

**EXECUTIVE  
BOARD  
MEETING**

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May 14, 2021

To: Members of the Executive Board

From: The Secretary

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

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Tentative Board Date:	<b>Thursday, May 27, 2021</b>
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Questions:	Mr. McGettigan, EUR (ext. 36407) Ms. Domit, EUR (ext. 34174) Mr. Guzzo, EUR (ext. 38167) Mr. Pienkowski, EUR (ext. 37625) Mr. Kelmanson, EUR (ext. 34906)
Document Transmittal in the Absence of an Objection and in accordance with Board policy:	Monday, May 17, 2021—European Central Bank After Board Consideration—Asian Infrastructure Investment Bank, European Investment Bank, Food and Agriculture Organization, Islamic Development Bank, Organisation for Economic Cooperation and Development, United Nations Development Programme, World Trade Organization

**\*Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**





# TURKEY

## STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

May 13, 2021

### KEY ISSUES

**Context:** In Turkey, as in other countries, the human and economic toll of the COVID-19 pandemic has been severe. Thousands of lives have been tragically lost and many livelihoods compromised. The initial policy response to the pandemic—and subsequent sharp growth rebound—set Turkey apart from its peers. Rapid monetary and credit expansion and large liquidity support meant that Turkey was among the few countries to experience positive economic growth in 2020. But these policies also aggravated pre-existing economic and financial vulnerabilities. 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 policy shift in late 2020—mainly towards tighter and more transparent monetary policy and slower credit growth—was both welcome and necessary. But the durability and depth of the shift were called into question in March 2021, following the change in central bank leadership, as the lira weakened markedly and interest rate spreads widened.

**Policies:** Although policy uncertainty and vulnerabilities have increased, Turkey's challenges are not insurmountable. Delivering a firm monetary policy stance will be necessary to rebuild credibility and buffers, while also responding to the human and economic needs arising from the pandemic, including through:

- Strongly committing to, and delivering, a firm monetary stance—with no premature easing and with further timely and well-calibrated tightening if inflation expectations rise further, to, at a minimum, keep the ex-ante real policy rate unchanged—and transparent and predictable reserve accumulation once conditions allow;
- targeted and temporary fiscal support to address pandemic-related needs, alongside pre-announced and credible medium-term consolidation;
- close monitoring of bank FX liabilities, continued reining in and refocusing of lending by state-owned banks, gradual unwinding of regulatory flexibility and loan deferrals, and, once the pandemic subsides, a rigorous third-party assessment of bank assets; and
- focused reforms to minimize long-term scarring in the labor market and in the non-financial corporate sector.

Approved By  
**Mahmood Pradhan**  
**(EUR) and Maria**  
**Gonzalez (SPR)**

Discussions were held virtually during January 11–25, 2021 and during April 16–30. The team consisted of Messrs. McGettigan (Head), Guzzo, Pienkowski and Ms. Domit (all EUR), Mr. Piontek (MCM), Mr. Sarr (FAD), Mr. Thakoor (SPR), and Messrs. Kelmanson, Çeçen and Ms. Kesimal (Senior Res. Rep. Office). Mr. Pradhan (EUR), Mses. DeLong and Fernando (LEG), and Messrs. Azal and Doğan (OED) also participated. The mission met with Central Bank Governor Kavcıoğlu, former Central Bank Governor Ağbal, former Deputy Minister of Treasury and Finance Aksu, other senior officials, and private sector representatives. Mses. Kumar, Maneely and Menguc assisted with the mission and preparation of the staff report.

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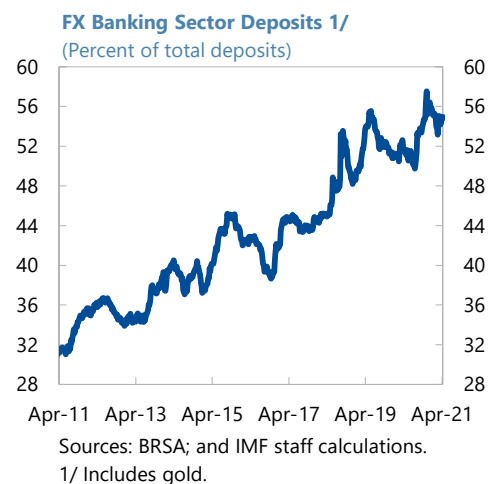
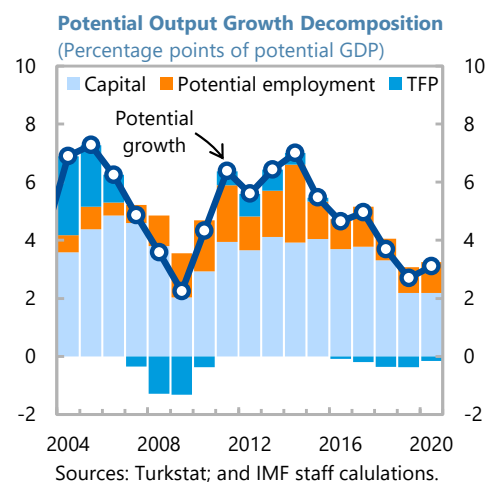
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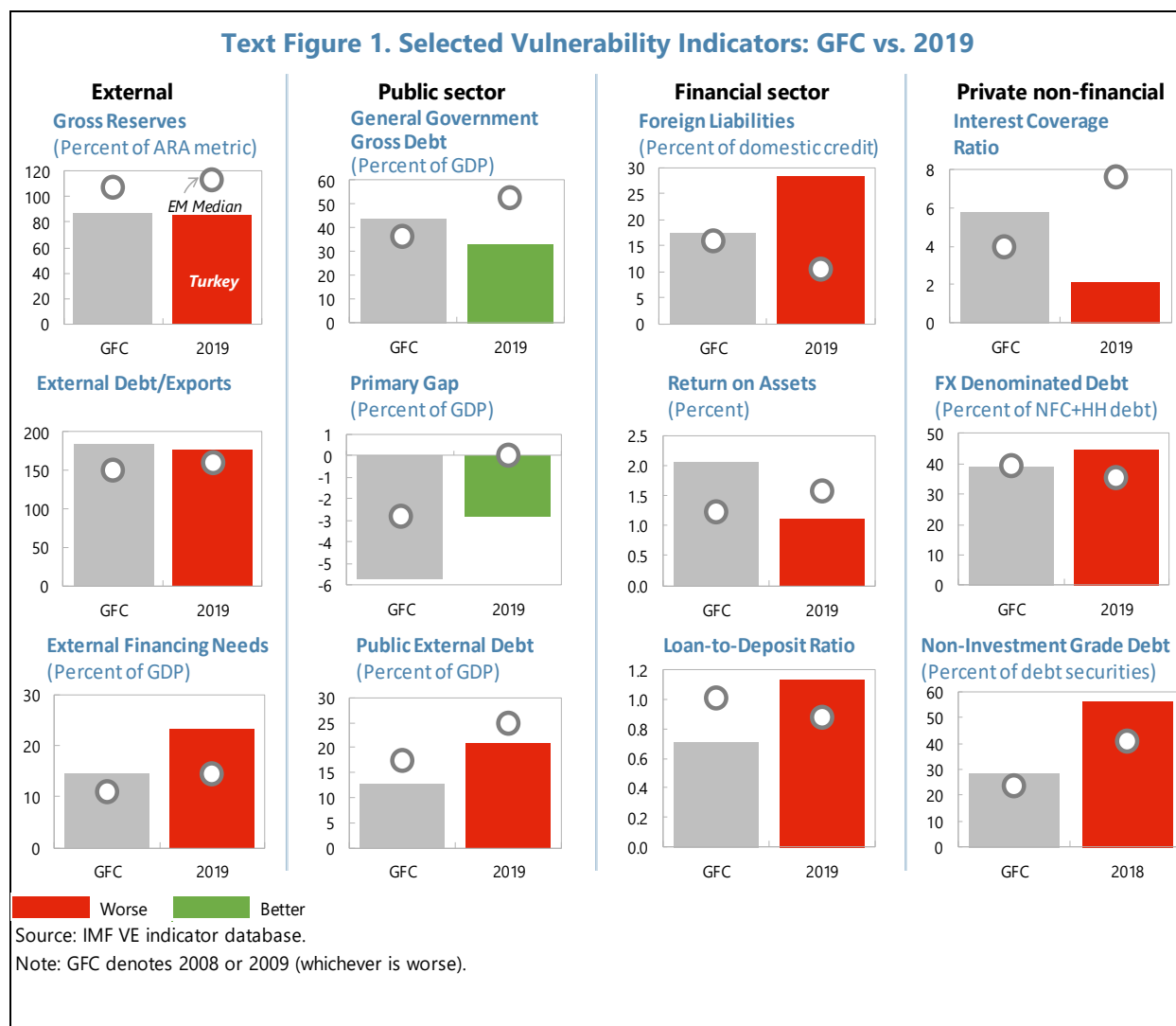
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## BACKGROUND—UNIQUE PRE-PANDEMIC VULNERABILITIES

