IMF Resident Representative Office in the Republic of Turkey

PRESS RELEASE

A routine International Monetary Fund (IMF) surveillance mission led by Mr. Donal McGettigan visited Turkey during September 12–23, 2019, for the annual Article IV consultation.[1]

In line with usual practice, the mission met with the Turkish authorities in addition to representatives from the private sector, political parties, academia, and think tanks, to hear a range of views about economic developments and prospects.

At the end of their visit, the team issued the following concluding statement, which can also be found on www.imf.org

[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. (IMF Factsheet on Surveillance)

1. Press Statement by Ben Kelmanson

Turkey: Staff Concluding Statement of the 2019 Article IV Mission

September 23, 2019

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Growth has rebounded, aided by policy stimulus and favorable market conditions, following the sharp lira depreciation and associated recession in late-2018. The lira has recovered and the current account has seen a remarkable adjustment. Turkey remains susceptible to *external and domestic risks, however, and prospects for strong, sustainable, medium-term growth look challenging without further reforms. Current positive market sentiment provides a good opportunity to enact a set of reforms that would address vulnerabilities, strengthen policy credibility, and set the economy on a higher and more sustainable growth path. Against this backdrop, we look forward to the forthcoming New Economic Program (NEP), which should clearly diagnose the challenges facing the economy and outline a comprehensive set of policies to address them.*

Background—Growth and Imbalances

1. **Turkey achieved strong growth in recent decades, but at the same time imbalances increased.** Initially, broad-based macroeconomic and structural reforms supported growth, poverty reduction, and income convergence with advanced economies. As reforms waned, however, growth became increasingly dependent on externally-funded credit and demand stimulus. As a result, Turkey entered 2018 with an economy running above potential and a large current account deficit, largely financed by debt-creating flows.

2. **These imbalances contributed to last year's sharp lira depreciation and associated recession.** Negative sentiment towards EMs and adverse geopolitical developments ultimately triggered sizeable lira depreciation in August 2018. The exchange rate shock and a necessary, but belated, monetary policy reaction were accompanied by a recession in the second half of the year and a sharp increase in unemployment.

Recent Developments—Stimulus and Recovery

3. **Growth has since resumed, aided by policy stimulus.** Buoyed by expansionary fiscal policy, rapid state bank credit provision, a strong contribution of net exports, and more favorable market sentiment, the economy registered positive growth in the first half of 2019. Staff now expects growth to be positive this year—about ¼ percent—despite the large negative carryover effects from last year's recession.

4. **The lira has recovered as market pressures have abated.** Import compression and a strong tourism season have led to a remarkable current account adjustment, and only a small deficit is expected this year. This, combined with improved market sentiment and geopolitical developments, have taken pressure off the lira.

5. **This set the stage for a steep decline in inflation.** High real policy rates, lira stability, favorable base effects, and resulting lower inflation have allowed the CBRT to cut policy rates. While inflation could fall to single digits over the coming months, staff expects end-year inflation of below 14 percent.

Outlook—Challenges Remain

6. **The current calm appears fragile.** Reserves remain low, and private sector FX debt and external financing needs high. Non-financial corporate balance sheets have been stressed by lira depreciation, higher interest rates, and lower growth. Banks report adequate capitalization and moderate NPLs, but loan restructuring has increased and staff expects the

lagged effect of the recession and the weaker lira to continue to put strains on asset quality. High dollarization reflects, among other things, weaker domestic sentiment and state bank funding needs. And, while public debt is low—a key strength for Turkey—the fiscal deficit has increased and uncertainty over the possible scale of contingent liabilities and potential debt rollover pressures limit available fiscal space.

7. **Prospects for strong sustainable growth have weakened and risks remain on the downside.** Despite the recent turnaround, without consistent implementation of a comprehensive package of reforms, medium-term growth is likely to remain subdued given balance sheet strains. Risks include a deterioration in sentiment towards emerging markets, possible policy implementation risks, and adverse domestic or geopolitical developments.

Policies—Securing Stronger and More Resilient Growth

8. **The main policy challenge is to move from a short-run growth focus to securing stronger and more resilient growth over the medium term.** This could be achieved through a five-pronged policy response:

- tight **monetary** policy to boost central bank credibility, underpin the lira, durably lower inflation, and strengthen reserves;
- steps to bolster medium-term **fiscal** strength;
- a comprehensive third party assessment of **bank** assets and new stress tests, with follow-up measures, as needed, to further strengthen confidence in banks;
- additional steps, building on existing reforms, to strengthen the insolvency and **corporate** restructuring framework; and
- focused **structural reforms** to support productivity growth and increase economic resilience.

Although these reforms may come with short-term output tradeoffs, the growth payoffs over the medium- and longer-term are likely to be large, and downside risks would also be significantly contained.

