

**EXECUTIVE
BOARD
MEETING**

SM/21/70
Correction 3

May 26, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Turkey—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/70 (5/14/21) have been provided by the staff:

Mischaracterizations of the Views of the Authorities

Page 26

Evident Ambiguity

Pages 14 (fifth bullet), 15 (para. 16), 24, 27, 33, 47, 56 (“EU definition”), 63 (para. 3)

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

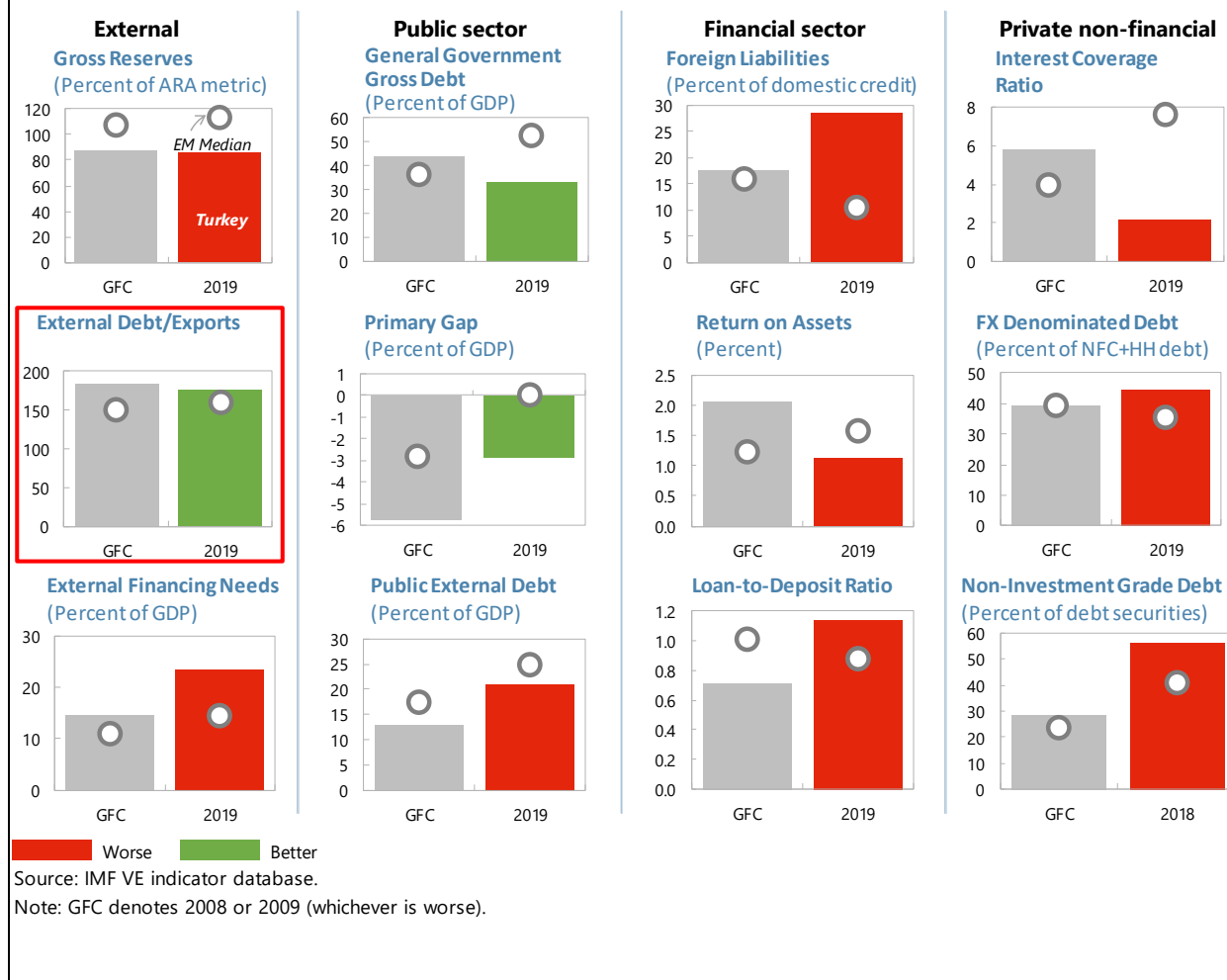
Pages 5, 6, 9, 12, 14 (second and sixth bullets), 15 (text table, data), 19, 21, 29, 46, 50, 53 (column 3), 56 (data), 57, 61, 63 (para. 1), 66, 71 (para. 1), 73, 74 (para. 2, line 12), 77

Typographical Errors

Pages 15 (text table, “includes”, 22, 36, 38, 71 (para. 3), 74 (para. 2, line 7), 75

Questions: Mr. McGettigan, EUR (ext. 36407)
Ms. Domit, EUR (ext. 34174)
Mr. Guzzo, EUR (ext. 38167)
Mr. Kelmanson, EUR (ext. 34906)
Mr. Pienkowski, EUR (ext. 37625)

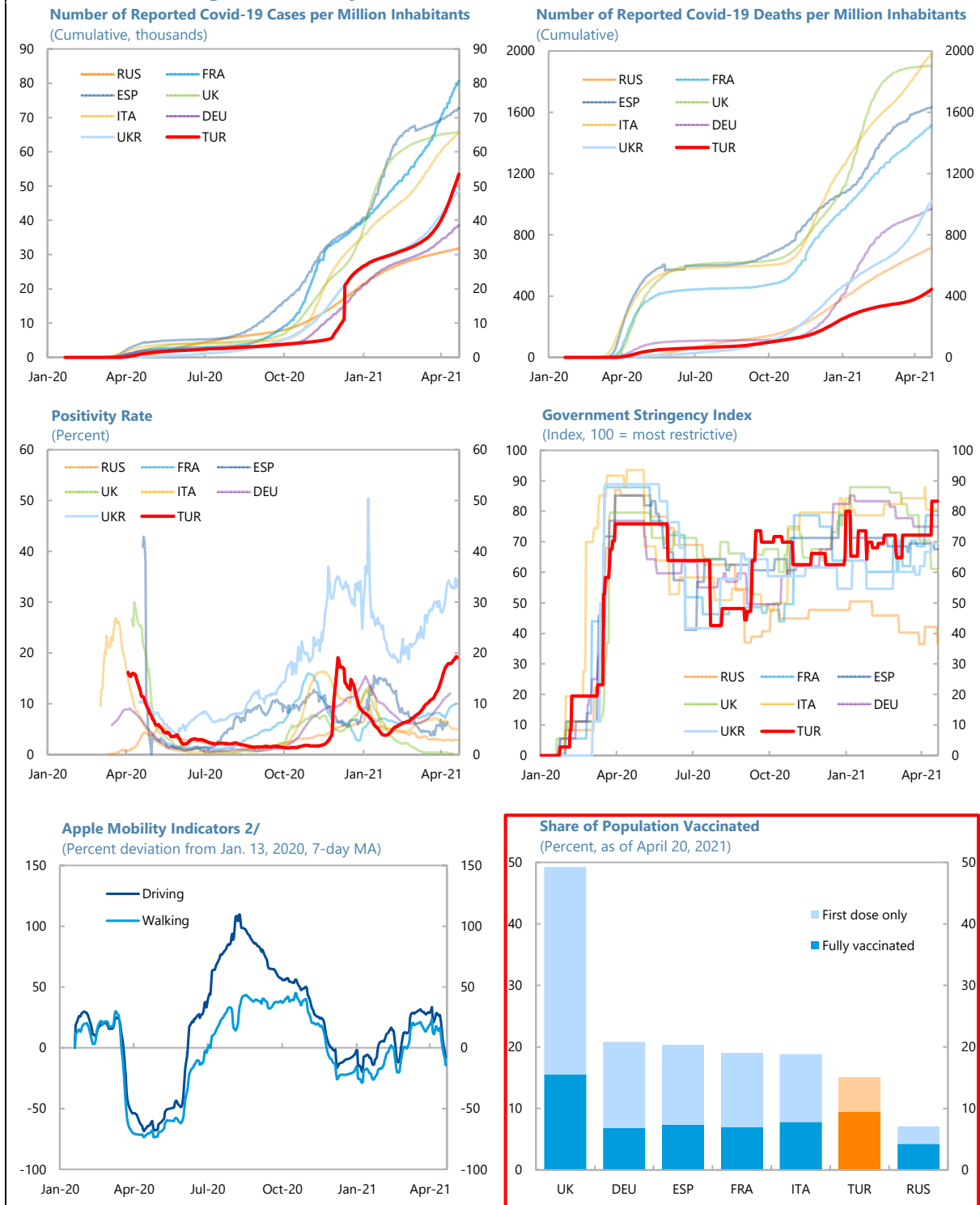
Text Figure 1. Selected Vulnerability Indicators: GFC vs. 2019



RECENT DEVELOPMENTS—PANDEMIC, STRONG RECOVERY, AND HIGHER VULNERABILITIES

3. As in other countries, the pandemic's human toll has been severe. As of late-April, more than 4 million COVID-19 cases had been reported in Turkey, with over 36 thousand fatalities. Containment measures were put in place and subsequently eased through successive waves of the pandemic, including in recent months. These containment measures included travel and mobility restrictions, weekend curfews, and the closures of schools, universities, entertainment venues, and non-essential stores and businesses. Vaccination started in January 2021, with 6 and 12.9 percent of the population partially and fully vaccinated by late April. The authorities' latest targets envisage vaccinating around 60 percent of the population by Autumn 2021, although risks around vaccine procurement remain.

Figure 1. Turkey: COVID-19 Pandemic—The Human Toll^{1/}



Sources: Apple; Blavatnik School of Government at University of Oxford; Bloomberg Finance L.P.; Our World in Data; [Turkey Ministry of Health](#); and IMF staff calculations.

1/ Reported COVID-19 case numbers underwent a methodological revision, which, combined with rising numbers under a second wave, resulted in series break in November.

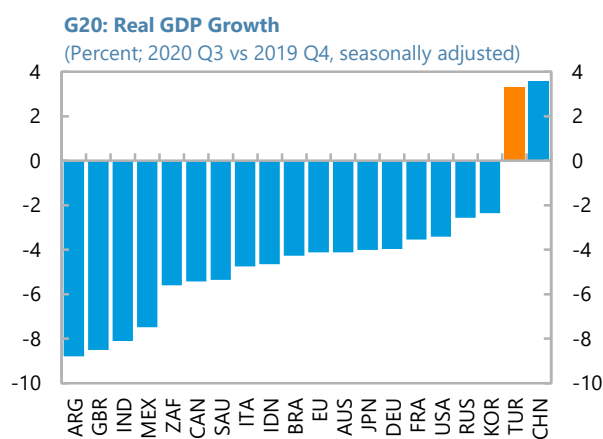
2/ Baseline refers to the relative volume of directions requests for each country on January 13, 2020.

Turkey: Selected Initial Pandemic Policy Responses

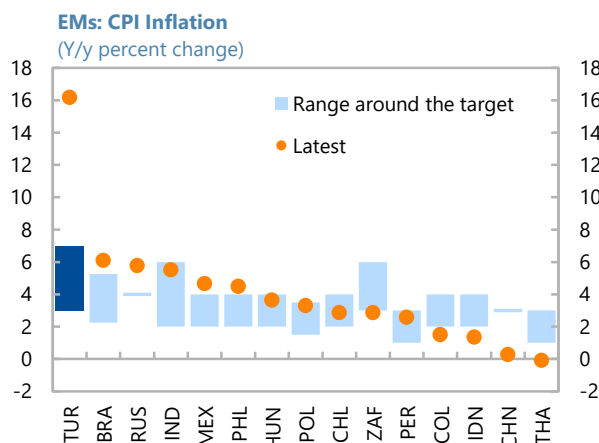
Monetary	Financial	Fiscal	Labor Market	Health
<ul style="list-style-type: none"> • Policy rate cut by 250 bps • Outright purchases of government bonds • Reserve requirements reduced for banks meeting real credit growth targets • Additional liquidity provided through repo and swap auctions at 100-150 bps below policy rate • FX swap auctions expanded to provide TRY liquidity • Liquidity limits for primary dealers increased • Collateral pool expanded 	<ul style="list-style-type: none"> • New regulatory ratio (Asset Ratio) to promote bank credit • State-owned Bank loan payment deferrals • LTV limit on mortgages raised • Minimum payment for individual credit cards lowered • Forbearance measures to limit impact of lira and securities' price declines • Delayed classification of stage 2 loans and NPLs • Firms' dividend payments limited to 25 percent of 2019 profits 	<ul style="list-style-type: none"> • Loan guarantees extended to firms and households • VAT, withholding tax and other taxes deferred • State-owned bank recapitalization • Grants to low-income households • Credit Guarantee Fund (CGF) limit doubled and extended to households 	<ul style="list-style-type: none"> • Ban on layoffs • Short-term work-retention scheme • Unemployment insurance • Wage subsidies • Hiring subsidies • One-off transfers through social assistance program 	<ul style="list-style-type: none"> • Additional payments to health sector personnel • Grants for COVID-19 treatment expenses • Investment in new hospitals

Sources: Banks Association of Turkey; BRSA; CBRT; MOTF; TWF; and the Official Gazette .

7. The policy response meant that Turkey was among the few countries with positive growth in 2020. While the initial collapse in activity was similar to elsewhere, the recovery was exceptional. Domestic demand registered its highest growth on record in the third quarter of 2020, driven by consumption and investment. By the third quarter, GDP was already far above its pre-pandemic level, setting Turkey apart from its peers. Although the fourth quarter saw a second COVID-19 wave and renewed mobility restrictions, activity continued to expand, leading to growth of 1.8 percent for 2020 as a whole. Recent data suggest growth momentum remained positive in early 2021. In addition, staff analysis suggests the output gap was nearly closed by the turn of the year, with remaining slack concentrated in the labor market.