**1. In the years leading up to the COVID-19 pandemic, growth in Turkey was driven by externally-funded demand stimulus.** In the early 2000s, broad-based macroeconomic and structural reforms supported income convergence with advanced economies. As reforms waned, however, productivity slowed and growth became increasingly dependent on externally-funded credit and demand stimulus.

**2. This growth model aggravated external and internal imbalances, leaving the economy vulnerable going into the pandemic.** Large current account deficits, financed mainly by debt, led to a weaker net international investment position, currency mismatches, and a buildup of external financing needs. Low and often negative real policy rates, rapid credit growth, and persistently high inflation undermined monetary policy credibility and eroded confidence in the lira, fueling deposit dollarization. Heavy foreign exchange (FX) sales, in an attempt to stem lira pressure, led to steep reserve losses. These developments had adverse implications for bank and non-financial corporate balance sheets. Accordingly, going into the pandemic, vulnerability indicators for all but the public sector had worsened compared to global financial crisis peaks and relative to other emerging markets.

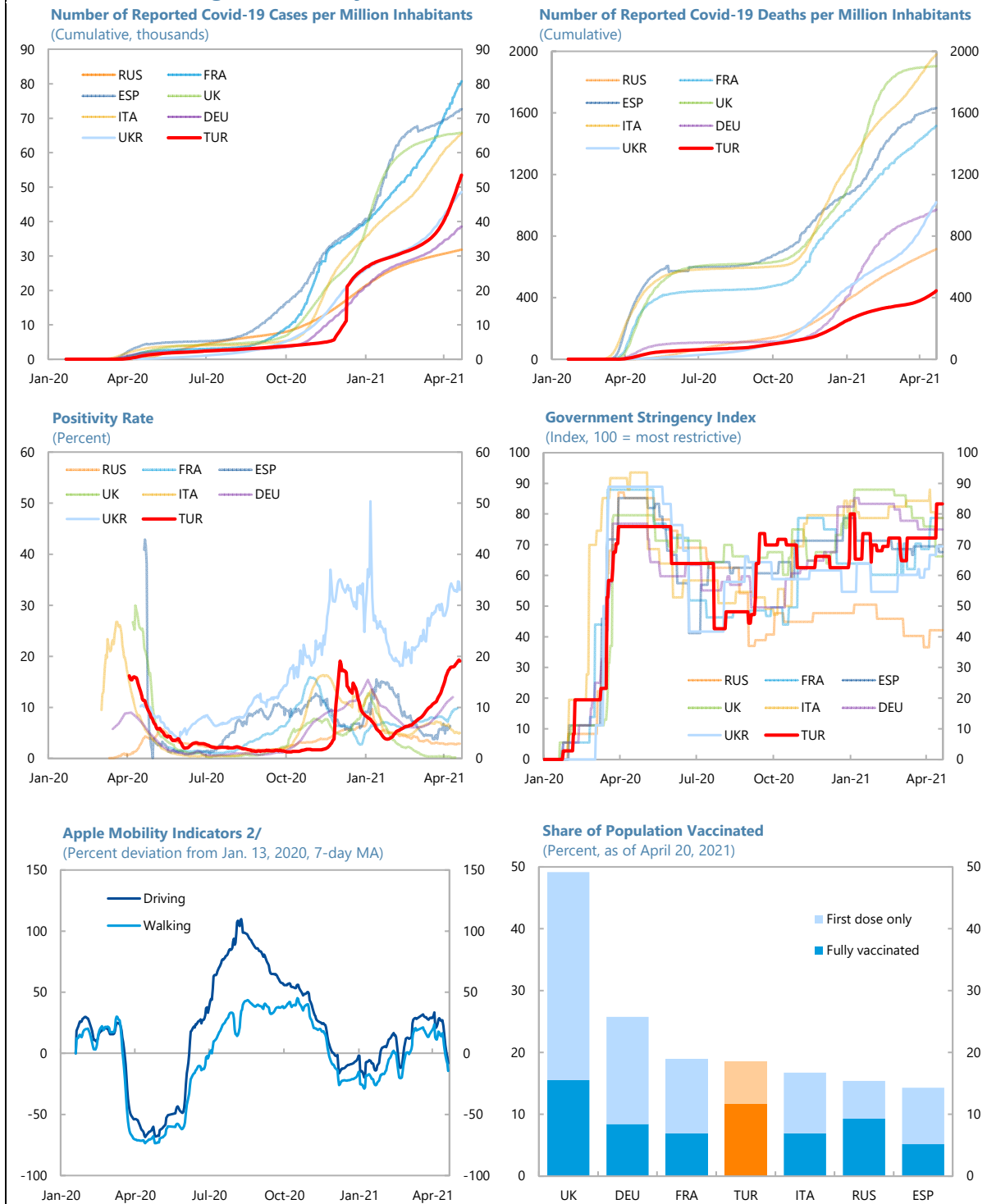




## RECENT DEVELOPMENTS—PANDEMIC, STRONG RECOVERY, AND HIGHER VULNERABILITIES

**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 7 and 12 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<sup>1/</sup>**



Sources: Apple; Blavatnik School of Government at University of Oxford; Bloomberg Finance L.P.; Our World in Data; 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.