Monetary Policy: Strengthening Credibility

9. **Durably lowering inflation remains the most important challenge for monetary policy, and is the best way to permanently lower interest rates.** The central bank continues to work to enhance its credibility, including by seeking to strengthen its communications. Nevertheless, in staff's view, the CBRT easing cycle has been too aggressive given still-high inflation expectations and the need to mitigate macro-financial risks. Monetary policy should keep rates on hold until there is a durable downturn in inflation and inflation expectations. This would also underpin the lira, allow reserves to be rebuilt, and support de-dollarization.

10. **Clearer monetary and intervention policy would further boost credibility.** Notwithstanding progress in simplifying the monetary policy framework, reducing the many instruments and rates through which liquidity is provided would further clarify the policy stance. A transparent framework for pre-announced FX purchases—with these being the sole preserve of the CBRT—should be implemented at the appropriate time. As volatility subsides, remaining measures that aimed at containing excessive volatility in capital flows should be phased out.

Fiscal Policy: Preserving the Anchor

11. **Fiscal policy—a longstanding strength for Turkey—should remain a key anchor.** The recent fiscal stimulus has helped the economy recover and we welcome the unwinding of some of the measures taken given recent economic strength. In staff's view, a neutral fiscal stance next year would still support growth, allowing automatic stabilizers to work, but further discretionary stimulus should be avoided to contain financing needs and preserve fiscal space.

12. **Measures of about 1½ percent of GDP over the medium term would help stabilize the debt burden around current, commendably low, levels.** Persistent gaps have opened up between primary spending and tax revenues, which could undermine Turkey's traditionally strong debt dynamics. Revenue mobilization measures could include broadening the tax base and enhancing revenue efficiency by raising and unifying reduced VAT rates. Personal income tax could also benefit from reforms. On spending, removing backward-looking public wage indexation, rationalizing subsidies and transfers, and better targeting social assistance would also help.

13. **Fiscal structural reforms would support consolidation.** Staff welcomes the authorities' efforts to strengthen oversight and management of PPPs, including through plans to publish a monitoring report and introduce a new PPP law. It would be important for the legislation to ensure that such partnerships are fully integrated with the overall budgetary process, including their authorization and appraisal. Consistent budget execution and a thorough monitoring of fiscal risks, including publication of a fiscal risk statement, would further strengthen fiscal credibility.

14. **Further monitoring of extra budgetary institutions would also be welcome.** The scope and role of extra-budgetary and other non-central government entities and institutions need to be carefully defined and monitored, with the maximum degree of transparency and a strong governance framework. In this regard, the investment mandate of the recently-established Turkey Wealth Fund (TWF) risks fragmenting management of public spending outside of the budgetary process. The TWF's governance structure could also be refined to limit potential conflicts of interest.

Financial and Corporate Sector Policies: Stability and Rebalancing

15. **Further steps to clean up bank and corporate balance sheets would support financial stability and stronger and more resilient growth over the medium term.**

Banks' impairment and restructuring practices should be reviewed to support loan repayments in a durable and sustainable manner. We encourage the authorities to further pursue their efforts to strengthen the current resolution regime. To complement this, an early comprehensive third-party asset quality review (AQR) and ensuing stress tests, accompanied, to the extent needed, by further measures, would help shore up market confidence.

16. **Actions to support credit growth should be limited.** Efforts to expand lending, including through state banks and the CGF, should be limited and should also ensure that resulting credit is provided only to viable borrowers. In line with past application of macro-prudential measures, the authorities should stand ready to use such tools to rein in excessive and/or imprudent credit growth. The recent changes to incentivize private bank lending with reserve requirements should be revisited.

17. **Additional efforts, building on existing reforms, to strengthen the insolvency regime and out-of-court restructuring would help release resources and restart productive lending.** Staff welcomes ongoing efforts, including a comprehensive review of existing insolvency legislation, to better balance debtor and creditor rights. This, combined with tighter NPL classification and enforcement, would inform better pricing of NPLs and increase the attractiveness of out-of-court solutions and encourage more durable restructurings.

Structural Reforms: Boosting Productivity

18. **Focused structural reforms would improve prospects for stronger sustainable growth and increase the economy's resilience to shocks.** Product market efficiency could be enhanced by simplifying business entry and exit, addressing barriers to competition and allowing automatic energy pricing adjustments. The quality of human capital could be raised by upgrading education and on-the-job training. Early childhood education and childcare could further increase female labor force participation. Labor market flexibility could be improved by eliminating backward-looking public wage indexation and aligning minimum wages with expected inflation and productivity. Severance pay could be reformed to encourage labor mobility.

19. **Governance reforms could also help growth prospects.** Improving regulatory predictability and simplifying administrative procedures would help the business environment and investment climate. Minimizing regulatory forbearance would enhance transparency. Improvements in governance could also magnify structural reform payoffs.

The IMF team would like to thank the authorities and private sector counterparts for their warm hospitality and constructive discussions.