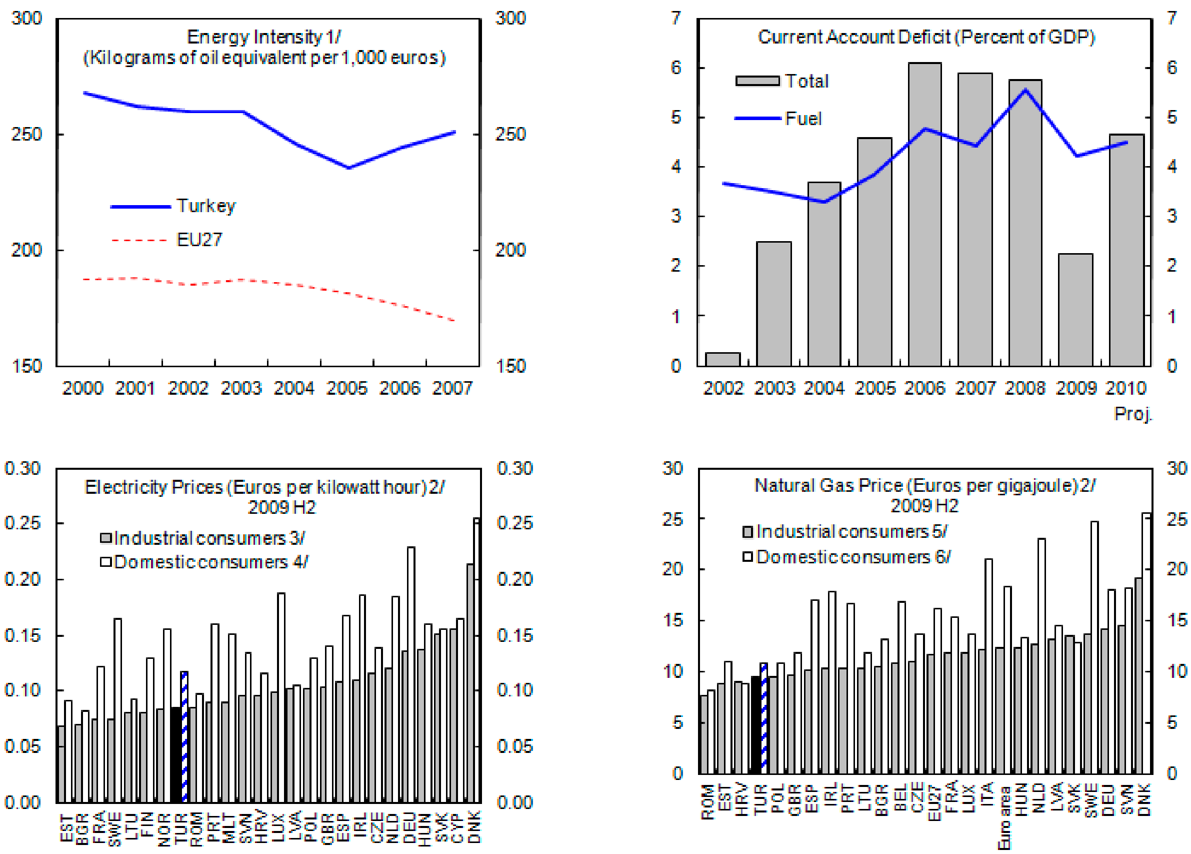


Sources: Eurostat; and IMF staff estimates.
1/ Inflation decomposition a la Mody and Ohnsorge, 2007. Virtual inflation captures the inflation that would prevail if inflation at the level of detailed subitems of Turkey's HICP basket were the same as the respective EU-27 average.
2/ Index "I" excludes food, nonalcoholic beverages, alcoholic beverages, tobacco, and gold.

7. **The current account deficit slumped during the crisis on weak demand, but has recently picked up sharply** (Figure 4). After more than halving to 2¼ percent of GDP in 2009, the current account deficit rebounded strongly since late in the year on surging imports, while exports are growing at a slower pace. Reflecting Turkey's dependence on

[1] The inflation targets for 2009 and 2010 were revised up in mid-2008 from 4 percent to 7.5 and 6.5 percent, respectively, on the expectation of persistent high global food and energy price inflation. The inflation target for 2011 has been set at 5.5 percent.

imported energy and high energy intensity of GDP relative to the EU (likely attributable to relatively low end-user electricity and gas prices), the energy trade deficit has been stable at around 4-5 percent of GDP, in contrast to non-energy imports, which are highly cyclical.



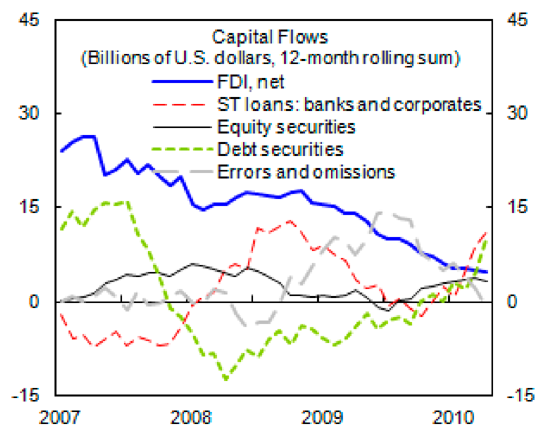
Sources: Eurostat; CBT; and IMF staff estimates.
1/ Gross inland consumption of energy divided by GDP (at constant prices, 1995=100).
2/ Prices include taxes.
3/ Price based on consumption between 2,000 and 20,000 megawatt hours.
4/ Price based on consumption between 2,500 and 5,000 kilowatt hours.
5/ Price based on consumption between 10,000 and 100,000 gigajoules.
6/ Price based on consumption between 20 and 200 gigajoules.

8. **The banking sector displayed considerable resilience to the crisis, helped by a supportive policy environment** (Figure 5). Strong capitalization, minimal FX exposure, primarily deposit-based funding, and adequate liquidity allowed banks to weather the financial and output shocks. Policy responses to the crisis—cuts in policy interest rates and relaxation of regulations on loan classification and provisioning (see below)—helped boost profits and capital ratios through wider interest margins, dampened NPLs (which rose from 3.8 percent of total loans at end-2008 to 5.6 percent of total loans at end-2009),[2] and a shift in assets to zero-risk-weighted government bonds (on expectations of future declines in the

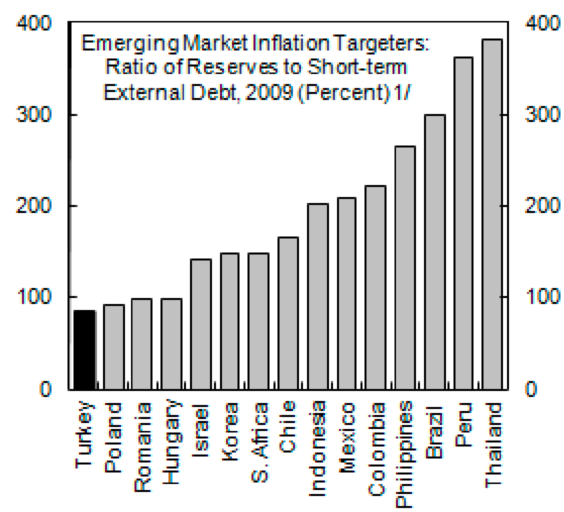
[2] According to the BRSA, although not expected, if all restructured loans were to become non-performing, the NPL ratio would rise to 7.6 percent.

policy rate). As a result, Turkish banks' profits rose 50 percent in 2009, and the average CAR increased to in excess of 20 percent (the two lowest individual bank CARs were 13 and 15 percent). The authorities' stress tests indicate the banking system's CAR would remain above the 12 percent regulatory minimum under severe credit, currency, or interest rate shocks.

9. **Although capital inflows have resumed, their quality has deteriorated since the onset of the crisis**. Since late 2008, the composition of external financing shifted from FDI and longer-term debt to shorter-duration and one-off inflows (errors and omissions in the BoP include drawdown of deposits held abroad by nonbanks and repatriations from a tax amnesty). Reflecting in part lower credit demand, corporates' external indebtedness declined. Turkish financial indicators (nominal exchange rate, equities, CDS spreads) recovered strongly since the start of the emerging market rally in March 2009 (Figure 6).[3] Debt rollover rates on borrowing by banks and corporates have more recently picked up (after correcting for changes in FX lending regulations—Box 3), albeit from depressed levels. With capital inflows having recovered, in August 2009 the CBT resumed daily FX purchase auctions—about US$10 billion to date—halted at the onset of the crisis, in order to continue to build reserves (currently at 82 percent of short-term external debt).



Sources: CBT; and IMF staff estimates.



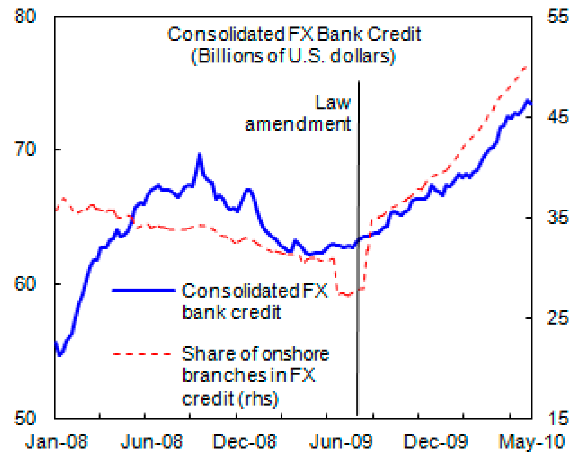
Source: IMF staff estimates.
1/ Ratio of gross international reserves at end-2009 to short-term debt (at original maturity) at end-2009 plus projected amortization of medium- and long-term debt in 2010.

[3] Movements in the lira were also cushioned by households' profit-taking on deposits, whereby deposits were converted from lira into FX (FX into lira) when the lira strengthened (weakened).

Box 3. Impact of Recent Regulatory Changes on FX Loans

Two recent regulatory measures (lifting the ban on onshore FX lending to unhedged corporates, and imposing reserve requirements on syndicated and securitized debt contracted by offshore branches) triggered changes in the size and composition of capital inflows that distort the time series on external debt rollovers and credit growth.

Allowing onshore lending in FX to unhedged firms: The June 16, 2009 amendment permits onshore lending in FX to Turkish firms with no FX income, provided the loan is for at least 1 year and for a minimum of US$5 million, or without any condition on maturity or amount if adequately collateralized by FX deposits in a domestic bank branch or FX-denominated bonds issued or guaranteed by an OECD country government or central bank. Previously, domestic unhedged corporates were not permitted to borrow FX onshore and, to evade this restriction, Turkish banks lent in FX through their offshore branches or issued FX-indexed loans onshore. (As before, households are not permitted to borrow in FX and, with the amendment, are no longer permitted to take out FX-indexed loans.) Following the amendment, which aimed to increase transparency, FX credit is gradually shifting from offshore branches to banks' onshore headquarters (HQ) operations, with the onshore migration expected to proceed in line with the maturity structure of existing offshore loans.



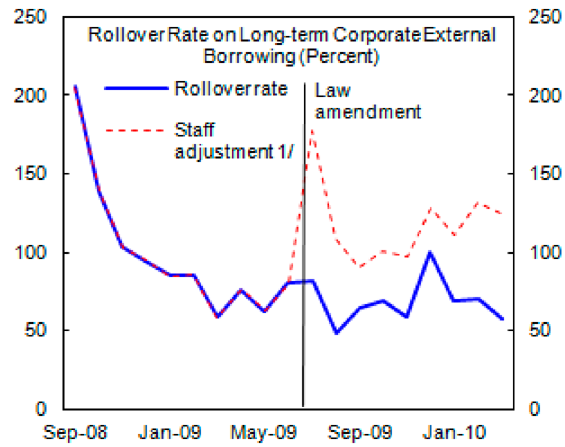
Sources: BRSA; and IMF staff calculations.

Imposing reserve requirements on debt contracted by offshore branches: From the beginning of 2010, all new syndicated and securitized loans contracted by offshore branches are subject to reserve requirements, thereby equalizing treatment with debt contracted by HQ and reducing the incentive for direct foreign borrowing by offshore branches.

As a result of these regulatory changes, the activities of offshore branches will be reduced, but with little impact on the consolidated (on- and offshore) banking sector. Nonetheless, this will create sizable temporary and permanent effects on rollover rates on foreign loans, external debt, and credit growth:

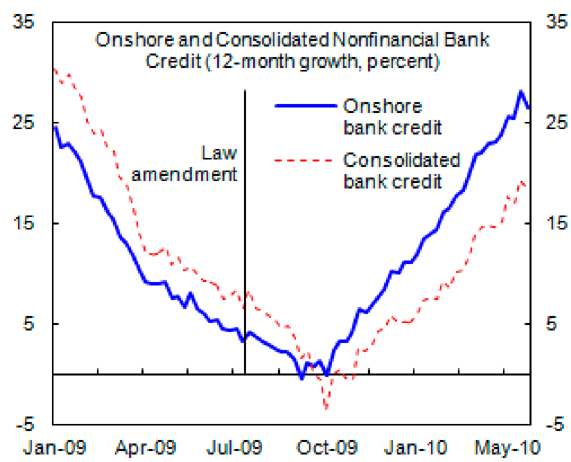
Box 3. Impact of Recent Regulatory Changes on FX Loans (continued)

- Corporates' external borrowing will decline permanently relative to the counterfactual of unchanged regulations (previously, more than a third of corporates' external credit stock reflected loans from offshore branches). Gradual migration to onshore loans will temporarily depress corporate external debt rollover ratios.



Sources: BRSA; and IMF staff calculations.
1/ Staff's adjusted corporate rollover rate uses as its baseline the pre-change share of onshore FX lending in consolidated banking sector FX lending and attributes the subsequent increase in the share to the regulatory changes.

- Onshore (corresponding to the residency concept used in the BoP) banks' external borrowing will permanently increase relative to the no-policy-change counterfactual as they issue directly a larger share of consolidated bank group external debt or—in the event offshore branches continue to issue syndicated loans—receive funds from their offshore branches. During the transition, inflows to HQ banks will increase as offshore branches transfer resources through deposit inflows (drawdown of banks' foreign assets abroad) and/or more syndicated loans are contracted by HQ banks (increasing banks' loan rollover ratio, and mirroring the temporary decline in corporate rollovers).



Sources: CBT, BRSA; and IMF staff calculations.

- Onshore credit growth will temporarily exceed credit growth by the consolidated banking sector, reflecting the shift in origination of FX loans.

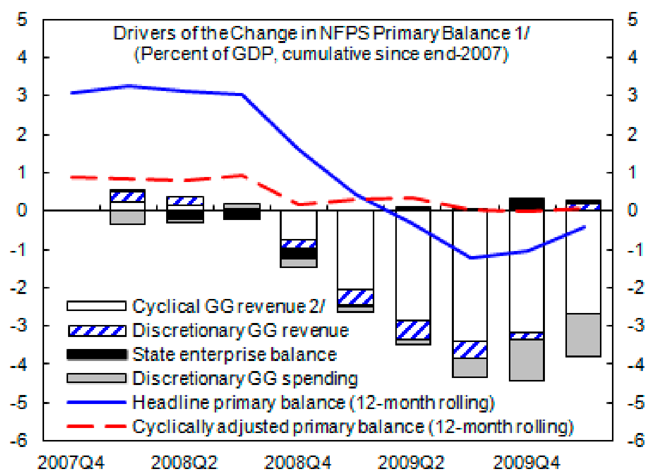
- The *composition* of external debt will shift from corporates to banks. The *level* of gross external debt may also decline to the extent that, prior to the regulatory changes, HQ borrowed abroad directly and onlent to foreign branches to fund loans to corporates (creating two foreign borrowing entries in the BoP—one by the HQ bank and the other by the corporate, in addition to an asset outflow corresponding to the buildup of deposits abroad by the HQ bank). With the migration to onshore FX lending, in most cases, only the HQ bank will borrow abroad.

C. Policy Responses

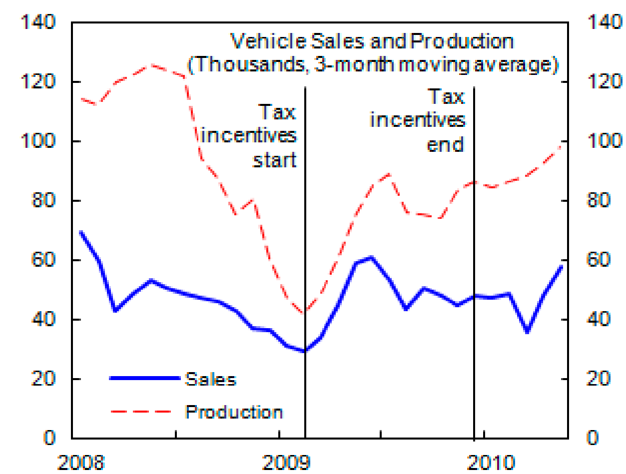
10. **The authorities' macroeconomic policy response to the severe GDP contraction was broadly appropriate in timing and magnitude and made feasible by the previously conservative stance of policies**.

Fiscal policy

11. **Cyclical factors and a structural loosening weakened the fiscal balance from mid-2008 to mid-2009**. Cyclical revenue loss accounted for the bulk of the deterioration in the nonfinancial public sector (NFPS) primary balance. However, an across-the-board discretionary loosening (including a long-planned 5 percentage point cut in social security premiums, a sizable increase in the real wage bill, and increased investment spending), unrelated to the downturn, was already underway when the crisis hit in late 2008. Subsequently, a package of targeted stimulus measures was adopted in early 2009 that included expanded short-time unemployment benefits and temporary tax cuts on purchases of cars and other durables, with the latter effective in boosting demand for these products.

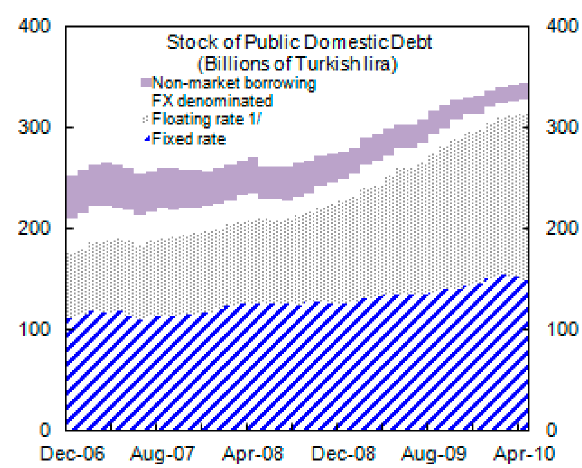


Sources: Turkish authorities; and IMF staff estimates.
1/ NFPS is the nonfinancial public sector.
2/ GG is the general government.



Source: Turkstat.

12. **As a result, public sector balance sheets deteriorated**. The NFPS primary balance declined by 4 percentage points during 2007-09 to a deficit of 1 percent of GDP (although the 2009 outturn was considerably better than anticipated due in part to an unexpectedly strong growth recovery). The debt-to-GDP ratio rose by 6 percentage points to 45 percent (Appendix I). To moderate government funding costs, the share of floating rate debt was increased sharply (mostly inflation-linked bonds).



Source: Turkish Treasury.
1/ Includes inflation-linked bonds.

As a result, interest rates on about 80 percent of lira debt will reset within 12 months.

13. **Since mid-2009, fiscal policy has focused on exiting from stimulus**. The widening spread between the cost of government borrowing and the policy rate raised concerns the rapidly growing deficit was weakening confidence and crowding out the nascent private sector credit recovery. In July 2009, excises on tobacco and petroleum were raised, yielding about 0.5 percent of GDP on a full-year basis, although it further skewed the tax burden toward indirect taxes. A Medium-Term Program (MTP), announced in September 2009, targets gradual fiscal consolidation over the next three years. The 2010 primary deficit target of 0.3 percent of GDP was supported by a zero real wage increase for civil servants, further hikes in already-high excises on petroleum and tobacco, increased healthcare copayments, and reduced payments to drug suppliers. However, an ad hoc increase in low pensions (costing 0.3 percent of GDP per annum) was granted at the beginning of 2010.

Debt and Deficit Targets in the September 2009 Medium-Term Program

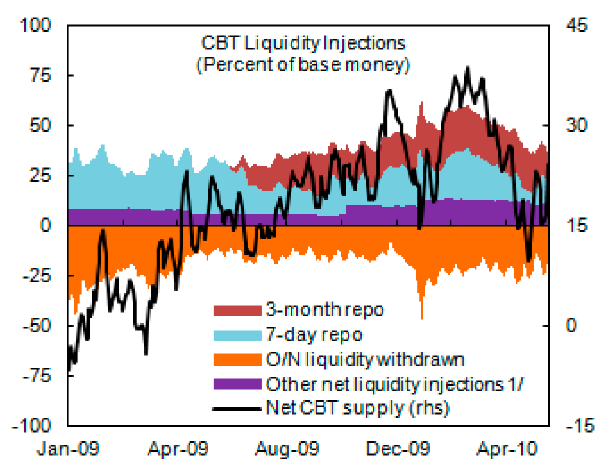
(Percent of GDP, unless otherwise noted)

	2007	2008	2009		2010	2011
	Actual	Actual	September 2009 MTP	Actual	September 2009 MTP	September 2009 MTP
Nonfinancial public sector primary balance	3.1	1.6	-2.1	-1.0	-0.3	0.4
General government debt (EU defined)	39.4	39.5	47.3	45.4	49.0	48.8
Memorandum items:						
Real GDP growth (percent)	4.7	0.7	-6.0	-4.7	3.5	4.0
GDP deflator growth (percent)	6.2	12.0	6.0	5.4	5.0	4.5

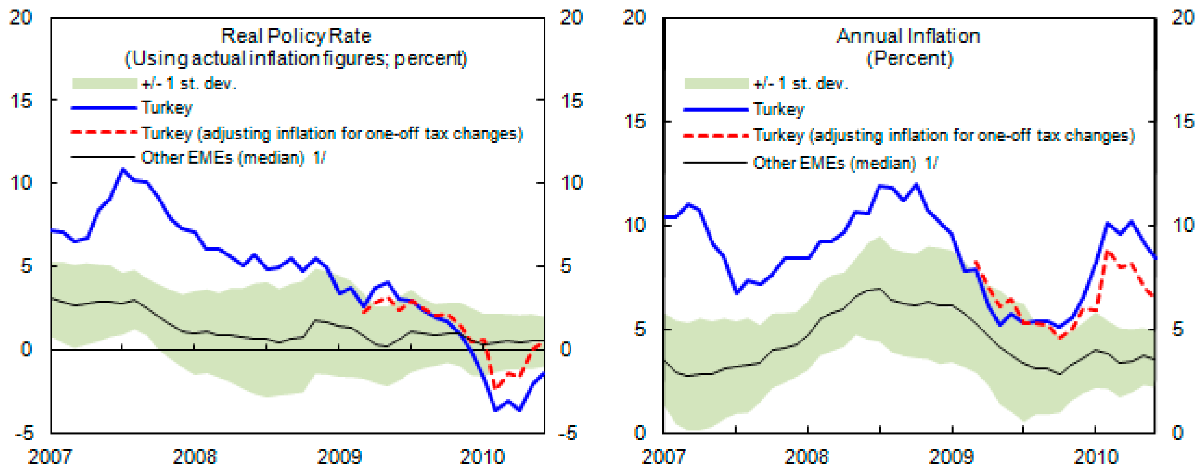
Sources: Turkish authorites; and IMF staff calculations.

Monetary policy

14. **With the prospect of subdued inflation and a rapidly widening output gap, monetary policy was eased aggressively, beginning in November 2008**. The policy rate was cut by a cumulative 10¼ percentage points (10 percentage points in real terms). Lira and FX liquidity were expanded through various operations, including reductions in reserve requirements and extension of repo maturities to three months, making the CBT a large net supplier of liquidity. Turkey's real policy rate is now low given the position in the cycle, even after adjusting for one-off excise increases.

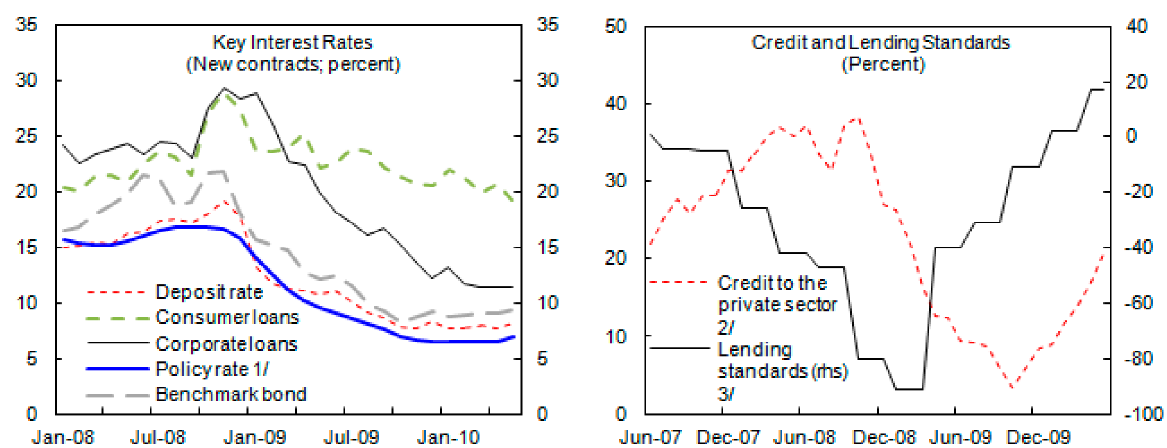


Source: CBT.
1/ Calculated as the net liquidity injection implied by the December, 2008, October, 2009, and April, 2010 changes in the reserve requirement ratios.



Sources: Turkstat; IMF, *World Economic Outlook*; and IMF staff estimates.
1/ Other emerging markets under inflation targeting. The band denotes a one-standard deviation band around the median value on this sample of inflation targeters.