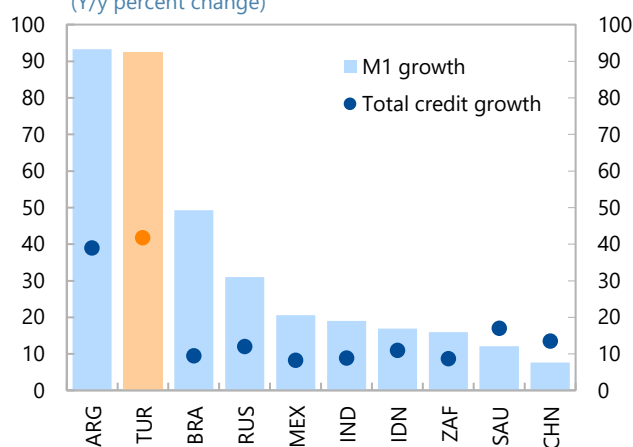
**4. The initial economic and financial impact of the pandemic was acute.** GDP fell sharply in the second quarter of 2020, as containment measures were put in place and external demand and tourism activity plummeted. Employment registered its largest fall on record in the first half of 2020, with a similar decline in labor force participation, muting recorded unemployment increases, while poverty is estimated to have risen by about 1½ million people as a result of the pandemic (Box 1). The pandemic has also hit Turkey’s large refugee population hard. Non-financial corporates experienced a steep fall in profits and a further shrinking of equity buffers (Box 2). Lower economic growth and lira depreciation worsened bank balance sheets, while household balance sheets, already strong, were less affected.

**5. The policy response relied initially on rapid monetary and credit expansion, and on extensive liquidity support, which set Turkey apart from most peers.** The Central Bank of the Republic of Turkey (CBRT) continued lowering policy rates which, with rising inflation expectations, turned real rates negative. The central bank also purchased TRY 70 billion (1.4 percent of GDP) of government securities on the secondary market. Rapid and cheap lending by state-owned banks

increased the credit gap to an estimated 25 percent of GDP, with state-owned banks now accounting for 45 percent of total banking system assets.<sup>1</sup> Credit was also fueled by regulatory changes, notably a new Asset Ratio and changes to reserve requirements, both tending to penalize banks with lower lending growth. Base money and credit rose sharply, outpacing most peers. Regulatory measures were also used to support non-financial corporates and to help preserve jobs. Quasi-fiscal measures were also used, including loan guarantees to firms and loan service deferrals by state-owned banks. These measures came to nearly 10 percent of GDP, among the highest in emerging markets (see differences in text charts).

**G20 EMs: M1 and Total Credit, 2020 Q3**

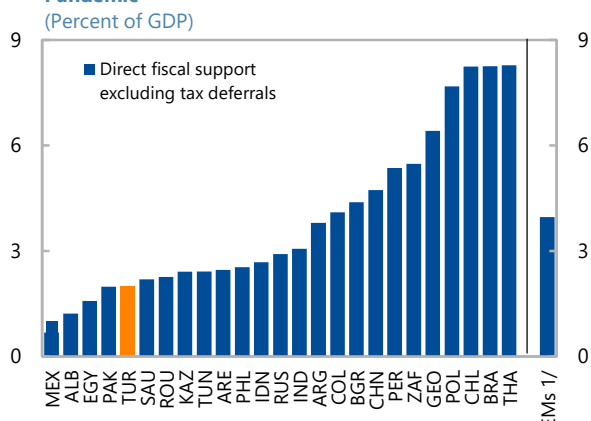
(Y/y percent change)



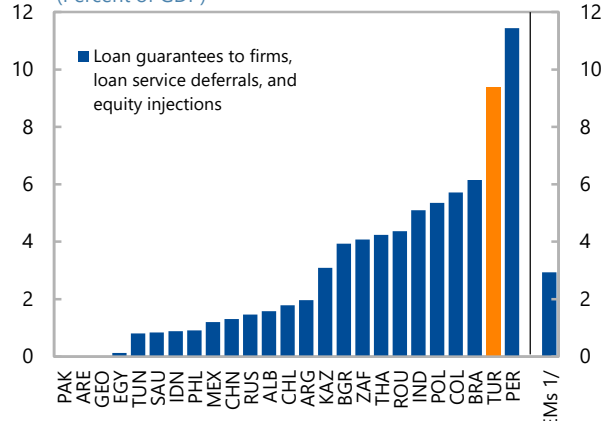
Sources: Haver Analytics; and IMF staff calculations.

<sup>1</sup> Based on IMF 2015, “Mind the Credit Gap,” Regional Economic Issues and IMF 2019, Turkey: Article IV Consultation Staff Report.

### EMs: Discretionary Direct Fiscal Response to the Pandemic



### EMs: Discretionary Liquidity Support

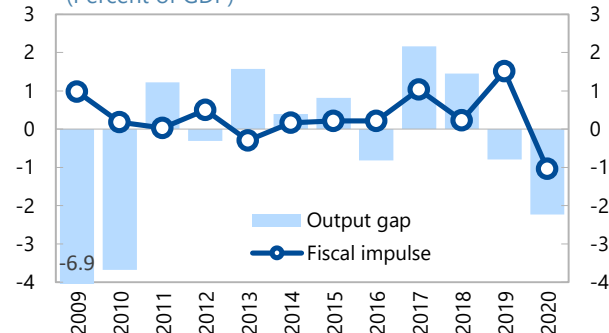


Sources: April 2021 Fiscal Monitor Update; and IMF staff estimates.  
1/ Excludes Turkey.

**6. By contrast, direct fiscal support was modest.** Spending on healthcare and on direct support to households, firms, and employees has amounted to about 2 percent of GDP, among the lowest in emerging markets. Reflecting such modest spending and stronger-than-expected revenues, the central government fiscal deficit widened only marginally in 2020, by about ½ percent of GDP, and the estimated direct fiscal impulse was negative. Revenues were helped by strong value added and special consumption tax revenues, as well as large transfers from the CBRT and high interest receipts. General government debt increased to around 40 percent of GDP, but remained low compared to most peers.<sup>2</sup>

### Turkey: Discretionary Fiscal Pandemic Support

#### Fiscal Impulse<sup>1/</sup> and Output Gap



Sources: MOTF; Turkstat; and IMF staff calculations.  
1/ Negative change in central government primary cyclically-adjusted balance, excluding one-off CBRT revenues.

Treasury backed loan guarantees	6.4
Loan service deferrals by SOBs	2.6
Tax deferrals to businesses	1.4
Short-term work scheme	0.5
Tax cuts for businesses	0.5
Equity injection into public banks from TWF	0.4
Performance pay for medics	0.2
Cash aid to employees	0.2
Cash aid to households	0.1
Healthcare	0.1
Unemployment benefits	0.1
<b>Total</b>	<b>12.6</b>
Of which:	
<b>Direct support (exc. tax deferrals)</b>	<b>1.9</b>
<b>Liquidity support</b>	<b>9.4</b>

Sources: MOTF; and IMF staff estimates.

Data as of March 2021.

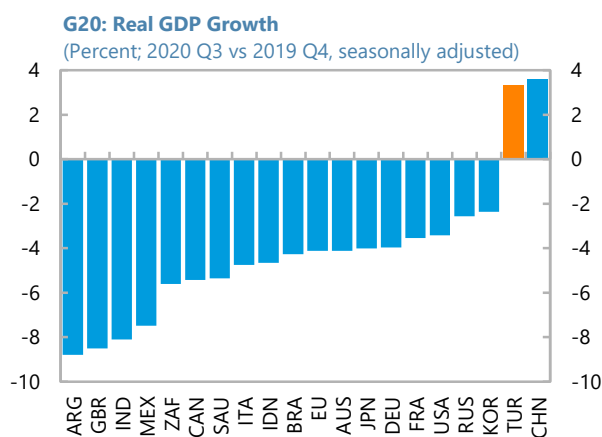
<sup>2</sup> Tax deferrals to businesses amounted to about 1½ percent of GDP, but only affected the overall 2020 deficit by about ½ percent of GDP, as around 70 percent of these had been repaid by 2020Q4. Some pandemic-related spending was financed by drawing on the assets of the Unemployment Insurance Fund, limiting the impact of the fiscal response on gross public debt.