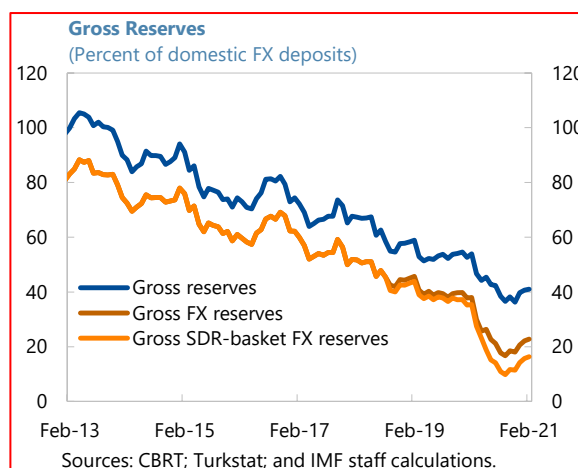
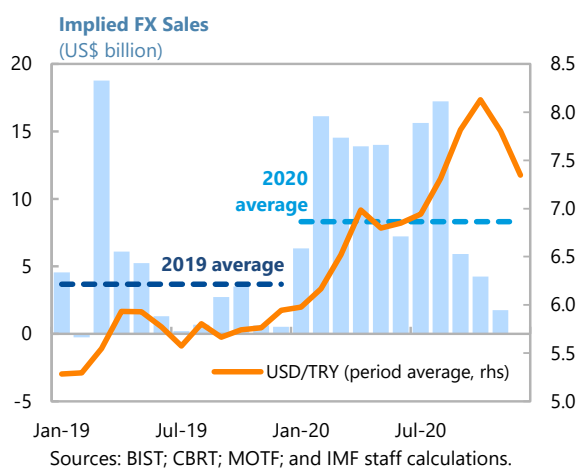


Sources: Haver Analytics; IMF WEO; and IMF staff calculations.



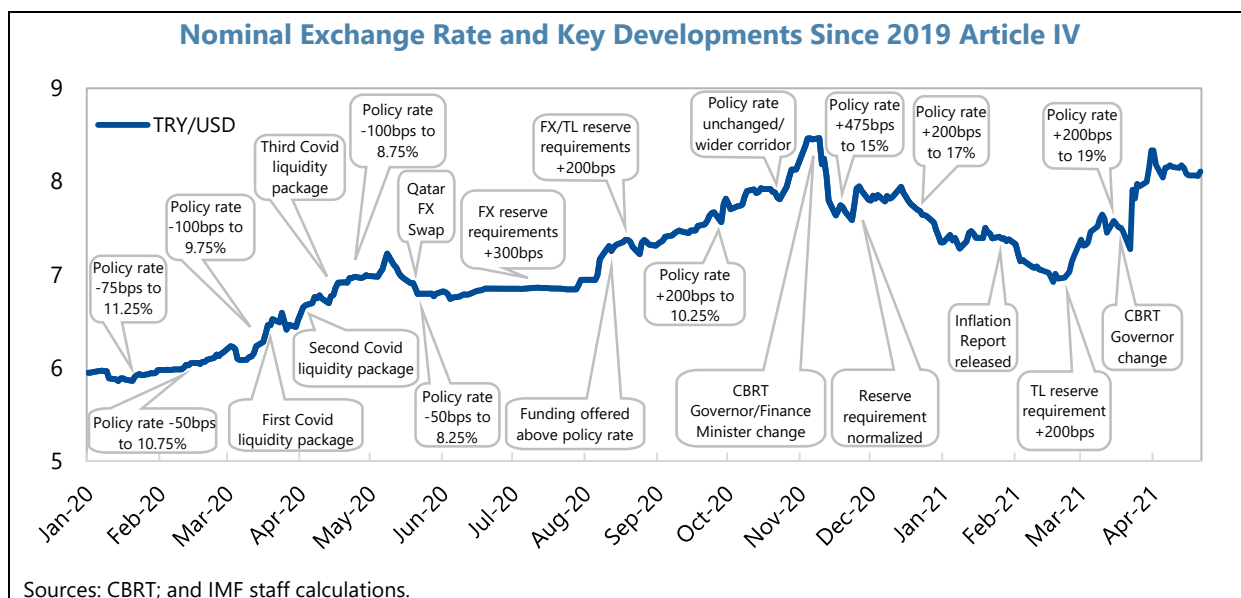
Sources: Country authorities; and IMF staff calculations.

measures were also employed to stem lira pressure, including tariffs and taxes aimed at limiting import demand, along with restrictions on local banks' FX swap positions with non-resident banks (a capital flow management measure under the Fund's Institutional View).



11. Reserves fell sharply and their quality deteriorated. By September 2020, gross reserves had fallen by more than 25 percent, to around USD 80 billion, or 65 percent of the Fund's ARA metric for reserves, a lower ratio than in most emerging markets, and well below the recommended range of 100-150 percent of the metric. External financing needs stood at around USD 210 billion, and domestic FX deposits, not included in external financing needs, stood at about USD 230 billion, with the reserves-to-deposit ratio at multi-year lows. Reserve quality also deteriorated, with roughly sixty percent of reserves consisting of non-SDR basket currencies and gold, compared to under thirty percent before the pandemic (Box 4). Also, reserves are almost entirely owed to banks in the form of deposits at the central bank and swaps, which means that a measure of "core" NIR that excludes all central bank FX liabilities, including swaps, became negative.

12. These adverse developments led, in the Fall, to a welcome shift away from expansionary monetary and credit policies. From August onwards, the CBRT started providing liquidity through more expensive facilities and tightened reserve requirements. At the same time, FX sales slowed gradually, while lending by state-owned banks was reined in. Much of the tightening was, however, put in place through a complex interest rate corridor framework. As the lira fell to new lows in early November, and following the appointment of a new Central Bank Governor and Minister of Treasury and Finance, the authorities intensified this policy shift. The CBRT simplified its operational framework, notably by adopting the one-week repo rate as its main policy instrument. The CBRT also hiked the policy rate from 10.25 to 17 percent by December, before raising it to 19 percent in March 2021, and strengthened monetary policy communication, including through clearer forward guidance.



Economic Reform Program (ERP) Highlights

The ERP aims at strong, sustainable, growth by seeking to promote macroeconomic stability, increased productivity, and stronger governance. Key measures in the plan include:

- **Fiscal** reforms aimed at greater spending discipline; the reform of public procurement tenders; stronger public debt management; a simplified and more investor-friendly and predictable taxation regime; enactment of the PPP framework law; and state-owned enterprise reform.
- A new **Price Stability Committee** coordinated by the Ministry of Treasury and Finance, and comprising the CBRT, the [Presidency of Strategy and Budget Directorate](#), Energy, Trade, Industry and Agriculture Ministries.
- **Financial sector** reforms, including operational restructuring and firm rehabilitation units in banks and the removal of nonperforming loans from bank balance sheets through securitization; steps to promote equity financing in non-financial corporates; and a Bond Guarantee Fund to help with corporate issuance.
- Measures to lower the **current account deficit**, by restructuring the Credit Guaranteed Fund to focus on high value-added investment, job rich production, and manufacturing prioritizing import substitution and exports in less developed regions of the country.
- Increasing **employment**, [including](#) through measures promoting youth employment and through reductions in social security and unemployment insurance contributions for new hires.
- **Other measures** aimed at stronger governance, investment, trade, and competition, including a new Financial Stability Committee and [Economic Economy Coordination Committee Board](#), convening monthly with regular reporting; TURKSTAT to be given the status of a "related institution," a separate legally autonomous entity; and appointments to senior public service positions to have more stringent qualification criteria.

OUTLOOK—HIGHLY UNCERTAIN, WITH SIGNIFICANT RISKS

16. GDP is expected to grow by 5.8 percent this year, mainly because of positive carryover, and to revert to a lower trend from 2022 onwards, while inflation is expected to remain well above target. Under the baseline, staff assumes no significant change in interest rates in the near term and some fiscal easing in 2021.³ Activity in Turkey’s major trading partners is assumed to return to pre-pandemic levels by late 2021, with broad vaccine availability by the summer in advanced economies and later on in large emerging markets, including Turkey. With a large positive carryover, growth is projected to reach 5.8 percent this year, returning to trend of about 3¼ percent from 2022 onwards.⁴ The small downward revision relative to the April WEO forecast reflects a more subdued recovery from the pandemic, both domestically and in key trading partners, as well as increased risk premia, and weaker investor confidence. Although there is a strong carryover, domestic demand is expected to slow during 2021, driven by previous monetary policy tightening and increased policy uncertainty. While the impact of higher interest rates gradually fades under the baseline, heightened uncertainty continues to weigh on domestic demand. Inflation is projected to remain high in 2021, reflecting exchange rate passthrough, higher commodity prices, and the latest minimum wage hike. As these effects fade, inflation is forecast to fall only gradually, reflecting inflation inertia, still-robust credit growth, and policy credibility challenges. The current account deficit is forecast to narrow, as exports improve despite a sluggish tourism recovery, supported by the weaker exchange rate **and stronger trading partner growth**. Reserve buffers are expected to decline further, with considerable uncertainty over the outlook for gold and oil imports, tourism receipts, and external financing. Public debt is expected to continue growing, but to stay low compared to most peers.

Turkey: Selected Economic Indicators, 2019–26								
	2019	2020	2021	2022	2023	2024	2025	2026
	(Percent change)							
GDP Growth	0.9	1.8	5.8	3.3	3.3	3.3	3.3	3.3
Inflation (end-year)	11.8	14.6	16.5	14.0	12.5	12.5	12.5	12.5
	(Percent of GDP)							
Current account balance	0.9	-5.1	-2.7	-1.7	-1.8	-1.9	-1.9	-2.0
Fiscal balance 1/	-2.9	-3.5 -3.4	-5.0	-5.3	-5.5	-5.5	-5.6	-5.8
Public debt	32.6	39.7 39.5	40.2	41.5	43.4	44.6	45.6	46.5

Source: IMF staff calculations.
1/ Central government overall balance, headline or authorities' definition, which includes items excluded from the IMF 'program' definition.

17. Vulnerabilities remain high. Buffers are lower than before the pandemic. “Core” net reserves are negative, while external financing needs and domestic FX deposits have increased. The highly-indebted NFC sector will need to deleverage in coming years, with a likely uptick in debt restructurings and insolvencies.

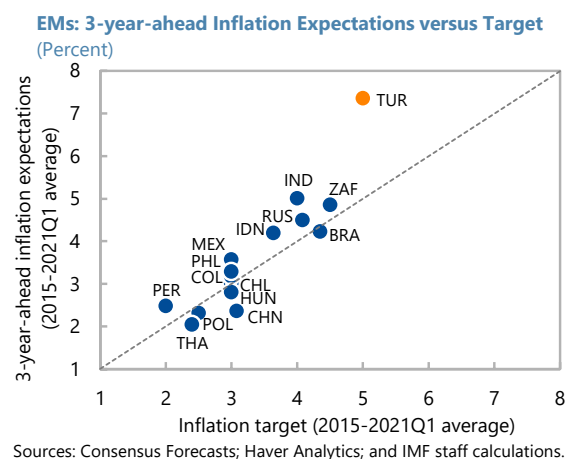
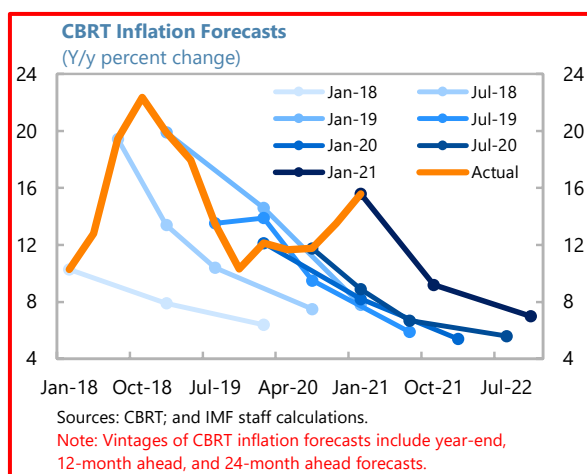
³ The authorities’ revised targets envisage maintaining the central government budget deficit in 2021 at 2020 levels. Staff’s baseline assumes a looser stance given the expected decline in non-tax revenues, uncertainty about the evolution of the pandemic, and historic performance relative to NEP targets.

⁴ GDP growth during 2021 is expected to be close to zero.

25. Targeted institutional reforms are needed to help strengthen central bank independence, a prerequisite for price stability and policy credibility. Independence rests on the central bank having the mandate, autonomy, and tools needed to bring inflation to target. In this context, the frequent turnover at the top of the central bank may increase policy uncertainty and de-anchor inflation expectations. Taken together, these worsen the inflation-output tradeoff, increasing the level of interest rates required to achieve any given inflation rate. The CBRT would benefit from measures to strengthen its independence, including reinstating previous qualification criteria for appointments and adherence to well-specified procedures for dismissing central bank board members, including the Governor. Steps should also be taken to strengthen the CBRT's financial autonomy, by reviewing the rules governing transfers to the budget.