15. **By supporting banks' balance sheets, monetary loosening facilitated renewed credit growth once lending standards eased**. Cuts in the policy rate were transmitted to market rates, but at speeds and pass-through rates that varied across instruments. Rates on corporate lending declined the most, by more than 15 percentage points. However, increased risk aversion and a drop in credit demand initially constrained new lending. In the interim, monetary policy relaxation accommodated fiscal expansion by increasing banks' appetite for government debt. Widening interest margins (especially on consumer credit), together with recovering domestic demand and easing lending standards in the second half of 2009, helped revive credit supply—initially by state banks—which accelerated further to an annualized rate of around 30 percent in the first 5 months of 2010.



Sources: CBT; and BRSA.
1/ The increase in May 2010 corresponds to the switch from the CBT overnight borrowing rate to the 7-day repo as the policy rate.
2/ 12-month credit growth of the consolidated banking sector (both onshore and offshore branches) to the nonfinancial private sector.
3/ Defined as the difference between the percentage of banks that have eased and tightened credit standards.

Financial sector policies

16. **Amendments to prudential regulations aimed to preserve banks' high capital adequacy ratios while encouraging lending**. Measures included regulatory approval prior to payout of bank dividends, a one-time reclassification of banks' holdings of government securities to the investment account, temporary easing of conditions for restructuring loans, and temporary elimination of general provisioning for new loans. The rescission of the ban on some onshore FX lending to unhedged corporates should, on a consolidated basis, have minimal effect on banks' related exposures, whereas the permanent ban on FX-indexed lending to households should reduce this source of indirect FX exposure (text table and Box 3).

Main Measures Affecting the Financial Sector Prudential Framework

Measure	Description	Adoption Date
Reclassification of banks' holdings of government securities	Allowed banks to reclassify on a one-time basis their available-for-sale securities to hold-to-maturity status consistent with changes in international accounting standards, thereby avoiding the need for mark-to-market pricing and recording capital write-downs when securities prices fall	October 2008
Dividend policy	Requires banks to seek approval from the BRSA before distributing dividends	October 2008; extended again in 2010 for 2009 profits
Reclassification of restructured loans	Allows banks to reclassify loans from "less than 90 days overdue" to "performing" if (i) the debtor falls behind because of a "temporary liquidity crunch"; (ii) the loans are restructured; and (iii) a minimum of 3 installment payments—amounting to at least 15 percent of the restructured loan—are subsequently paid; TL 11 billion in loans (about 3 percent of total loans) were restructured under this provision through March 2010	January 2009; extended in March 2010 for another year
Restrictions on FX lending	Allows non FX-earnings companies to borrow in FX from local banks (previously, only FX-earning companies could borrow FX), provided FX loan amount is greater than US$5 million and maturity date is longer than a year; bans consumers from taking out FX-linked loans	June 2009
General provisioning on new loans	Allows banks with CARs above 16 (nearly all banks) to lower their general provisioning rate from one to zero percent for cash loans other than credit cards until March 2011; this provisioning rate had been increased from 0.5 to 1.0 percent as a measure under the last SBA	March 2010

Sources: Turkish authorities; and IMF staff.

D. Political Setting

17. **The political calendar is expected to be quite full over the next two years.** Parliamentary elections are due by mid-2011. The ruling Justice and Development (AK) Party has been in power since 2002. A constitutional reform package was recently approved by Parliament and goes to referendum in mid-September. A presidential election, for the first time by direct popular vote, is due in 2012.

II. Report on the Discussions

A. Macroeconomic Outlook and Risks

18. **There was agreement that growth would be strong in the near term, with a wider current account deficit and above target inflation**. For 2010, strong carryover from a depressed base and robust within-year momentum were expected to propel GDP growth to 6-7 percent. This would be underpinned by private consumption—on account of low real interest rates—restocking, and, to a lesser extent, exports. The current account deficit was expected to widen sharply to close to 5 percent of GDP reflecting mostly the growth recovery, despite a solid increase in export demand. Inflation was projected to be well above the mid-point of the target band at the end of the year. From 2011, annual growth was expected to moderate as favorable base effects dissipate, but with continuing quarter-on-quarter domestic-led growth. Inflation was expected to subside, but the current account deficit was seen as gradually increasing, with external debt rising to more than 50 percent of GDP in 2015. Nonetheless, with only modest remaining exposure to the Fund (SDR 5 billion outstanding), capacity to repay was not seen as a concern (Appendix I).

19. **Risks to near-term growth were seen as broadly balanced, with the unsettled situation in Europe posing a two-way hazard** (Appendix II). Weaker-than-projected export demand from Europe (from slower activity and a more depreciated euro), less funding from EU banks, or a generalized increase in risk aversion may deflate domestic and external demand. Looking forward, in the event of domestic political uncertainty, confidence may also weaken. However, the authorities also noted that Turkey's relatively strong fundamentals and sound policy framework—soon to be supplemented by a fiscal rule—help differentiate Turkey from its regional emerging market peers and may attract larger capital inflows that would boost growth.

20. **Views on longer-term growth prospects were mixed**. The authorities considered that following a temporary dip caused by the recent drop in investment and factor productivity growth, potential growth could reach 5 percent in the medium term provided adequate stable long-term capital inflows were secured to finance investment and technology transfer. The mission expected growth in the medium term to be around 4 percent (average growth over the last decade was 3.7 percent), supported on the one hand by sound balance sheets and potential for income convergence, but restrained by weak external competitiveness and labor market inefficiencies. Removing these obstacles could therefore improve medium-term growth prospects.

B. Current Account Deficit, Competitiveness, and External Stability

21. **Officials attributed the high correlation between growth and the current account deficit to structural factors**. They saw the cross-border nature of vertically-integrated production, dependence on imported energy, and a low saving rate brought by the large share of below-working-age population as supporting a relatively high level of the current account deficit. Relative prices were seen as playing a modest role, consistent with results of a survey on the reasons firms demand imported intermediate goods which found that, on average, respondents assigned a 20 percent weight to cost factors and an 80 percent weight to

structural factors that are less likely to respond to changes in the real exchange rate (e.g., lack of or limited domestic supply, vertically integrated production structure of multinational firms, and credits provided from abroad). The survey also found that the cost of intermediate inputs is not only related to the exchange rate, but also to the foreign trade regime (e.g., the inward processing regime implemented to promote exports and the customs union).[4] They noted that, given the trend nature of the CPI-based real exchange rate, it was therefore not surprising it was nearing its historical peak, but that 2½-3 percentage points of the annual increase reflected productivity enhancements in the tradable sector that entail no loss of labor cost-based competitiveness (Balassa-Samuelson effect). Moreover, attempting to depress the nominal value of the lira (while not seen as a feasible strategy—see below) would, in any event, fail to durably improve competitiveness given high pass-through to wages and prices. Increasing participation in individual retirement plans and the gradual increase underway in retirement ages were seen as raising the saving rate.[5]

22. **The mission saw inadequate competitiveness as an important contributor to the high import elasticity of growth**. The cyclical sensitivity of imports is apparent from the faster growth of imports than domestic demand and GDP during the pre-crisis boom, and from the much sharper import drop during the downturn. The mission noted the survey responses could be interpreted as suggesting locally-sourced products had been forced out of (or had never entered) the market because they could not compete, causing firms to rely heavily on imported intermediates and depressing domestic value-added in final production. Moreover, growth in consumption had also become more skewed toward imports at the same time the real exchange rate had been appreciating. Regarding energy dependence, while structural reforms are needed to moderate demand for imported energy (see below), in the interim, competitiveness should be strengthened to generate sufficient export earnings to cover the cost of energy imports and avoid excessive external debt.[6] Staff sees Turkey's current account deficit norm at around 2½ percent of GDP, consistent with a considerable competitiveness gap (Box 4).

[4] The CBT's survey of large industrial firms found the share of imported intermediate goods had increased by 10 percentage points during 2002-07 to 62 percent due to: (i) inadequate quantity and/or quality of domestic alternatives; (ii) input sourcing decisions taken at headquarters by multinational companies; (iii) a shift from labor- to capital-intensive products but without a corresponding increase in capacity to produce capital-intensive intermediates; and (iv) particularly in labor-intensive sectors, resort to cheaper imported intermediate and investment goods (about 30 percent of respondents).

[5] Currently, many individuals start receiving social security pensions in their late 40s. However, reforms in 1999 and 2008 are slowly raising the minimum retirement age, so that most persons will be retiring at age 65 by the 2060s.

[6] This contrasts with temporary structural factors, such as income convergence and a young population, that support a higher current account deficit norm today in view of the future improvement in export potential they will generate to facilitate repayment of previously accumulated external debt.

Box 4. External Competitiveness

From several perspectives, Turkey is experiencing a considerable competitiveness gap:

- Based on **CGER-type assessments**, staff estimates that Turkey has a considerable competitiveness gap, based on the results of the three standard methodologies. The current account norm (-2.4 percent of GDP) reflects mainly Turkey's low old-age dependency ratio (supporting a high saving rate), but that is partially offset by a sizable per-capita income differential and fast-growing population (pushing up investment and lowering saving).

- **REER price-based indices** increased considerably in recent months owing to nominal appreciation and persistent inflation differentials. Both the CPI- and PPI-based REERs rose by about 9 percent during December 2009-June 2010, approaching their historical peaks.

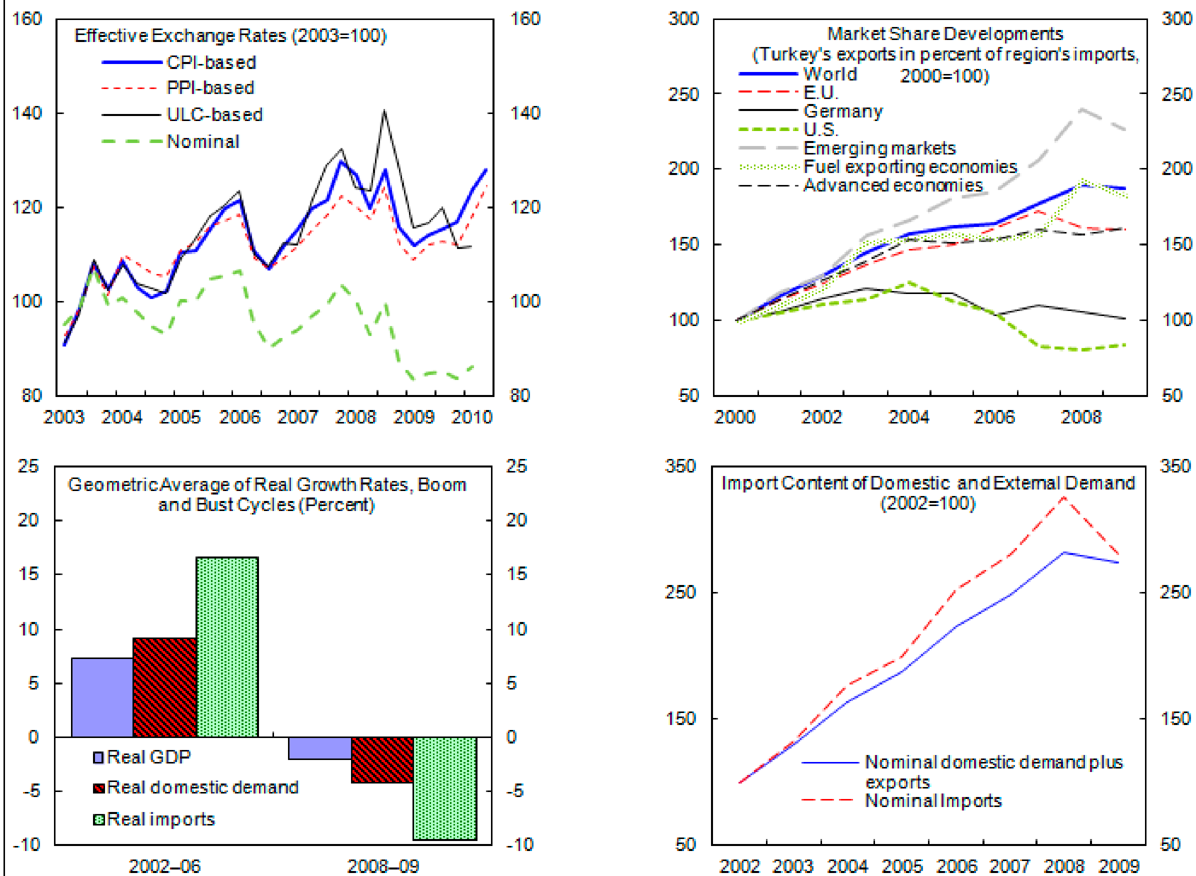
- The **ULC-based REER** index dropped by about one-third during mid-2008 to Q1 2010, deviating from its previous tendency to co-move with price-based REERs and signaling a significant improvement in labor competitiveness, although the current level remains 12 percent above the 2003 level.[1/] Given recent increases in employment and the rising minimum wage, the decline in the ULC REER suggests that (consistent with reports heard by the mission) since the onset of the crisis, firms have shifted part of their workforce—or part of the activities of individual workers—to the informal sector in order to save on labor costs and increase employment flexibility. There is, however, a limit to the future savings that can be obtained through this strategy.

- The **market share of Turkey's exports** in major advanced country imports has been stagnant in recent years. Moreover, recent declines in penetration of emerging market and fuel exporters' markets have started to reverse the significant gains of earlier years.

- While **export growth** has been fairly rapid during the pre- and post-crisis periods (which may be suggestive of strong competitiveness), the import content of domestic demand and exports has risen steadily, implying a declining domestic content in products destined to satisfy domestic and external demand. This reflects in part the assembly-type nature of Turkey's rapidly expanding sectors, including transport vehicles. As a result of the low domestic content, these industries may be footloose and, as experience in Central and Eastern Europe shows, willing to uproot to more competitive countries.

[1/] The ULC REER data was first published by the CBT in July 2010.

Box 4. External Competitiveness (cont.)



Sources: CBT; Turkstat; IMF, *Direction of Trade Statistics*; and IMF staff estimates.

23. **With growth resuming, the Turkish economy has reverted to its pre-crisis unbalanced path, even as global and domestic uncertainties have resurfaced.** A small fraction of the global flood of liquidity is making its way to Turkey, fuelling credit, boosting consumption and investment, and financing imports. The mission noted that while fewer inflows would reduce the current account deficit, with growth dependent on imports, this would severely depress activity. Therefore, low reserve cover and the shorter duration of capital inflows constitute important risks to the stability of financing and GDP. In addition, persistent inflation differentials may promote a cycle of real overvaluation and even greater import dependence that would eventually drag down growth. Typically, such cycles do not unwind gradually, and the external financing needed to sustain them—particularly if short term—will be sensitive to risk perceptions. To ameliorate these concerns, the mission urged decisive action to strengthen competitiveness.

C. Policies

24. **The policy discussions focused on ways to enhance growth performance and reduce vulnerabilities**. The authorities emphasized the appropriate timing and pace at which to withdraw policy stimulus, including through implementation of the new fiscal rule. The mission advocated countercyclical macro policies to contain the current account deficit and inflation, together with structural reforms to improve competitiveness and reduce dependence on imports. A policy mix that emphasizes early fiscal adjustment was seen as moderating the need for monetary tightening that, in the presence of large, interest-sensitive capital flows, could otherwise compromise the external objective.

Fiscal policy

25. **With the authorities expected to review their fiscal targets in the coming weeks, the mission urged avoiding a procyclical policy stance in 2010.** Staff expected revenue to overperform considerably because: (i) the 2009 revenue outturn was 0.9 percent of GDP higher than assumed in the 2010 budget; and (ii) 2010 nominal GDP growth is projected to be 6 percent higher than budgeted. Staff urged the authorities to save revenue overperformance by adhering closely to budgeted spending levels and maintaining current tax and formula-based energy pricing policies.[7] Under staff's revenue projection, this would improve the primary balance to at least 0.6 percent of GDP (compared to the current target of -0.3) and ensure a sizable structural improvement. Such an approach would help contain the current account deficit and inflation pressures, while limiting private sector crowding out, promoting the new fiscal rule's success by reducing required adjustment in 2011 (see below), and reinforcing Turkey's fiscal discipline credentials. Given heightened global uncertainties and a desire for prudent forecasting, the authorities indicated they do not intend to revise up significantly their revenue projections and did not indicate how a substantial revenue overrun—should it arrive—might be deployed.

[7] Under staff's recommended approach, nominal spending in the budget would be augmented only for the ad hoc January 2010 pension increase, formula-based increases in revenue sharing with local governments, and mandatory inflation-indexed increases in wages and pensions.

Selected Fiscal Variables, 2008–10

(Percent of GDP, unless otherwise noted)

	2008	2009		2010		
		Original MTP 1/	Actual	Original MTP 1/	No saving revenue overperformance 2/	Saving revenue overperformance 3/
Nonfinancial public sector						
Primary balance	1.6	-2.1	-1.0	-0.3	-0.3	0.6
Cyclically adjusted primary balance 4/	0.2	-0.6	0.0	0.8	-0.2	0.8
Fiscal effort 5/	-0.7	-0.8	-0.2	1.4	-0.2	0.8
Cumulative fiscal effort from 2008 5/	…	-0.8	-0.2	0.7	-0.3	0.6
Overall balance	-2.8	…	-5.6	…	-4.1	-3.3
General government debt (EU defined)	39.5	47.3	45.4	49.0	44.1	43.1
Memorandum items:						
Real GDP growth (percent)	0.7	-6.0	-4.7	3.5	6.1	6.1
GDP deflator growth (percent)	12.0	6.0	5.4	5.0	8.2	8.2

Sources: Turkish authorites; and IMF staff calculations.

1/ Numbers in the authorities' September 2009 Medium-Term Plan (MTP). Cyclically adjusted balances are imputed by staff.
2/ Assumes the authorities maintain the 2010 primary surplus target in the MTP of -0.3 percent of GDP (under staff's macro which assumes higher-than-budgeted growth and revenue).
3/ Assumes the authorities stick to budgeted limits for discretionary spending in 2010 and save all revenue overperformance above inflation adjustments to pension and wages, obligatory local government transfers, and the Jan. pension increase.
4/ Percent of potential GDP. Cyclical adjustments are made using staff's assumptions for potential growth and the cyclical sensitivity of the primary balance.
5/ Fiscal effort is defined as the change in the cyclically adjusted primary balance.

26. **From 2011, the government will apply a deficit-based fiscal rule, which it viewed as a major addition to Turkey's institutional framework—on a par with central bank independence and inflation targeting**.[8] The proposed rule requires (allows) a specific amount of tightening (loosening) each year in proportion to how far the overall deficit is above (below) the medium-term target (set at 1 percent of GDP) and GDP growth is in excess (falls short) of its average long-term real growth rate (set at 5 percent) (see Appendix III). The rule binds the general government, with a separate balanced budget requirement for the state enterprise sector. Accompanying improvements to public financial management procedures include more transparent and comprehensive reporting of fiscal projections and outturns, some tightening of oversight over local government borrowing, and elimination of some loopholes to deliver spending outturns more in line with the target.

27. **Staff agreed the rule provides a prudent anchor, but urged further reforms to underpin implementation**. With the parameters chosen by the authorities, the deficit and debt are expected to moderate under a wide range of scenarios notwithstanding that, with a value of 5 percent, the average long-term real growth rate exceeds staff's estimate of medium-term growth.[9] Regarding 2011, if—as recommended—most 2010 revenue overperformance is saved, no additional fiscal adjustment would be needed to meet the 2011

[8] Fiscal rule legislation has been submitted to parliament and is expected to be approved by end July.

[9] This is because the entire set of parameters collectively determines the targets set by the rule.

target, but if overperformance is not saved, 0.3 percent of GDP of new measures would be required (Box 5).[10] However, with the rule setting only a ceiling on the deficit, consideration should be given to doing better than the rule to address current account and inflation concerns while relieving the burden on monetary policy. Further improvements to the implementing framework are needed to safeguard the target, including mechanisms to ensure timely implementation of within-year corrective measures, strengthen fiscal coordination between central and local governments, and encourage conservative budget forecasts. However, strength of commitment will ultimately determine the success of the rule.

28. **The authorities recognized the fiscal rule was not a substitute for needed structural reforms**. The authorities reported that tax administration was being strengthened by increasing the number of auditors and through pending legislation to institute mechanisms to promote more uniform and transparent tax opinions. Staff noted that the Revenue Administration would also benefit from increased budget flexibility and urged that these enhanced capacities be used to increase scrutiny of wage reporting in conjunction with the Social Security Institution, while ensuring continued improvements in audit procedures and evenhandedness across all tax payers to promote better voluntary tax compliance. In addition, the mission urged continued implementation of measures to control healthcare, wage, and pension expenditure. Indeed, restraining public sector wage growth could also help moderate private sector wages. Staff regretted the ad hoc pension increase in January 2010 that breached the CPI indexation principle established in the 2008 social security reform and essential to support pension system sustainability. The authorities confirmed they intend to apply only CPI indexation for the semi-annual July 2010 increase.

Monetary and exchange rate policies

29. **The CBT views its post-crisis exit strategy, which focuses on normalizing liquidity conditions, as distinct from short-term interest rates decisions taken to bring inflation into line with medium-term inflation targets**. With the CBT's daily FX purchases providing a stable supply of lira liquidity and reduced risk of liquidity disruptions, the CBT intends to gradually withdraw the exceptional liquidity support it supplied during the crisis. The pace of withdrawal will be determined flexibly in response to market conditions, including possible spillovers from external events. Initial steps have been taken, with a modest reduction in the amount of short-term repo funding and a small increase in the FX reserve ratio and, as a result, market interest rates have begun to pick up slightly. Further

[10] The draft fiscal rule legislation requires general government deficits to be measured according to ESA-95 accounting principles. This will entail discrete changes to the fiscal numbers currently reported by both the authorities and Fund staff. For example, privatization receipts will be removed from the authorities' definition of revenue, while state bank dividends will be added to the staff definition (developed under previous SBAs for program monitoring purposes). Net differences with staff's definition are expected to be less than 0.3 percent of GDP. The transition to the new definition should be managed carefully to ensure transparency.

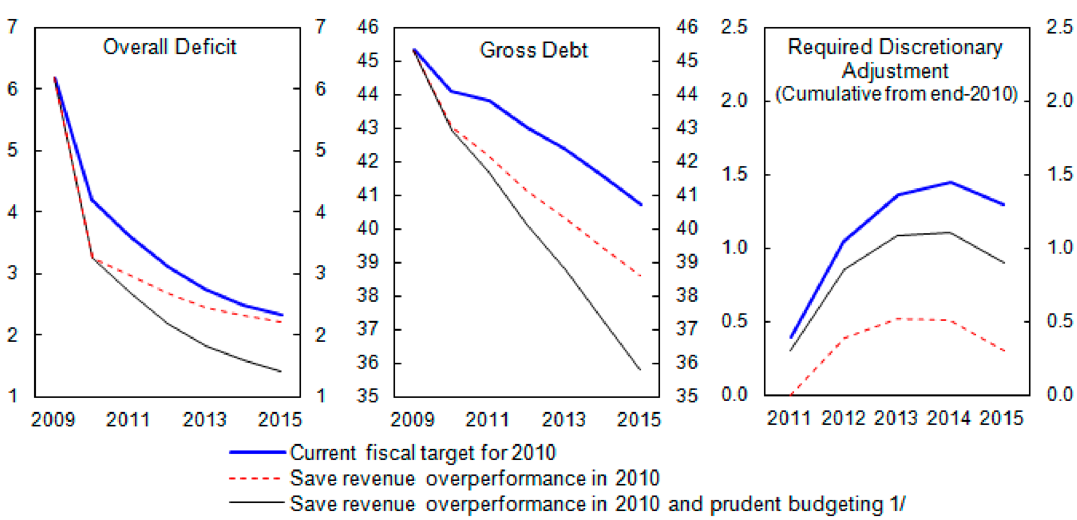
adjustments in reserve requirements will be implemented if credit growth is excessive and a risk to macroeconomic stability.

Box 5. Near-Term Implications of the Fiscal Rule

How fiscal policy is implemented in 2010 and how the rule's ceiling is treated will affect the fiscal paths:

- If the current fiscal target for 2010 (-0.3 percent of GDP) is maintained, reducing the general government overall deficit from around 4¼ percent of GDP in 2010 to 2¾ percent of GDP by 2013 as dictated by the rule requires cumulative discretionary ("discretionary" because the rule automatically adjusts for the growth cycle) adjustment of 1.3 percent of GDP. This would reduce the general government debt ratio by about 2 percentage points.
- If most revenue overperformance in 2010 is saved, deficit targets during 2010–13 would be lower and the debt reduction would be larger, but the needed cumulative discretionary adjustment during 2011-13 would be limited to 0.5 percent of GDP.
- With the rule only setting a ceiling on the deficit, fiscal policy is permitted to be tighter than the rule. This may be warranted if economic conditions prevail that are not captured by the rule (such as financing constraints or current account considerations). In any event, good practice suggests the ceiling should be treated as a "third rail" that is typically overperformed. Doing so requires prudent budgeting and adequate buffers to ensure the rule is met under most contingencies. If such mechanisms lead to overperformance against the rule by 0.3 percent of GDP per year on average and if revenue overperformance in 2010 is saved, the discretionary adjustment required during 2011-13 would still be smaller than in the baseline, but with much faster debt and deficit reduction.

General Government Debt, Deficit, and Adjustment Paths Under Possible Fiscal Rule and Different Policies (Percent of GDP)



Sources: Turkish authorities; and IMF staff estimates.
1/ Assumes that prudent budgeting (to ensure the rule is met) results in average overperformance against the rule of 0.3 percent of GDP per year.