### Turkey: Selected Initial Pandemic Policy Responses

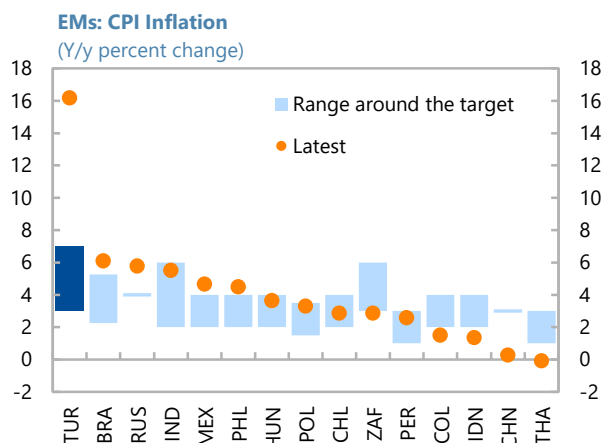
Monetary	Financial	Fiscal	Labor Market	Health
<ul style="list-style-type: none"> <li>• Policy rate cut by 250 bps</li> <li>• Outright purchases of government bonds</li> <li>• Reserve requirements reduced for banks meeting real credit growth targets</li> <li>• Additional liquidity provided through repo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

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.



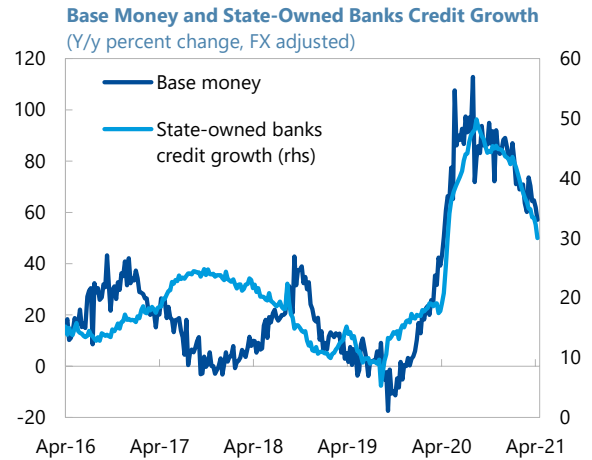
Sources: Country authorities; and IMF staff calculations.

**Figure 2. Turkey: COVID-19 Pandemic—The Economic Impact**

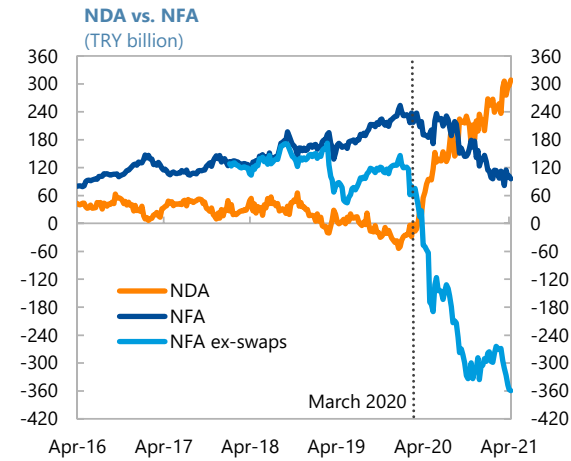
*The initial collapse in economic activity...*



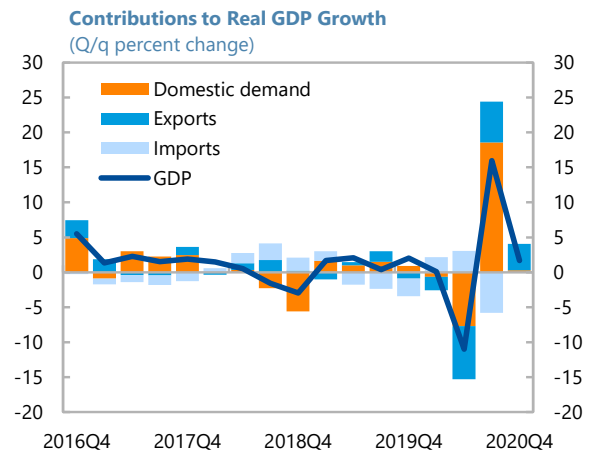
*... spurred a rapid monetary and credit expansion...*



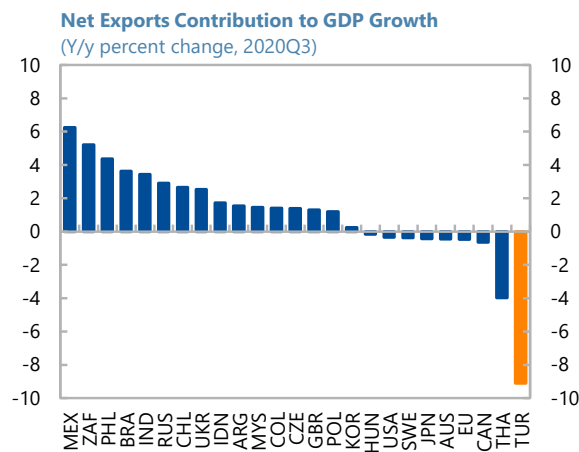
*... pressuring the lira and reserves.*



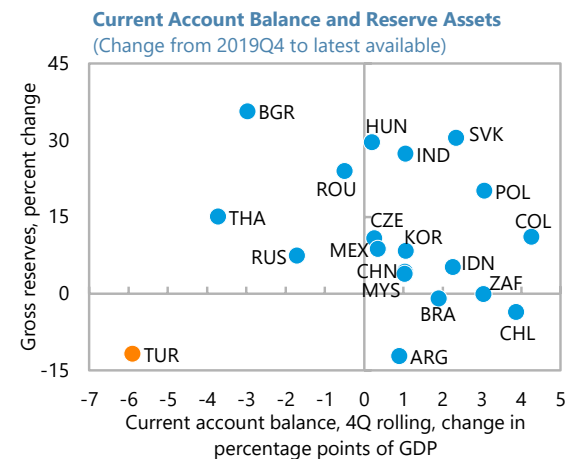
*While it led to a rapid growth rebound ...*



*... it also blunted the trade response ...*



*... and led to a large current account deficit.*



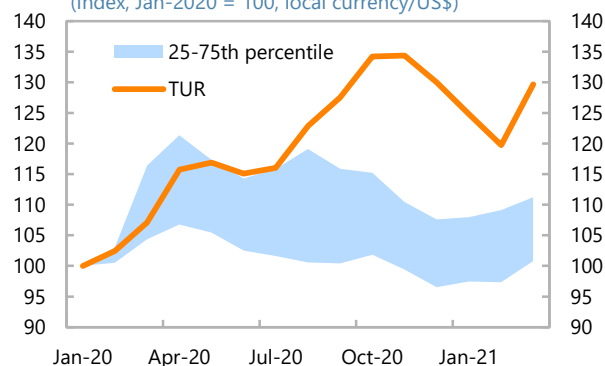
Sources: BRSA; CBRT; Haver Analytics; Turkstat; and IMF staff calculations.

**8. But the same policies that buoyed growth also exacerbated serious pre-pandemic vulnerabilities, leading to further lira weakness.** Loose monetary policy meant that inflation remained in double digits, well above the 5 percent target. Central bank credibility continued to weaken, as did confidence in the lira, which depreciated by nearly 40 percent from January to October 2020. Dollarization also increased, reaching almost 60 percent of bank deposits. Increased lending and regulatory flexibility provided much-needed liquidity, but also raised corporate leverage.