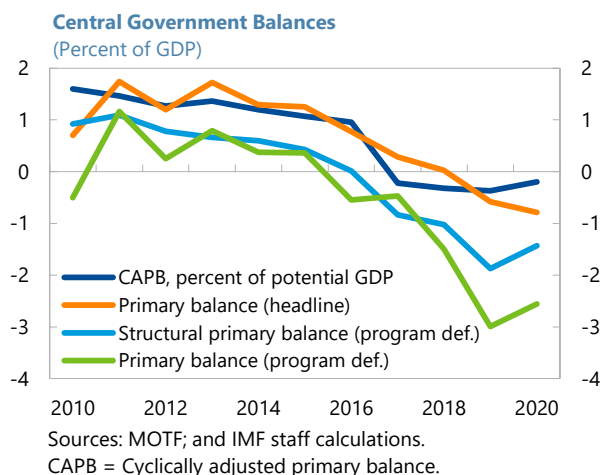
26. The authorities should strongly commit to, and deliver, a firm monetary policy stance. The initial policy response to the pandemic de-anchored inflation expectations and put a severe strain on the lira, the balance of payments, reserves, and financial stability. The monetary policy tightening in late 2020 and early 2021 was welcome and broadly in line with Turkey's needs given a real neutral interest rate of about 3–4 percent, the gaps between inflation expectations and the target, ongoing inflationary pressures (lira depreciation, large minimum-wage hike, higher commodity prices), and the nearly closed output gap. But market developments following the change in central bank leadership in March 2021 added to Turkey's vulnerabilities. As a result, the inflation-output tradeoff has deteriorated, and real interest rates will need to remain higher than the neutral rate for longer than before to durably lower inflation and, later on, to rebuild reserve buffers and credibility. The more upfront the commitment to a firm monetary policy stance is, the faster the decline in inflation will be, and the sooner interest rates can be cut in the future.

27. Further timely and well-calibrated monetary policy tightening would be needed if inflation expectations increase further. Higher inflation expectations point to weakening credibility and serve to mechanically lower the real policy rate. Accordingly, if inflation expectations increase further, the central bank should react promptly by hiking its policy rate to, at a minimum, keep the ex-ante real policy rate unchanged.



28. Operational simplification and increased transparency complement the firm stance. The normalization of the monetary and reserve requirement frameworks is welcome, as are moves to

33. The authorities' fiscal targets for this year appear tight and there is room for some easing. The authorities revised down their fiscal deficit target, keeping the 2021 central government overall headline balance unchanged at 2020 levels.⁵ Given the expected decline in CBRT transfers this year, achieving an unchanged balance would require additional revenue or spending measures, implying a negative fiscal impulse.⁶ Staff forecasts a somewhat looser stance this year given the implied fiscal tightening under difficult circumstances and given past slippages relative to initial fiscal targets. Based on bottom-up estimates, staff recommends using some of Turkey's remaining fiscal space to provide around 1 percent of GDP this year in additional targeted and temporary support to address pandemic-related needs, notably, to support vulnerable households and workers and to minimize scarring. While the authorities publish information on public tenders, including those related to pandemic spending, transparency could be enhanced by publishing the [beneficial ownership information-names](#) of companies awarded pandemic procurement contracts ~~and their beneficial ownership information~~. Finally, financing of fiscal support measures through the Unemployment Insurance Fund should be strictly limited.



34. A credible and detailed fiscal consolidation plan should be announced at the same time, to be enacted only when the post-pandemic recovery is entrenched. Public debt is projected to increase under the baseline, from around 40 to roughly 47 percent of GDP, over 2020–26 and gross financing needs are also projected to increase. The authorities should therefore commit to future well-specified consolidation measures equivalent to about 1½ percent of GDP to bring debt down over time, helping strengthen Turkey's fiscal anchor.⁷ Some possible measures are set out in the overleaf text table:

⁵ The target was revised down from 4.3 to 3.5 percent of GDP. The authorities have not published the measures underpinning this change relative to the initial budget.

⁶ The authorities classify one-off CBRT transfers above the line, contrary to *Government Finance Statistics* conventions.

⁷ Absent additional consolidation measures, staff's baseline projects the general government primary deficit (IMF program definition) to settle at around 3 percent of GDP over the medium term, compared to a debt-stabilizing primary deficit of about 2 percent of GDP (see Annex III).

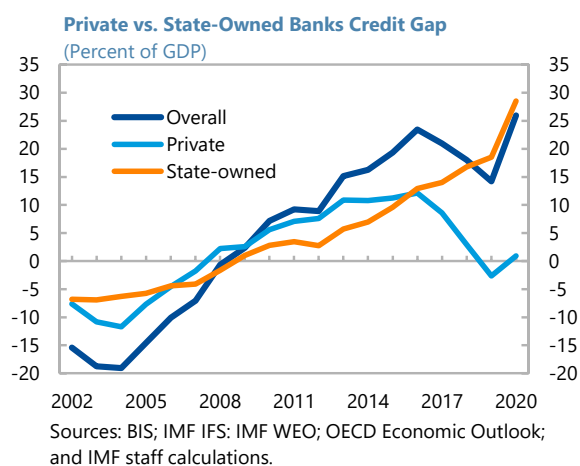
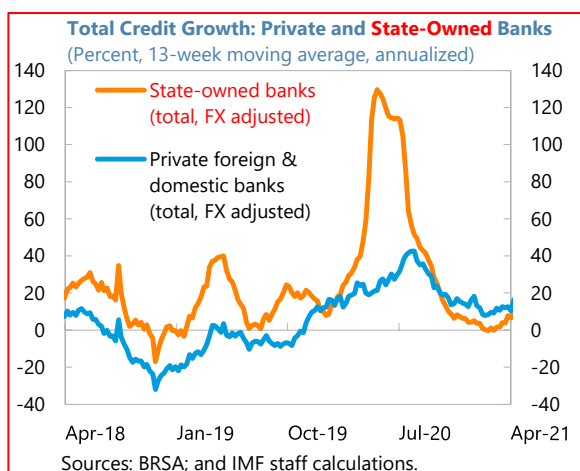
Turkey: Menu of Possible Medium-Term Fiscal Measures (Percent of GDP)	
Possible consolidation options:	Yield
<i>Revenue</i>	
(i) Personal Income Tax reform (collection, progressivity)	0.1
(ii) Streamline VAT exemptions, raise and unify reduced rates	0.9
<i>Expenditure</i>	
(iii) Eliminate backward-looking wage indexation	0.3
(iv) Contain net lending to public entities	0.2
(v) Rationalize ad-hoc transfers/subsidies	0.5
(vi) Rationalize investment incentives	0.3
Source: IMF staff estimates.	

35. Fiscal structural reforms would support consolidation, strengthen fiscal governance, and mitigate fiscal risks. The oversight and management of Public Private Partnerships (PPPs) should be strengthened further, including through: (i) publishing regular PPP monitoring reports, and (ii) finalizing draft 2019 PPP legislation—a commitment made in the March 2021 Economic Reform Program—, [and \(iii\)](#) giving the Ministry of Treasury and Finance the mandate to manage fiscal costs and risks at all PPP project stages. Other priorities include publishing regular comprehensive information on the quasi-fiscal operations of all state-owned enterprises (Box 5) and assessing contingent liability risks arising from the pandemic policy response. The authorities should also further strengthen fiscal risk management by charging the Ministry of Treasury and Finance with monitoring and assessing fiscal risks and publishing regular fiscal risk statements. Finally, continuing to strengthen budget execution, including introducing supplementary budgets when needed, would enhance public financial management.

36. The scope and role of extra-budgetary funds and other non-central government entities should be carefully defined and monitored. In particular, investment and borrowing by the Turkey Wealth Fund should be integrated into the budget and its financial statements audited by the Court of Accounts, while its governance framework should be refined to limit potential conflicts of interest.

37. Debt management should build on earlier moves aimed at addressing rollover and currency risks. Deteriorating primary balances and, until recently, shorter domestic debt borrowing maturities and increased reliance on domestic FX borrowing, have led to increased rollover needs and currency risks. Debt management should continue to build on moves to lengthen borrowing maturities and to lower reliance on domestic gold instruments and on FX borrowing to contain currency risks. The Ministry of Treasury and Finance should also reduce its reliance on domestic gold and FX borrowing.

To help address the credit overhang, staff recommends that state-owned bank lending be reined in and focus, over time, on meeting identified market gaps. Ensuring a level playing field for both state-owned and private banks is crucial to promote prudent pricing of risk and efficient credit allocation and any implied subsidies by state-owned banks should be treated transparently in the budget. As the pandemic subsides, new lending through the Credit Guarantee Fund should be restricted to small and medium-sized enterprises, in line with its original mandate.



40. Bank foreign exchange liabilities warrant careful monitoring. State-owned banks experienced a marked, if temporary, worsening of their overall open FX position in 2020. The large stock of domestic FX deposits and the high share of liquid FX assets held at the central bank leave both state-owned and other bank balance sheets vulnerable to FX shocks. While broader economic reforms would help address this vulnerability—through reduced dollarization and higher central bank FX reserves—careful monitoring is needed in the interim, including through regular stress tests. Staff recommends: (i) continuing to strictly enforce FX liquidity coverage ratios; (ii) ensuring state-owned bank open FX positions are kept within regulatory limits and that such banks abstain from FX intervention; (iii) assessing banks' FX liquidity risks at the Financial Stability Committee level; and (iv) strengthening bank resolution frameworks, including through amending relevant legislation.

41. Regulatory flexibility should be reversed gradually, and some of banks' capital and liquidity buffers used as needed. The regulatory framework offered ample discretion in recognizing loan impairment before the pandemic and further discretion has been provided since then. Monitoring should be intensified, with banks required to continually assess borrowers' creditworthiness until conditions have normalized. Prudential standards and provisioning rules should be strengthened as the pandemic eases to promote timely recognition of loan losses. The BRSA should also phase out regulatory flexibility over time and discourage loan deferrals and evergreening. Such moves would promote debt restructuring, which would in turn help support more durable repayment capacity for viable firms. Banks should be encouraged to use some of their capital and liquidity buffers as required to make room for any further needed provisioning of impaired assets. With such buffers set to decline, restrictions on capital distributions should continue to be only gradually relieved under pre-agreed parameters, and where the forward-looking assessment of capital adequacy is confirmed by supervisors. In addition, the proposed revisions to the Banking Law to strengthen BRSA independence should be enacted soon.

44. Building on progress to date, further work is needed to strengthen Turkey’s AML/CFT framework. The 2019 Financial Action Task Force report identified important weaknesses in the AML/CFT framework. If left unaddressed, such weaknesses could lead to “grey listing” and to possible pressures on corresponding banking relationships. Progress has been made in addressing key recommendations, including targeted sanctions for proliferation financing, financial institution supervision, and regulating designated non-financial businesses and professions. Effective implementation of these measures is needed, including to address shortcomings related to politically-exposed persons and to ensure targeted financial sanctions are implemented without delay, as well as any other measures to minimize cross-border regulatory compliance risks for the financial sector.

Authorities’ Views

45. The authorities noted that the financial system was resilient, reflecting strong capital and liquidity buffers. Despite regulatory flexibility and rapid credit expansion, the authorities expected ample bank capital to handle higher nonperforming loans especially given prudent loan-loss provisioning. FX liquidity buffers were also deemed adequate to cover short-term FX liabilities. The authorities did not see a strong need for a third-party asset quality review given [their assessment of bank asset quality and](#) resilience.

46. The authorities committed to further progress on AML/CFT measures. They highlighted recent progress on AML/CFT measures and agreed more was needed to ensure full compliance with the Financial Action Task Force’s recommendations.

47. In a welcome move, the authorities requested that the FSAP be brought forward. They confirmed their intention to advance the next FSAP to 2021.

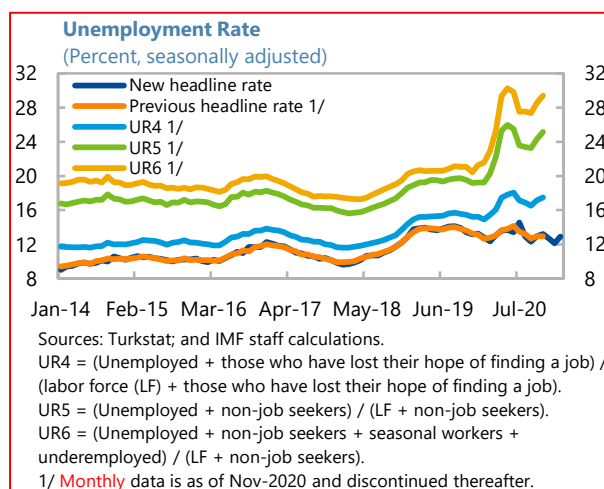
D. Structural Policy Pandemic Response—Supporting the Recovery and Mitigating Long-Term Scarring

While growth recovered quickly from the pandemic, scarring risks remain. Structural policies should aim at supporting the recovery and mitigating any long-term adverse effects. Policies should focus on supporting youth employment and female labor force participation, increasing labor market flexibility, and ensuring that viable but temporarily-insolvent firms are restructured, while winding down unviable firms. Once the pandemic subsides, the reform focus should be broadened.

Labor Market

48. Additional targeted labor market support would help the vulnerable and minimize

scarring. Labor market conditions deteriorated sharply in the first half of 2020, with large falls in employment and labor force participation, followed by a partial recovery. The authorities' policy response was broad, but relatively modest in scale (Box 1). Additional policies should be used to support the vulnerable, to foster job creation, and to minimize scarring, particularly from youth unemployment and low female labor force participation. Once mobility restrictions are eased durably, policies need to move their focus from preserving existing jobs to helping workers move more easily across firms and sectors.



Menu of Possible Policy Options to Support Labor Market Recovery from the Pandemic and Minimize Scarring^{1/}

General policies

- Until mobility restrictions are eased durably, increase the focus of the short-term job retention scheme on viable jobs and the hardest-hit sectors.
- Increase compensation for compulsory unpaid leave.
- Temporarily ease eligibility criteria for and increase the duration and size of unemployment insurance.
- To aid labor mobility, consider severance pay reform and/or adopting the ILO convention on temporary employment and private employment agencies.
- Gradually remove layoff ban and increase targeted hiring subsidies as mobility restrictions ease.