30. **With inflation expectations above-target amid strong credit and domestic demand growth, the CBT intends to initiate a limited tightening of monetary policy to gradually bring inflation back to target**. The CBT expects the recent spike in inflation to moderate as temporary factors dissipate and some product market rigidities are relaxed. Nonetheless, with domestic demand growing more rapidly than external demand and the output gap in the nontradables sector nearly closed, the CBT expects to increase policy interest rates beginning in the last quarter of 2010, with the timing and magnitude dependent on domestic and international developments.[11] CBT officials viewed credit as the main transmission channel for monetary policy, with an increase in the policy interest rate moderating demand for new loans and, hence, demand for locally-made products. As a result, nontradables inflation would be dampened, but leaving the nominal exchange rate and capital flows little affected. While tightening would also be consistent with the CBT's financial stability mandate, monetary policy officials saw potential for more restrictive fiscal and macroprudential policies to moderate domestic demand, thereby limiting the need to raise policy interest rates. Going forward, they saw the fiscal rule as improving the predictability of monetary policy.

31. **The mission considered that a more accelerated reversal of monetary stimulus was warranted under its baseline**. Policies are needed to moderate credit growth to further dampen inflation expectations and keep the current account deficit in check. This task is made more difficult by surplus global liquidity and low interest rates in the advanced economies. But delaying may necessitate an even sharper response that creates further complications by attracting large short-term inflows and hurting banks because of their maturity mismatches. Therefore, a broad-based monetary tightening—through reversal of CBT liquidity support and a series of small increases in the policy rate—should be brought forward. An even faster monetary tightening would be needed if the required fiscal adjustment on a cyclically-adjusted basis is not forthcoming. However, in the event global growth appears sets to slow sharply (which—consistent with the WEO—is not staff's current baseline), there was agreement that monetary tightening could be halted and possibly reversed.

32. **Parties agreed on the need to further accumulate reserves, but opinions differed on whether to step up the amount of regular pre-announced FX purchases**. The mission noted that with the duration of debt becoming shorter, reserve cover of short-term debt would recover only slowly under current auction amounts. Therefore, should capital inflows remain stable or strengthen, the amount of daily preannounced FX purchases—within the current floating exchange rate regime—could be increased modestly (but keeping the amount small relative to daily interbank FX turnover) to more quickly accumulate reserves, as well as lean against a compression of tradables prices that would further push demand toward imports.

[11] Subsequent to the mission, the CBT indicated that in view of slowing exports to Europe and the recent decline in inflation, low levels of interest rates can be maintained for a long period.

However, the CBT was wary of this strategy unless accompanied by larger, more stable, inflows. Moreover, they doubted whether this would deliver a weaker lira since stepping up significantly the amount of reserves would boost confidence and attract more inflows that would tend to make the currency a one-way bet, particularly if the purchases were sterilized.

Financial sector policies

33. **Better coherence between monetary and financial sector policies could be achieved by quickly phasing out relaxed regulations on general provisioning and classification of restructured loans**. The authorities saw maintaining these measures until 2011 as necessary to encourage banks to roll over existing loans. The mission is of the view that while temporary easing of prudential norms may have been appropriate in the midst of the crisis to discourage panic responses, recent extensions and broadening are unwarranted amid rapid credit growth. Moreover, relaxation of prudential regulations obscures assessment of asset quality and understates NPL ratios, which may also be supported by temporarily low real interest rates. It also weakens sound risk management practices by banks that are essential to avoiding a deterioration in fundamentals as lending is expanded to offset the impact of falling interest margins on profits.

34. **Several other recent and prospective changes to Turkey's prudential framework were discussed**:

- *Credit card debt:* In view of the high NPL rate on credit card debt (about 10 percent), the mission endorsed the proposal to disallow increases in credit limits if the cardholder is unable to consistently make on-time payments of the monthly minimum balance due.

- *FX lending*: The mission welcomed the 2009 prohibition on FX-indexed lending to households. They noted that lifting the restriction on onshore unhedged large-volume lending in FX may only represent a shift from offshore branches, but cautioned that lending in FX to unhedged firms—even prominent companies—is risky given global uncertainties and the prevailing competitiveness gap. The mission advocated assigning higher-than-standard risk weights on FX loans to unhedged businesses and requiring banks to report to the BRSA the volume of such lending and associated loan performance on a monthly basis.

- *Banks' issuance of lira-denominated bonds*: While the BRSA's recent refusal of banks' request to issue lira bonds helps limit banks' reliance on possibly volatile wholesale funding, it also hampers their ability to reduce their maturity mismatch and discourages longer-term lending. The mission therefore supported the BRSA's intention to reconsider this ban once uncertainty in Europe abates. They cautioned, however, that with much of this new funding expected to be funneled to mortgage lending—thereby making such credit accessible to a new class of borrower—the

BRSA should closely oversee banks' internal assessments of this category of credit risk and ensure appropriate norms are applied on borrowers' debt servicing capacity, complementing existing protections.[12]

- *Too big to fail*: While Turkey's banking sector is not especially concentrated (the three largest private banks account for around 40 percent of sector assets and the largest bank is state owned), the authorities were keen to address possible risks from concentration, drawing on the ongoing international dialogue on systemically important financial institutions. The mission advised that policies be calibrated to Turkey's specific circumstances and phased in gradually to limit possible disruptions in the financial system.

35. **Important aspects of a sound framework for financial sector supervision, contingency planning, and crisis management are in place, but some additional measures are recommended**. With increased regional financial stability risks, bank-by-bank data on lira and FX liquidity requirements are collected daily and interactions with European supervisors have increased. Domestically, cooperation and exchange of information between relevant government and supervisory institutions have also been stepped up. Further improvements should be made by: (i) incorporating into stress tests the indirect effects of market risk on banks' credit portfolios to provide a more accurate assessment of banks' resilience, while also employing more complex scenarios (such as possible direct and indirect implications of unsettled international financial markets); (ii) better collecting and monitoring of data on unlisted companies—which comprise the vast majority of the business sector and account for a large share of direct foreign borrowing—to help identify systemic vulnerabilities in a timely manner; and (iii) implementing regulatory and legislative changes to expedite resolution of failed banks—a key recommendation of the 2007 FSAP (Appendix IV). The authorities have requested an FSAP update for 2011.

Structural reforms

36. **The authorities viewed rapid economic growth, combined with lower labor taxes, as essential to creating employment**. Policies instituted to encourage job creation include a permanent 5 percentage point cut in employers' social security premiums and increased funding for active labor market policies. However, permanently reducing unemployment was seen to depend on sustaining high GDP growth rates and, over the longer term, better tailoring education to employers' needs.

37. **The mission interpreted the downward rigidity of unemployment as indicative of inefficiencies in the labor market and urged actions to promote job-rich growth and enhance competitiveness**. Turkey's high minimum wage, generous severance pay scheme,

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[12] The 2007 mortgage law established a maximum loan-to-value ratio of 75 percent for residential mortgages and 50 percent for commercial mortgages.

and tight restrictions on temporary employment contribute to the low domestic content of production by encouraging firms to substitute imported capital and intermediate goods for labor and domestically sourced inputs. To promote job creation in the formal sector and enhance competitiveness of exporters—which are more likely than other firms to operate in the formal sector—formal sector labor costs and regulations should be reduced to better align them with practices in comparable EU and OECD countries, accompanied by efforts to shrink the shadow economy. This would avoid a drop in tax collections that may result from minimum wage restraint (since many workers declare only the minimum wage rather than their true income), and a permanent improvement in tax compliance could support a revenue-neutral cut in labor and other taxes borne by producers.

38. **Structural policies could also narrow the current account deficit by increasing fiscal savings to be used for competitiveness-enhancing tax cuts or deficit reduction beyond that required by the fiscal rule**. Accelerating the phase-in of higher retirement ages (currently, many individuals start receiving social security pensions in their late 40s) would reduce pension spending and increase formality by delaying the transition from employment in the formal sector to working as a pensioner in the shadow economy. Sustained and uniform application of energy pass-through pricing formulas would also narrow the current account deficit by increasing fiscal savings and reducing dependence on imported energy.

III. Staff Appraisal

39. **Far-reaching reforms and solid macroeconomic policies instituted in the aftermath of Turkey's 2000-01 crisis paid invaluable dividends during the recent global financial crisis**. Persistent fiscal primary surpluses, conservative monetary policy in the context of inflation targeting, and overhaul of banking supervision and regulation helped contain pre-crisis vulnerabilities relative to other countries in the region. Healthy balance sheets of banks and households, supported by the reflow of international capital and the authorities' decisive policy response made possible by the previously prudent stance of policies, prompted an early and robust credit-led rebound.

40. **Sustaining the recovery while limiting external imbalances requires bringing forward the exit from crisis-related stimulus and implementing reforms to moderate import dependence**. Policies should restrain domestic demand and lower the cost of formal sector employment. With relaxed monetary policy in advanced countries creating a large pool of interest-sensitive capital flows and with inflation pressures moderating at home, emphasis should be on structural reforms, fiscal restraint, and macro-prudential policies. Indeed, if Turkey's recovery falters due, for example, to increased risk aversion or weaker global demand, halting or even reversing the monetary tightening would be appropriate, but structural reforms and fiscal consolidation on a cyclically adjusted basis should continue to maintain confidence in external and fiscal sustainability.

41. **Further unwinding the recent fiscal stimulus is needed to contain domestic demand and promote fiscal sustainability**. For 2010, saving revenue overperformance in excess of mandatory spending increases while maintaining existing tax policies and the energy pricing formula is warranted to avoid procyclicality and promote domestic saving. It would also limit the need to sharply tighten monetary policy, promote successful implementation of the fiscal rule in 2011—its inaugural year—by reducing the required adjustment next year, more quickly moderate public debt, and signal the government's commitment to avoid pre-election spending.

42. **The new fiscal rule is an important addition to Turkey's policy framework, but fully realizing its disciplining role requires continuous political commitment and adequate supporting savings**. The rule's formulation, choice of parameters, and comprehensiveness of institutional coverage will together establish prudent, feasible, and appropriately countercyclical deficit ceilings. Envisaged improvements in transparency and elimination of spending loopholes are welcome. However, the framework should be further strengthened by ensuring prudent forecasts, timely implementation of within-year corrective measures, and improved coordination within general government. With only reputational sanctions, strong political backing and sufficient measures will be essential to sustain the rule. Evenhanded strengthening of tax administration and containment of spending pressures, including through a possible accelerated phase-in of higher retirement ages, will therefore be needed.

43. **Bringing forward a moderate tightening of monetary conditions could obviate the need for a sharper and larger tightening later on**. A delayed tightening could be counterproductive by attracting sizable capital inflows and be detrimental to banks because of their maturity mismatch. Tightening should be broad based with the aim of raising real borrowing costs and moderating inflation expectations. Greater recourse to contractionary monetary policy—with its attendant risks—would be needed if the appropriate fiscal adjustment is not forthcoming.

44. **Modestly increasing regular FX purchases would accelerate reserve buildup at a time when the quality of external financing has declined**. This would not compromise the freely flexible exchange rate—which staff strongly endorses— under the inflation targeting framework or create expectations of one-way currency movements. It could, however, give support to external competitiveness by leaning against the wind of lira appreciation.

45. **Financial sector forbearance measures should be quickly phased out and macroprudential tools strengthened**. With credit growing at a rapid clip, relaxed regulations on loan classification and provisioning are unnecessary and could impede an accurate assessment of credit quality and encourage imprudent lending decisions. Future risks should be averted by tightening regulations on credit card debt limits, increasing risk weights on lending in foreign currency to unhedged firms, and ensuring banks apply sound

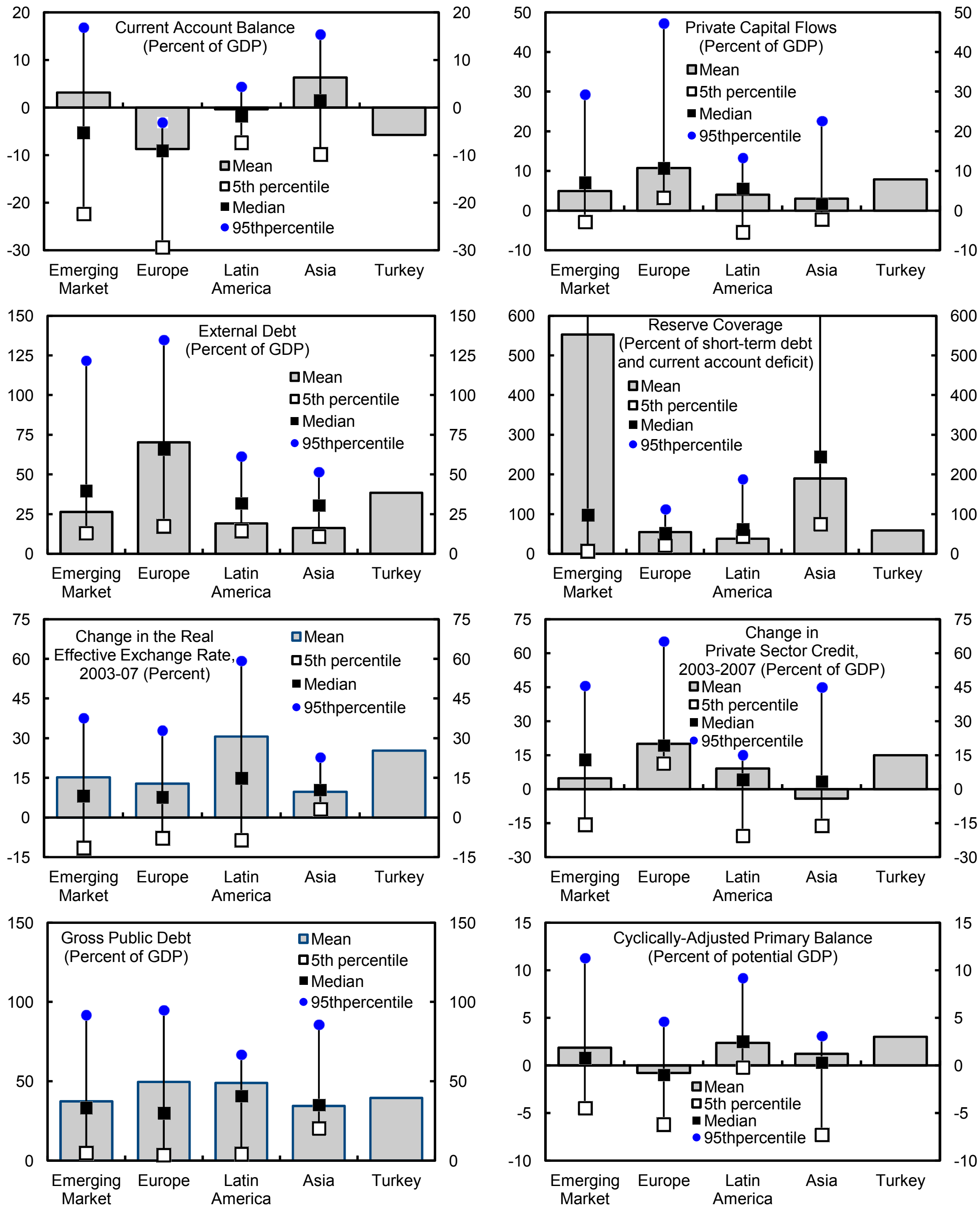
debt service limits on mortgage borrowers. Doing so would also enhance coordination with, and strengthen the effectiveness of, monetary policy.

46. **Further improvements in supervision and crisis management are needed, while changes in regulations may be warranted to reflect initiatives at the international level**. Stress tests should be updated to better reflect the indirect impact of market risk and utilize more realistic shock scenarios. Capacity to respond to bank distress, including the legal authority to resolve a troubled bank, should be strengthened. Any amendments to the regulatory framework to reduce the risk from systemically important institutions should be tailored to Turkey-specific conditions and introduced gradually to avoid unnecessary dislocation.

47. **Reducing dependence on external savings requires rebuilding competitiveness and moderating demand for energy imports**. Better aligning Turkey's productivity-adjusted employment costs with those of regional peers would foster formal-sector jobs and reduce the import content of production. Doing so requires lowering the minimum wage (especially in low-income regions), scaling back severance benefits, and allowing more flexible work practices. This approach would be more effective and less distortive than the current practice of selective tax breaks. Realigning the minimum wage should be accompanied by better tax enforcement to avoid a drop in revenue on account of the high proportion of tax filers who declare the minimum wage. A permanent increase in tax revenue would also facilitate a revenue-neutral cut in labor and other business taxes. Sustained, uniform application of the energy cost pass-through pricing formula would promote conservation and investment in more efficient generation capacity and in renewables, thereby moderating demand for imported energy.

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

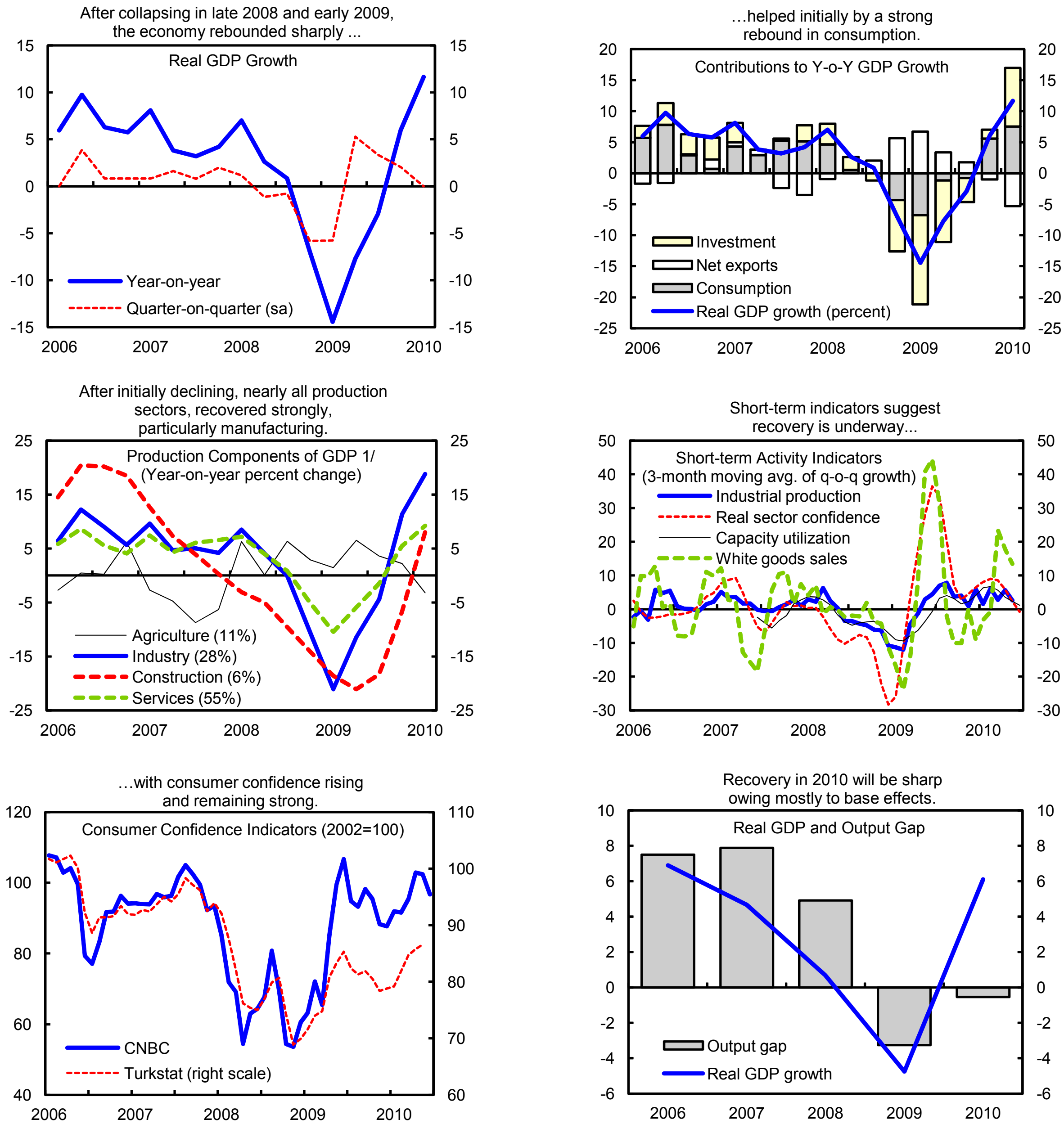
Figure 1. Turkey: Pre-Crisis Strengths and Vulnerabilities, 2007 1/



Source: IMF, *International Financial Statistics*; IMF, *World Economic Outlook*; and IMF staff calculations.

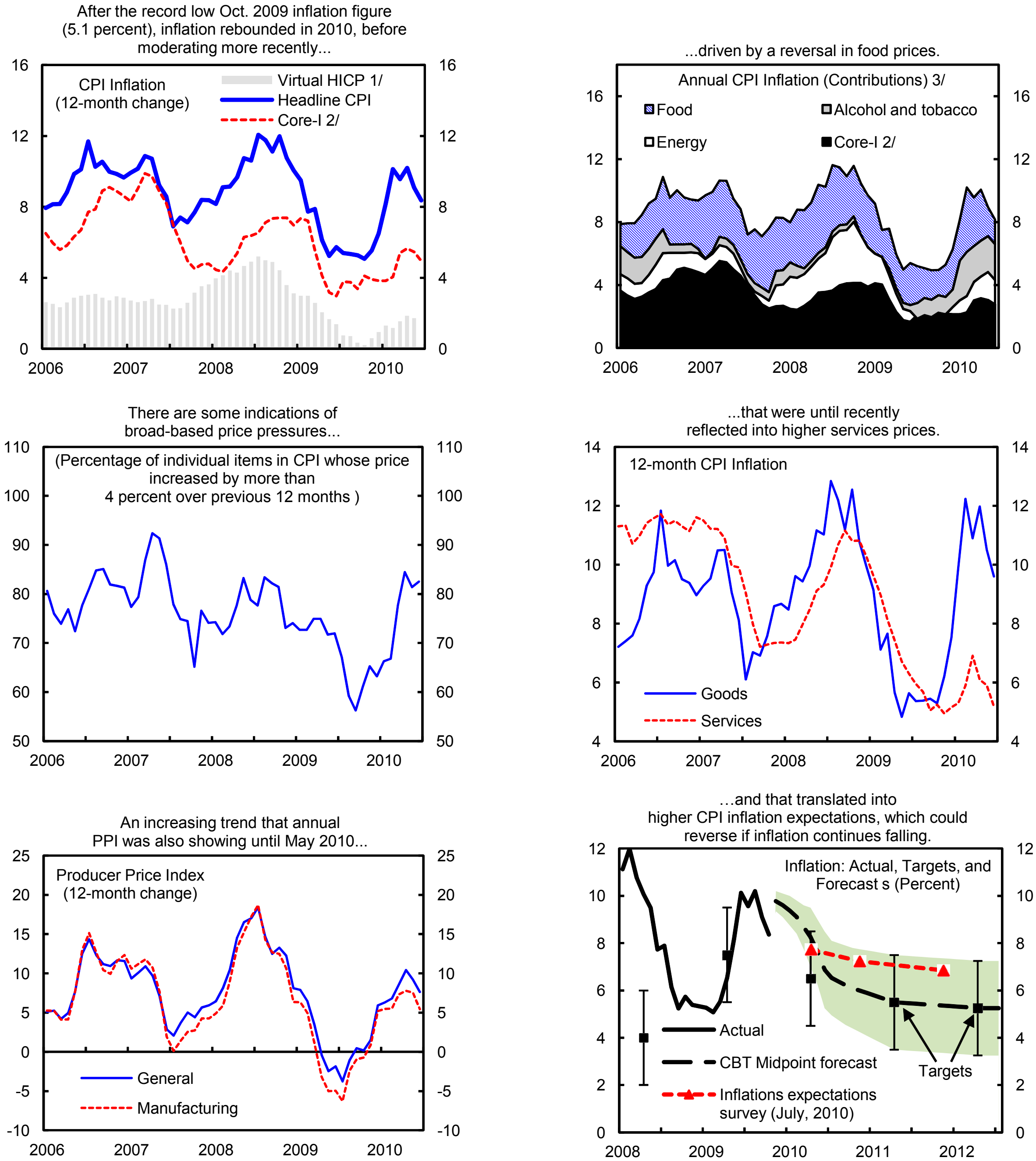
1/ Sample includes all emerging market countries in the IMF Vulnerability exercise, including oil producers in Africa and the Middle East. Regional means are weighted by GDP. Europe Region excludes Russia.