**9. The policies also led to wider external imbalances.** Excess money fed into increased demand for foreign goods and assets. The rebound in domestic demand supported imports, while exports, notably in tourism, suffered a sharp decline. Weaker monetary policy credibility led to a surge in gold imports, adding to the current account deficit, a marked change from the surplus recorded in 2019. As confidence ebbed, the quality of Turkey's external financing worsened, with increased reliance on short-term funding, a slowdown in net FDI inflows and, through much of 2020, net portfolio outflows. While Turkey's external position in 2020 was moderately weaker than the level implied by fundamentals and desirable policies, the real effective exchange rate is estimated to have been undervalued by around 15–25 percent, although the uncertainty around such estimates is high (Annex II).

**EMs: Exchange Rates**

(Index, Jan-2020 = 100, local currency/US\$)

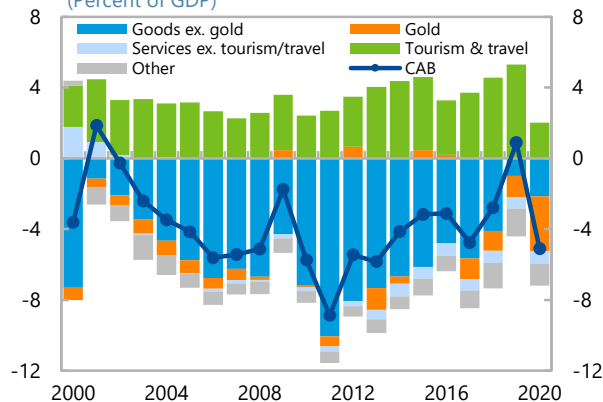


Sources: Country authorities; and IMF staff calculations.

Note: Interquartile range of a sample of 15 emerging markets.

**Current Account Balance**

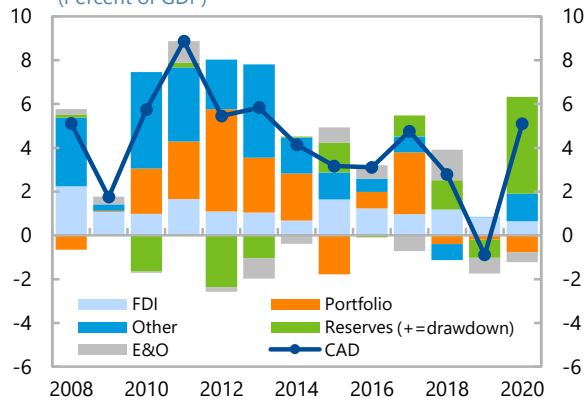
(Percent of GDP)



Sources: CBRT; and IMF staff calculations.

**Current Account Balance and Financing**

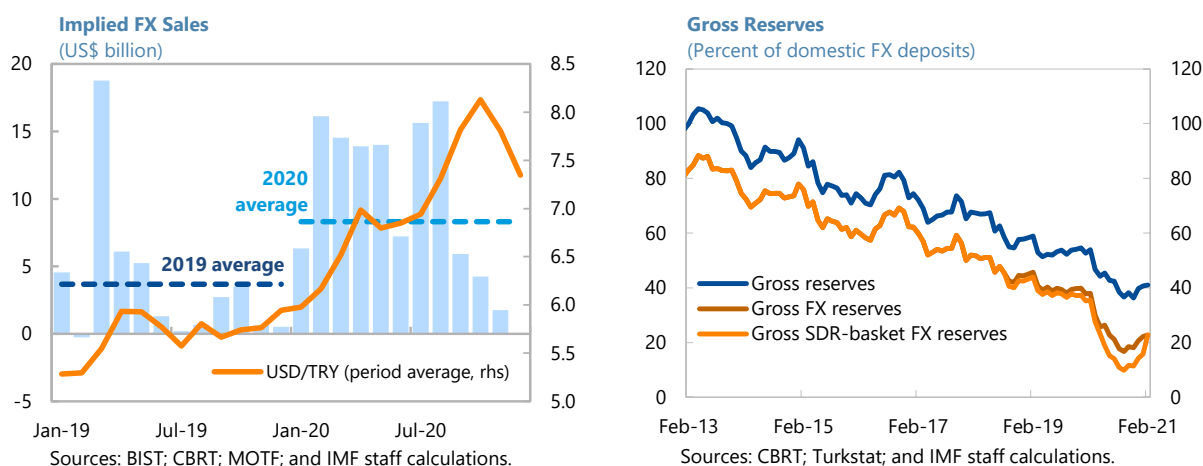
(Percent of GDP)



Sources: CBRT; and IMF staff calculations.

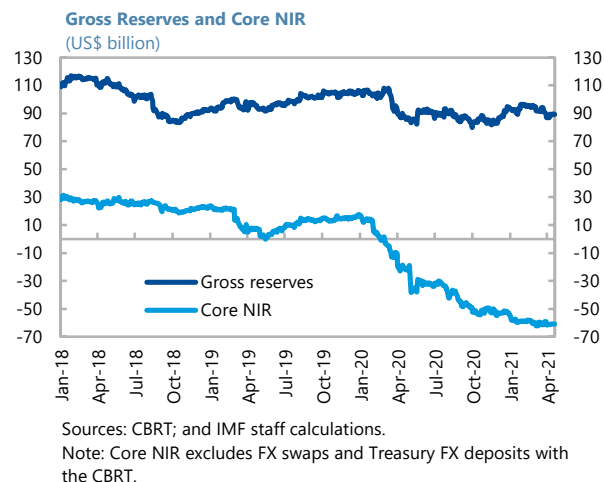
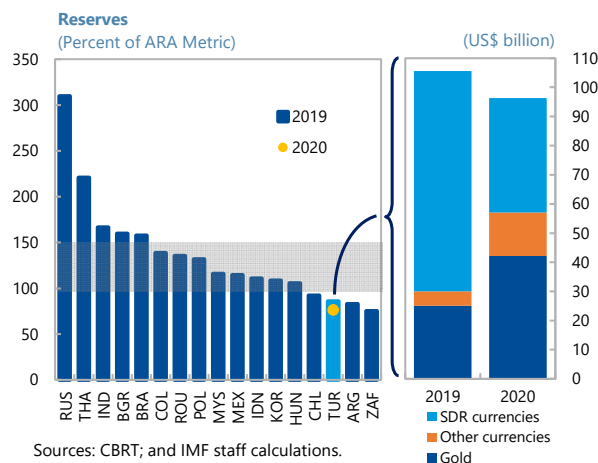
**10. The authorities attempted to stem pressure on the lira with large FX sales and administrative measures.** Based on publicly-available information on key net reserve determinants—export rediscount credits, FX swaps, gold movements, and net external and domestic FX borrowing by the government, all of which added to reserves last year, and FX sales to energy company Botas, which lowered reserves—staff estimates that net inflows to reserves came to about USD 95 billion during 2020. Since net international reserves actually fell by USD 27 billion, this suggests that large FX sales took place in 2020. Meanwhile, the FX position of state-owned banks deteriorated to a large negative overall position by August, before closing again in late 2020 (Box 3). Administrative

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.