Policies focused on the young, women, and the most vulnerable

- Increase coverage, size, and frequency of lump-sum transfers under the non-contributory social assistance programs.
- Enact secondary legislation to allow flexible work arrangements, especially part-time working.
- Review employment policies that hinder the hiring of female and young workers.
- Expand affordable childcare as mobility restrictions ease.
- Strengthen active labor market policies focusing on digitalization and skill-building, particularly among the young (only around 10 percent of workers in Turkey can work from home).

^{1/} Clear sunset clauses are needed for many measures to prevent later rigidities.

Authorities' Views

49. The authorities agreed with the need to minimize scarring, but were more sanguine about recent developments. They took comfort from the small size of the initial increase, and subsequent fall, in headline unemployment, and they expected labor market conditions to continue to improve. The authorities shared staff's concerns about female labor force participation and youth unemployment but pointed to the protracted nature of such challenges. They agreed with the need to

Menu of Possible Policy Options to Support Corporate Restructuring and Minimize Scarring

Out of court/hybrid measures

- Extend the regulations governing Framework Agreements, currently scheduled to expire at end-2021, until a permanent legislative solution is identified.
- Revive (with modifications, if needed) the 'Restructuring Upon Settlement' rules designed to allow hybrid procedures, where courts intervene only at key decision points during simple restructurings.
- Encourage foreign creditors to join Framework Agreements by allowing them to join arbitration bodies and ensuring viability assessments are conducted independently.
- To support 'triaging', the BRSA could provide guidance to banks on how to conduct firm viability assessments and encourage bank workout units to follow specific procedures based on pre-defined debtor characteristics.

Changes to the formal insolvency regime

- Secured creditors should be integrated more fully into the Concordat (the court-led, pre-bankruptcy, debt restructuring mechanism) by allowing them to be subject to 'cram-downs' and by providing more flexibility in treatment between creditors.
- Reduce the maximum stay on creditors offered under the Concordat from up to 30 months to below 12 months. Eliminate the assumption of almost automatic issuance and extension of stays by courts.
- New financing provided during a restructuring should be given explicit protection relative to existing debt.
- Introduce flexible regulation for survival of all essential contracts, i.e., those necessary for the continuation of the day-to-day operations, such as utilities or internet.
- Exempt bank officials from criminal liability in a court sanctioned Concordat plan and all restructuring deals, not just those agreed in the Framework Agreements, apart from cases of clear breaches of the law.

Other measures

- Fiscal incentives for debt write-downs should be broadened to include all restructuring agreements.
- Increase the capacity of courts to deal more efficiently with enforcement and insolvency cases.
- Stronger coordination between all relevant government bodies (Ministry of Justice, Ministry of Treasury and Finance, regulators).

Authorities' Views

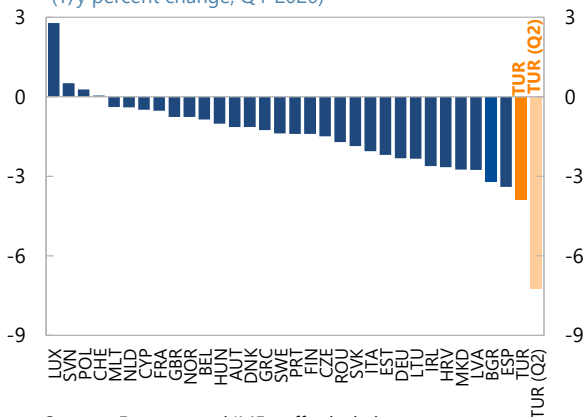
52. The authorities acknowledged the corporate insolvency risks, but underscored other positive developments and policy improvements. While acknowledging the risks associated with the high debt-to-equity ratio of firms and their reliance on FX borrowing, the authorities did not expect a significant wave of restructurings and bankruptcies as a result of the pandemic. They also highlighted the improvement in the net open FX positions of firms since early 2018, and their growing **positive** short ~~term long~~ ~~open~~ FX position, which they partly attributed to the policy measures limiting borrowing in foreign currency. They also noted that the ongoing review of Turkey's insolvency regime should help better balance debtor and creditor rights, speed up insolvency proceedings, and reduce costs.

Box 1. Labor Market Developments and Policy Response

Labor market conditions deteriorated sharply during the pandemic, and by much more than headline unemployment would suggest. While conditions have started to improve, risks from scarring remain. The authorities' policy response has been broad, but small in scale.

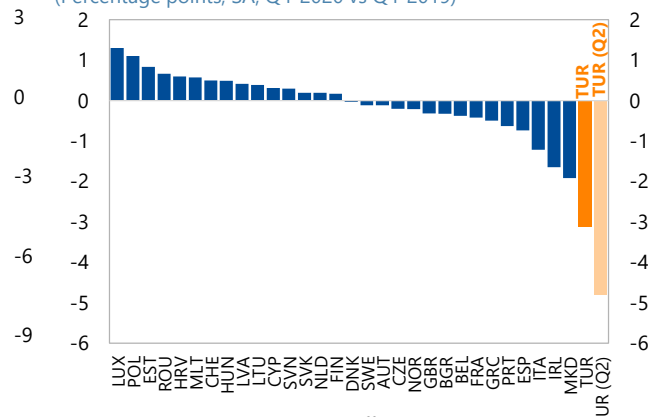
Labor market conditions deteriorated sharply during the pandemic. Employment registered its largest fall on record—and the largest in the region—in the second quarter of 2020. Most of the decline was matched by a sharp drop in labor force participation rather than an increase in the number of unemployed, limiting the resulting increase in the official unemployment rate. Broader slack measures, which include non-job seekers and seasonal workers, deteriorated more sharply. The decline in working hours was even more severe, reflecting both the crisis and the nature of the policy response.¹ While conditions have improved along with the recovery in economic activity, employment and labor force participation remain lower than **before the their pre-pandemic peaks**, particularly in the most affected sectors.

Box Figure 1. Europe: Change in Employment
(Y/y percent change, Q4-2020)



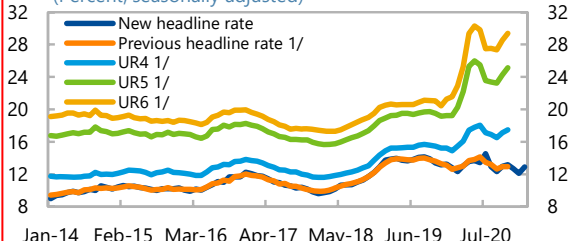
Sources: Eurostat; and IMF staff calculations.

Box Figure 2. Europe: Change in Labor Force Participation
(Percentage points, SA, Q4-2020 vs Q4-2019)



Sources: Eurostat; and IMF staff calculations.

Box Figure 3. Turkey: Unemployment Rate
(Percent, seasonally adjusted)



Jan-14 Feb-15 Mar-16 Apr-17 May-18 Jun-19 Jul-20

Sources: Turkstat; and IMF staff calculations.

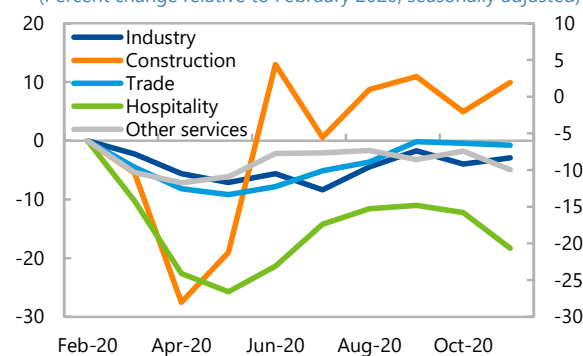
UR4 = (Unemployed + those who have lost their hope of finding a job) / (labor force (LF) + those who have lost their hope of finding a job).

UR5 = (Unemployed + non-job seekers) / (LF + non-job seekers).

UR6 = (Unemployed + non-job seekers + seasonal workers + underemployed) / (LF + non-job seekers).

1/ Monthly data is as of Nov-2020 and discontinued thereafter.

Box Figure 4. Turkey: Employment by Sector
(Percent change relative to February 2020, seasonally adjusted)



Sources: Turkstat; and IMF staff calculations.

Note: Data is through Nov-2020 and discontinued thereafter.

The pandemic also exacerbated pre-existing challenges. The decline in employment and labor force participation was particularly acute among the young. One in every four young Turkish workers is now unemployed—much higher than in many peers—and one in every four workers outside the labor force is young. The crisis also exacerbated gender imbalances. Female labor force participation (32 percent) is the lowest in Europe and remains significantly below the male rate (69 percent). While progress had been made

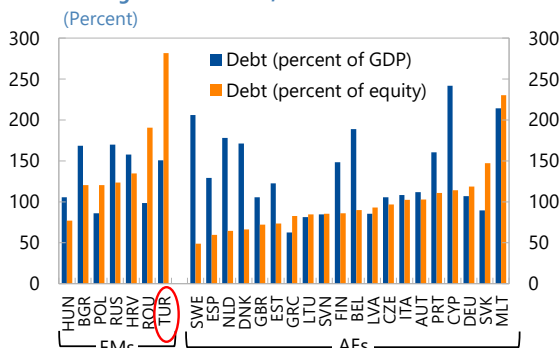
Box 2. Vulnerabilities in Non-Financial Corporates (NFCs)

Turkish NFCs were vulnerable before the pandemic, with high leverage, partially-hedged foreign exchange exposures, and stagnant profits. Generous liquidity provision in 2020 provided much-needed support, but it also increased indebtedness. NFCs are vulnerable to exchange rate and interest rate shocks.

NFCs before the pandemic

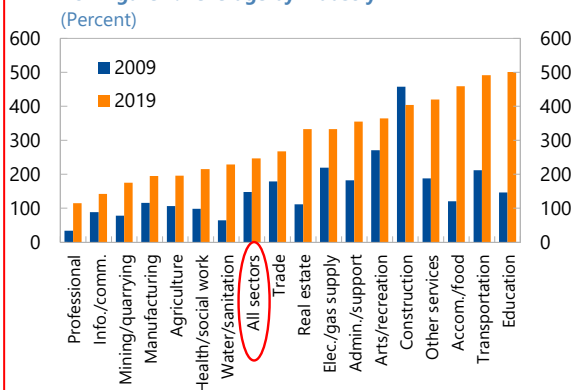
Firm leverage increased considerably over the last decade (Box Figures 1 and 2). NFC debt as a share of total equity rose sharply over the last decade, from 150 to 250 percent, standing out from peers. While the increase in leverage was widespread, it was particularly large in the transportation and the accommodation and food sectors.

Box Figure 1. NFC Debt, 2019



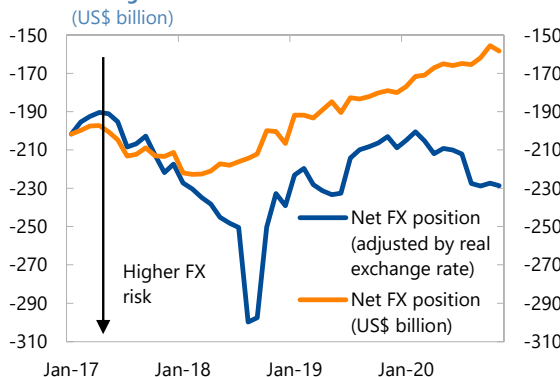
Sources: Haver Analytics; and IMF staff calculations.
 Note: Uses unconsolidated financial accounts data, which involves different accounting principles to the company accounts data in the "Leverage by Industry" chart.

Box Figure 2. Leverage by Industry



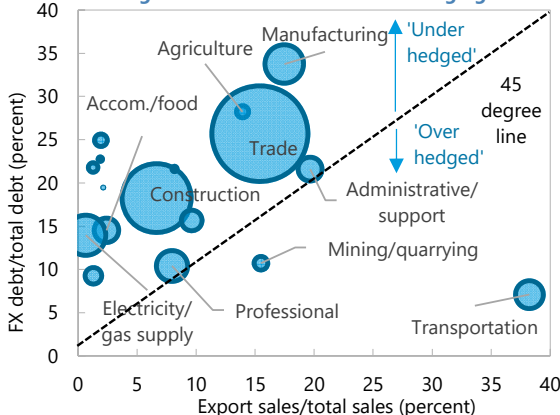
Sources: CBRT; and IMF staff calculations.
 Note: Leverage = non-equity liabilities/total equity using the new CBRT company accounts database.

Box Figure 3. Net FX Position



Sources: CBRT; Haver Analytics; and IMF staff calculations.
 Note: The exchange rate adjustment uses a CPI-based real exchange index to deflate the net FX position.

Box Figure 4. FX Debt and 'Natural Hedging'



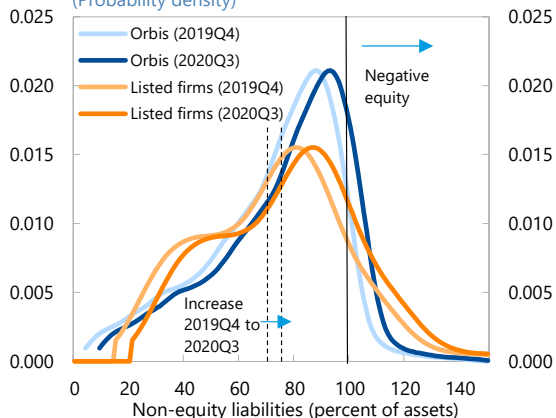
Sources: CBRT; and IMF staff calculations.

A large share of NFC debt is foreign currency (FX) denominated. Around 20 percent of total debt is FX denominated—a smaller share than at the peak in 2017 (25 percent) but much higher than a decade ago. The 30 percent depreciation of the real exchange rate since early 2017, has acted as a major headwind to firm deleveraging (Box Figure 3). NFCs have built a positive short-term net FX position, however, mitigating FX liquidity risks. Export sales tend to act as a "natural hedge" for FX debt. Using a rudimentary metric, based on such natural hedges, only the transportation and mining sectors benefit from a higher share of exports to total sales than FX debt to total debt (Box Figure 4). The manufacturing, trade, and construction sectors—the three largest issuers of FX debt in nominal terms—seem particularly poorly hedged in this respect.