Figure 2. Turkey: Real Sector Developments, 2006−10
(Percent, unless otherwise indicated)



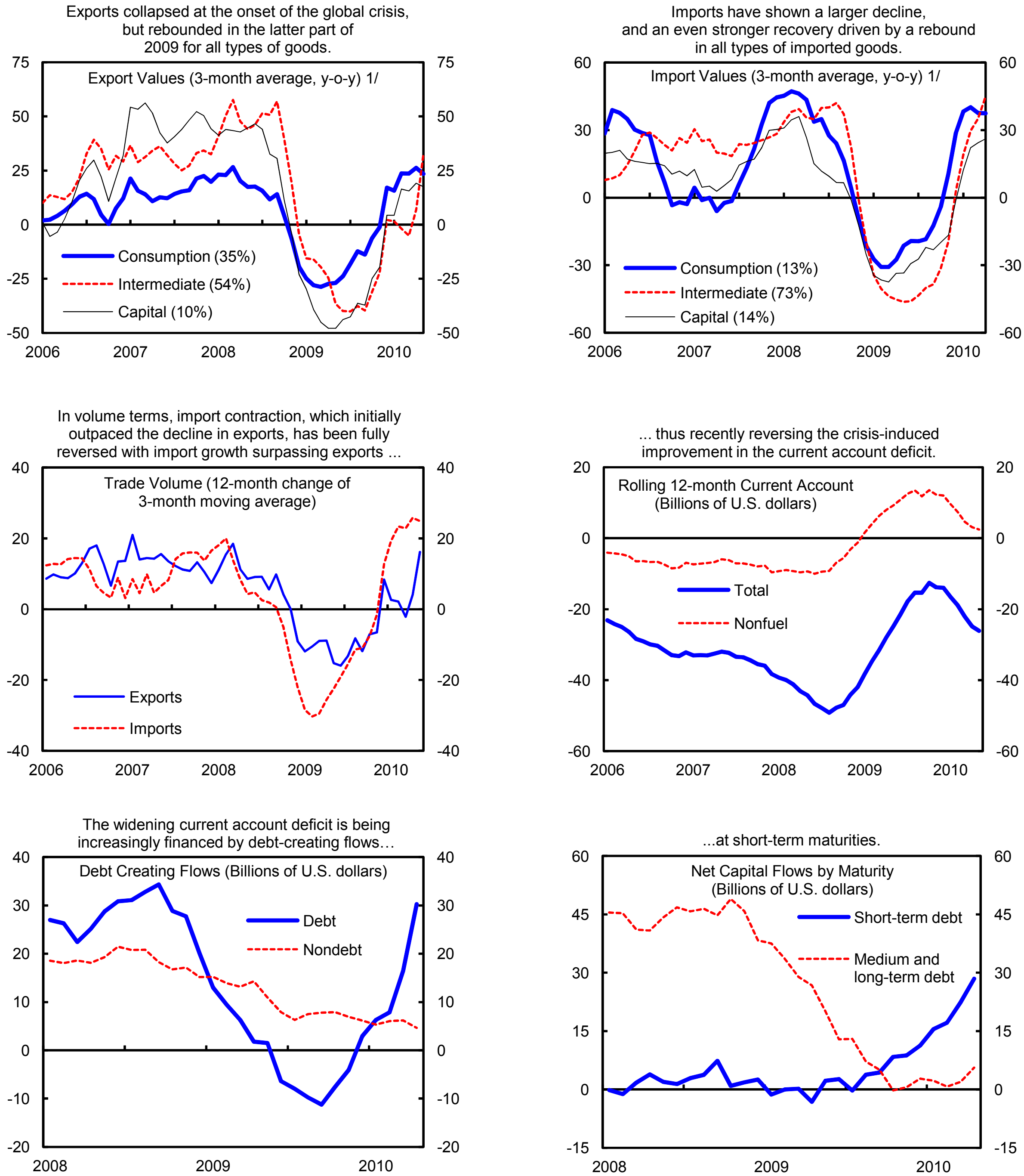
Sources: Turkstat; CNBC; and IMF staff estimates.
1/ Values in parentheses denote shares of total value added in 2009.

Figure 3. Turkey: Inflation Developments, 2006–10
(Percent, unless otherwise indicated)



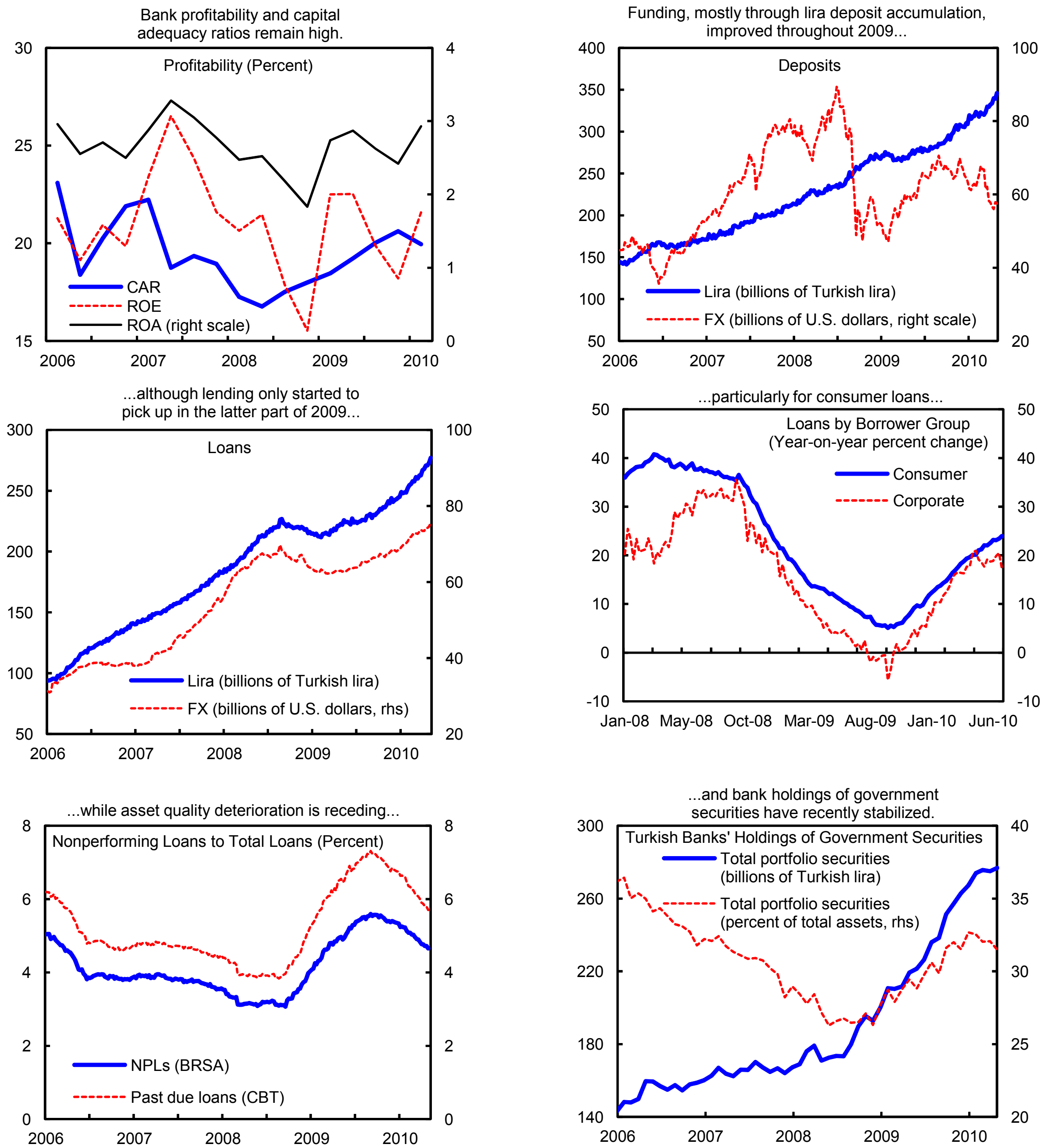
Sources: Turkstat; CBT; and IMF staff estimates.
1/ Inflation decomposition a la Mody and Ohnsorge, 2007. Virtual inflation captures the inflation that would prevail if inflation at the level of detailed subitems of Turkey's HICP basket were the same as the respective EU-27 average.
2/ Index "I" excludes food, nonalcoholic beverages, alcoholic beverages, tobacco, and gold.
3/ Calculated based on 2010 weights.

Figure 4. Turkey: External Sector Developments, 2006−10



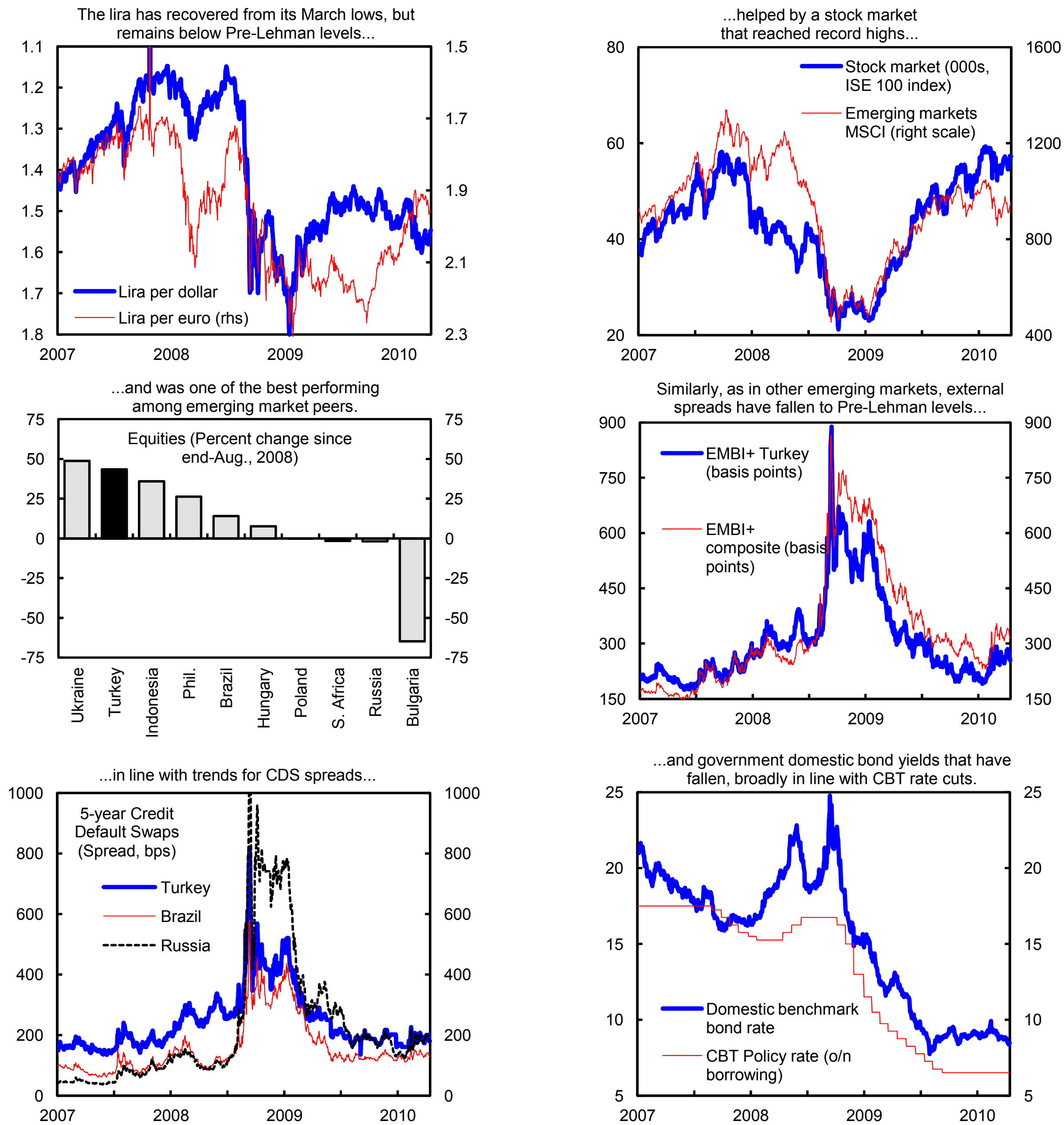
Sources: Turkstat; and IMF staff estimates.
1/ Values in parentheses denote shares of total in April, 2010.

Figure 5. Turkey: Banking System, 2006–10
(Percent, unless otherwise indicated)



Sources: BRSA; CBT; and IMF staff calculations.

Figure 6. Turkey: Financial Indicators, 2007–10
(Percent, unless otherwise indicated)



Source: Bloomberg.

Table 1. Turkey: Selected Economic Indicators, 2005–11

	2005	2006	2007	2008	2009	2010	2011
					Prelim.	Proj.	
				(Percent)			
Real sector							
Real GDP growth rate	8.4	6.9	4.7	0.7	-4.7	6.1	3.6
Private consumption growth rate	7.9	4.6	5.5	-0.3	-2.3	6.1	4.2
Private gross fixed investment growth rate	16.2	15.0	2.6	-9.0	-22.3	20.5	5.7
Contributions to GDP growth							
Private domestic demand	8.8	6.3	5.0	-1.8	-8.1	8.7	4.0
Public spending	1.0	0.9	0.8	0.6	0.7	-0.5	0.3
Net exports	-1.4	-0.3	-1.2	1.9	2.7	-2.1	-0.7
GDP deflator growth rate	7.1	9.3	6.2	12.0	5.4	8.2	6.2
Nominal GDP growth rate	16.1	16.9	11.2	12.7	0.4	14.8	10.0
CPI inflation (12-month; end-of period)	7.7	9.7	8.4	10.1	6.5	7.6	6.2
PPI inflation (12-month; end-of-period)	2.7	11.6	5.9	8.1	5.9	7.1	6.2
Unemployment rate	10.2	9.9	10.3	11.0	14.1	...	...
Average nominal treasury bill interest rate	16.2	18.1	18.1	19.3	10.9	...	...
Average ex-ante real interest rate	6.0	8.6	6.9	12.2	2.0	...	...
				(Percent of GDP)			
Nonfinancial public sector 1/							
Primary balance	5.0	4.7	3.1	1.6	-1.0	-0.3	0.2
Cyclically adjusted primary balance	3.6	2.5	0.8	0.2	0.0	-0.2	0.3
Net interest payments	5.3	5.1	4.9	4.4	4.6	3.7	3.5
Overall balance	-0.3	-0.4	-1.9	-2.8	-5.6	-4.1	-3.4
Debt of the public sector							
General government gross debt (EU definition)	52.3	46.1	39.4	39.5	45.4	44.1	43.8
Net debt 2/	46.3	40.0	34.4	34.5	39.4	38.4	38.1
Net external debt	14.0	12.8	9.7	11.8	12.4	12.5	12.0
Net domestic debt	32.3	27.2	24.7	22.7	27.0	25.9	26.1
Share of FX debt (percent of gross public debt)	37.6	37.3	31.6	34.2	29.7	28.8	27.4
External sector							
Current account balance	-4.6	-6.1	-5.9	-5.7	-2.3	-4.7	-5.1
Nonfuel current account balance	-0.7	-1.3	-1.5	-0.2	2.0	-0.2	-0.6
Exports of goods and nonfactor services	21.8	22.5	22.2	24.0	23.2	22.2	23.0
Imports of goods and nonfactor services	25.5	27.7	27.4	29.0	24.6	26.2	27.6
Trade balance	-6.9	-7.8	-7.2	-7.3	-4.0	-6.5	-7.2
Gross financing requirement	15.9	21.0	18.7	18.8	17.0	14.9	18.8
Foreign direct investment (net)	1.9	3.6	3.1	2.2	1.0	1.2	1.7
Gross external debt 3/	35.2	39.3	38.4	37.9	43.6	41.3	43.4
Net external debt	20.3	21.0	21.0	21.6	25.1	25.0	26.7
Short-term external debt (by remaining maturity)	14.2	15.0	11.6	15.5	13.2	15.2	15.8
Monetary aggregates							
Nominal growth of M2 broad money (percent)	24.5	24.7	15.7	26.7	13.0	...	...
GDP (billions of U.S. dollars) 4/	482.7	529.2	649.1	730.3	615.3	...	...
GDP (billions of Turkish lira)	648.9	758.4	843.2	950.5	954.0	1,095.6	1,205.5

Per capita GDP (2009): $8,723 (WEO) Poverty rate (2008): 17.1 percent (Turkstat poverty line estimate)

Quota (2009): SDR 1,191.3 million (1,837 million U.S. dollars)

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

1/ Fiscal projections assume the authorities adhere to their budget target for 2010 and implement the fiscal rule in 2011.

2/ Nonfinancial public sector net debt.

3/ 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 CBT).

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

Table 2. Turkey: Balance of Payments, 2007–15

(Billions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Prelim.			Proj.			
Current account balance	-38.3	-41.9	-13.9	-33.2	-37.7	-41.7	-45.0	-48.0	-51.8
Trade balance	-46.8	-53.0	-24.9	-45.5	-52.5	-59.2	-64.6	-70.6	-77.0
Exports (f.o.b.)	115.4	140.8	109.6	120.7	130.8	141.8	154.1	167.7	181.5
Of which:									
Exports (f.o.b.) in trade returns	107.3	132.0	102.1	113.9	123.5	134.1	146.0	159.0	172.4
Shuttle trade	6.0	6.2	4.8	5.3	5.6	5.8	6.1	6.4	6.8
Imports (f.o.b.)	-162.2	-193.8	-134.5	-166.2	-183.3	-200.9	-218.8	-238.2	-258.5
Of which:									
Imports (c.i.f.), incl. non-monetary gold	-170.1	-202.0	-140.9	-173.4	-191.3	-209.6	-228.1	-248.3	-269.3
Fuel imports (c.i.f.)	-33.9	-48.3	-29.9	-36.9	-38.7	-40.8	-42.6	-44.3	-46.2
Services and Income (net)	6.2	9.0	8.6	9.9	12.1	14.1	15.5	17.8	19.4
Services and Income (credit)	35.4	41.7	38.2	41.1	43.9	48.6	55.2	62.2	67.6
Of which:									
Tourism receipts	18.5	22.0	21.3	23.6	25.3	27.6	30.3	33.2	36.4
Services and Income (debit)	-29.1	-32.8	-29.6	-31.1	-31.8	-34.4	-39.7	-44.4	-48.3
Of which:									
Interest	-13.4	-14.9	-12.7	-12.9	-12.7	-14.3	-18.4	-21.9	-24.5
Private transfers (net)	1.4	1.4	1.1	1.3	1.5	2.0	2.7	3.2	4.0
Official transfers (net)	0.8	0.7	1.2	1.1	1.2	1.3	1.4	1.6	1.8
Capital account balance (excluding IMF)	48.7	33.5	8.6	43.7	48.9	54.3	59.9	63.6	68.7
Including errors and omissions	50.3	39.2	13.2	42.8	48.9	54.3	59.9	63.6	68.7
Direct investment 1/	19.9	15.7	6.4	8.2	12.6	14.3	15.4	16.3	17.0
Portfolio investment in securities	-0.2	-5.6	-1.6	6.9	8.8	10.1	10.2	10.7	11.3
Public sector (central and local governments and EBFs)	1.0	2.3	3.4	5.5	4.7	3.7	4.6	4.9	4.9
Bonds (net)	0.9	0.6	1.8	3.4	3.7	3.1	4.0	4.3	4.3
Eurobond drawings	4.6	4.0	3.8	6.1	5.5	5.5	5.5	5.5	5.5
Eurobond repayments	-3.7	-3.4	-1.9	-2.7	-1.8	-2.4	-1.5	-1.2	-1.2
Loans (net)	0.1	1.7	1.6	2.1	1.0	0.6	0.6	0.6	0.6
Loan disbursements	3.4	5.2	4.8	4.0	3.5	3.2	3.0	3.0	3.0
Loan repayments	-3.3	-3.5	-3.2	-1.9	-2.5	-2.6	-2.4	-2.4	-2.4
Central Bank of Turkey (excl. reserve assets, liabilities)	-1.1	-1.4	-0.8	-0.4	-0.5	-0.5	-0.5	-0.4	-0.4
Deposit money banks (net)	0.3	-1.0	7.2	23.3	11.6	11.9	12.6	12.7	13.8
FX deposits abroad (- denotes accumulation)	-3.5	-9.1	6.1	14.0	2.0	0.5	-0.2	-0.7	-1.2
Other (net)	3.9	8.1	1.2	9.3	9.6	11.4	12.8	13.4	15.0
Medium and long-term (net)	7.3	0.7	-1.3	0.1	2.2	2.3	2.6	3.4	3.7
Short-term (net)	-3.4	7.4	2.5	9.1	7.4	9.1	10.2	10.0	11.3
Other private sector (net)	28.7	23.5	-6.1	0.3	11.7	14.8	17.6	19.5	22.1
Medium and long term (net)	25.9	22.9	-9.5	-1.9	8.2	10.3	12.8	14.2	16.3
Short term (net)	2.9	0.6	3.4	2.1	3.6	4.5	4.8	5.3	5.7
Errors and omissions	1.6	5.6	4.7	-0.9	0.0	0.0	0.0	0.0	0.0
Overall balance	12.0	-2.8	-0.7	9.6	11.2	12.6	14.9	15.6	16.9
Overall financing (NIR change, + denotes decline)	-12.0	2.8	0.7	-9.6	-11.2	-12.6	-14.9	-15.6	-16.9
Change in gross official reserve assets (+ denotes decline)	-8.0	1.1	-0.1	-7.5	-8.6	-10.7	-14.0	-15.6	-16.9
Change in reserve liabilities (IMF)	-4.0	1.7	-0.7	-2.1	-2.7	-2.0	-0.8	0.0	0.0
Purchases	1.1	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-5.1	-1.9	-0.7	-2.1	-2.7	-2.0	-0.8	0.0	0.0
SDR allocation	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0

Table 2. Turkey: Balance of Payments, 2007–15 (concluded)

(Billions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Prelim.			Proj.			
Memorandum items:									
Trade in goods and services									
Percent of GDP									
Current account balance (incl. shuttle trade)	-5.9	-5.7	-2.3	-4.7	-5.1	-5.4	-5.5	-5.6	-5.7
Nonfuel current account balance	-1.5	-0.2	2.0	-0.2	-0.6	-0.9	-1.1	-1.3	-1.5
Trade account balance (incl. shuttle trade)	-7.2	-7.3	-4.0	-6.5	-7.2	-7.7	-8.0	-8.2	-8.5
Exports of goods and nonfactor services	22.2	24.0	23.2	22.2	23.0	23.7	24.5	25.2	25.7
Imports of goods and nonfactor services	27.4	29.0	24.6	26.2	27.6	28.6	29.5	30.4	31.1
Percent change									
Value growth in exports of goods (incl. shuttle trade)	23.0	19.7	-23.3	14.4	8.3	8.4	8.7	8.8	8.3
Value growth in exports of goods (excl. shuttle trade)	25.2	23.1	-22.1	10.1	8.5	8.5	8.9	8.9	8.4
Value growth in imports of goods	20.4	19.5	-30.6	23.6	10.3	9.6	8.9	8.9	8.5
Volume growth in exports of goods 2/	10.9	6.1	-8.1	7.2	6.1	6.9	7.6	7.5	7.5
Volume growth in imports of goods	11.1	-2.1	-13.2	15.2	7.9	7.7	7.5	7.5	7.4
Volume growth in imports of goods exluding fuel	11.6	-2.6	-12.0	24.4	9.5	9.2	8.9	8.7	8.6
Terms of trade	3.1	-4.0	7.9	-3.1	0.1	0.1	0.1	0.1	0.0
Reserve and debt indicators									
Gross foreign reserves (Central Bank of Turkey) 3/									
Billions of U.S. dollars	76.2	74.0	73.8	81.3	89.9	100.5	114.6	130.2	147.1
Months of goods and nonfactor service imports	4.9	4.0	5.6	5.1	5.1	5.3	5.5	5.8	6.1
Net international reserves (Central Bank of Turkey)	56.1	57.1	56.3	64.3	73.0	83.7	97.8	113.5	130.5
Net international reserves (net of IMF)	43.9	48.8	48.7	58.9	70.2	82.9	97.8	113.5	130.4
External debt (end-of-period)									
Billions of U.S. dollars	249.6	277.0	268.2	291.1	318.6	351.2	389.3	430.4	475.2
Percent of GDP 4/	38.4	37.9	43.6	41.3	43.4	45.5	47.9	50.2	52.4
Percent of exports of goods and nonfactor services	174.8	161.9	194.9	187.3	189.8	193.3	197.3	200.9	205.0
Short-term debt (end-of-period)									
Billions of U.S. dollars	43.1	50.4	49.6	66.7	77.3	90.0	103.9	118.1	133.8
Reserves to short-term debt ratio	176.7	146.8	148.8	121.8	116.2	111.7	110.3	110.2	109.9
Short-term debt plus medium- and long-term repayments									
Billions of U.S. dollars	84.0	97.3	83.2	103.4	113.6	127.0	143.3	161.5	177.2
Reserves to short-term debt ratio	90.7	76.1	88.6	78.6	79.1	79.1	80.0	80.6	83.0
Debt service ratio 5/	31.8	31.7	29.4	28.2	25.7	24.6	25.2	26.0	24.8

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

1/ Including privatization receipts.

2/ Volumes based on *World Economic Outlook* deflators.

3/ Changes in stocks may not equal balance of payments flows due to valuation effects of exchange rate changes.

4/ 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 CBT).

5/ Interest plus medium- and long-term debt repayments in percent of current account receipts (excluding official transfers).