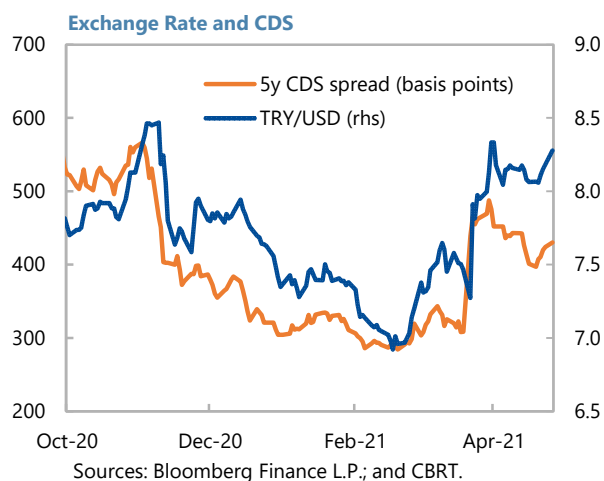
**12. These adverse developments led, in the Fall, to a welcome shift away from expansionary monetary and credit policies.** From August onwards, the CBRT started providing liquidity through more expensive facilities and tightened reserve requirements. At the same time, FX sales slowed gradually, while 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.

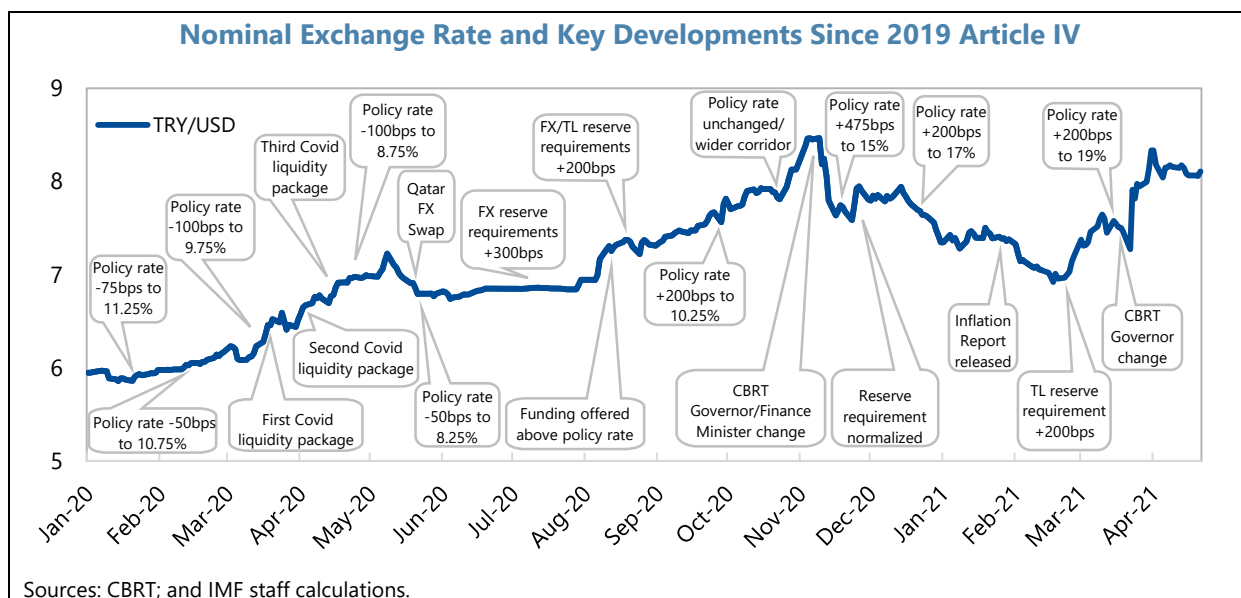


**13. These moves were accompanied by an easing of administrative measures and a commitment to broader economic reforms.** The easing included dropping the Asset Ratio and the lending incentives in the reserve requirement framework and loosening restrictions on FX swaps between local banks and foreign counterparts.

**14. The authorities also announced a new economic reform program (ERP) to complement the monetary policy shift.** In March 2021, the authorities unveiled a new ERP, which also included elements from past plans (text box). While many of the ERP objectives are reasonable (notably with regards to ensuring macroeconomic stability, boosting productivity, and strengthening governance), the merits of some of its components, including the new Price Stability Committee, are less obvious. The plan could also benefit from a clearer diagnosis of Turkey's key challenges, notably low reserves, mounting dollarization, and high external financing needs, and further elaboration of policy measures to address these challenges. Such elaboration would help policy credibility.

**15. The November policy shift was initially well received, but its durability and depth have been called into question.** The shift to more orthodox policies led to sizable portfolio inflows, narrower spreads, and a sharp lira appreciation. In contrast to international investors, however, Turkish residents' reaction to the shift was more muted, with deposit dollarization remaining at historic highs. Furthermore, policy uncertainty resurfaced, and inflation expectations shifted further upwards after the unexpected change of CBRT Governor in March 2021 and the use of more dovish forward guidance in subsequent monetary policy communication. Most of the financial market gains made following the November policy shift have been unwound, with a weaker lira and wider spreads.





### 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 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** 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 Coordination Committee, 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.<sup>3</sup> 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.<sup>4</sup> 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. 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	-5.0	-5.3	-5.5	-5.5	-5.6	-5.8
Public debt	32.6	39.7	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.

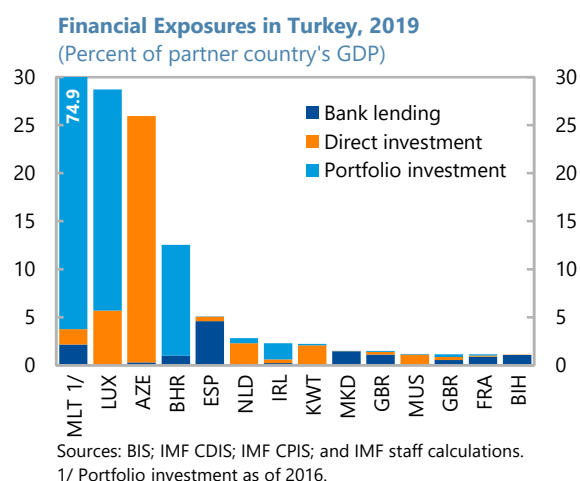
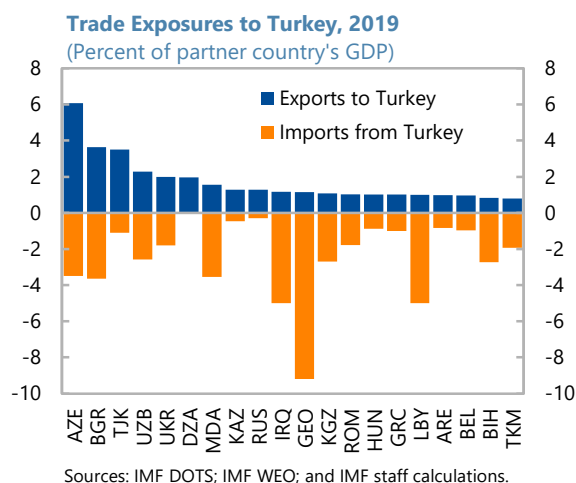
<sup>3</sup> The authorities' revised targets envisage maintaining the central government budget deficit in 2021 at 2020 levels. Staff's baseline assumes a looser stance given the expected decline in non-tax revenues, uncertainty about the evolution of the pandemic, and historic performance relative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

<sup>4</sup> GDP growth during 2021 is expected to be close to zero.