Box 2. Vulnerabilities in Non-Financial Corporates (NFCs) (Concluded)

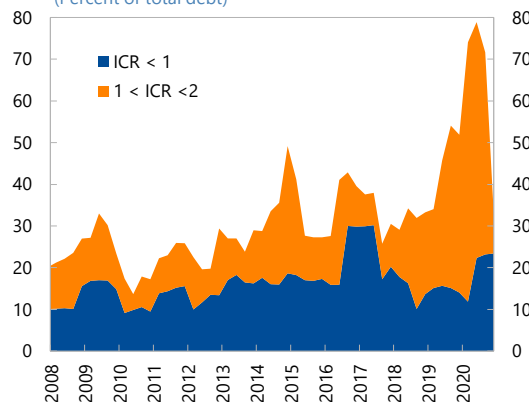
risen: from 7 to 13 percent (using the comprehensive Orbis database), or to 15 to 22 percent (for listed firms). For listed firms, over 20 percent of debt was issued by firms with an ICR below 1 last year (Box Figure 10). Importantly, the estimates are highly uncertain and dependent on the pace of the recovery and on policy measures.

Box Figure 9. Distribution of Firms by Leverage
(Probability density)



Sources: Bloomberg Finance L.P.; Orbis; and IMF staff calculations.

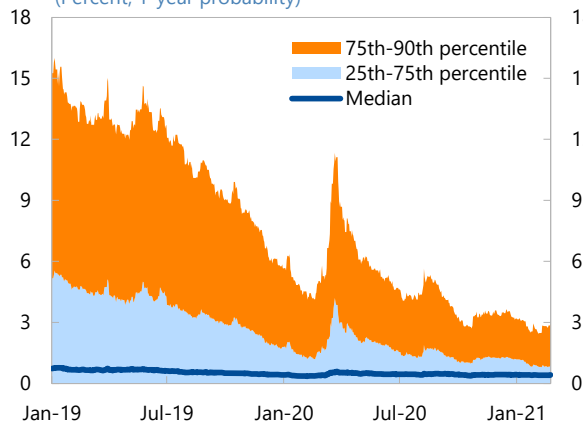
Box Figure 10. Debt at Risk for Listed Firms
(Percent of total debt)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.

But there are also signs of resilience. After an initial spike, the implied probability of default for *listed* firms declined to pre-pandemic levels (Box Figure 11). And, while spreads on commercial loans have been rising, they remain well below 2018 peaks, suggesting that larger firms, with greater access to capital, may be weathering the pandemic better than smaller firms (Box Figure 12).

Box Figure 11. Expected Default Frequency
(Percent, 1-year probability)



Sources: Moody's; and IMF staff calculations.

Box Figure 12. Spread on New Corporate Loans
(Percent)

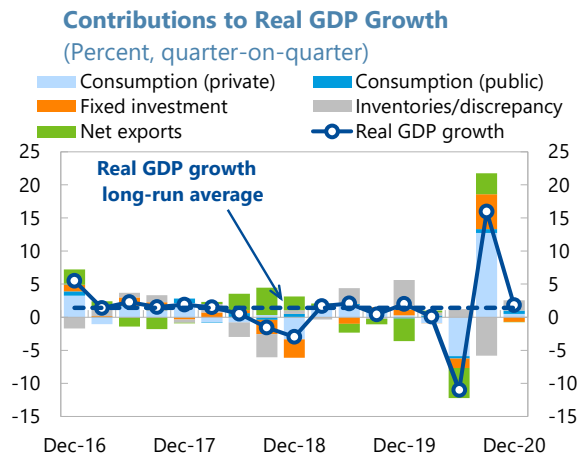


Sources: CBRT; and IMF staff calculations.

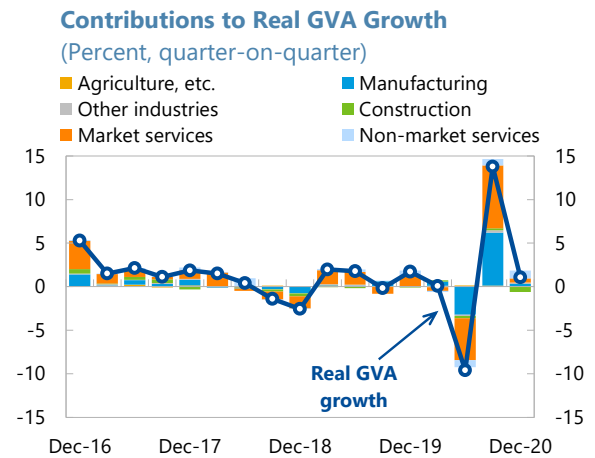
Note: Spread = weighted average interest rate on [commercial](#) loans - TRY LIBOR

Figure 5. Turkey: Real Sector Developments

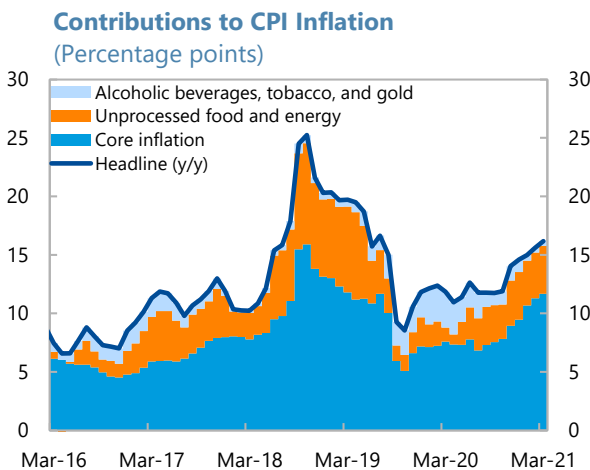
GDP rebounded sharply, driven by domestic demand ...



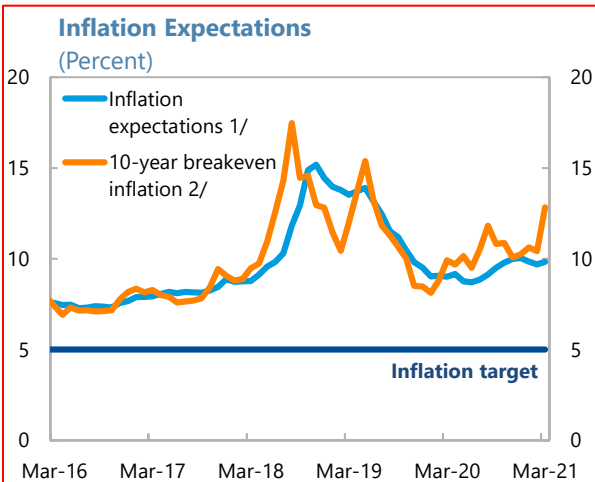
... and both services and manufacturing activity.



Inflation picked up, driven by expansionary policies ...



... which also led to increasing inflation expectations.



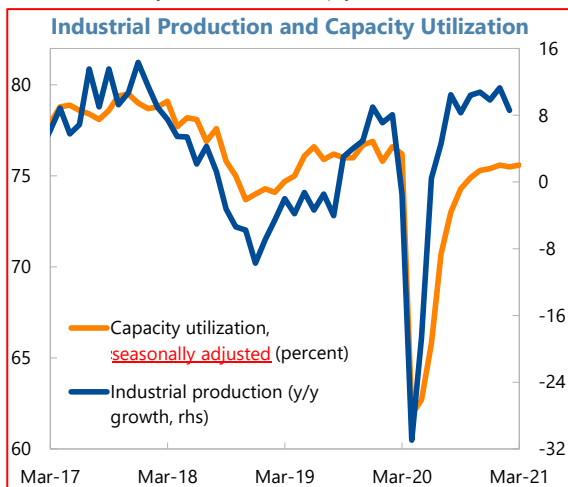
Sources: Bloomberg Financial Markets L.P.; CBRT; European Commission; TurkStat; and IMF staff calculations.

1/ Average of 12-month ahead and 24-month ahead, end-period inflation expectations

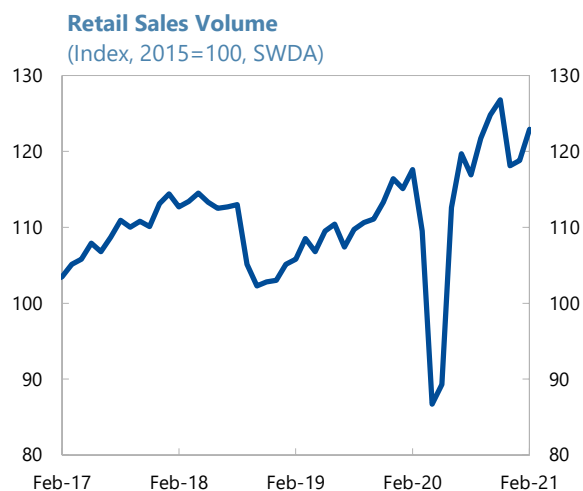
2/ Difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond.

Figure 6. Turkey: Coincident and Leading Indicators

Industrial activity rebounded sharply ...



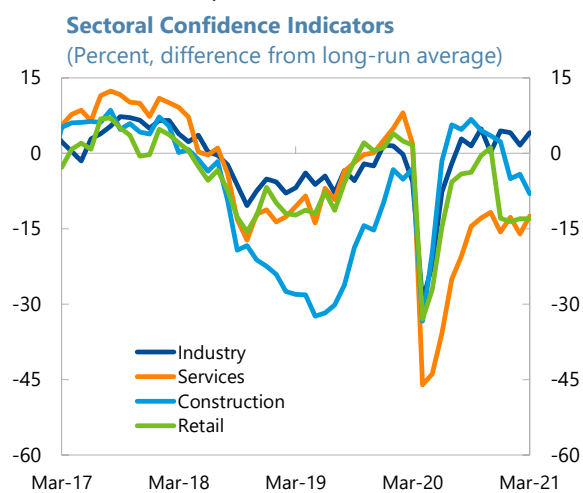
... as did retail sales.



Leading and sentiment indicators improved ...



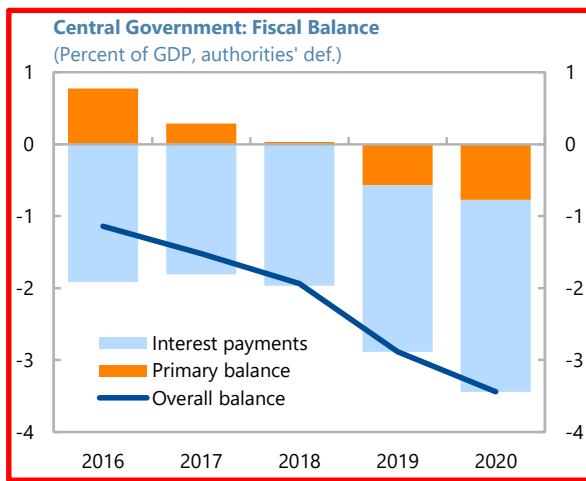
... with increased confidence across sectors.



Sources: Turkstat; Haver Analytics; and IMF staff calculations.

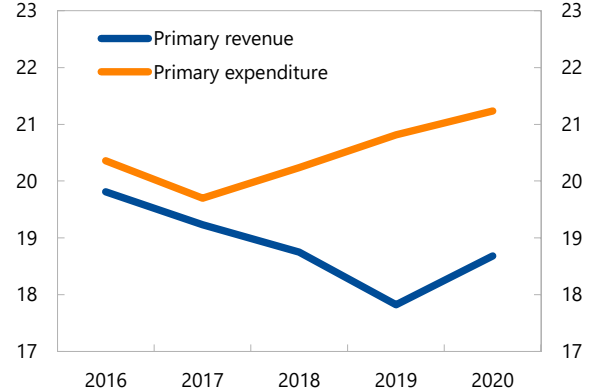
Figure 9. Turkey: Fiscal Stance

The central government deficit widened marginally ...

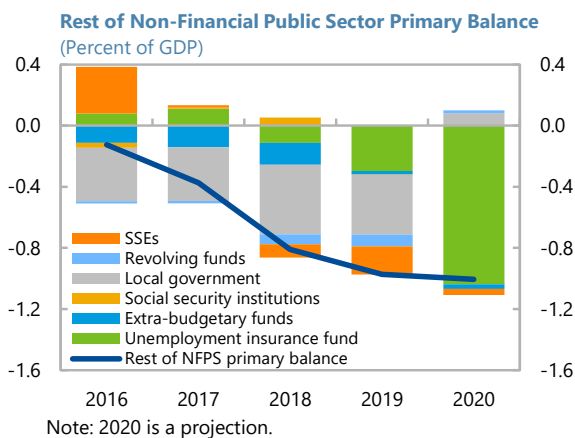


... reflecting strong revenues and a modest rise in spending.

Central Government: Primary Revenue and Expenditure
(Percent of GDP, program definition)

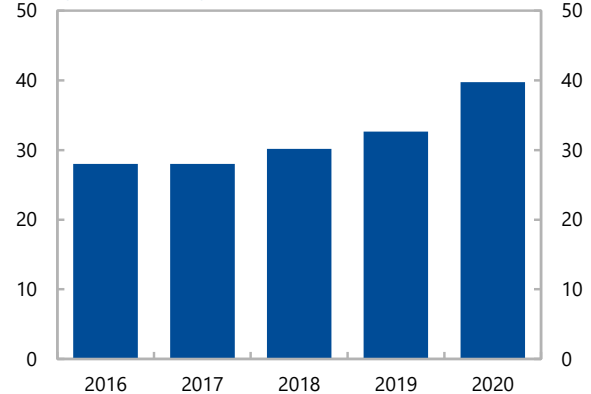


The deficit for the rest of the public sector was stable.