Table 3. Turkey: External Financing Requirements and Sources, 2007–15

(Billions of U.S. dollars)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Prelim.			Proj.			
Gross financing requirements	121.1	137.0	104.3	104.7	138.0	153.9	172.4	193.2	215.7
Current account deficit (excluding official transfers)	39.1	42.7	15.1	34.3	38.9	43.0	46.4	49.5	53.6
Amortization on debt securities	3.7	3.4	1.9	2.7	1.8	2.4	1.5	1.2	1.2
Government Eurobonds	3.7	3.4	1.9	2.7	1.8	2.4	1.5	1.2	1.2
Medium- and long-term debt amortization	28.8	35.6	44.2	28.8	32.3	31.9	34.7	38.2	42.2
Public sector 1/	3.3	3.5	3.2	1.9	2.5	2.6	2.4	2.4	2.4
Private non-bank sector	22.3	24.9	33.8	22.9	25.0	26.1	28.8	32.1	35.7
Banks	3.1	7.2	7.3	4.0	4.8	3.2	3.5	3.7	4.1
Short-term debt amortization	42.6	43.1	50.4	49.6	66.7	77.3	90.0	103.9	118.1
Public sector (net) 1/	4.3	4.4	5.1	5.4	5.3	5.2	5.2	5.1	5.1
Trade credits 2/	16.4	21.1	22.0	21.1	24.6	27.4	30.3	33.2	36.4
Banks	20.7	16.6	21.8	22.4	35.4	43.2	52.6	63.1	73.6
Other private	1.2	1.0	1.5	0.7	1.4	1.6	1.9	2.4	3.1
Increase in portfolio and other investment assets	6.9	12.2	-7.4	-10.6	-1.7	-0.8	-0.2	0.3	0.6
Available financing	121.1	137.0	104.3	104.7	138.0	153.9	172.4	193.2	215.7
Foreign direct investment (net)	19.9	15.7	6.4	8.2	12.6	14.3	15.4	16.3	17.0
Portfolio flows	6.5	-0.4	4.9	14.3	14.9	16.2	16.4	16.9	17.6
Government Eurobonds	4.6	4.0	3.8	6.1	5.5	5.5	5.5	5.5	5.5
Private non-bank sector (net) 3/	1.9	-4.4	1.1	8.2	9.4	10.7	10.9	11.4	12.1
Medium and long-term debt financing	61.1	55.2	37.3	26.0	43.0	44.6	50.2	55.9	62.3
Public sector 1/	2.5	3.8	4.0	3.7	3.1	2.8	2.7	2.7	2.7
Private non-bank sector	48.2	43.5	27.4	18.2	33.0	36.3	41.5	46.2	51.9
Banks	10.4	7.9	5.9	4.1	7.0	5.5	6.0	7.1	7.8
Short-term financing	42.9	56.9	48.7	65.7	77.5	90.0	103.9	118.2	133.9
Public sector 1/	4.4	5.1	5.4	5.3	5.2	5.2	5.1	5.1	5.0
Trade credits	21.1	22.0	21.1	24.6	27.4	30.3	33.2	36.4	39.7
Banks	17.3	29.8	22.2	35.7	44.9	54.6	65.6	76.7	89.2
Other private	10.4	7.9	5.9	4.1	7.0	5.5	6.0	7.1	7.8
Official transfers	0.8	0.7	1.2	1.1	1.2	1.3	1.4	1.6	1.8
Other 4/	2.0	6.1	6.6	-0.9	0.0	0.0	0.0	0.0	0.0
NIR change (excl. short-term liabilities, - denotes increase)	-12.0	2.8	-0.8	-9.6	-11.2	-12.6	-14.9	-15.6	-16.9
Accumulation of gross reserves	-8.0	1.1	-0.1	-7.5	-8.6	-10.7	-14.0	-15.6	-16.9
IMF (net)	-4.0	1.7	-0.7	-2.1	-2.7	-2.0	-0.8	0.0	0.0
Purchases	1.1	3.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-5.1	-1.9	-0.7	-2.1	-2.7	-2.0	-0.8	0.0	0.0
Memorandum item:									
Net public sector financing (incl. IMF, excl. reserves)	1.3	8.4	8.5	9.4	8.2	7.9	9.9	11.2	11.4

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

1/ Includes Central Bank of Turkey (excludes IMF purchases and repurchases).
2/ Series reflects stock of short term trade credits at end of previous year.
3/ Portfolio equity and domestic government debt (net).
4/ Errors and omissions and other liabilities.

Table 4. Turkey: Consolidated Fiscal Presentation, 2005–11 1/

	2005	2006	2007	2008	2009	2010	2011
					Prelim.	Proj.	
	(Millions of new Turkish lira)						
Nonfinancial public sector primary balance	32,535	35,440	25,863	15,125	-9,803	-3,749	2,031
General government	30,897	33,928	23,345	14,660	-15,604	-5,490	-380
Central govt. and social security	26,649	33,723	22,641	17,282	-13,592	-5,715	-2,038
Primary revenue	181,411	223,010	224,973	250,715	253,527	300,602	330,230
Tax revenue	119,627	137,480	152,835	168,109	172,417	204,905	225,636
Nontax revenue	20,975	27,350	24,203	25,576	27,464	30,615	33,688
Social security	40,808	58,180	47,935	57,031	53,646	65,081	70,907
Primary expenditure	154,761	189,286	202,331	233,433	267,119	306,317	332,268
Central government current	75,742	96,006	102,488	115,893	132,895	157,610	161,825
Central government capital	10,340	12,098	13,003	17,616	19,847	19,771	27,658
Social security 2/	68,680	81,183	86,840	99,925	114,377	128,937	142,785
Other general government	4,248	204	703	-2,622	-2,013	226	1,658
State economic enterprises	1,638	1,513	2,518	465	5,802	1,741	2,411
Memorandum items:							
Primary spending (less revenue transfers) 3/	141,943	175,162	185,139	213,177	245,815	281,161	304,582
Current	131,603	163,065	172,136	195,561	225,967	261,391	276,924
Capital	10,340	12,098	13,003	17,616	19,847	19,771	27,658
Pension spending	38,537	45,076	51,981	58,885	67,408	80,072	88,414
Health spending 4/	17,641	23,017	26,608	32,111	37,608	38,259	42,702
GDP	648,932	758,391	843,178	950,534	953,974	1,095,594	1,205,545
	(Percent of GDP)						
Nonfinancial public sector primary balance	5.0	4.7	3.1	1.6	-1.0	-0.3	0.2
General government	4.8	4.5	2.8	1.5	-1.6	-0.5	0.0
Central govt. and social security	4.1	4.4	2.7	1.8	-1.4	-0.5	-0.2
Primary revenue	28.0	29.4	26.7	26.4	26.6	27.4	27.4
Tax revenue	18.4	18.1	18.1	17.7	18.1	18.7	18.7
Nontax revenue	3.2	3.6	2.9	2.7	2.9	2.8	2.8
Social security	6.3	7.7	5.7	6.0	5.6	5.9	5.9
Primary expenditure	23.8	25.0	24.0	24.6	28.0	28.0	27.6
Central government current	11.7	12.7	12.2	12.2	13.9	14.4	13.4
Central government capital	1.6	1.6	1.5	1.9	2.1	1.8	2.3
Social security 2/	10.6	10.7	10.3	10.5	12.0	11.8	11.8
Other general government	0.7	0.0	0.1	-0.3	-0.2	0.0	0.1
State economic enterprises	0.3	0.2	0.3	0.0	0.6	0.2	0.2
Memorandum items:							
Primary spending (less revenue transfers) 3/	21.9	23.1	22.0	22.4	25.8	25.7	25.3
Current	20.3	21.5	20.4	20.6	23.7	23.9	23.0
Capital	1.6	1.6	1.5	1.9	2.1	1.8	2.3
Pension spending	5.9	5.9	6.2	6.2	7.1	7.3	7.3
Health spending 4/	2.7	3.0	3.2	3.4	3.9	3.5	3.5

Sources: Turkish authorities; and IMF staff estimates.

1/ Fiscal projections assume the authorities adhere to their budget target for 2010 and implement the fiscal rule in 2011. The table includes figures which are submitted by Turkish Authorities during the program period and may not reflect final figures. SEE figures are those monitored under consolidated government sector.

2/ Social Security Institutions plus budget spending on social security (such as civil servants' health and Green Card).

3/ Consolidated central government and social security spending.

4/ Measured as health spending by the Social Security Institution and budget for Green Card and civil servants. This is a lower estimate for health spending, as it excludes some items (such as Ministry of Health spending on medical personnel salaries).

Table 5. Turkey: Public Sector Finances, 2005−11 1/

(Millions of new Turkish lira)

	2005	2006	2007	2008	2009	2010	2011
					Prelim.	Proj.	
Nonfinancial public sector primary balance	32,535	35,440	25,863	15,125	-9,803	-3,749	2,031
Central government	26,725	32,833	21,858	17,377	-14,343	-5,715	-2,038
Primary revenue	140,602	164,830	177,038	193,685	199,881	235,521	259,324
Tax revenue	119,627	137,480	152,835	168,109	172,417	204,905	225,636
Personal income taxes	24,490	28,983	34,447	38,030	38,445	42,575	47,288
Corporate income taxes	12,048	11,158	13,751	16,905	18,023	19,415	21,364
VAT	34,326	41,337	43,286	46,777	46,984	56,774	62,630
SCT	33,345	36,926	39,111	41,832	43,620	55,322	60,241
Other	15,419	19,077	22,241	24,565	25,345	30,819	34,113
Nontax revenue 2/	20,975	27,350	24,203	25,576	27,464	30,615	33,688
Primary expenditure	113,878	131,997	155,180	176,307	214,224	241,236	261,362
Personnel	37,389	42,887	49,373	55,264	63,136	73,414	80,303
Goods and services, *of which:*	15,186	19,001	22,258	24,412	29,594	26,756	29,103
Defense and security	6,498	7,630	7,599	8,327	9,644	8,900	9,793
Transfers, *of which:*	50,963	58,010	70,545	78,116	101,646	115,931	128,468
Social security institutions	23,762	18,543	33,063	35,133	52,685	58,199	65,993
Agricultural subsidies	3,707	4,747	5,555	5,809	4,495	5,605	6,168
Transfers of revenue shares	12,819	14,124	17,192	20,256	21,304	25,156	27,686
Capital transfers	1,384	2,637	3,542	3,174	4,314	3,508	3,403
Capital expenditure	10,340	12,098	13,003	18,516	19,847	19,771	27,658
Unidentified ((-) implies measures needed)	…	…	…	…	…	5,365	-4,172
Rest of the public sector	5,811	2,608	4,005	-2,252	4,541	1,966	4,069
Extrabudgetary funds	917	-1,988	1,345	-696	-903	-69	216
Revolving funds 3/	839	782	259	228	185	60	270
Social security institutions	-76	891	783	-96	752	0	0
Unemployment insurance fund	1,681	2,278	2,879	3,580	2,305	3,099	4,163
Local governments 3/	810	-868	-3,780	-5,734	-3,600	-2,865	-2,992
State economic enterprises 4/	1,638	1,513	2,518	465	5,802	1,741	2,411
Nonfinancial public sector overall balance	-1,776	-3,269	-15,851	-26,746	-53,351	-44,651	-40,627
Interest expenditure (net)	34,311	38,709	41,714	41,871	43,549	40,902	42,658
Memorandum items:							
Central govt. overall balance (auth. def.)	-7,110	-4,625	-13,687	-17,670	-52,215	-41,703	-38,826
Total revenue	152,576	173,483	190,360	209,598	215,060	247,821	273,255
Primary revenue (from above)	140,602	164,830	177,038	193,685	199,881	235,521	259,324
Interest revenue	8,431	4,267	3,923	4,036	5,003	2,300	2,300
Program adjustments 5/	3,543	4,387	9,399	11,877	10,176	10,000	11,631
Total expenditure	159,686	178,109	204,046	227,269	267,275	289,524	312,080
Primary expenditure (from above)	113,878	131,997	155,180	176,307	214,224	241,236	261,362
Interest expenditure	45,680	45,945	48,732	50,661	53,201	47,018	49,403
Program adjustments	129	166	135	300	-150	1,270	1,316

Table 5. Turkey: Public Sector Finances, 2005–11 (concluded) 1/

(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011
					Prelim.	Proj.	
Nonfinancial public sector primary balance	5.0	4.7	3.1	1.6	-1.0	-0.3	0.2
Central government	4.1	4.3	2.6	1.8	-1.5	-0.5	-0.2
Primary revenue	21.7	21.7	21.0	20.4	21.0	21.5	21.5
Tax revenue	18.4	18.1	18.1	17.7	18.1	18.7	18.7
Personal income taxes	3.8	3.8	4.1	4.0	4.0	3.9	3.9
Corporate income taxes	1.9	1.5	1.6	1.8	1.9	1.8	1.8
VAT	5.3	5.5	5.1	4.9	4.9	5.2	5.2
SCT	5.1	4.9	4.6	4.4	4.6	5.0	5.0
Other	2.4	2.5	2.6	2.6	2.7	2.8	2.8
Nontax revenue 2/	3.2	3.6	2.9	2.7	2.9	2.8	2.8
Primary expenditure	17.5	17.4	18.4	18.5	22.5	22.0	21.7
Personnel	5.8	5.7	5.9	5.8	6.6	6.7	6.7
Goods and services, *of which* :	2.3	2.5	2.6	2.6	3.1	2.4	2.4
Defense and security	1.0	1.0	0.9	0.9	1.0	0.8	0.8
Transfers, *of which* :	7.9	7.6	8.4	8.2	10.7	10.6	10.7
Social security institutions	3.7	2.4	3.9	3.7	5.5	5.3	5.5
Agricultural subsidies	0.6	0.6	0.7	0.6	0.5	0.5	0.5
Transfers of revenue shares	2.0	1.9	2.0	2.1	2.2	2.3	2.3
Capital transfers	0.2	0.3	0.4	0.3	0.5	0.3	0.3
Capital expenditure	1.6	1.6	1.5	1.9	2.1	1.8	2.3
Unidentified ((-) implies measures needed)	...	...	...	...	...	0.5	-0.3
Rest of the public sector	0.9	0.3	0.5	-0.2	0.5	0.2	0.3
Extrabudgetary funds	0.1	-0.3	0.2	-0.1	-0.1	0.0	0.0
Revolving funds 3/	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.0	0.1	0.1	0.0	0.1	0.0	0.0
Unemployment insurance fund	0.3	0.3	0.3	0.4	0.2	0.3	0.3
Local governments 3/	0.1	-0.1	-0.4	-0.6	-0.4	-0.3	-0.2
State economic enterprises 4/	0.3	0.2	0.3	0.0	0.6	0.2	0.2
Nonfinancial public sector overall balance	-0.3	-0.4	-1.9	-2.8	-5.6	-4.1	-3.4
Interest expenditure (net)	5.3	5.1	4.9	4.4	4.6	3.7	3.5
Memorandum items:							
Central govt. overall balance (auth. def.)	-1.1	-0.6	-1.6	-1.9	-5.5	-3.8	-3.2
Total revenue	23.5	22.9	22.6	22.1	22.5	22.6	22.7
Primary revenue (from above)	21.7	21.7	21.0	20.4	21.0	21.5	21.5
Interest revenue	1.3	0.6	0.5	0.4	0.5	0.2	0.2
IMF adjustments 5/	0.5	0.6	1.1	1.2	1.1	0.9	1.0
Total expenditure	24.6	23.5	24.2	23.9	28.0	26.4	25.9
Primary expenditure (from above)	17.5	17.4	18.4	18.5	22.5	22.0	21.7
Interest expenditure	7.0	6.1	5.8	5.3	5.6	4.3	4.1
IMF adjustments	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Nominal GDP (billions of new Turkish lira)	649	758	843	951	954	1,096	1,206

Sources: Turkish authorities; and IMF staff estimates.

1/ Fiscal projections assume the authorities adhere to their budget target for 2010 and implement the fiscal rule in 2011. The table includes figures which are submitted by Turkish Authorities during the program period and may not reflect final figures. SEE figures are those monitored under consolidated government sector.

2/ Excluding privatization proceeds, transfers from CBT, and interest receipts.

3/ Excluded from consolidated government sector.

4/ Excluding severance payments for retirees.

5/ IMF deficit definition excludes profit transfers of the CBT, proceeds from the sale of assets of the central government, and dividend payments from Ziraat Bank from revenue.

Table 6. Turkey: Medium-Term Scenario, 2003–15

(Percent change, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2003–08	2010–15
							Prelim.			Proj.				Average	Average
Real GDP	5.3	9.4	8.4	6.9	4.7	0.7	-4.7	6.1	3.6	3.9	4.0	4.0	4.0	5.9	4.3
Real domestic demand	8.8	11.7	9.5	7.0	5.7	-1.2	-7.2	8.2	4.3	4.4	4.2	4.2	4.2	6.9	4.9
Private consumption	10.2	11.0	7.9	4.6	5.5	-0.3	-2.3	6.1	4.2	4.2	3.9	3.7	3.7	6.5	4.3
Private investment	23.7	36.1	16.2	15.0	2.6	-9.0	-22.3	20.5	5.7	5.7	5.7	6.3	6.3	14.1	8.4
Public spending	-6.0	2.9	7.5	6.9	6.5	4.5	5.1	-3.2	2.3	3.1	3.4	3.6	3.6	3.7	2.1
Exports	6.9	11.2	7.9	6.6	7.3	2.7	-5.4	6.7	5.3	6.2	7.1	7.0	7.0	7.1	6.5
Imports	23.5	20.8	12.2	6.9	10.7	-4.1	-14.4	14.9	7.6	7.7	7.5	7.3	7.3	11.7	8.7
Contributions to GDP growth (percent)															
Real domestic demand	8.5	11.8	9.8	7.2	5.9	-1.2	-7.4	8.2	4.3	4.5	4.3	4.3	4.3	7.0	5.0
Private consumption	6.8	7.7	5.6	3.3	3.8	-0.2	-1.6	4.3	3.0	3.0	2.8	2.6	2.6	4.5	3.0
Private investment	3.1	5.6	3.1	3.1	0.6	-2.0	-4.4	3.3	1.0	1.1	1.1	1.2	1.2	2.3	1.5
Public spending	-0.9	0.4	1.0	0.9	0.8	0.6	0.7	-0.5	0.3	0.4	0.5	0.5	0.5	0.5	0.3
Net exports	-3.3	-2.4	-1.4	-0.3	-1.2	1.9	2.7	-2.1	-0.7	-0.6	-0.3	-0.3	-0.3	-1.1	-0.7
Exports	1.6	2.7	1.9	1.6	1.8	0.7	-1.4	1.7	1.3	1.6	1.9	1.9	2.0	1.7	1.7
Imports	-4.9	-5.1	-3.3	-1.9	-3.0	1.2	4.1	-3.8	-2.1	-2.2	-2.2	-2.2	-2.3	-2.8	-2.5
Saving and investment (percent of GDP)															
Public Savings-Investment Balance (percent of GDP)	-5.3	1.0	4.9	4.9	3.1	2.0	-0.4	1.1	1.7	2.2	2.6	2.8	3.0	1.8	2.2
Private Savings Investment Balance (percent of GDP)	2.9	-4.7	-9.5	-11.0	-9.0	-7.7	-1.8	-5.8	-6.8	-7.6	-8.1	-8.4	-8.8	-6.5	-7.6
Employment rate	...	41.3	41.5	41.5	41.5	41.7	41.2	...	...	...	...	...	...	41.5	...
Unemployment rate (percent)	10.5	10.3	10.2	9.9	10.3	11.0	14.1	...	...	...	...	...	...	10.4	...
GDP deflator	23.3	12.4	7.1	9.3	6.2	12.0	5.4	8.2	6.2	5.4	4.5	4.3	4.1	11.7	5.5
Consumer prices															
Period average	25.3	8.6	8.2	9.6	8.8	10.4	6.3	8.7	5.9	5.8	4.8	4.3	4.1	11.8	5.6
End-period	18.4	9.4	7.7	9.7	8.4	10.1	6.5	7.6	6.2	5.1	4.6	4.1	4.1	10.6	5.3
Nonfinancial public sector (percent of GDP)															
Primary balance	4.8	5.4	5.0	4.7	3.1	1.6	-1.0	-0.3	0.2	0.9	1.2	1.2	1.0	4.1	0.7
Cyclically adjusted primary balance	6.0	5.2	3.6	2.5	0.8	0.2	0.0	-0.2	0.3	0.9	1.2	1.2	1.0	3.0	0.7
Overall balance	-7.2	-3.6	-0.3	-0.4	-1.9	-2.8	-5.6	-4.1	-3.4	-2.8	-2.4	-2.2	-2.1	-2.7	-2.8
General government gross debt (EU definition)	67.4	59.2	52.3	46.1	39.4	39.5	45.4	44.1	43.8	42.9	42.1	41.2	40.2	50.6	42.4
External indicators															
Current account (percent of GDP)	-2.5	-3.7	-4.6	-6.1	-5.9	-5.7	-2.3	-4.7	-5.1	-5.4	-5.5	-5.6	-5.7	-4.7	-5.3
Gross external debt (percent of GDP) 1/	47.5	41.0	35.2	39.3	38.4	37.9	43.6	41.3	43.4	45.5	47.9	50.2	52.4	39.9	46.8
Real Effective Exchange Rate (CPI-based, levels, EOP)	140.6	143.2	171.4	160.1	190.3	168.8	170.2	...	...	...	...	...	...	162.4	...

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

1/ 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 CBT).

Table 7. Banking System at a Glance, 2007–10

(Percent, unless otherwise indicated)

	2007	2008	2009	2010 1/
Balance sheet and quality of loans				
Banking system				
Assets (percent of GDP)	69.0	77.1	87.4	78.5
Loans / total assets	48.9	49.8	46.6	48.0
Government securities / total assets	28.3	26.5	31.5	32.0
Loans / total deposits	79.7	80.2	75.6	77.3
Year-on-year loan growth	30.3	28.7	6.9	27.1
Funds borrowed / total assets	12.3	12.7	10.3	10.7
NPLs (gross, percent of total loans)	3.6	3.8	5.6	5.1
Provisioning ratio (percent of NPLs)	86.8	79.8	83.6	82.9
State-owned Banks				
Assets (percent of GDP)	21.0	23.5	28.2	25.4
Loans / total assets	38.2	41.1	40.7	41.7
Government securities / total assets	39.5	38.2	39.9	40.7
Loans / total deposits	54.2	58.8	60.3	60.9
Year-on-year loan growth	32.5	36.1	19.3	27.0
Deposits/total Assets	70.5	69.9	67.6	68.5
Funds borrowed / total assets	5.1	5.7	4.8	5.6
NPLs (gross, percent of total loans)	4.1	3.8	4.5	4.4
Provisioning ratio (percent of NPLs)	96.0	87.9	86.6	84.8
FX exposure (Banking system)				
FX assets / FX liabilities (including off-balance sheet items)	100.1	100.0	100.2	99.9
FX assets / FX liabilities (on-balance sheet only)	84.6	86.9	93.4	93.7
FX loans / total loans	24.0	28.6	26.6	27.0
FX deposits / total deposits	33.4	33.5	31.6	30.3
Capital ratios (Banking system)				
Capital adequacy ratio	18.9	18.0	20.6	20.0
Shareholders' equity / total assets	13.0	11.8	13.3	13.6
Profitability and liquidity ratio (Banking system)				
Return on assets 2/	2.8	1.8	2.4	2.8
Return on equity 2/	21.6	15.5	18.3	21.6
Liquid assets / total assets 3/	37.1	26.6	33.0	33.2
Memorandum items:				
Share of assets held by the five largest banks	62	62	63	63
Share of assets held by the three largest public banks	29	29	31	31
Share of assets held by the three largest private banks	38	39	39	39
Number of banks	50	49	49	49
Number of employees	167,760	182,665	184,205	186,620
Number of branches	8,122	9,304	9,581	9,601

Sources: BRSA; CBT; Turkish Banker's Association; and IMF staff calculations.

1/ As of March 2010.
2/ Annualized for March 2010.
3/ Calculated for Deposit Money Banks by the Turkish Banker's Association.

Appendix I. Debt Sustainability Analysis and Capacity to Repay the Fund

Public debt is projected to moderate as a share of GDP, but large shocks could interrupt its decline. Under the baseline, both general government debt (EU definition) and nonfinancial public sector net debt decline over the projection period (Appendix Table I.1). Standard tests, which do not include the endogenous fiscal adjustment required under the planned fiscal rule (for stress tests of the fiscal rule's endogenous response, see Appendix III), indicate that public debt sustainability is generally robust to various combinations of shocks, although sizable contingent liabilities or large exchange rate depreciations would generate large initial jumps in the debt ratio. An alternative no-policy-adjustment scenario (keeping the deficit unchanged at its 2009 level) or a much slower recovery than projected (real GDP growth 1.5 percentage points lower each year during 2011–15) would significantly increase debt ratios in the absence of fiscal adjustment.

Under the baseline, gross external debt, while increasing, remains sustainable, but is vulnerable to a large exchange rate shock (Appendix Table I.2). External debt is expected to rise to 52.4 percent of GDP by 2015 on account of a moderate widening of the current account deficit, somewhat slower average GDP growth than prior to the crisis, and a gradual increase in debt-creating inflows, although partly offset by increasing FDI and equity inflows. Standard tests show the external debt path is robust to a ¼ standard deviation interest rate shock and increases only moderately (to about 60 percent of GDP) against comparable shocks to growth or the current account. However, a real depreciation of 30 percent in 2011 would cause gross external debt to increase by almost 30 percent of GDP by 2013. Nevertheless, a real exchange rate shock of this size would likely precipitate adjustment in the current account and other second-round effects that would mitigate the impact on external debt, but which are not captured in a static debt sustainability exercise.

Turkey's decreasing exposure to the Fund and moderate external debt levels should ensure adequate capacity to repay the Fund (Appendix Table I.3). Under the baseline scenario, the exposure to Turkey would decline very rapidly and fall to only SDR1.9 billion in 2011 (129 percent of new quota, 0.4 percent of GDP, or 3.1 percent of reserves). Annual debt service to the Fund would remain very small at around 0.3–0.4 percent of GDP.