**18. Downside risks have intensified and the outlook is unusually uncertain.** Uncertainty about external financing and the direction of policies has increased the downside skew and widened the confidence band around staff's central forecasts. A premature relaxation of monetary and credit policies that further erodes credibility and buffers, or interest rate increases in advanced economies and higher global risk aversion, could expose Turkey's vulnerabilities. If such risks materialize, they could lead to higher risk premia and significantly tighter financing conditions, causing a weaker exchange rate, lower growth, higher inflation, and a sharper current account correction. By contrast, in a scenario where looser domestic financial conditions prevail without increased risk aversion, the outcomes for growth, inflation, and the current account deficit could all end up higher than projected. Other important risks include vaccination delays or declines in efficacy at home and abroad and adverse geopolitical developments (Annex I).

**19. The realization of risks in Turkey would likely lead to moderate outward spillovers.**

Channels include trade links with neighbors (e.g., with Azerbaijan), remittances (Montenegro, Bulgaria), and financial exposures through portfolio flows (Malta, Luxembourg, Bahrain) and direct investment (Azerbaijan). Exposure through bank lending is mostly linked to some euro area financial institutions holding equity stakes in Turkish banks (e.g., Spain). A severe episode of financial dislocation could affect other vulnerable emerging markets through confidence channels, although most observers still see Turkey's difficulties as idiosyncratic—as evidenced by limited spillovers during the market gyrations in late March.



## POLICIES—PANDEMIC RESPONSE: RECOVERY AND RESILIENCE

*Although policy uncertainty and vulnerabilities have increased, Turkey's challenges are not insurmountable. The authorities should strongly commit to, and deliver, a firm policy stance to rebuild credibility and buffers, while continuing to respond to the human and economic needs arising from the pandemic.*

**20. A more sustainable set of policies than in staff's baseline would help prospects for strong durable growth and for rebuilding buffers.** The new set of policies should combine: strongly

committing to, and delivering, a firm monetary stance—with no premature easing and further timely and well-calibrated tightening needed if inflation expectations rise further—formalizing the recent simplification of the CBRT’s operational framework, prudent credit policies, and the unwinding of remaining administrative measures as conditions allow. The new policies should also include temporary and targeted fiscal spending this year to address pandemic-related needs, accompanied by a credible commitment now to detailed fiscal consolidation, to be enacted once the post-pandemic recovery is entrenched. Such policies would help improve sentiment, while keeping the policy stance broadly neutral. Over time, and as conditions allow, priority should be given to rebuilding buffers from current low levels. As the recovery unfolds, the authorities should move from focusing on preserving jobs and firms to helping labor and capital move as needed, to minimize long-term scarring. Priorities here should include supporting female labor force participation and youth employment, increasing labor market flexibility while providing accompanying support, ensuring that viable but temporarily-weakened firms are restructured, and winding down non-viable firms over time.

**21. These policies would involve trade-offs.** The proposed policy response would likely sacrifice some near-term growth in favor of stronger and more resilient growth over the medium term. Specifically, tight monetary and credit policies would likely accelerate deleveraging and temporarily reduce demand, highlighting the need for a looser near-term fiscal stance focused on supporting the most vulnerable. Structural reforms may also involve some near-term costs as resources are reallocated to more productive sectors, calling for careful sequencing.

**22. A more sustainable set of policies would yield better outcomes, however, and, by addressing vulnerabilities, reduce Turkey’s exposure to downside risks.** Medium- and long-term benefits of the rebalanced policy framework would outweigh any near-term costs. The benefits would include sustainably lower interest rates, a stronger lira, faster and more durable disinflation, higher reserves, and, ultimately, stronger and more durable growth.

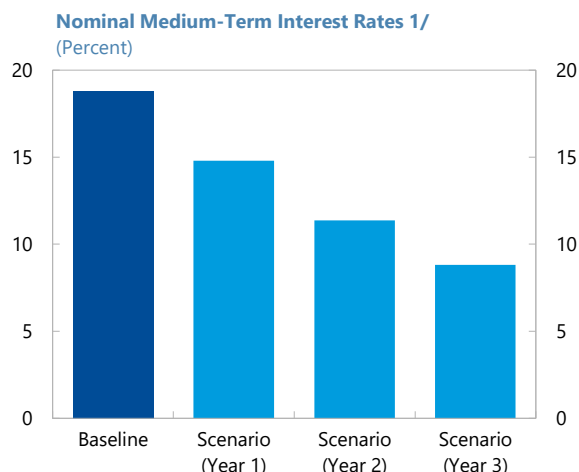
### ***Authorities’ Views***

**23. The authorities broadly agreed with staff’s baseline, with some differences.** They shared staff’s views on the near-term growth outlook. That said, the authorities expected somewhat more favorable growth over the medium term. Their baseline also envisaged a more favorable outlook for external financing. Finally, they also expected inflation to be significantly lower than in staff’s baseline.

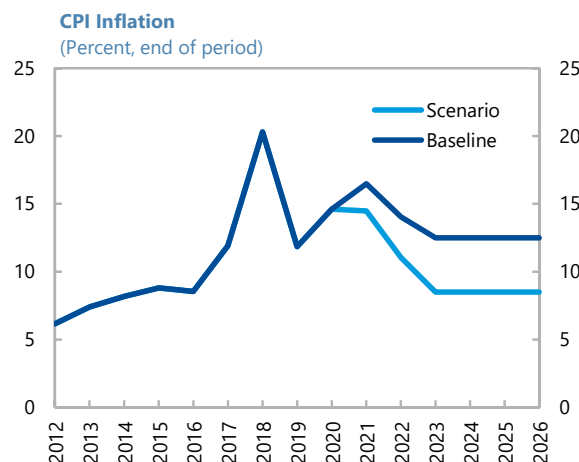
**24. The authorities believe policies are on the right track.** They agreed with the need to deliver a firm monetary stance and credit tightening and to strengthen monetary policy operations. They committed to pursue prudent fiscal policy over the medium term to preserve the fiscal anchor. They also agreed with the need to rebuild reserves given Turkey’s large external financing needs and high deposit dollarization. But there were some important differences. Compared to staff, the authorities favored more frontloaded fiscal tightening with no easing this year, and with additional support deployed only if needed. They were also more sanguine on downside risks, notably from bank and corporate balance sheets. Finally, while the authorities agreed with the need for focused reforms to support medium-term growth, they identified different reform priorities.

### Illustrative Scenario—Benefits of a More Sustainable Policy Framework

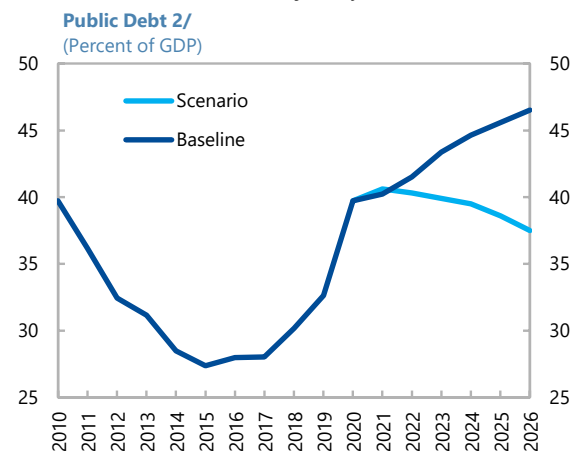
Benefits include a sustainable decline in interest rates ...