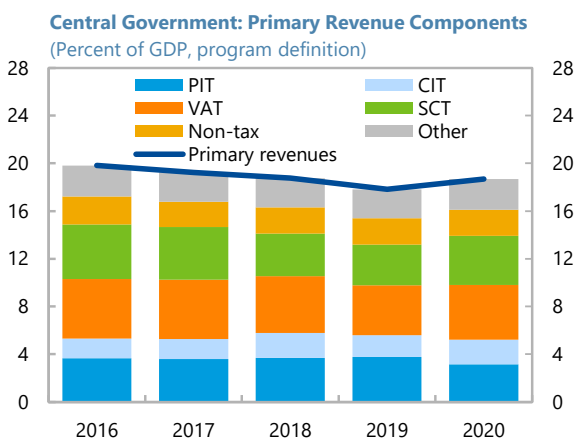


Public debt increased but remained relatively low.

General Government Gross Debt, EU Definition
(Percent of GDP)

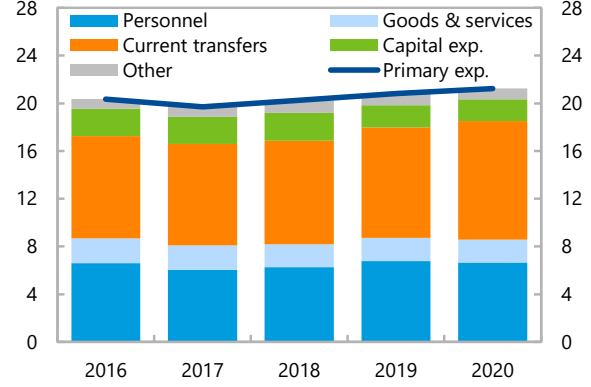


Revenue strength was driven by indirect taxes and CIT.



Spending was contained despite higher current transfers.

Central Government: Primary Expenditure Components
(Percent of GDP, program definition)



Sources: Ministry of Treasury and Finance; and IMF staff calculations.

Table 1. Turkey: Selected Economic Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
			Prelim.	Proj.					
Population (2020): 84.2 83.6 million									
Per capita GDP (2020): US\$ 8,505 8,562									
Life expectancy (2018): 77.4 years									
Gini index (2018): 41.9									
Quota: SDR 4,658.6 million									
Real sector									
(Percent)									
Real GDP growth rate	3.0	0.9	1.8	5.8	3.3	3.3	3.3	3.3	3.3
Final domestic demand	1.1	-2.0	3.8	3.7	2.3	3.5	3.7	3.8	4.0
Private consumption	0.5	1.5	3.2	6.0	2.8	3.3	3.3	3.6	3.8
Public consumption	6.6	4.4	2.3	2.8	2.7	2.8	3.0	3.0	3.0
Investment	-0.3	-12.4	6.5	-1.0	0.7	4.5	5.3	4.9	4.9
Exports	9.0	4.9	-15.4	22.7	8.6	7.4	6.9	6.7	6.6
Imports	-6.4	-5.3	7.4	3.6	5.5	8.8	8.1	8.2	8.5
Contributions to real GDP growth 1/									
Private consumption	0.3	0.9	1.7	3.4	1.5	1.8	1.9	2.1	2.2
Public consumption	0.9	0.6	0.3	0.4	0.4	0.4	0.5	0.5	0.5
Investment (incl. inventories)	-2.5	-3.8	7.1	-3.3	0.4	1.5	1.4	1.2	1.3
Net exports	4.2	3.2	-7.3	5.3	1.0	-0.5	-0.4	-0.5	-0.7
GDP deflator growth rate	16.5	13.9	14.3	20.4	11.4	11.0	11.5	12.4	12.2
Nominal GDP growth rate	19.9	15.0	16.2	26.2	14.7	14.4	14.9	15.6	15.5
Inflation (period-average)	16.3	15.2	12.3	16.9	14.9	12.8	12.5	12.5	12.5
Inflation (end-year)	20.3	11.8	14.6	16.5	14.0	12.5	12.5	12.5	12.5
Unemployment rate	11.0	13.7	13.2	12.5	11.0	10.5	10.5	10.5	10.5
Output gap (percent of potential GDP) 1/	1.5	-0.8	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
(Percent of GDP)									
Fiscal sector									
Nonfinancial public sector									
Primary balance	-2.3	-3.8	-3.4	-3.4	-3.2	-3.2	-3.0	-2.9	-2.9
Overall balance	-3.9	-5.8	-5.4	-6.1	-6.3	-6.5	-6.5	-6.6	-6.7
General government gross debt (EU definition)	30.2	32.6	39.7	39.5	40.2	41.5	43.4	44.6	45.6
External sector									
Current account balance	-2.8	0.9	-5.1	-2.7	-1.7	-1.8	-1.9	-1.9	-2.0
Gross international reserves (billions of US dollars)	93.0	105.7	93.3	78.3	77.6	76.5	75.2	73.2	70.3
Ratio to ARA Metric for emerging markets (percent)	74.8	84.2	73.5	...	...	...	...	...	...
Gross financing requirement	25.9	22.3	29.4	27.6	25.9	24.2	23.0	21.6	19.9
Gross external debt 2/	56.9	57.2	62.9	58.4	56.7	52.6	48.2	43.8	40.3
Net external debt	38.1	35.9	42.8	42.4	41.6	39.2	36.4	33.6	31.5
Net international investment position	-47.5	-45.7	-56.4	-54.9	-54.2	-51.1	-48.0	-45.1	-42.5
Short-term external debt (by remaining maturity)	22.7	22.8	26.9	25.3	24.7	23.4	21.9	19.9	18.5
Terms of trade (year-on-year percent change)	-8.4	0.4	2.9	-7.6	0.6	0.7	0.7	0.6	0.4
REER (CPI-based, 2003=100)	77.2	75.2	67.4	...	...	...	...	...	...
Monetary conditions									
(Percent)									
Real average cost of CBRT funding to banks	1.4	5.4	-1.7	...	...	...	...	...	...
Nominal growth of M2 broad money	18.4	27.3	33.9	...	...	...	...	...	...
Memorandum items									
GDP (billions of U.S. dollars)	780	761	716	...	...	...	...	...	...
GDP (billions of Turkish lira)	3,758	4,320	5,019	6,336	7,270	8,313	9,551	11,045	12,761
Real effective exchange rate (year-on-year percent change)	-14.3	-2.6	-10.4	...	...	...	...	...	...
Sources: Turkish authorities; and IMF staff estimates and projections.									
1/ Staff estimates.									
2/ The external debt ratio is calculated by dividing external debt in US\$ by staff-estimated GDP in US\$. GDP in US\$ is calculated as GDP in TL divided by the annual average exchange rate.									

Table 4. Turkey: Public Sector Finances, 2018–26
(Percent of GDP)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
			Prelim.	Proj.					
Nonfinancial public sector primary balance	-2.3	-3.8	-3.4	-3.4	-3.2	-3.2	-3.0	-2.9	-2.9
Central government	-1.5	-3.0	-2.6	-2.7	-2.6	-2.6	-2.5	-2.4	-2.4
Primary revenue	18.7	17.8	18.8	18.5	18.5	18.5	18.5	18.5	18.5
Tax revenue	16.5	15.6	16.6	16.3	16.3	16.3	16.3	16.3	16.3
Personal income taxes	3.7	3.8	3.2	3.5	3.6	3.6	3.6	3.6	3.6
Corporate income taxes	2.1	1.8	2.1	1.8	1.8	1.8	1.8	1.8	1.8
VAT	4.8	4.2	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Special consumption tax	3.6	3.4	4.1	3.8	3.8	3.8	3.8	3.8	3.8
Other	2.4	2.4	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Nontax revenue 1/	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Primary expenditure, of which:	20.2	20.8	21.3	21.2	21.1	21.1	21.0	21.0	21.0
Personnel	6.3	6.8	6.7	6.7	6.8	6.8	6.8	6.8	6.8
Goods and services	1.9	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Current transfers, of which:	8.7	9.2	10.0	9.7	9.5	9.5	9.4	9.4	9.4
Transfers to households	1.0	1.0	1.1	1.0	1.1	1.1	1.1	1.1	1.1
Social security institutions	4.0	4.5	5.0	4.8	4.5	4.5	4.4	4.4	4.4
Agricultural subsidies	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Transfers of revenue shares	2.6	2.3	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Capital transfers	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditure	2.4	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Net lending	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Rest of the public sector	-0.8	-0.8	-0.8	-0.7	-0.6	-0.6	-0.5	-0.5	-0.5
Extrabudgetary funds	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Revolving funds	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social security institutions	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment insurance fund	-0.1	-0.1	-1.0	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3
Local governments	-0.5	-0.4	0.2	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
State-owned enterprises	-0.1	-0.2	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0
Nonfinancial public sector overall balance 1/	-3.9	-5.8	-5.4	-6.1	-6.3	-6.5	-6.5	-6.6	-6.7
Interest expenditure (net)	1.6	2.0	2.0	2.7	3.1	3.3	3.5	3.7	3.8
Memorandum items:									
Revenues excluded from IMF 'program definition'	1.5	2.5	1.8	0.7	0.7	0.7	0.7	0.7	0.7
Central government primary balance (headline) 2/	0.0	-0.6	-0.8	-2.0	-1.9	-1.9	-1.8	-1.7	-1.7
Central government overall balance (headline) 2/	-1.9	-2.9	-3.5	-3.4	-5.0	-5.3	-5.5	-5.6	-5.8
Central government cyclically-adjusted primary balance (headline) 2/ 3/	-0.4	-1.9	-0.9	-2.0	-1.9	-1.8	-1.8	-1.7	-1.7
Central government cyclically-adjusted overall balance (headline) 2/ 3/	-2.4	-4.2	-3.4	-5.0	-5.3	-5.5	-5.5	-5.6	-5.8
General government primary balance (headline) 2/	-0.8	-1.2	-1.7	-2.6	-2.4	-2.4	-2.3	-2.2	-2.1
General government overall balance (headline) 2/	-2.9	-3.7	-4.5	-5.7	-6.0	-6.2	-6.2	-6.3	-6.4
General government cyclically-adjusted primary balance (headline) 2/ 3/	-0.9	-2.2	-1.3	-2.6	-2.4	-2.4	-2.3	-2.2	-2.2
General government cyclically-adjusted overall balance (headline) 2/ 3/	-3.0	-4.7	-4.1	-5.7	-6.0	-6.2	-6.2	-6.2	-6.4
General government gross debt (EU definition)	30.2	32.6	39.7	39.5	40.2	41.5	43.4	44.6	45.6

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

1/ IMF program definition which excludes several items from non-tax revenue and the primary balance, including privatization proceeds, transfers from CBRT, dividend payments from Ziraat Bank and interest receipts.

2/ Headline or authorities' definition which includes items excluded from the IMF 'program' definition.

3/ The cyclically-adjusted balance adjusts for the economic cycle and excludes one-off CBRT revenues.

Table 5. Turkey: Financial Soundness Indicators, 2012–20
(In percent, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	
Capital Adequacy										
CAR	18	15	16	16	16	17	17	18	19	
CT1R	15	13	14	13	13	14	14	15	16	
RWA / Assets	80	84	83	83	82	76	77	77	67	
Asset Quality										
NPLs / Gross Loans	3	3	3	3	3	3	4	5	4	
Provisions / Gross NPLs	75	76	74	75	77	79	68	65	75	
Profitability										
Total Int. Income / Int. Bearing Assets (av) 1/ 2/	9	8	8	8	8	9	11	11	8	
Cost / Income (Efficiency) 3/	73	71	74	76	72	73	77	78	-	
ROAA 1/ 4/	2	2	1	1	2	2	1	1	1	
ROAE 1/ 4/	16	14	12	11	14	16	15	11	11	
Funding and Liquidity										
Loan-to-Deposit ratio	103	111	118	119	119	123	118	103	104	
Loan-to-Deposit ratio (TL)	113	127	133	142	134	148	138	130	-	
Loan-to-Deposit ratio (FX)	82	84	92	89	99	90	96	78	-	
Non-Core / Core Liabilities 5/	44	52	55	56	56	57	57	47	51	
Non-Core / Core Liabilities (TL) 5/	26	29	30	32	29	32	33	28	-	
Non-Core / Core Liabilities (FX) 5/	91	103	113	101	106	101	94	71	-	
Leverage Ratio 1/ 6/	5	5	6	5	5	5	5	6	5	
Liquid Assets / Assets 7/	26	24	23	22	21	23	21	23	25	
Assets / Liabilities (3 months, int. sensitive)	82	79	75	74	76	73	78	71	72	
FX Risk										
FX Assets / FX Liabilities (on-balance sheet) 6/	94	91	91	91	94	88	91	88	86	
NOP / Regulatory Capital	2	-1	-2	1	-1	1	3	0	4	
NOP before hedging / Regulatory Capital	-14	-29	-28	-30	-22	-43	-34	-41	-58	
Balance Sheet										
					<i>(Percent of GDP)</i>					
Total Assets	87	95	97	100	104	104	103	104	122	
o/w Gross Loans	50	57	60	63	66	67	64	61	71	
Liabilities	75	84	86	89	93	93	92	93	110	
o/w Deposits	49	52	51	53	55	55	54	59	69	
Shareholders' Equity	12	11	11	11	11	11	11	11	12	
Off-Balance Sheet										
					<i>(Percent of GDP)</i>					
o/w Commitments	109	89	83	88	94	103	95	93	100	
o/w Contingencies	15	18	19	20	21	21	21	19	20	
Miscellaneous										
Deposit Interest Rate (Percent) 8/	8	8	9	11	10	13	23	10	16	
Loan Interest Rate (Percent) 9/	12	13	13	16	15	18	32	15	22	

Sources: BRSA data; and IMF staff calculations.