Appendix Table I.1. Turkey: Public Sector Debt Sustainability Framework, 2005–15 1/

(Percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2005	2006	2007	2008	2009 Prel.			2010	2011	2012	2013	2014	2015
General government gross debt 2/	52.3	46.1	39.4	39.5	45.4			44.1	43.8	42.9	42.1	41.2	40.2
Nonfinancial (NFPS) public sector net debt	46.3	40.0	34.4	34.5	39.4			38.4	38.1	37.3	36.5	35.5	34.5
Of which: foreign-currency denominated	17.1	14.4	10.9	11.8	11.6			11.3	10.7	10.5	9.7	8.8	7.9
Change in NFPS net debt	-7.7	-6.3	-5.6	0.1	4.8			-1.0	-0.3	-0.8	-0.9	-1.0	-1.0
Identified debt-creating flows	-9.2	-7.6	-6.2	0.2	4.3			-1.8	-0.7	-1.1	-1.1	-1.2	-1.0
Primary deficit	-5.0	-4.7	-3.1	-1.6	1.0			0.3	-0.2	-0.9	-1.2	-1.2	-1.0
Automatic debt dynamics	-2.1	-0.7	-1.5	3.5	4.4			-1.4	0.0	0.4	0.6	0.6	0.4
Contribution from interest rate/growth differential	-2.2	-1.6	0.9	0.5	4.4			-1.4	0.0	0.4	0.6	0.6	0.4
Of which: contribution from real interest rate	1.7	1.2	2.6	0.7	2.8			0.7	1.3	1.8	2.0	1.9	1.7
Of which: contribution from real GDP growth	-3.9	-2.7	-1.7	-0.2	1.6			-2.1	-1.3	-1.4	-1.4	-1.3	-1.3
Contribution from exchange rate depreciation	0.1	0.8	-2.4	3.0	-0.1			..	..	..	..	..	..
Other identified non-debt-creating flows	-2.1	-2.2	-1.5	-1.8	-1.1			-0.8	-0.6	-0.6	-0.5	-0.5	-0.4
Privatization receipts (negative)	-0.6	-1.6	-0.8	-1.0	-0.2			-0.4	-0.3	-0.3	-0.3	-0.3	-0.2
Other sources (includes state bank dividends and central bank profits)	-1.5	-0.6	-0.7	-0.7	-1.2			-0.4	-0.3	-0.2	-0.2	-0.2	-0.2
Residual 3/	1.5	1.3	0.3	-0.1	0.5			0.9	0.6	0.4	0.4	0.3	0.1
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (percent)	8.4	6.9	4.7	0.7	-4.7	3.8	5.1	6.1	3.6	3.9	4.0	4.0	4.0
Average nominal interest rate on public debt (percent) 4/	11.4	12.9	13.7	14.4	13.3	26.6	27.2	10.9	10.1	10.7	10.5	10.2	9.5
Average real interest rate (nominal rate minus change in GDP deflator, percent)	4.3	3.5	7.5	2.4	7.9	8.8	5.7	2.6	3.9	5.3	5.9	5.9	5.3
Nominal appreciation (increase in U.S. dollar value of local currency, percent)	-0.4	-5.0	21.3	-23.0	0.4	-7.0	21.6	-6.0	-4.4	-3.5	-3.0	-2.4	-2.4
Inflation rate (GDP deflator, percent)	7.1	9.3	6.2	12.0	5.4	21.5	18.4	8.2	6.2	5.4	4.5	4.3	4.1
A. Alternative Scenarios (based on nonfinancial public sector net debt)													
A1. Key variables are at their historical averages in 2010–15					39.4			37.3	35.8	34.9	34.0	33.1	32.1
A2. No policy change (constant primary balance) in 2010–15					39.4			39.4	40.5	41.9	43.6	45.3	47.0
A3. 2010 GDP growth is reduced (relative to baseline) by one standard deviation					39.4			40.5	40.3	39.6	38.9	38.1	37.2
B. Bound Tests													
B1. Real interest rate is at baseline plus one-half standard deviation					39.4			38.4	38.6	38.6	38.7	38.8	38.9
B2. Real GDP growth is at baseline minus one-half standard deviation					39.4			38.4	39.2	39.7	40.1	40.4	40.8
B3. Primary balance is at baseline minus one-half standard deviation					39.4			38.4	39.1	39.4	39.7	39.9	40.1
B4. Combination of B1-B3 using one-quarter standard deviation shocks					39.4			38.4	39.4	40.1	40.9	41.7	42.5
B5. One time 30 percent real depreciation in 2011 5/					39.4			38.4	43.7	43.0	42.4	41.5	40.7
C. Tailored Tests													
C1. Slow recovery 6/					39.4			38.4	39.2	40.1	41.4	43.2	45.4

1/ The baseline scenario assumes that the government does not save revenue overperformance in 2010 and implements the fiscal rule from 2011 onwards. Bound tests are predicated on the baseline scenario, but do not include the fiscal adjustment implied by the fiscal rule in response to shocks.

2/ General government debt consistent with the Maastricht definition.

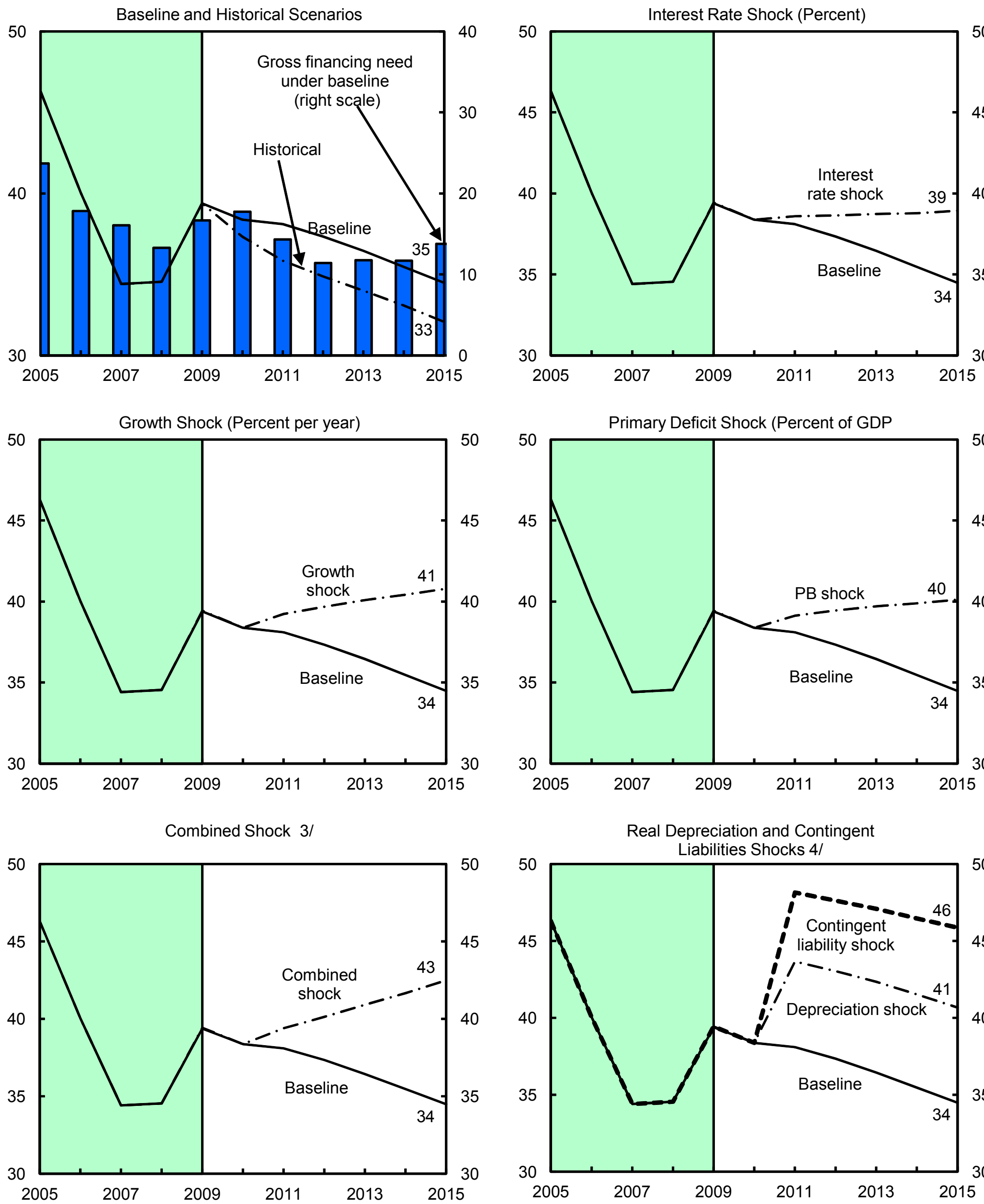
3/ For projections, it includes exchange rate changes.

4/ Calculated as nominal interest expenditure divided by previous period debt stock.

5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

6/ Assumes that real GDP growth is 1.5 percentage points lower each year during 2011-15. The primary surplus is adjusted for the cumulative shortfall in growth (relative to baseline).

Appendix Figure I.1. Turkey: Public Debt Sustainability: Bound Tests 1/ 2/
(Net NFPS debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. 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/ The baseline scenario assumes that the government does not save revenue overperformance in 2010 and implements the fiscal rule from 2011 onwards. Bound tests are predicated on the baseline scenario, but do not include the fiscal adjustment implied by the fiscal rule in response to shocks.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2011, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Table I.2. Turkey: External Debt Sustainability Framework, 2005–15

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 7/
Baseline: external debt 1/	35.2	39.3	38.4	37.9	43.6	41.3	43.4	45.5	47.9	50.2	52.4	-3.3
Change in external debt	-5.8	4.1	-0.8	-0.5	5.7	-2.2	2.1	2.1	2.4	2.2	2.2	
Identified external debt-creating flows (4+8+9)	-6.1	-1.0	-5.2	-0.8	7.9	0.7	1.4	1.3	1.3	1.1	1.1	
Current account deficit, excluding interest payments	3.6	4.9	4.8	4.2	0.6	3.4	3.9	4.1	3.8	3.6	3.6	
Deficit in balance of goods and services	4.9	6.3	6.6	6.6	3.2	5.1	5.8	6.2	6.4	6.6	6.7	
Exports	21.7	22.3	22.0	23.4	22.4	22.1	22.9	23.5	24.3	25.0	25.6	
Imports	26.6	28.6	28.6	30.1	25.6	27.2	28.6	29.7	30.7	31.5	32.3	
Net non-debt creating capital inflows (negative)	-3.0	-4.0	-3.9	-2.3	-1.5	-1.7	-2.3	-2.4	-2.5	-2.7	-2.7	
Automatic debt dynamics 2/	-6.7	-1.9	-6.1	-2.7	8.7	-1.0	-0.2	-0.3	0.0	0.2	0.2	
Contribution from nominal interest rate	1.0	1.2	1.2	1.6	1.7	1.3	1.2	1.3	1.7	2.0	2.1	
Contribution from real GDP growth	-2.8	-2.2	-1.5	-0.2	2.1	-2.3	-1.4	-1.6	-1.7	-1.8	-1.9	
Contribution from price and exchange rate changes 3/	-4.9	-0.9	-5.8	-4.0	5.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	0.3	5.1	4.4	0.3	-2.2	-2.9	0.7	0.7	1.2	1.1	1.1	
External debt-to-exports ratio (percent)	162.4	176.0	174.8	161.9	194.9	187.3	189.8	193.3	197.3	200.9	205.0	
Gross external financing need (billions of U.S. dollars) 5/	84.7	108.1	121.8	131.9	98.0	119.5	140.6	156.1	174.4	195.2	213.3	
Percent of GDP	17.5	20.4	18.8	18.1	15.9	17.0	19.2	20.2	21.5	22.8	23.5	
Scenario with key variables at their historical averages 6/						41.3	39.6	38.2	37.2	36.3	35.5	-3.9
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	8.4	6.9	4.7	0.7	-4.7	6.1	3.6	3.9	4.0	4.0	4.0	
GDP deflator in U.S. dollars (percent change)	13.5	2.6	17.2	11.8	-11.5	7.8	0.6	1.3	1.2	1.6	1.7	
Nominal external interest rate (percent)	3.1	3.7	3.6	4.6	3.7	3.4	3.1	3.2	4.0	4.4	4.5	
Growth of exports (U.S. dollar terms, percent)	14.5	12.9	20.9	19.8	-19.6	12.9	8.0	8.2	8.6	8.6	8.2	
Growth of imports (U.S. dollar terms, percent)	19.1	18.1	22.5	18.3	-28.2	21.4	9.8	9.2	8.5	8.6	8.2	
Current account balance, excluding interest payments	-3.6	-4.9	-4.8	-4.2	-0.6	-3.4	-3.9	-4.1	-3.8	-3.6	-3.6	
Net nondebt creating capital inflows	3.0	4.0	3.9	2.3	1.5	1.7	2.3	2.4	2.5	2.7	2.7	

1/ 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 CBT).

2/ 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 U.S. dollar terms, g = real GNP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

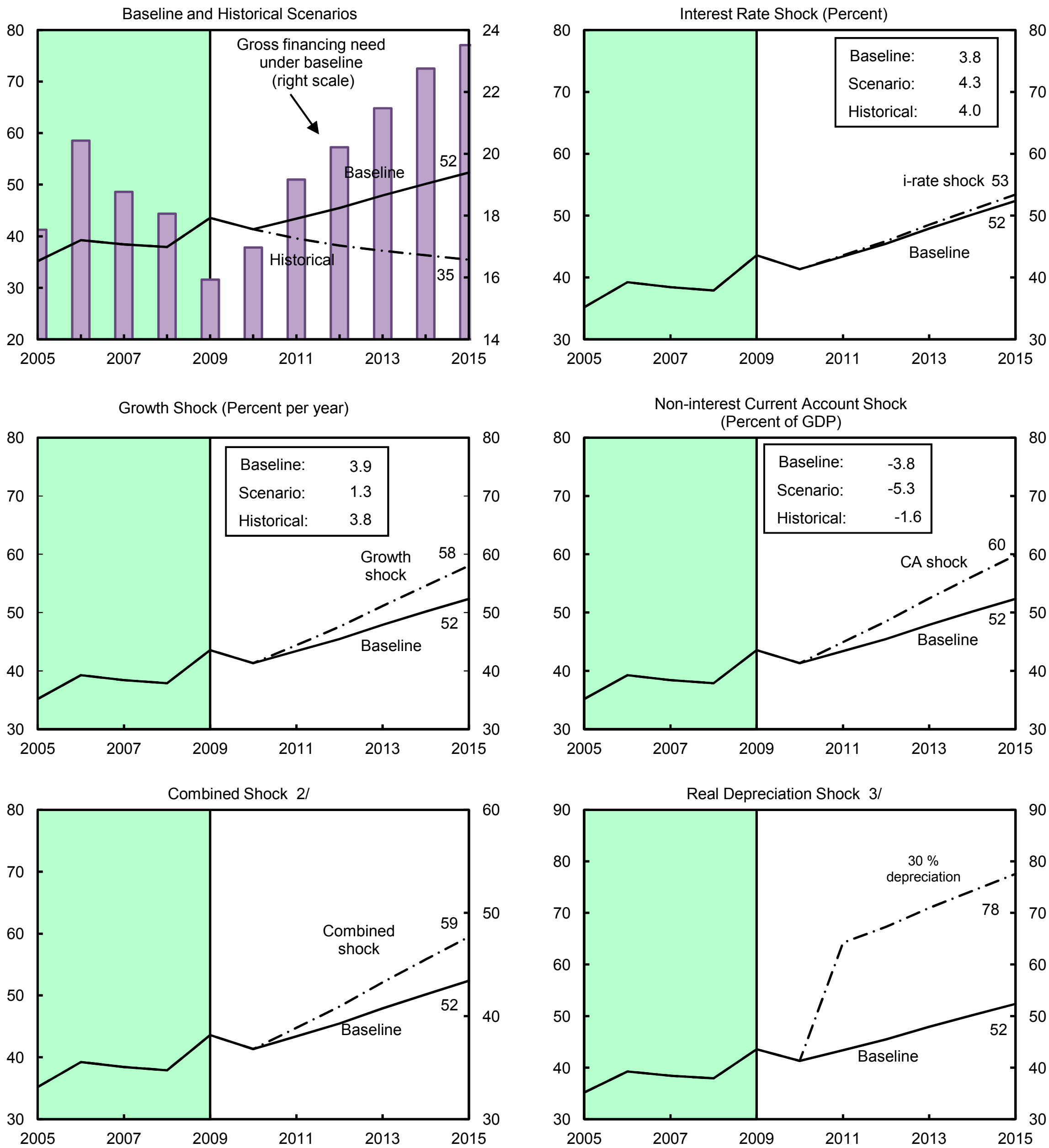
4/ For projection, line includes the impact of price and exchange rate changes.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period. Differs slightly from external financing requirement in Staff Report because includes official transfers and IMF repurchases but excludes increase in portfolio and other investment assets.

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

7/ 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.

Appendix Figure I.2. Turkey: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. 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/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

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

Appendix Table I.3. Turkey: Indicators of Fund Credit, 2007–15 1/

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Outstanding Fund credit (end of period)									
Billions of SDRs	4.5	5.5	5.1	3.7	1.9	0.6	0.0	0.0	0.0
Percent of quota	380	465	426	307	157	47	0	0	0
Percent of new quota	380	465	349	251	129	39	0	0	0
Percent of exports of goods and nonfactor services	5	5	6	4	2	0	0	0	0
Percent of GDP	1	1	1	1	0	0	0	0	0
Percent of public sector external debt	10	11	10	6	3	1	0	0	0
Percent of overall external debt	3	3	3	2	1	0	0	0	0
Percent of end-period foreign reserves	9	11	11	7	3	1	0	0	0
Repurchases of Fund Credit									
Billions of SDRs	3.4	1.2	0.5	1.4	1.8	1.3	0.6	0.0	0.0
Percent of quota	283	104	38	119	149	110	47	0	0
Percent of new quota	283	104	31	98	122	90	39	0	0
Percent of exports of goods and nonfactor services	4	1	1	1	2	1	0	0	0
Percent of GDP	1	0	0	0	0	0	0	0	0
Percent of public sector external debt service	27	11	5	13	16	12	5	0	0
Percent of overall medium- and long-term external debt service	11	3	2	5	6	4	2	0	0
Percent of start period foreign reserves	8	3	1	3	3	2	1	0	0
Percent gross public sector external financing 2/	31	15	6	18	22	16	8	0	0
Net Fund Resource Flows 3/									
Billions of SDRs	-3.0	1.0	-0.6	-1.5	-1.8	-1.3	-0.6	0.0	0.0
Percent of quota	-252	84	-47	-126	-152	-111	-47	0	0
Percent of new quota	-252	84	-38	-103	-125	-91	-39	0	0
Percent of exports of goods and nonfactor services	-3	1	-1	-2	-2	-1	0	0	0
Percent of GDP	-1	0	0	0	0	0	0	0	0
Percent of public sector external debt service	-24	9	-6	-14	-17	-12	-5	0	0
Percent of overall medium- and long-term external debt service	-10	3	-2	-5	-6	-4	-2	0	0
Percent start period foreign reserves	-7	2	-1	-3	-3	-2	-1	0	0
Percent gross public sector external financing 2/	-28	12	-8	-19	-22	-16	-8	0	0

Source: IMF staff estimates and projections.

1/ Projected on an obligations basis.
2/ Consolidated government and CBT. Includes reserve accumulation before repurchases.
3/ Purchases less repurchases and charges.

APPENDIX II: SPILLOVER CHANNELS FROM THE EURO AREA

Direct trade and financial links between Turkey and the most vulnerable euro-area countries are limited. However, the euro area as a whole is the primary market for Turkish exports and an important source for direct investment and other capital inflows. Hence, weaker euro area growth and appreciation of the lira against the euro coupled with depreciation against the U.S. dollar could significantly worsen Turkey's trade balance. In addition, a deterioration in global investor sentiment could, given Turkey historical sensitivity to international developments, reduce capital flows. On the other hand, Turkey's improved fundamentals and favorable growth prospects could instead position Turkey as a regional safe haven, thereby increasing capital inflows—consistent with developments in recent months.

A. Bank Spillovers

Direct channels of contagion from Turkish subsidiaries of banks headquartered in the most vulnerable euro-area countries (Greece, Ireland, Italy, Portugal and Spain—hereafter, EA-5) are relatively limited. Four such bank subsidiaries operate in Turkey and represent about 12 percent of banking sector assets (table below).[1] In all cases, and in contrast to funding models common in Eastern Europe, the Turkish subsidiaries do not depend heavily on funding from their EA-5 parents, relying instead on domestically sourced deposits (the average loan-to-deposit ratio is around 95 percent). Therefore, distress in EA-5 parent banks would be unlikely to have direct system-wide implications in Turkey due to the moderate market share of the local subsidiaries and their low dependence on parent bank funding.

Financial Position of EA-5 Banks' Subsidiaries in Turkey, March, 2010 (Percent)

Parent Bank Country	Greece	Portugal	Italy
Assets / total assets of Turkish banking system	4.1	0.1	8.1
Deposits / total assets of Turkish banking system	2.7	0.1	5.1
Total assets / total assets of parent bank 1/	7.7	0.6	13.6
Deposits/ total deposits of parent bank 1/	6.6	0.9	15.1

Sources: Bank for International Settlements; Bankscope; and Turkish Banker's Association.

1/ Based on the 2008 balance sheet data of subsidiaries and the consolidated balance sheet of each parent bank.

Other cross-border claims between the EA-5 and Turkey are also small. Direct cross-border lending from EA-5 bank headquarters directly to Turkish residents (not intermediated through a Turkish bank subsidiary) amounts to about $7.1 billion (only about 1 percent of the

[1] The smallest of these is in the process of being bought out by domestic capital.

Turkish banking assets) (table below).[2] Similarly, consolidated claims of Turkish banks on EA-5 residents, which include sovereign bonds and equities in addition to bank loans, are negligible (around US$ 1 billion).[3]

BIS Foreign Claims by Nationality of Reporting Banks, December, 2009 (Billions of U.S. dollars)

Creditor/Debtor Country	Greece	Ireland	Italy 3/	Portugal	Spain	Rest of Euro Area
Consolidated foreign claims of BIS reporting banks on Turkey 1/	25.2	0.0	0.0	0.8	0.4	64.3
Of which: direct cross-border lending 1/ 2/	6.4	0.0	0.0	0.3	0.4	27.2
Consolidated foreign claims of Turkish BIS reporting banks 1/	0.4	0.1	0.6	0.0	0.0	12.0

Sources: Bank for International Settlements; and IMF staff calculations.

1/ Based on June 2010 BIS consolidated foreign claims data vintage.

2/ Calculated by subtracting the loans and domestic government securities of the respective subsidiaries and branches in Turkey from total foreign claims.

3/ Unicredit does not have the majority share of Yapi ve Kredi Bankasi, so the latter claims on the Turkish economy are not included in BIS data.

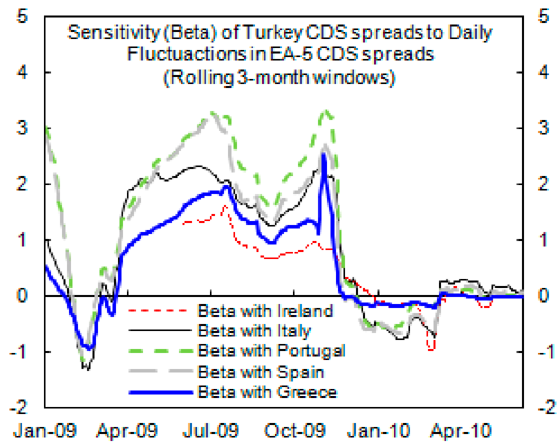
The broad range of financial transactions between euro area banks and Turkish banks pose an important source of contagion. Banks from other euro-area countries have only five relatively small subsidiaries in Turkey that represent, as a group, about 8 percent of the Turkish banking sector assets, while claims of Turkish banks on the rest of the euro-area (EA) are only US$12 billion. However, the Turkish banking sector is dependent on other EA banks as an important source for syndicated loans, currency swaps, and trade credit. Hence, impairment of other EA banks could have a significant impact on the funding of Turkish banks. Moreover, other EA banks provide a larger amount of credit directly to the Turkish economy (about US$30 billion).

[2] The BIS total foreign claims data (on the immediate borrower's basis) includes direct cross-border claims of foreign banks and claims of their foreign affiliates—subsidiaries and branches. To isolate direct cross-border claims, loans issued and government securities held by subsidiaries and branches are deducted from the total foreign claims.

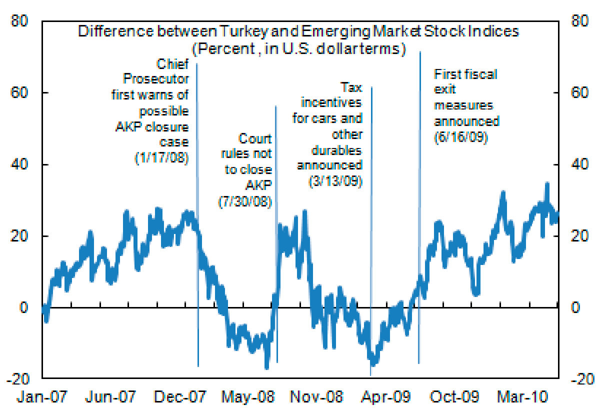
[3] According to the CBT, its holdings of euro-area government bonds are well diversified and it does not hold any significant amounts of EA-5 sovereign debt.

B. Sovereign Risk Contagion

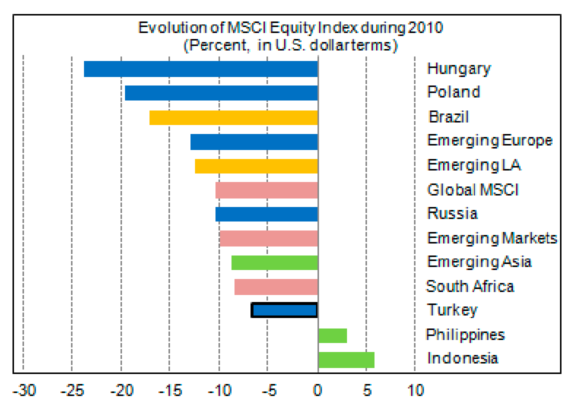
The sensitivity of Turkish financial markets to global risk appetite appears to have declined during the EA-5 sovereign debt crisis, with Turkey performing better than emerging markets in general. Turkish sovereign CDS spreads—which historically have been very responsive to global risk sentiment—appear to have decoupled from EA-5 CDS spreads since late 2009. In addition, Turkish equities have outpaced most regional EM averages in recent months. These developments may reflect the strength of the ongoing recovery in the Turkish economy, its resilience during the 2008-09 crisis, and stronger fundamentals than some EA countries. As a result, nonresidents have increased their share of Turkish government bonds (from 8.5 percent in February 2010 to 10.6 percent in May 2010, equivalent to about US$ 5 billion), while retaining their 65 percent share of equity holdings. However, the decoupling has not been complete, since more permanent inflows (e.g., FDI) have not yet recovered and the lira weakened somewhat against the US dollar (but strengthened against the euro) in May 2010. While too early to predict with confidence, it is possible that, going forward, Turkey could be perceived as a regional a safe haven.