1/ Current year data are annualized using 12-month rolling sums.

2/ Net of NPL provisions.

3/ Other non-interest income added to expenses when <0.

4/ Net income as a share of average assets or equity over last 12 months.

5/ Core liabilities include deposits and shareholders' equity.

6/ Proxied by T1 Capital over last 2 months average balance sheet assets and average off-balance sheets exposures (> 3 percent).

7/ Liquid assets as reported by the BRSA in their liquidity position table.

8/ On TRY only, excluding sight and interbank.

9/ Consumer Loans (Personal+Vehicles+Housing).

Annex II. External Sector Assessment

<p>Overall Assessment: <i>The external position in 2020 was moderately weaker than the level implied by medium-term fundamentals and desirable policies.</i> Expansionary monetary policy and rapid provision of credit by state-owned banks put pressure on the lira last year through dollarization, import, and financial account channels, which led in turn to sales of foreign exchange reserves to support the lira. Despite the marked real exchange rate depreciation, the current account deficit resurfaced because of lower exports (including tourism) and robust imports (including gold). The monetary tightening from late-2020 saw a return of capital inflows and modest reserves build-up, but outflows and reserve losses resumed in March 2021, amid rising policy uncertainty and lira depreciation. Policy uncertainty, large gross external financing needs (GEFN), and relatively low reserves increase Turkey's vulnerability to shocks. Only over the time will the REER undervaluation, with its usual lags, help move the current account back towards its norm, aided by less expansionary policies.</p> <p>Potential Policy Responses: Policies that could support Turkey's external rebalancing and bring the current account balance closer to its norm include (i) keeping credit growth at sustainable rates; (ii) maintaining a firm monetary policy stance, with additional measured tightening if inflation expectations increase further, to, at a minimum, keep the ex-ante real policy rate unchanged, which would also help ensure sustainable credit growth; (iii) enhancing the fiscal anchor with a credible commitment to future consolidation to bring debt down over time—which would also create greater space for meeting pandemic-related needs in 2021 and minimize scarring; and (iv) taking additional steps to build policy credibility, which would encourage capital inflows and support de-dollarization and a buildup of reserves.</p>							
Foreign Asset and Liability Position and Trajectory	<p>Background. In 2020, Turkey's NIIP declined from -46 to -56 percent of GDP, driven entirely by foreign liabilities, which rose from 79 to 90 percent of GDP.¹ External debt increased from 57 to 63 percent of GDP, driven by lower USD GDP. Over 70 percent of external debt is held by the private sector, and about one third is short-term (on a remaining maturity basis). Debt is expected to remain sustainable over the medium term, but debt servicing remains vulnerable to global and domestic financial conditions.</p> <p>Assessment. Turkey's NIIP has become more negative since the 2000s, with 2020 affected by one-off factors related to the pandemic. The size and composition of external liabilities, coupled with low reserves, increases Turkey's vulnerability to liquidity shocks, sudden shifts in investor sentiment, and a global upswing in interest rates. The FX exposure of nonfinancial companies, including short-term loans, is high, with the potential to affect bank asset quality. NIIP is projected to improve to about -45 percent of GDP in 2025, driven by a decline in liabilities, mainly loans.</p>						
2020 (% GDP)	NIIP: -56.0	Gross Assets: 33.6	Res. Assets: 13.0	Gross Liab.: 90.1	Debt Liab.: 58.0		
Current Account	<p>Background. After posting a surplus for the first time in nearly two decades in 2019, the current account registered a deficit of 5.1 percent of GDP in 2020, driven by weaker goods and services exports—including tourism—and robust imports. Credit-driven consumption and investment fueled imports, more than offsetting the lower oil import bill. Gold imports increased from 1½ percent 2019 to 3½ percent of GDP in 2020, driven by policy uncertainty, a weakening currency, and elevated inflation.</p> <p>Assessment. The EBA CA model estimated norm is -1.5 percent of GDP (with a standard error of ±1.7 percent of GDP). The CA deficit of 5.1 percent of GDP narrows to 4.8 percent of GDP after cyclical adjustment. Adjusting for temporary pandemic-related shocks (+1.6, -0.3, and -0.2 percent of GDP for tourism, global shift from services to tradable goods, and oil prices, respectively) and surge in gold imports (+1 percent of GDP) gives a staff CA gap of -1.2 percent of GDP relative to the CA norm. One-off shocks and the range surrounding the norm increase the uncertainty around this assessment.</p>						
2020 (% GDP)	Actual CA: -5.1	Cycl. Adj. CA: -4.8	EBA Norm: -1.5	EBA Gap: -3.3	COVID-19 Adj.: 1.1	Other Adj.: 1.0	Staff Gap: -1.2
Real Exchange Rate	<p>Background. The average REER depreciated for a third consecutive year, with a depreciation of more than 10 percent in 2020. The nominal depreciation against the dollar in 2020 was 23.6 percent.</p> <p>Assessment. The IMF staff CA gap implies a REER gap of 5 percent in 2020 (applying an estimated elasticity of 0.24). The EBA REER level and index approaches suggest the REER was undervalued in 2020 by around 31 to 35 percent (with a standard error of ± 8 percent). Considering the recent sharp depreciation of the REER, which is expected to support a rise in Turkey's current account balance toward its norm over the coming years, staff gives more weight to the EBA REER approaches as the CA continues to adjust. Overall, IMF staff assesses the REER to have been undervalued by about 15-25 percent, with a midpoint of 20 percent and large uncertainties surrounding these estimates.</p>						
Capital and Financial Accounts: Flows and Policy Measures	<p>Background. Net capital inflows increased only modestly in 2020, from USD 5.5 to USD 8.2 billion. E&O remained negative, likely reflecting unrecorded capital outflows. The modest increase in net inflows was driven by other investment (notably the increased bilateral currency swap agreement with Qatar), which more than offset larger net portfolio outflows and lower net FDI. Turkey introduced limits to bank swaps and other derivative transactions with foreign counterparties as well as export surrender/repatriation requirements (both CFMs) in August 2018. These were being unwound when new bouts of volatility resurfaced in late-2019. Limits to bank swaps and other derivative transactions with foreign counterparties were thus reintroduced and tightened in December 2019 and February–April 2020. These were relaxed in November 2020.</p> <p>Assessment. The quality of financing continued to worsen in 2020, with increased reliance on short-term financing and reserve drawdown. With annual gross external financing needs projected at about 24 percent of GDP on average in 2021-2026 (29.4 percent of GDP in 2020), Turkey remains vulnerable to adverse shifts in global investor sentiment. Remaining CFMs should be phased out as conditions improve to increase market liquidity and support de-dollarization.</p>						
FX Intervention and Reserves Level	<p>Background. The de jure exchange rate is classified as free floating. The CBRT undertook significant forex sales in 2020 to contain pressures on the lira. Gross reserves declined from USD 105.7 billion at end-2019 to USD 93.3 billion by end-December. NIR dropped by USD 2726.2 billion to USD 43.714.5 billion by end-2020.² The composition of reserves has also changed, with an increasing share of gold and non-SDR-basket currencies.</p>						

Annex III. Public Debt Sustainability

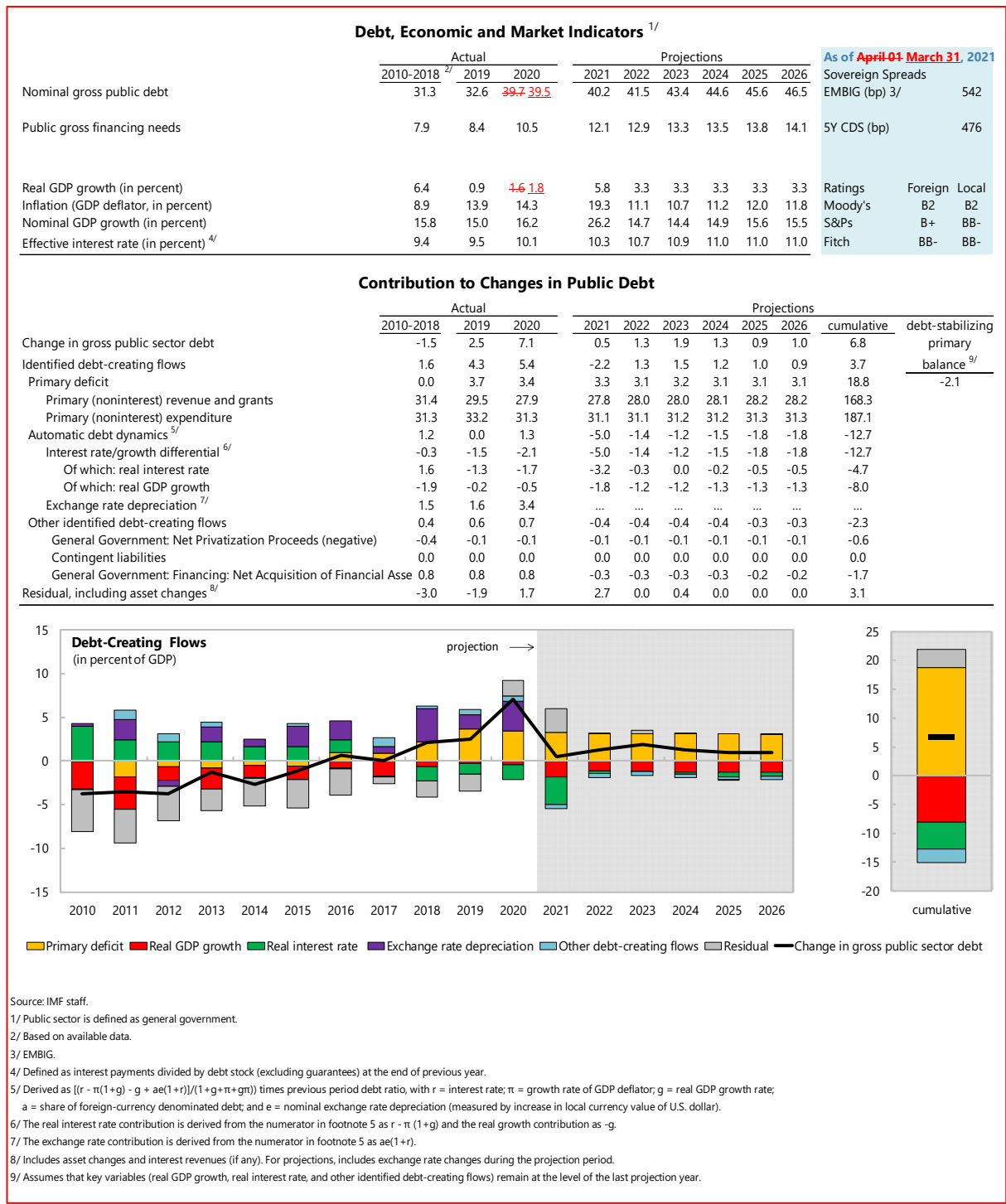
Turkey's public debt to GDP ratio increased to around 40 percent in 2020, well above its ten-year average.¹ Gross public sector financing needs have also increased and are expected to remain high over the medium term, posing significant liquidity risks. The public DSA suggests that, although Turkey's public debt remains below vulnerability benchmarks over the medium term, under both the baseline and shock scenarios, debt increases and does not stabilize by 2026. The debt structure has shifted towards shorter-maturity domestic borrowing and higher reliance on foreign-currency borrowing, increasing the pass-through to the budget from exchange rate shocks. High external financing requirements point to risks arising from external debt. Large quasi-fiscal operations in recent years increase Turkey's exposure to a contingent liability shock.

Baseline and Realism of Projections

1. **Debt levels.** Turkey's debt-to-GDP ratio increased from 32.6 percent to 39.75 percent between 2019 and 2020. Staff forecasts the ratio will increase to around 47 percent of GDP by 2026, driven by large primary deficits.
2. **Growth.** Real GDP growth reached 1.8 percent in 2020 and is projected to rebound to 5.8 percent in 2021 mainly on account of carryover effects, before falling to trend growth of about 3¼ percent over the medium term. The high sensitivity of public debt to GDP growth, highlights the relevance of growth shocks in the stress tests.
3. **Sovereign yields.** Yields on domestic bonds remained volatile and the average cost of domestic borrowing (fixed interest) was 13.6 percent at end-2020. The spread against US bonds ~~is~~ was over 500 bps in early April 2021, below its peak in summer 2018 but slightly higher than late-2019 levels. The effective interest rate is projected to hover around 11 percent over the medium term.
4. **Fiscal adjustment.** The general government primary balance deteriorated only marginally in 2020. The structural primary deficit (which adjusts for the cycle and one-off revenue items) is projected at 3.3 percent of GDP in 2021 and is expected to stabilize at around 3 percent in the medium term. Forecast errors of fiscal balances have been significant in the recent past due to the volatility of growth as well as the mid-2018 crisis.
5. **Maturity and rollover.** The current general government debt composition is associated with moderate pass-through of interest rate and exchange rate movements. At end-2020, the average maturity of the central government debt was 5.1 years, around 70 percent was in fixed interest, and 56 percent denominated in foreign currency. However, the sensitivity of public debt to interest and exchange rate shocks has increased, notably due to a decline in the average maturity of new domestic issuance and to the growing share of foreign currency denominated debt. The

¹ Measured as general government gross debt according to Maastricht criteria. Fiscal balances in this DSA are based on the IMF program definition.

Figure 1. Turkey Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario
(in percent of GDP, unless otherwise indicated)



Annex IV. External Debt Sustainability¹

Turkey's external debt, while sustainable under the baseline, is high and vulnerable to valuation shocks. Debt increased modestly, to 63 percent of GDP, in 2020. Under the baseline, external debt declines to around 40 percent of GDP by 2026, as growth returns to trend and the real exchange rate appreciates. The external debt path remains sensitive to large lira depreciation. High external financing needs and low reserves expose the economy to liquidity risks.

Background

- 1. External debt has continued to increase.** After rising for much of the past decade, external debt increased further, to 63 percent of GDP, in 2020, mainly driven by lira depreciation. Much of the debt is held by the [financial sector and the non-financial](#) private sector (around 45 percent of GDP), roughly equally split between banks and non-banks. In parallel, external debt owed by non-financial corporations declined in 2020.
- 2. The share of short-term debt is projected to continue to increase.** Short-term debt is expected to increase further over the next five years, from around 30 to 35 percent of overall debt. Net non-debt creating inflows, mostly FDI, have slowed and are expected to remain below the long-term average of 1.5 percent of GDP. Despite recent Eurobond issuance at shorter tenors, the average time to maturity of the government's external debt stock remains high, at ten years.

Assessment

- 3. Turkey's external debt, while sustainable under the baseline, is vulnerable to lira depreciation.** [Turkey's](#) historically large current account deficit, which averaged 4.3 percent of GDP (excluding interest payments) over 2009–2018, resurfaced in 2020, after posting a surplus in 2019. Turkey's external debt trajectory declines under the baseline, which assumes lower current account deficits and slower debt accumulation by the private sector. Standard stress tests suggest that the debt level could increase substantially under a real depreciation shock since most external debt is FX- denominated. Under a permanent 30 percent lira depreciation over the baseline, debt would temporarily exceed 90 percent of GDP by end-2021, but decline to around 64 percent by 2026.
- 4. Turkey's external debt sustainability remains susceptible to liquidity and rollover risks.** Just over one third of Turkey's private external debt is short term, including because of bank borrowing at shorter tenors, large bank deposits by non-residents, and trade credits. Turkey's gross external financing needs (USD 211 billion in 2020; 29.4 percent of GDP; 226 percent of GIR) are expected to average around 24 percent of GDP over 2021–2026, exposing the economy to liquidity risks, especially given low international reserves. And a significant amount of Eurobonds maturing over the same period could create rollover risks.

¹ This external debt sustainability analysis is based on the definition of external debt used by the authorities, covering liabilities arising from loans obtained from nonresidents and liabilities related to bonds issued in international capital markets. Government securities issued in Turkish lira are excluded, while Eurobonds held by domestic banks are included in this presentation of external debt.

Table 1. Turkey: External Debt Sustainability Framework, 2016–2026
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -4.3	
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026		
Baseline: External debt	47.0	52.9	56.9	57.2	62.9	58.4	56.7	52.6	48.2	43.8	40.3		
Change in external debt	0.8	5.9	4.0	0.3	5.6	-4.4	-1.7	-4.1	-4.4	-4.4	-3.6		
Identified external debt-creating flows (4+8+9)	1.2	3.4	6.1	-1.0	7.9	-1.2	-1.1	-0.4	-0.6	-0.5	0.0		
Current account deficit, excluding interest payments	2.5	4.0	1.8	-2.0	4.3	1.9	0.8	0.8	1.1	1.2	1.4		
Deficit in balance of goods and services	2.2	3.8	1.4	-2.5	4.0	1.3	0.2	0.2	0.4	0.6	1.0		
Exports	22.9	25.9	30.5	32.3	28.4	32.5	33.3	32.9	32.1	31.2	30.2		
Imports	25.1	29.7	31.8	29.8	32.3	33.8	33.5	33.1	32.6	31.8	31.2		
Net non-debt creating capital inflows (negative)	-1.3	-1.3	-1.0	-0.9	-0.1	-0.5	-1.0	-0.5	-0.9	-1.0	-0.7		
Automatic debt dynamics 1/	0.0	0.7	5.4	1.8	3.6	-2.6	-0.9	-0.8	-0.8	-0.6	-0.7		
Denominator: 1+g+r+gr	1.0	1.0	0.9	1.0	0.9	1.1	1.0	1.1	1.1	1.1	1.1		
Contribution from nominal interest rate	0.6	0.7	1.0	1.1	0.8	0.8	0.9	0.9	0.8	0.8	0.6		
Contribution from real GDP growth	-1.5	-3.6	-1.7	-0.5	-1.0	-3.4	-1.8	-1.7	-1.6	-1.4	-1.3		
Contribution from price and exchange rate changes 2/	0.9	3.6	6.1	1.3	3.8	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-0.4	2.5	-2.1	1.3	-2.2	-3.3	-0.7	-3.7	-3.7	-3.9	-3.6		
External debt-to-exports ratio (in percent)	205.2	204.0	186.8	177.1	221.6	180.0	170.2	160.0	150.1	140.3	133.2		
Gross external financing need (in billions of US dollars) 4/	191.9	206.0	201.9	169.9	210.6	213.7	210.2	215.8	226.4	237.3	243.1		
in percent of GDP	22.1	24.0	25.9	22.3	29.4	27.6	25.9	24.2	23.0	21.6	19.9		
Scenario with key variables at their historical averages 5/						64.6	68.5	72.0	75.6	79.1	82.4	0.4	
Key Macroeconomic Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation					For debt stabilization	
Nominal GDP (US dollars)	869.3	858.9	779.6	760.9	715.9			774.2	810.7	890.4	985.7	1097.8	1221.8
Real GDP growth (in percent)	3.3	7.5	3.0	0.9	+6.18	5.2	3.2	5.8	3.3	3.3	3.3	3.3	3.3
Exchange rate appreciation (US dollar value of local currency, percent change)	-10.0	-17.2	-24.3	-15.1	-19.0	-14.1	6.0	-14.3	-8.7	-4.0	-3.6	-3.7	-3.7
GDP deflator (change in domestic currency)	8.1	11.0	16.5	13.9	14.3	10.1	3.6	19.3	11.1	10.7	11.2	12.0	11.8
GDP deflator in US dollars (change in percent)	-2.6	-8.1	-11.8	-3.3	-7.4	-5.6	4.7	2.2	1.4	6.3	7.1	7.9	7.7
Nominal external interest rate (in percent)	1.4	1.5	1.7	1.8	1.4	1.6	0.2	1.3	1.7	1.8	1.7	1.8	1.6
Growth of exports (US dollar terms, in percent)	-5.4	11.9	6.7	3.5	-17.4	3.2	11.0	23.7	7.4	8.4	8.2	8.3	7.7
Growth of imports (US dollar terms, in percent)	-4.8	16.7	-2.7	-8.5	1.9	2.3	12.7	13.1	3.7	8.6	8.9	8.8	9.3
Current account balance, excluding interest payments	-2.5	-4.0	-1.8	2.0	-4.3	-3.5	2.6	-1.9	-0.8	-0.8	-1.1	-1.2	-1.4
Net non-debt creating capital inflows	1.3	1.3	1.0	0.9	0.1	1.1	0.5	0.5	1.0	0.5	0.9	1.0	0.7

Source: IMF staff calculations.

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

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

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

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

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

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

Annex V. Implementation of Past Fund Advice

- 1. Recent Fund advice focused on risks associated with externally-funded credit and demand stimulus.** The 2019 Article IV staff report argued the economy remained susceptible to external and domestic risks. Prospects for strong and durable growth over the medium term looked challenging without reforms to address vulnerabilities, strengthen policy credibility, and boost productivity. The Fund advised the authorities to move the focus from short-run growth to higher and more resilient medium-term growth through a comprehensive reform package. While the policy shift was a step in the right direction, this shift needs to be redoubled to contain risks, and rebuild buffers, and secure stronger and durable growth.
- 2. In line with the 2017 FSAP recommendations, enhancements to supervision continued alongside improvements in bank recovery planning.** The BRSA's banking sector risk assessment was broadened and strengthened to include an examination of profitability, a closer look at concentration risks in the loan book, and risks from derivatives and early loan redemptions. Supervision of the insurance sector has also improved, despite the challenges faced by remote surveillance arising from the pandemic. The Insurance and Private Pension Regulation and [Supervisory Supervision](#) Agency now collects data and prepares risk maps composed of quantitative and qualitative risk assessments for insurance, reinsurance and pension companies. Capital adequacy, financial status, and risk management and organizational structures are examined for deficiencies. On bank recovery planning, systemically-important banks will submit draft recovery plans to the BRSA this year, which should be in line with the EU's bank recovery and resolution directive. ~~Cross border coordination arrangements are also expected to be part of the recovery plan agreements.~~
- 3. However, other 2017 FSAP recommendations have been delayed because of the immediate response to the pandemic.** Proposals to further strengthen the BRSA's independence by revising the Banking Law have been postponed, including with regards to board appointment procedures and the ability of the relevant minister to take action against the BRSA. On systemic risk oversight, the Financial Stability and Development Committee (FSDC) is still working on rules and procedures to improve systemic risk assessment and coordination of macroprudential policies to make the committee more accountable for its decisions, as well as mandating for meetings of the FSDC to occur monthly. While the emergency funding provided by the CBRT during the COVID-19 stress helped avert a liquidity crisis, the CBRT is still conducting studies of the appropriate tools for emergency liquidity assistance that should be established through amendments to central bank regulations. The authorities' request to bring forward the next FSAP to 2021 is welcome and provides an opportunity to update staff's assessment of these issues.



Appendix I. Draft Press Release

IMF Executive Board Concludes 2021 Article IV Consultation with Turkey

FOR IMMEDIATE RELEASE

Washington, DC – May 28, 2021: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Turkey.

In the years leading up to the COVID-19 pandemic, growth in Turkey became increasingly dependent on externally-funded credit and demand stimulus. This growth was accompanied by large current account deficits, financed mainly by debt, which led in turn to high external financing needs. At the same time, rapid credit growth, led by state-owned banks, and high inflation undermined monetary policy credibility and fueled deposit dollarization. The resulting pressure on the lira contributed to large reserve losses. As a result, Turkey entered the pandemic with lower buffers than most peers.

As in other countries, the human and initial economic toll of the pandemic in Turkey has been severe. Thousands of Turkish lives have been tragically lost and many livelihoods compromised. Virus containment measures helped prevent an even steeper toll, but also contributed to an unavoidable and unprecedented fall in economic activity and employment by mid-2020. But the initial policy response to the pandemic—and subsequent exceptionally sharp growth rebound—set Turkey apart from its peers. Large interest rate cuts, rapid credit provision by state-owned banks, administrative and regulatory credit incentives, and extensive **large** liquidity support meant that Turkey was among the few countries to experience positive economic growth in 2020. Employment has partially recovered along with the rebound in economic activity, but labor market conditions remain challenging, particularly among females and the youth. Direct fiscal support—including to workers and vulnerable households—has been relatively modest, with the central government deficit widening only marginally in 2020. Public debt remains low and some fiscal space remains available albeit somewhat limited by contingent liabilities and potential debt rollover pressures.

But the same policies that buoyed growth also exacerbated pre-existing vulnerabilities, with buffers now lower than before the pandemic. Higher inflation, increased dollarization, and a large shift in the current account position increased pressure on the lira and gave rise to heavy foreign exchange sales, which led in turn to steep reserve declines from already-low levels. A shift towards a firm monetary policy stance since the Fall, focused on reining in inflation, was initially well received but its durability has recently been called into question, with the lira

¹Under 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. Due to the COVID-19 pandemic, the 2021 discussions were carried out virtually.

Table 1. Turkey: Selected Economic Indicators, 2019–26

	2019	2020	2021	2022	2023	2024	2025	2026
			Proj.					
Population (2020): 84.2 million								
Per capita GDP (2020): US\$8,505								
Quota: SDR 4,658.6 million								
Real sector	<i>(Percent, unless otherwise noted)</i>							
Real GDP growth rate	0.9	1.8	5.8	3.3	3.3	3.3	3.3	3.3
Contributions to real GDP growth								
Private consumption	0.9	1.7	3.4	1.5	1.8	1.9	2.1	2.2
Public consumption	0.6	0.3	0.4	0.4	0.4	0.5	0.5	0.5
Investment (incl. inventories)	-3.8	7.1	-3.3	0.4	1.5	1.4	1.2	1.3
Net exports	3.2	-7.3	5.3	1.0	-0.5	-0.4	-0.5	-0.7
Output gap	-0.8	-2.2	0.0	0.0	0.0	0.0	0.0	0.0
GDP deflator growth rate	13.9	14.3	20.4	11.4	11.0	11.5	12.4	12.2
Inflation (period-average)	15.2	12.3	16.9	14.9	12.8	12.5	12.5	12.5
Inflation (end-year)	11.8	14.6	16.5	14.0	12.5	12.5	12.5	12.5
Unemployment rate	13.7	13.2	12.5	11.0	10.5	10.5	10.5	10.5
	<i>(Percent of GDP)</i>							
Fiscal sector								
Nonfinancial public sector overall balance	-5.8	-5.4	-6.1	-6.3	-6.5	-6.5	-6.6	-6.7
General government overall balance (headline) 1/	-3.7	-4.5	-5.7	-6.0	-6.2	-6.2	-6.3	-6.4
General government gross debt (EU definition)	32.6	39.75	40.2	41.5	43.4	44.6	45.6	46.5
External sector								
Current account balance	0.9	-5.1	-2.7	-1.7	-1.8	-1.9	-1.9	-2.0
Gross external debt	57.2	62.9	58.4	56.7	52.6	48.2	43.8	40.3
Gross financing requirement	22.3	29.4	27.6	25.9	24.2	23.0	21.6	19.9
Monetary conditions	<i>(Percent)</i>							
Real average cost of CBRT funding to banks	5.4	-1.7	...	...	...	...	...	...
Growth of broad money (M2)	27.3	33.9	...	...	...	...	...	...
Growth of credit to private sector	10.9	34.7	...	...	...	...	...	...
Sources: Turkish authorities; and IMF staff estimates and projections.								
1/ Headline (or authorities' definition), which includes items excluded from the IMF 'program' definition.								