Sources: Bloomberg; and IMF staff estimates.



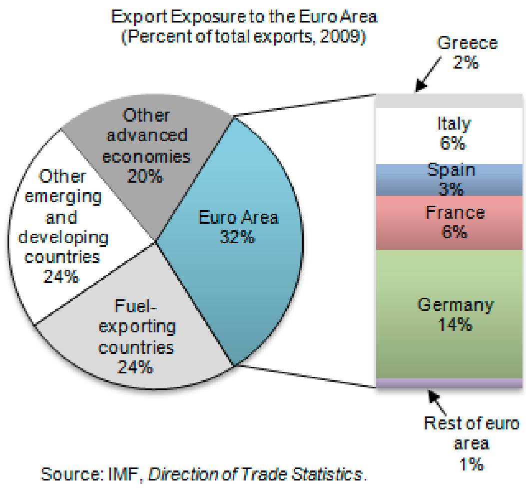
Sources: Bloomberg; and IMF staff estimates.



Sources: Bloomberg; and IMF staff estimates.

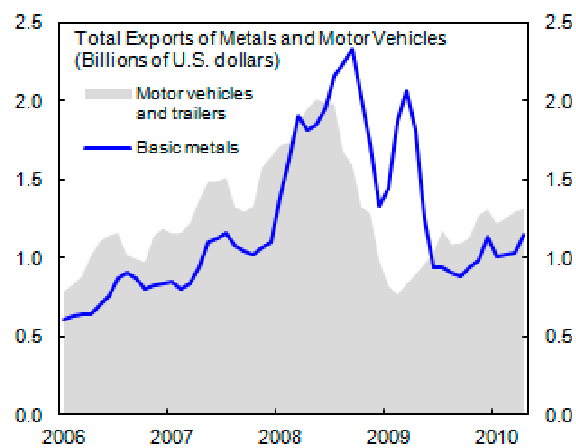
C. Trade Spillovers

Although direct trade channels with the EA-5 are limited, the euro area is Turkey's main trading partner. The EA-5 accounts for around 10 percent of Turkey's total exports, with Italy accounting for 6 percentage points. Nevertheless, the euro area as a whole absorbs 32 percent of Turkish exports, with Germany the largest export market at almost 15 percent. Although penetration of new markets (notably North Africa, Russia, and other fuel-exporting countries) has risen over time, it is unlikely demand from these countries could ramp up quickly to compensate for a potential protracted period of low demand in the euro area, especially in view of the types of products sold to the EA.



Source: IMF, *Direction of Trade Statistics*.

Weak demand from EU could imply considerable excess capacity in some of Turkey's key sectors. Exports to the EA are concentrated in the textile/apparel and vehicle sectors, with the EA-5 absorbing 15 percent and 18 percent, respectively, of total sector exports, with the rest of the euro area collectively absorbing around 50–60 percent. The exposure of metal manufacturers to the EA-5 is instead limited, accounting for only 5 percent of total sector exports (although around 30 percent for the euro area as a whole). Due to the highly cyclical nature of demand, the vehicle sector stands to be among the most affected by slow growth in the euro area, as evidenced during the 2008–09 crisis.



Source: Turkstat.

Sectoral Exposure to Euro Area Countries

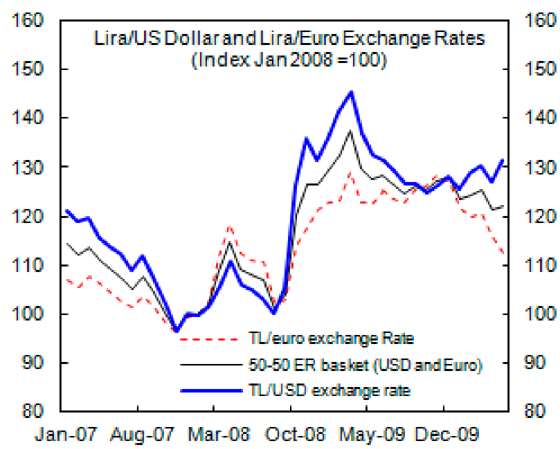
(Percent of total exports by sector from Turkey, 2009)

	EA-5		Rest of EA		
	Italy	Other	Germany	Other	Total EA
Agriculture, fishing, and forestry	9.4	13.0	8.9	9.1	31.0
Mining	3.7	13.3	1.6	7.1	22.0
Manufacturing	5.6	10.7	9.8	12.6	33.0
Of which: Vehicles	12.6	17.6	12.1	33.5	63.2
Textiles and apparel	6.1	14.6	19.1	14.0	47.7
Other	2.7	7.6	9.0	15.5	32.1

Sources: Turkstat; and IMF staff estimates.

D. Exchange rate effects

Appreciation of the Turkish lira against the euro, combined with depreciation relative to the U.S. dollar would affect Turkey through several channels. Since the beginning of the year, the lira has strengthened by more than 10 percent against the euro, but depreciated by 4 percent against the US dollar.



Source: CBT.

Trade channel

Turkey's bilateral trade balance with the EA is likely to worsen as a result of cross exchange rate movements, but the impact on the overall trade balance is more uncertain. Turkey's external trade is denominated mostly in euros and U.S. dollars. The effect of a change in the bilateral euro-lira and dollar-lira exchange rate on the trade balance depends on the elasticity of imports and exports to the exchange rate, the initial trade balance in each currency, and the size of the individual bilateral exchange rate movements.

Effect of the Exchange Rate on the Trade Balance

The trade balance denominated in lira of goods exchanged in currency i (TB_i) is defined as:

$$TB_i \equiv X_i - e_i M_i, \quad i = €, \$ \qquad (1)$$

where TB_i and exports (X_i) are denominated in lira (for convenience as numeraire), imports (M_i) are denominated in foreign currency i, the exchange rate (e_i) is expressed as lira per unit of foreign currency (hence, an increase is a lira depreciation), and prices of exports and imports are normalized to unity.[1] The total trade balance is therefore the sum of the euro and dollar trade balances. Differentiating (1) with respect to e_i, and multiplying by e_i/X_i gives the condition that a depreciation improves the trade balance if:

$$\eta_{X,ei} \; X_i/(e_i M_i) + \left| \eta_{M,ei} \right| > 1 \;. \quad (2)$$

Therefore, the effect of a change in the exchange rate on the trade balance depends on the elasticity of exports and imports with respect to the exchange rate ($\eta_{Q,ei}$, Q = X, M, and where $\eta_{M,ei}$ is negative), and the initial ratio of exports to imports to currency area i. A depreciation is more likely to improve the trade balance when exports and imports (the latter in absolute terms) are more responsive to the exchange rate, and the more positive is the bilateral trade balance.

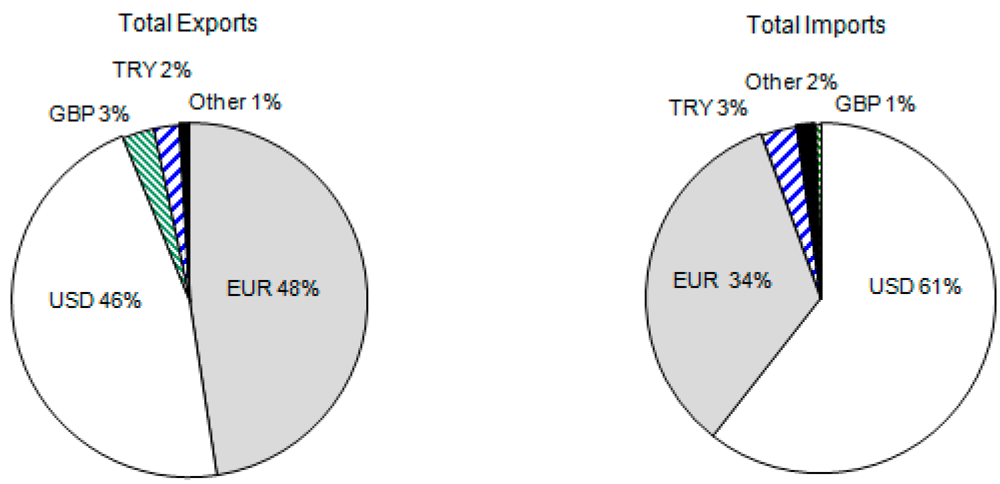
[1] For simplicity, it is assumed that trade in currency i is not affected by a change in exchange rate j, consistent with specialization of imports and exports. It is also assumed all else is unchanged, therefore abstracting from changes in GDP growth rates that may accompany shifts in bilateral exchange rates.

Turkey's bilateral trade balance with the EA is expected to worsen if the lira appreciates against the euro. Turkey's euro-denominated trade is currently close to balance, so the unweighted sum of the elasticities will determine the effect on the trade balance (the Marshall-Lerner (ML) condition). It is reasonable to expect that euro-denominated trade is fairly responsive to the exchange rate since exports to the EA are primarily manufactured goods that can be readily sourced from other countries (including from the European Union), while imports from the EA are a mix of intermediates used in the production of exports (and hence whose import elasticity is linked to the elasticity of final export demand) and a wide variety of consumer goods, the demand for which is likely to be price elastic.

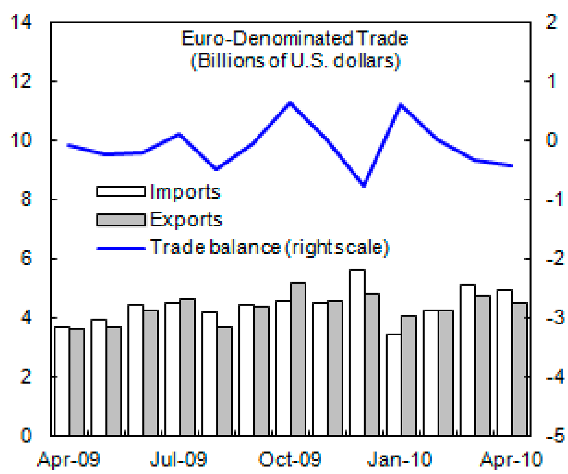
The effect of a depreciation relative to the US dollar on Turkey's dollar-denominated trade balance is less clear. Dollar-denominated exports are only half of dollar-denominated imports, thereby dampening the effect of the export elasticity. In addition, more than 30 percent of Turkey's dollar-denominated imports are energy products, which—given the high energy intensity of Turkish GDP and dependence on imported energy—are not likely to be very sensitive to changes in price. Hence, the "standard" result that a depreciation improves the trade balance may not hold in the case of the US dollar-denominated trade.

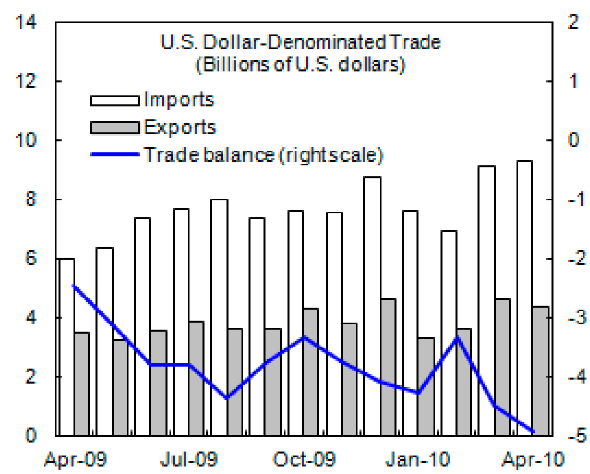
The net effect on Turkey's overall trade balance will also depend on the relative shift in the lira against the euro and the dollar. In recent weeks, the lira has tended to appreciate by more relative to the euro than it has depreciated relative to the dollar. This pattern of exchange rate movements makes it more likely that Turkey's trade balance would deteriorate as a result of shifts in the cross euro-dollar exchange rate.

Currency Composition of Exports and Imports, March 2010



Source: Turkstat.





Sources: Turkstat; and IMF staff calculations.

Financial channel

The financial channel may also be significant, but relevant data is very limited. While Turkish households are long in FX and Turkish corporates hold short FX positions, the foreign-currency denomination of their balance sheets is unknown. Based on a sample of 43 large companies, Finans Invest concludes that a 15 percent weakening of the euro against the U.S. dollar and a 5 percent depreciation of the lira against the dollar would result in small losses in non-operating income, but with considerable variation across firms.

Appendix Table II.1. Financial Position of European Banks' Subsidiaries in Turkey

Origin of Bank Subsidiary in Turkey	EA5	Euro Area Banks	Total Banking System 1/
Balance sheet items		(Billions of U.S. dollars)	
Total assets	66.8	111.1	543.4
Of which:			
Cash	4.3	7.6	27.2
Government securities	15.0	23.4	191.4
Loans	40.8	69.4	266.8
Total liabilities	66.8	111.1	543.4
Of which:			
Deposits	43.1	67.7	348.9
Funds borrowed	5.3	13.3	48.0
Shareholders' equity	8.7	14.5	74.0
Key ratios		(Percent)	
Balance sheet			
Loans / total assets	61.1	62.4	49.1
Government securities / total assets	22.5	21.0	35.2
Loan / deposits ratio	94.7	102.5	76.5
Funds borrowed / total assets	7.9	12.0	8.8
FX exposure 2/			
FX loans / total loans	26.7	24.0	28.4
FX deposits / total deposits	38.9	37.9	32.9
FX funds borrowed / total funds borrowed	83.5	81.9	82.1
Quality of loans 2/			
NPL (gross)	6.3	5.8	5.0
Net NPLs (after provisioning)	1.2	1.5	0.9
Capital ratios 2/			
Capital adequacy ratio	17.3	17.3	20.2
Shareholders' equity / total assets	13.1	13.1	13.6
Profitability and liquidity ratio 2/			
Net profit / total assets	0.8	0.6	0.7
Net profits / total shareholders' equity	5.9	4.8	5.4
Liquid assets / total assets	19.2	23.0	33.2
Memorandum items:			
Assets / total assets of Turkish banking system	12.3	20.5	…
Deposits / total assets of Turkish banking system	7.9	12.5	…
Bond holdings / total bond holdings of Turkish banking system	5.6	8.8	…
Assets / total assets of parent bank 1/ 3/	12.9	8.5	…
Deposits / total deposits of parent bank 1/ 3/	12.8	10.2	…

Sources: Turkish Banker's Association; BRSA; and IMF staff calculations.

1/ Deposit money banks.
2/ For EA5 countries or Euro area, average regional ratios are calculated by weighing individual bank ratio by asset size.
3/ Based on the 2008 consolidated balance sheet of each parent bank.

APPENDIX III. TURKEY'S NEW FISCAL RULE

The Turkish government is in the process of adopting a fiscal rule. The rule should help promote sustainable, countercyclical fiscal policy and will be accompanied by some improvements in the public financial management framework. However, success will require strong ownership and vigorous implementation.

The proposed rule

The Turkish government has announced plans to implement a fiscal rule from 2011. The rule establishes a medium-term overall deficit target of 1 percent of GDP for the general government. It then sets minimum reductions (or maximum increases) in the deficit each year that are consistent with converging to the medium-term deficit target over time.

Algebraically, the rule is of the form:

$$\Delta d = a(d_{-1} - d^*) + b(g - g^*)$$

where
Δd = the ceiling on the change in the overall deficit (as a percent of GDP) in the current year;
a = the convergence coefficient (a negative fraction between 0 and 1);
d_{-1} = the overall deficit in the previous year (in percent of GDP);
d^* = the medium-term deficit target (in percent of GDP);
b = the cyclicality coefficient (a negative fraction reflecting the desired sensitivity of the deficit to the cycle);
g = real GDP growth in the current year (in percent); and
g^* = assumed average long-run real GDP growth (in percent).

The ceiling on the annual change in the deficit (Δd) is the sum of two terms: The first term, $a(d_{-1}-d^*)$, calls for reducing a fraction (a) of the difference between the previous year's deficit and the medium-term deficit target. The second term, $b(g-g^*)$, accommodates the economic cycle, with higher growth requiring more adjustment and lower growth requiring less adjustment. The rule sets a ceiling on the change in the deficit—fiscal policy may be tighter than prescribed by the rule if economic conditions (such as financing or current account considerations) so require.

The variables d^*, g^*, a, and b will be fixed by legislation. Specifically, the draft fiscal rule legislation (which is currently in parliament) sets the medium-term deficit target (d^*) = 1; assumed average long-run growth (g^*) = 5; the convergence coefficient (a) = -0.33; and the cyclicality coefficient (b) = -0.33:

$$\Delta d = -0.33(d_{-1}-1) - 0.33(g-5)$$

While the average growth rate of 5 percent is optimistic, this is balanced by the relatively prudent medium-term deficit target of 1 percent of GDP. This reflects the algebraic equivalence between different combinations of $d*$ and $g*$. For example, if growth actually averages 4 percent (consistent with staff's medium-term projection), the deficit will converge to 2 percent, rather than the targeted 1 percent of GDP. Nonetheless, a 2 percent deficit should still ensure low debt levels over time.[1] The convergence coefficient of -0.33 implies that a third of the difference between last year's deficit and the medium-term target of 1 percent of GDP must be eliminated each year. The cyclical coefficient of -0.33 allows full operation of automatic stabilizers and some modest discretionary countercyclical policy, since general government revenue is slightly below 33 percent of GDP and the elasticity of revenue with respect to GDP is thought to be 1 or less (given the high reliance on petroleum and tobacco excises, which are not highly cyclical).

One way to view the rule is that it essentially establishes a minimum amount of structural adjustment each year, which in turn is a function of how far the overall deficit is from its medium-term target. To see this, note that if $g*$ equals potential growth, then the percentage change in the output gap in the current year can be approximated by ($g-g*$). If the coefficient b is set just to reflect automatic stabilizers, then the structural adjustment in any given year is the following:[2]

Structural adjustment in current year = $-\Delta d + b(g-g^*)$

Re-arranging the rule, one can see that the required amount of structural adjustment each year is a function of how far the headline deficit is from its medium-term target:

Structural adjustment in current year = $-\Delta d + b(g-g^*) = -a(d_{-1}-d^*)$

[1] Specifically, a 2 percent of GDP deficit should cause debt to converge (very slowly) to roughly 25 percent of GDP in the very long run if nominal GDP growth averages 8 percent. To see this, note that the continuous time relationship between debt and the deficit is given by $\Delta D = d - Dy$, where D and ΔD are the debt ratio and its change, d is the overall deficit ratio, and y is the nominal GDP growth rate. Therefore, as D rises, ΔD falls and vice-versa, so any fixed overall deficit target and fixed nominal GDP growth rate, y, causes debt to converge to a specific level. The long-run debt ratio is obtained by setting ΔD =0, yielding $D = d/y$.

[2] This leaves aside the issue of one-off fiscal effects, so that "structural adjustment" is equal to the change in the cyclically adjusted balance.

Desirable properties of this type of rule include the following:

- it is countercyclical;
- it applies symmetrically to both revenue and spending (unlike spending rules), limiting opportunities for revenue loopholes and promoting strong revenue collection;
- it does not require explicit estimation of the level of the output gap; this is desirable because the level of the output gap is quite uncertain and subject to large revisions;
- it is relatively simple for a structural balance-type rule; and
- it allows gradual adjustment when the deficit is away from its medium-term target; as a result, the amount of required adjustment in any given year should always be feasible, making the rule more politically durable.

Stress tests

To illustrate how the proposed rule behaves under different macroeconomic conditions, it is stress tested using five scenarios (see box). The simulations assume the rule takes effect in 2011 and that the macroeconomic scenarios diverge starting in 2012. The results of the simulations are shown in Appendix Figure III.1. In general, the rule behaves appropriately in response to the wide range of scenarios and shocks considered:

- In the baseline scenario (with long-run growth assumed to be 4 percent), the overall deficit converges to 2 percent of GDP, and debt falls gradually to 38 percent of GDP by 2020. In all scenarios, debt stays contained below 50 percent of GDP by 2020, including in the low growth scenario.
- Fiscal effort—defined as the change in the cyclically adjusted primary balance—remains feasible at little more than 1 percentage point of GDP in a single year, except in the initial years of the large shock and contingent liability scenarios, when the rule requires somewhat more adjustment to offset the significant increase in interest payments in these scenarios. Since the large shock scenario describes the "financing crunch" shocks that emerging markets have experienced in the past (i.e., when recession and depreciation coincides with sharply *rising* borrowing costs), tighter fiscal policy as required by the rule may be appropriate in such cases.
- However, if the rule is successful, Turkey may instead experience cycles as described by the boom-bust scenario in which interest rates *fall* during the bust (as occurred during the recent crisis and is common in advanced economies). In this scenario, the rule requires large primary surpluses during the boom, thereby creating space for a substantial stimulus (negative fiscal effort) of around 1.5 percent of GDP in the year output drops by 5 percent and with the primary surplus falling from over 3 percent of GDP at the peak of the boom to -2 percent of GDP at the trough of the cycle.

Stress Test Scenarios

The following five stress test scenarios are used to simulate the fiscal rule:

Baseline scenario: Staff's baseline scenario.

Large shock scenario: In this shock: (i) real GDP growth falls to -3 percent in 2012 and 0.5 percent in 2013; (ii) the exchange rate depreciates 20 percent above the baseline in 2012; and (iii) domestic and external borrowing costs rise by 5 and 2 percentage points, respectively, in 2012. The shock then dissipates in subsequent years (i.e., growth rates, interest rates, and the exchange rate level gradually return to baseline). This scenario illustrates how the rule responds to a combined shock to growth, interest rates, and the exchange rate.

Low growth scenario: Growth remains 1 percentage point below the baseline scenario indefinitely, starting in 2012.

Contingent liability shock scenario: Government debt is assumed to suddenly increase by 15 percentage points of GDP in 2012 (e.g., due to a call on guarantees).

Boom-bust scenario: Real growth is assumed to reach 7 percent during 2012 to 2015, and then collapse to -5 percent in 2016, after which it recovers gradually. Interest rates are assumed to be 2 percentage points higher than the baseline during the boom (2012-2015) and 3, 2, and 1 percentage points lower than the baseline during the first, second, and third year of bust, respectively.

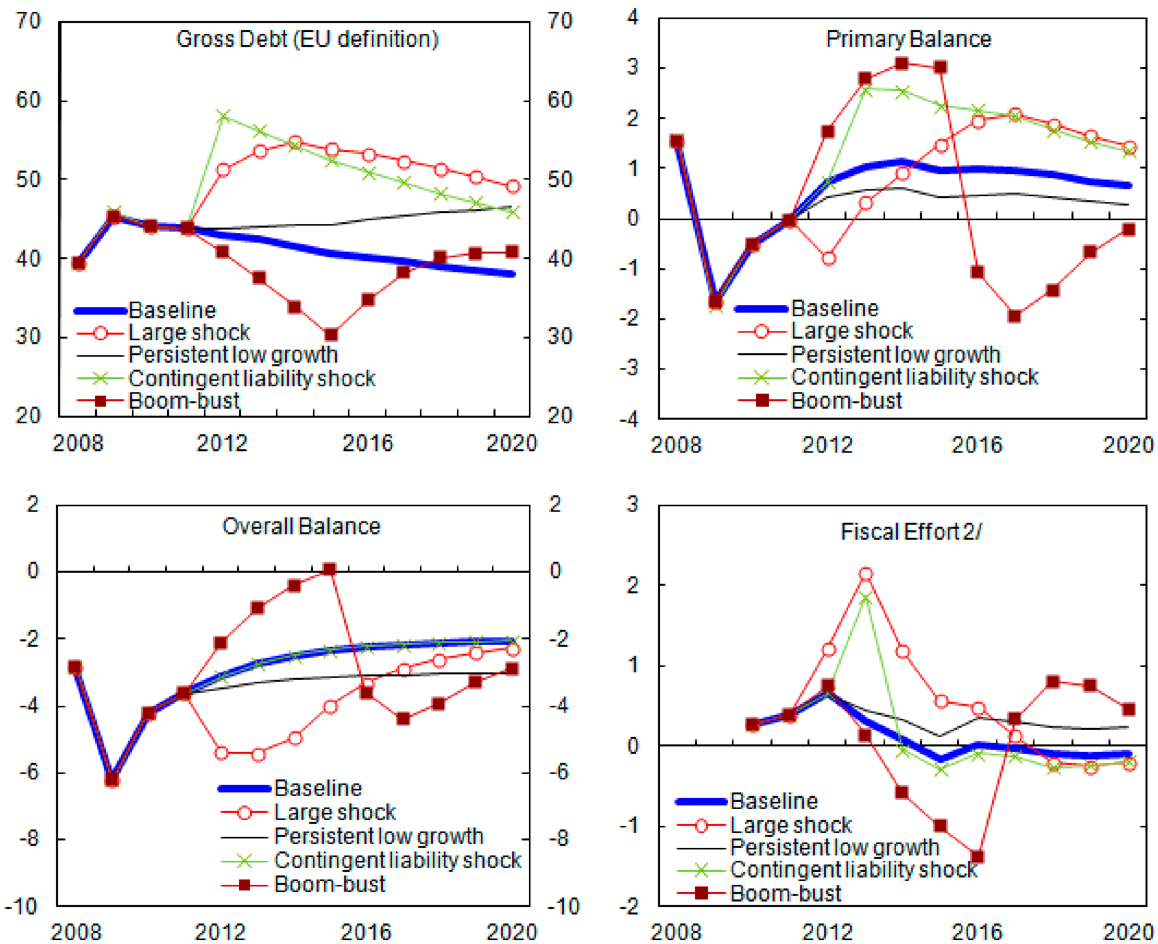
Real GDP Growth Rates in Stress Test Scenarios, 2010–20

(Percent)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Baseline	6.1	3.6	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Large shock scenario	6.1	3.6	-3.0	0.5	2.0	4.0	4.0	4.0	4.0	4.0	4.0
Low growth scenario	6.1	3.6	2.9	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Contingent liability scenario	6.1	3.6	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Boom-bust scenario	6.1	3.6	7.0	7.0	7.0	7.0	-5.0	0.0	3.0	4.0	4.0

Source: IMF staff calculations.

Appendix Figure III.1. General Govt Fiscal Indicators under Fiscal Rule and Various Scenarios 1/
(Percent of GDP)



Sources: IMF staff estimates.
1/ Assumptions for each scenario are described in the box.
2/ Fiscal effort is defined as the change in the cyclically adjusted primary balance.

Operationalizing the rule

The deficit ceilings set by the rule would apply both *ex ante* during the budget preparation process and *ex post* to the final outturn. A Medium-Term Program (MTP) projecting the main fiscal variables for the next three years will be published by June 15 of each year. Deficit targets in the MTP must be consistent with ceilings established by the rule, and a preliminary budget for the following year would be prepared on this basis. In October, the budget would be submitted to parliament, with any required revisions to the deficit target based on updated projections for the following year's growth and the projected deficit for the current year. During the budget year, the Economic Coordination Council would be required to submit proposed adjustment measures for cabinet's consideration in the event a violation of the rule is projected. Final performance against the rule would be judged based on the actual deficit outturn and the deficit ceiling as determined by the rule, using the actual growth outturn and the actual deficit outturn in the previous year.

Sanctions would be reputational. To strengthen reputational considerations and facilitate monitoring, the Ministry of Finance would publish quarterly fiscal monitoring reports. The Minister of Finance and Minister in charge of the State Planning Office would also be required to appear before parliament's Budget and Planning Committee at mid-year to report on compliance with the rule in the previous year, reasons for any deviations, and the outlook for compliance in the current year.

The draft fiscal rule legislation makes several improvements to Turkey's public financial management framework. Of note, it (i) requires the Minister in charge of the Treasury to co-approve domestic borrowing by local governments that exceeds 10 percent of annual revenue (along with the Ministry of Interior, which currently makes such approvals); (ii) reduces the ability to spend beyond budgeted levels from various privatization receipts; (iii) requires annual publication of long-run actuarial analyses of the pension and healthcare systems; (iv) bans off-budget offsetting of debts and receivables; and (v) strengthens monitoring of arrears. The law also establishes a balanced budget requirement for the state enterprise sector as a whole.

The rule's success could be further promoted by adopting additional public financial management reforms. Particularly useful would be mechanisms to encourage prudent budgeting, ensure timely implementation of within-year deficit-reducing measures when needed, and strengthen fiscal coordination between central and local governments.

Above all, the rule's success will depend on strong ownership and vigorous implementation.

Appendix IV: Current Status of Main Recommendations from the 2007 FSAP

Main Area	Specific Recommendations	Action Taken[1]
	Banking	
Implementation of banking law	Implement all regulations of the new banking law. Develop and implement a comprehensive plan for the BRSA to supervise banks in line with new legal and regulatory framework, including risk management.	All the sub-regulations issued pursuant to the banking law are in effect and executed on a continuous basis.
Review and amend procedures for handling failing banks	Reduce legal uncertainty that could cause disruptive court challenges. Eliminate the need for a supermajority on the banking supervisory board to transfer control of a failed bank to the SDIF. Shorten the period an intervened bank may be kept open. Ensure active involvement of all relevant agencies to promote timely and cost-effective action (e.g., by including SDIF into contingency planning).	The procedures related to handling problem banks are given explicitly in Banking Law articles 67–71. BRSA believes that the need for a supermajority to transfer control of a failed bank to the SDIF is essential for such an important action. The supermajority is also required for the establishment of a bank in Turkey. According to article 100 of the Banking Law, the Coordination Committee (including SDIF) convenes once every three months, exchanges information on the banking sector, and discusses measures to be taken as a result of the supervision of deposit banks. Moreover, issues related to contingency planning are evaluated by a Systemic Risk Coordination Committee.

[1] Prepared by the authorities. Staff's full assessment will occur in the context of the 2011 FSAP update.

Review mechanisms to ensure financial independence of supervisory agencies	Amend the legislation to allow the BRSA to be fully responsible for managing its expenditures budget without consulting the relevant Minister and, in general, any interference from the government. The BRSA should have the final decision on all technical issues related to its relevant sub-regulations.	No progress since the last FSAP report.
Conclude Memoranda of Understanding (MoUs) with remaining significant foreign supervision counterparties	The BRSA should develop informal or formal arrangements with foreign supervisors (particularly with countries where Turkish banks have material presence or with the home countries of banks with a major presence in Turkey) to ensure ongoing cooperation and information sharing.	The BRSA has signed MoUs with 13 out of 26 countries where Turkish banks have presence (i.e., subsidiaries, jointly-controlled undertakings, branches, and representative offices). The BRSA will finalize negotiations with the relevant supervisory authorities once the banking law is amended to introduce confidentiality provisions necessary to comply with some foreign supervisors' rules.
Prudential norms	Ensure FX-indexed loans are subject to similar constraints as FX loans.	Need no longer arises since FX-indexed loans to consumers are now prohibited.
Data management	To support enhanced supervisory practice, the authorities need to make better use of the information that is already available, and, as needed, selectively gather new types of information (e.g., on portfolio duration, corporate and household financial indicators, and dealings in derivatives).	To deepen the supervisory practices, consolidated supervision and financial data gathering have been paid special attention. In this context, for instance, to improve the off-site monitoring function, the Supervision IV Department was established in September 2008 to produce and report analyses on a consolidated basis. Daily information is obtained from banks and is regularly analyzed. Legislation on IT reporting systems for supervision is complete, and new supervision guidelines are being prepared. Supervision program for the year 2010 was formed in accordance with the guidelines.

Privatization	Complete privatization of state banks.	In the Medium-Term Program, the government has announced that preparation studies for public offerings of some shares of Ziraat Bank will be started; decisions regarding implementation will be made by taking into account progress and market conditions.
Taxation	Phase out transaction taxes: Banking and Insurance Transaction Tax (BITT) and Resource Utilization Support Fund (RUSF)	BITT on housing finance and investment fund transactions have been exempted. BITT rate has been reduced from 5 to 1 percent for purchases/sales of T-bills issued by CBT or securities acquired or sold by some public administrations (e.g., housing development administration or privatization agency). RUSF rate on consumer loans provided by banks and financial institutions was reduced from 15 to 10 percent.
Households and insurance sectors		
Mortgage and insurance law	Complete and implement regulations associated with the new laws. Establish prudential norms for mortgage lending, and assign related oversight responsibilities.	New mortgage and insurance law passed. Bylaw on Insurance Related Individual Credits was published on January 17, 2009. General Conditions for Payment Protection Insurance are in effect since February 2008 to protect debtors' installments to creditor against unemployment and incapability risks.
Data provision	Establish mechanisms to generate more reliable data on insurance companies' provisions and capital.	Legislation setting the rules for the calculation of "Capital Adequacy of Insurance, Reinsurance, and Pension Companies" has been adopted.
Capital Markets		
Resolve problems regarding privatization of the ISE	Remove ISE status as a government agency by privatizing it, allowing ISE governance to be competitive and cost effective.	Amendment in the Capital Markets Law needs to be made by December 31, 2010. (Depending on Parliament Schedule)

Capital markets law	Adopt a capital Markets Law in 2008. Key regulatory issues relate to the treatment of market conduct of large shareholders and corporate governance in publicly owned companies. The current system for valuing illiquid assets needs to be improved.	Amendment in the Capital Markets Law needs to be made by December 31, 2010. (Depending on Parliament Schedule) [2]
Corporate Governance		
Encourage market participation	Strengthen minority shareholders' protection and raise board members' accountability.	New communique requiring independent review/valuation for related party transactions that meet specific criteria (e.g. the amount of transactions exceeds a threshold) was adopted in 2008. The ongoing project on reviewing and amending corporate governance principles according to international developments (including the European Commission's recommendations on remuneration of directors of listed companies) is expected to be finalized by end-2010.
Accounting and auditing standards	Further strengthen accounting and auditing, especially in smaller nonfinancial firms (and non-listed firms).	Small and non-listed firms would be harmonized with internationally accepted accounting standards. (Depending on Parliament Schedule). [3]

[2] The recent financial architecture is going to change in the near future and the new Capital Markets Law has to take into consideration all these changes in its pertinent part.

[3] The financial architecture is going to be altered significantly and thus these changes may require corresponding changes in accounting and auditing standards.

INTERNATIONAL MONETARY FUND

TURKEY

Staff Report for the 2010 Article IV Consultation and Post-Program Monitoring—Informational Annex

Prepared by the European Department

July 13, 2010

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Annexes

ANNEX I: FUND RELATIONS

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 was temporarily suspended during subsequent discussions on a possible new Fund-supported program). Outstanding Fund credit amounted to SDR 4.8 billion (407 percent of quota) as of May 31, 2010.

The 2010 Article IV and Post-Program Monitoring Discussions were held in Ankara and Istanbul during May 12–26, 2010. The staff team comprised Ms. van Elkan (Head, EUR), Messrs. Cerutti, Fletcher, and Mati (all EUR), Mr. Tyson (FAD), Mmes. Goretti (SPR) and Mitchell-Casselle (MCM), and Mr. Lombardo (Res. Rep). Mr. Demirkol (Advisor, OED) joined the meetings. Mr. Kiekens (Executive Director) attended the concluding meeting.

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

(Data as of May 31, 2010)

I. **Membership Status**: Turkey became a member of the Fund on March 11, 1947. It has accepted the obligations of Article VIII, Sections 2, 3, and 4 as of March 22, 1990.

II. **General Resources Account**:	**Millions of SDRs**	**Percent of Quota**
Quota	1,191.30	100.00
Fund holdings of currency	5,929.33	497.72
Reserve position in Fund	112.78	9.47

III. **SDR Department**:	**Millions of SDRs**	**Percent of Allocation**
Net cumulative allocation	1,071.33	100.00
Holdings	969.75	90.52

IV. **Outstanding Purchases and Loans**:	**Millions of SDRs**	**Percent of Quota**
Stand-By Arrangements	4,850.80	407.19

V. **Latest Financial Arrangements:**

Type	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	02/04/02	15,038.40	11,738.96
Of which: SRF	12/21/00	12/20/01	5,784.00	5,784.00

VI. **Projected Payments to Fund [1/]:**

(In millions of SDRs; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2010	2011	2012	2013	2014
Principal	1,197.09	1,780.01	1,311.59	562.11	
Charges/Interest	37.83	40.77	17.79	3.26	0.26
Total	1,234.91	1,820.78	1,329.28	565.37	0.26

[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.

VII. **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.

VIII. **Exchange Rate Arrangement**:

Since February 22, 2001, the lira has been under an independent floating exchange rate regime.

IX. **Article IV Consultations**:

The last Article IV staff report (SM/07/151) was issued on May 4, 2007, and the accompanying Selected Issues paper (SM/07/154 and EBS/07/48) was issued on May 7, 2007. Board discussion took place on May 18, 2007.

X. 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. 03/363
Fiscal ROSC	March 24, 2006	Country Report No. 06/126
FSSA and related ROSCs	May 7, 2007	Country Report No. 07/361
Data ROSC	September 3, 2009	Country Report No 09/286

XI. Recent Technical Assistance:

Dept.	Timing	Purpose
FAD/MFD	Feb. 05	Treasury cash management and state bank reform
MFD	2005–06 (several missions)	Inflation targeting and monetary policy implementation
ICM	May 05	Investor relations office
FAD	July 05	Income tax reform
FAD	2005–08 (numerous missions)	Revenue administration reforms
FAD	Feb. 07	Health spending
STA	June 07 and Nov. 07	Revision of national accounts statistics and communication strategy
STA	Nov. 3-17, 2008	DATA ROSC

ANNEX II. WORLD BANK RELATIONS[1]

1. **Turkey and the World Bank Group have a strong partnership, which continuously deepened over the last ten years.** Economic growth, which averaged 6.8 percent annually between 2002 and 2007, slowed in 2008. As the global financial crisis and economic downturn hit Turkey's real economy hard in 2008 and 2009, the World Bank Group responded flexibly and quickly by (1) increasing new International Bank of Reconstruction and Development (IBRD) financing, to US$2.1 billion in FY09 and US$3 billion in FY10, and (2) re-focusing the program on addressing the impact of the crisis, in particular access to credit and jobs, while also (3) expanding the program on energy security and efficiency, clean and renewable energy, environmental management, and climate change as a long-term strategic priorities, in line with Turkey's rise as a regional and global player. Both the IBRD and the International Finance Corporation (IFC) accelerated and expanded financing to the private sector, including Small and Medium Enterprises, which generate the bulk of employment in Turkey and have been heavily credit constrained during the crisis. These adjustments to the current FY08–11 Country Partnership Strategy (CPS) are reflected in the CPS Progress Report (January 2010).

2. **Turkey is among the IBRD's largest borrowers and ranks fifth as of June 2010 in terms of exposure with US$ 10.2 billion in loans outstanding, representing 8.2 percent of the IBRD portfolio**. The current CPS FY08–11 IBRD is expected to provide up to US$ 8.1 billion financing of which up to US$ 6.3 billion financing has already been delivered in the first three fiscal years. In the last year under the current CPS, IBRD plans to commit up to US$ 1.8 billion. Turkey's active portfolio comprises 18 projects with a total commitment of US$ 5.7 billion (June 2010) which performs well and is improving with a continuing trend towards fewer, larger operations.

3. **IFC's new commitments reached US$351 million in FY09 and US$401 million in FY10**. IFC has supported infrastructure projects and investments by existing clients with a focus on improving competitiveness, energy efficiency and clean production. IFC continued providing trade and medium-term finance to local banks and supporting Turkish companies investing outside of Turkey (from Latin America to Russia and MENA).

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 assessments of the economic and social impact of the crisis and policies and programs to mitigate it and promote growth recovery, Country Economic Memorandum on informality and on savings and growth, a programmatic Public Expenditure Review, studies of female labor force participation, the inequality of opportunities, the

[1] Prepared by World Bank staff.

quality of education, an investment climate assessment, and technical assistance on food safety, sustainable development, watershed management.

5. **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, EU, United Nations organizations, and key bilateral partners.

ANNEX III. STATISTICAL ISSUES

1. **Data provision to the Fund is broadly adequate for surveillance and program monitoring 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 very 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 in 2009, and a new CPI was compiled. 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 only by product (and not by economic activity).

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) and in current prices for the income approach. The national accounts are compiled in accordance with the *1993 System of National Accounts* (*1993 SNA*) methodology.

4. **In March 2008, revised annual and quarterly estimates were released for 1998 onwards following the introduction of *ESA 1995* in Turkish National Accounts**. The new national accounts data implement the main recommendations from the 2001 Data Module of the Report on the Observance of Standards and Codes (Data ROSC): (i) improved estimation and deflation of output and household consumption; (ii) disaggregated deflation of trade in services and inclusion of shuttle trade in exports of goods; and (iii) improvement in the estimation of selected aggregates. 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 new data are published quarterly with a three month 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 some 2−3 weeks**. 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 and state economic enterprises (SEEs); 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.

7. **Turkey reports fiscal data for publication in the *Government Finance Statistics Yearbook***. The latest data available are for 2008 and cover the central government budgetary sector (including annex budget units). Data are not provided for social security units or local government. Monthly data are being reported 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 about a two-to-three-month lag. The CBT does not expect to meet the SDDS timeliness requirement for the analytical accounts of the banking sector in the short term due to delays in the preparation of year-end bank balance sheets. The CBT reports to STA the Standardized Report Form (SRF) 1SR for the Central Bank on a monthly basis with a two-week lag and SRF 2SR for the Other Depository Corporations with a two-to-three-month lag.

9. **In February 2010, Turkey made a high-level political commitment to work with the Financial Action Task Force on Money Laundering (FATF) to address its strategic AML/CFT deficiencies**[1]. Since that time, Turkey has demonstrated progress in improving its AML/CFT regime, including by drafting CFT legislation. However, the FATF has determined that certain strategic AML/CFT deficiencies remain. The authorities plan to address these deficiencies by implementing their action plan, which calls for: (i) adequately

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[1] Statement by the Financial Action Task Force (FATF) on "Improving global AML/CFT compliance: ongoing process", June 25, 2010.

criminalizing terrorist financing; and (ii) implementing an adequate legal framework for identifying and freezing terrorist assets.

External sector statistics

10. **In line with SDDS prescriptions, Turkey disseminates**:

- monthly balance of payments (BOP) statistics with a 5–6 week lag;
- weekly international reserves with a one-week lag;
- monthly data on the template on international reserves and foreign currency liquidity (reserve template) within one month after the reference period;
- monthly merchandise trade data with a one month lag;
- quarterly external debt with one quarter lag; and
- international investment position (IIP) data with a six month lag.

11. **The central bank reports quarterly BOP data to STA with about four months lag**. Balance of payments and IIP statistics are compiled in broad conformity with the conceptual framework of the fifth edition of the *Balance of Payments Manual* (*BPM5).* The CBT periodically reviews the international transactions reporting system (ITRS) to address problems of coverage and misclassification using supplemental data sources and estimation techniques.

TURKEY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of June 30, 2010)

	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]	Memo Items: Data Quality Accuracy and reliability[9]
Exchange Rates	06/30/10	06/30/10	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	06/30/10	06/30/10	W	W	W		
Reserve/Base Money (narrow definition)	06/30/10	06/30/10	W and M	W and M	W and M	O,O, LO, O	O, O, O, O, O
Reserve/Base Money (broad definition)	06/30/10	06/30/10	W and M	W and M	W and M		
Broad Money	06/30/2010	06/30/10	W and M	W and M	W and M		
Central Bank Balance Sheet	June 2010	06/30/10	W and M	W and M	W and M		
Consolidated Balance Sheet of the Banking System	June 2010	06/30/10	W and M	W and M	W and M		
Interest Rates[2]	06/30/10	06/30/10	D/W/M	D/W/M	W/M		
Consumer Price Index	June 2010	07/02/2010	M	M	M	O,LO,O,LO	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	May, 2010	05/15/2010	M	M	M	O, LO, O, O	O, O, LO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May, 2010	05/15/2010	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2010	06/30/2010	M	M	M		
External Current Account Balance	April 2010	06/11/2010	M	M	M	O, O, O, LO	O, O, O, O, O
Exports and Imports of Goods and Services	April 2010	06/11/2010	M	M	M		
GDP/GNP	Q1 2010	06/30/2010	Q	Q	Q	O, LO,O, O	LO, O, LO, O, LO
Gross External Debt	April 2010	06/17/2010	Q	Q	Q		
International Investment Position[6]	April 2010	06/18/2010	A	A	A		

[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.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/107
FOR IMMEDIATE RELEASE
July 30, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation and Post-Program Monitoring with Turkey

On 30 July, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation and Post-Program Monitoring with Turkey.[1]

Background

Almost a decade of sound macroeconomic policies and reforms allowed Turkey to enter the global financial crisis in a stronger position than many other countries in Emerging Europe. Prior to the crisis, a more contained foreign credit-induced boom, better focus of policies on leaning against the cyclical upswing, and a more restrictive regulatory environment for credit helped limit the build-up of vulnerabilities and kept banks' and households' balance sheets strong.

These strengths helped the Turkish economy rebound quickly from the steep drop in output precipitated by the global financial crisis. After plummeting during late 2008 and early 2009, GDP recovered rapidly on the reflow of capital and the consequent improvement in domestic confidence. The broadly appropriate relaxation of fiscal, monetary, and financial policies also contributed to the recovery. In all, GDP fell 4¾ percent in 2009. However, the current account deficit, which shrank in 2009 on weak demand, has since widened. Large excise increases and food price shocks in early 2010 caused a temporary spike in inflation that also raised inflation expectations. Unemployment, while moderating from its peak, remains elevated. Nevertheless, the banking sector has seen only a modest rise in the share of nonperforming loans and capital adequacy ratios remain high.

The recovery is expected to remain strong in the near term, accompanied by widening external imbalances. Growth is likely to exceed 6 percent this year owing to base effects and solid

[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. 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.

within-year momentum from credit-driven demand. Inflation is forecast to continue to subside but remain in the upper half of the target band. With the resumption of growth and abundant global capital flows, the current account deficit is expected to widen to 4¾ percent of GDP on buoyant import growth. This reflects the heavy cost of formal sector employment and the high energy intensity of output. With growth dependent on foreign financing, low reserve cover and the shorter duration of capital inflows could raise output volatility if global conditions deteriorate or risk appetite weakens.

Executive Board Assessment

Executive Directors commended the Turkish authorities for their far-reaching reforms and prudent policy stance that limited vulnerabilities prior to the crisis, paved the way for an effective crisis response, and contributed to the robust economic recovery now underway. Directors considered that Turkey's main challenge is to contain external imbalances that could undermine the recovery. In particular, they noted that an excessive reliance on imports would deteriorate the external position, making growth dependent on potentially unstable external financing, given the uncertain global outlook.

Directors observed that containing external imbalances requires bringing forward the exit from crisis-related stimulus and undertaking reforms to limit import dependence by lowering production costs. They encouraged the authorities to step up the unwinding of fiscal stimulus in 2010 by saving all revenue overperformance in excess of mandatory spending increases. This would help contain current account and inflation pressures, limit private sector crowding out, and reinforce the authorities' fiscal discipline credentials.

Directors welcomed the preparation of a new fiscal rule, which they considered would significantly strengthen the policy framework, and hoped that it will underpin the preparation of the 2011 budget. In this regard, they looked forward to a swift approval of the draft legislation and hoped the delay in its consideration would be short lived. They noted that the success of the rule would depend on the authorities' steadfast commitment, backed by strong political support and sufficient auxiliary measures, including a strengthening of tax administration and containment of spending pressures.

With interest rates in advanced countries at historical lows and inflation pressures at home moderating, most Directors called for a gradual monetary tightening, which would obviate the need for a sharper and larger tightening later on. Directors endorsed staff's proposal for a moderate increase in the amount of daily, preannounced foreign-currency purchases to more quickly build reserves to protect against capital account volatility, while preserving exchange rate flexibility within the inflation-targeting framework.

Directors generally called for phasing out financial sector regulatory relaxation—initially introduced, as in many countries, in response to the global crisis. To prevent the buildup of future risks, Directors recommended strengthening macro-prudential regulations on credit cards, unhedged lending to firms, and debt-service limits on mortgages, as well as utilizing more comprehensive stress test scenarios. Directors welcomed the authorities' request for an FSAP update during 2011.

Directors took note of staff's assessment of the existence of a competitiveness gap. They underscored the need for bold structural reforms to bolster competitiveness, secure job-rich growth, reduce reliance on external saving, and lower import dependence. They advocated better alignment of employment costs with those of regional peers. In this regard, Directors welcomed the preparation of a comprehensive employment strategy, which aims at increasing flexibility and addressing some structural issues in the labor market. Sustained and uniform application of the energy cost pass-through pricing formula would moderate demand for imported energy by promoting conservation and more efficient generation capacity.

The next Article IV consultation with Turkey is expected to be held on the standard 12-month cycle.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Turkey: Selected Economic Indicators, 2005−10

	2005	2006	2007	2008	2009 Prelim.	2010 Proj.
			(Percent)			
Real sector						
Real GDP growth rate	8.4	6.9	4.7	0.7	-4.7	6.1
Private consumption growth rate	7.9	4.6	5.5	-0.3	-2.3	6.1
Private gross fixed investment growth rate	16.2	15.0	2.6	-9.0	-22.3	20.5
Contributions to GDP growth						
Private domestic demand	8.8	6.3	5.0	-1.8	-8.1	8.7
Public spending	1.0	0.9	0.8	0.6	0.7	-0.5
Net exports	-1.4	-0.3	-1.2	1.9	2.7	-2.1
GDP deflator growth rate	7.1	9.3	6.2	12.0	5.4	8.2
Nominal GDP growth rate	16.1	16.9	11.2	12.7	0.4	14.8
CPI inflation (12-month; end-of period)	7.7	9.7	8.4	10.1	6.5	7.6
PPI inflation (12-month; end-of-period)	2.7	11.6	5.9	8.1	5.9	7.1
Unemployment rate	10.2	9.9	10.3	11.0	14.1	…
Average nominal treasury bill interest rate	16.2	18.1	18.1	19.3	10.9	...
Average ex-ante real interest rate	6.0	8.6	6.9	12.2	2.0	...
			(Percent of GDP)			
Nonfinancial public sector 1/						
Primary balance	5.0	4.7	3.1	1.6	-1.0	-0.3
Net interest payments	5.3	5.1	4.9	4.4	4.6	3.7
Overall balance	-0.3	-0.4	-1.9	-2.8	-5.6	-4.1
Debt of the public sector						
General government gross debt (EU definition)	52.3	46.1	39.4	39.5	45.4	44.1
Net debt 2/	46.3	40.0	34.4	34.5	39.4	38.4
External sector						
Current account balance	-4.6	-6.1	-5.9	-5.7	-2.3	-4.7
Nonfuel current account balance	-0.7	-1.3	-1.5	-0.2	2.0	-0.2
Gross financing requirement	15.9	21.0	18.7	18.8	17.0	14.9
Foreign direct investment (net)	1.9	3.6	3.1	2.2	1.0	1.2
Gross external debt 3/	35.2	39.3	38.4	37.9	43.6	41.3
Net external debt	20.3	21.0	21.0	21.6	25.1	25.0
Short-term external debt (by remaining maturity)	14.2	15.0	11.6	15.5	13.2	15.2
Monetary aggregates						
Nominal growth of M2 broad money (percent)	24.5	24.7	15.7	26.7	13.0	…
GDP (billions of U.S. dollars) 4/	482.7	529.2	649.1	730.3	615.3	…
GDP (billions of Turkish lira)	648.9	758.4	843.2	950.5	954.0	1,095.6
Per capita GDP (2009): $8,723 (WEO)						
Quota (2009): SDR 1,191.3 million (1,837 million U.S. dollars)						

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

1/ Fiscal projections assume the authorities adhere to their budget target for 2010.

2/ Nonfinancial public sector net debt.

3/ 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 CBT).

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