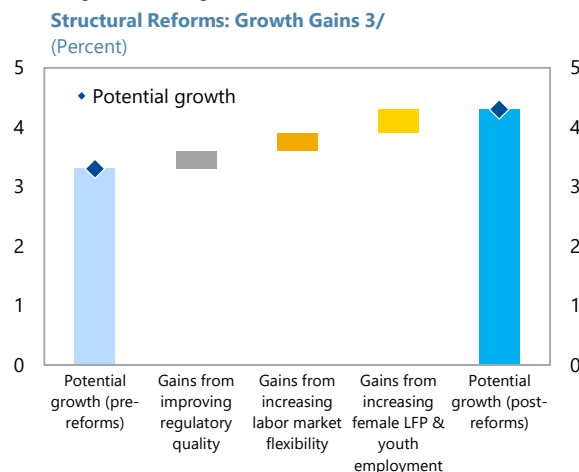
... faster and more durable disinflation ...



... a more sustainable debt trajectory, and ...



... stronger durable growth.



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

1/ Yield on 5-year treasury bonds.

2/ General government gross debt.

3/ See IMF (2019) "Productivity Payoffs of Structural Reforms in Turkey," IMF (2018) "Economic Gains from Gender Inclusion, New Mechanisms, New Evidence," and OECD (2021) "Turkey Economic Survey."

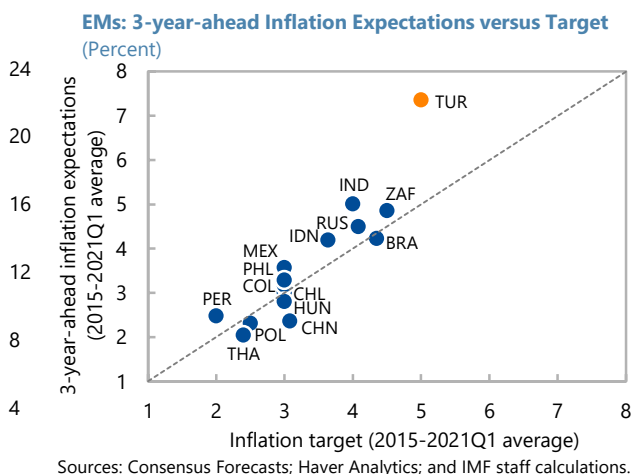
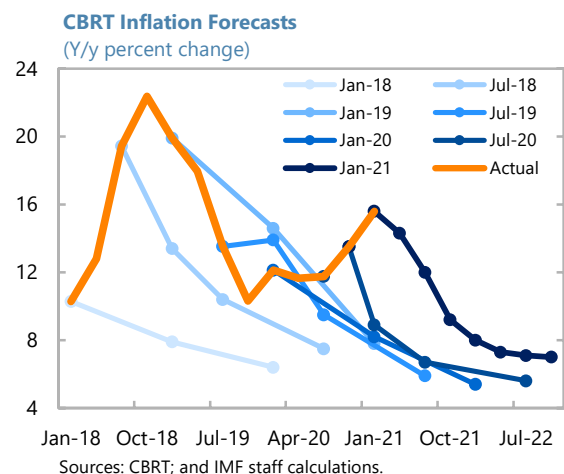
## A. Monetary Policy—Rebuilding Credibility and Buffers

Restoring central bank credibility, bringing inflation towards target, and rebuilding reserves all remain crucial but challenging, especially given heightened policy uncertainty. Meeting such challenges will require strongly committing to, and delivering, a firm monetary stance, increasing the policy rate if inflation expectations increase further, and a transparent FX reserve accumulation strategy should conditions allow in the future. Over time, such moves will help restore credibility, which will in turn help underpin the lira, reduce dollarization, allow reserves to be rebuilt over time, and, crucially, permanently lower interest rates and risk premia.

**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

release daily information on FX swaps and weekly reports on international reserves and FX liquidity. These improvements should continue and be codified as needed.

**29. Broader reforms would help rebuild monetary policy credibility.** Priorities include addressing backward wage indexation, ensuring consistency between inflation forecasts and monetary policy decisions, and further enhancing related communication. Improvements in the latest Inflation Reports are welcome and should be continued. The CBRT should also conduct a technical review of its monetary policy and operational frameworks—as has been done elsewhere—as a way of codifying welcome changes and identifying the scope for further improvements.

**30. Should conditions permit in the future, FX reserve purchase auctions should be used to rebuild buffers.** With low reserves, further FX sales to the market should only be considered for exceptional cases of market volatility. Delivering a firm monetary stance in Turkey may, over time, provide an environment for modest reserve accumulation. Transparent FX reserve accumulation auctions, similar to Turkey’s approach in the early 2000s, should be seen as a model to follow in the future should capital inflows increase durably, while export rediscount credits, a more opaque method of building FX reserves, could be gradually discontinued in due course.

**31. Phasing out administrative measures aimed at supporting the lira would reduce distortions and encourage investment.** The easing of limits on FX swaps between local banks and foreign counterparts is welcome and should be ensured at all times to allow ease of access to lira funding in offshore markets. The remaining limits and the requirements for export proceeds to be repatriated within a given time frame should be eliminated over time, as conditions allow, since they constitute capital flow management measures under the Fund’s Institutional View. Gradually removing such provisions would improve lira liquidity and ultimately encourage inward investment. Phasing should be carefully sequenced to minimize market dislocation and financial stability risks. The new import tariffs should be reversed as they distort domestic production, consumption, and investment, and have negative spillovers to other countries.

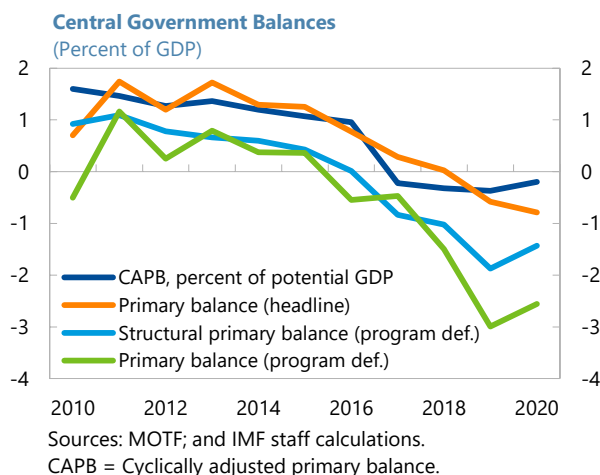
### **Authorities’ Views**

**32. The authorities agreed with the need to deliver a firm monetary policy stance.** The CBRT reiterated its commitment to price stability, to a flexible exchange rate, and to a fully-fledged inflation-targeting regime. The CBRT also pledged to maintain a simple operational framework, including by continuing to use the one-week repo rate as the main policy instrument. They saw merits in introducing a predictable FX reserve accumulation program once conditions allowed, but continued to see export rediscount credits as a useful reserve accumulation tool.

## **B. Fiscal Policy—Addressing Pandemic-Related Needs, Strengthening the Anchor**

*Turkey has some fiscal space, part of which the authorities should use to provide additional support to those most affected by the pandemic and to help minimize scarring. To strengthen Turkey’s fiscal anchor, the near-term support should be accompanied by a credible commitment now to future, well-specified, consolidation measures. Reforms to improve transparency and control of quasi-fiscal activity and contingent liabilities are also needed.*

**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.<sup>5</sup> 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.<sup>6</sup> 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 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.<sup>7</sup> Some possible measures are set out in the overleaf text table:

<sup>5</sup> 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.

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

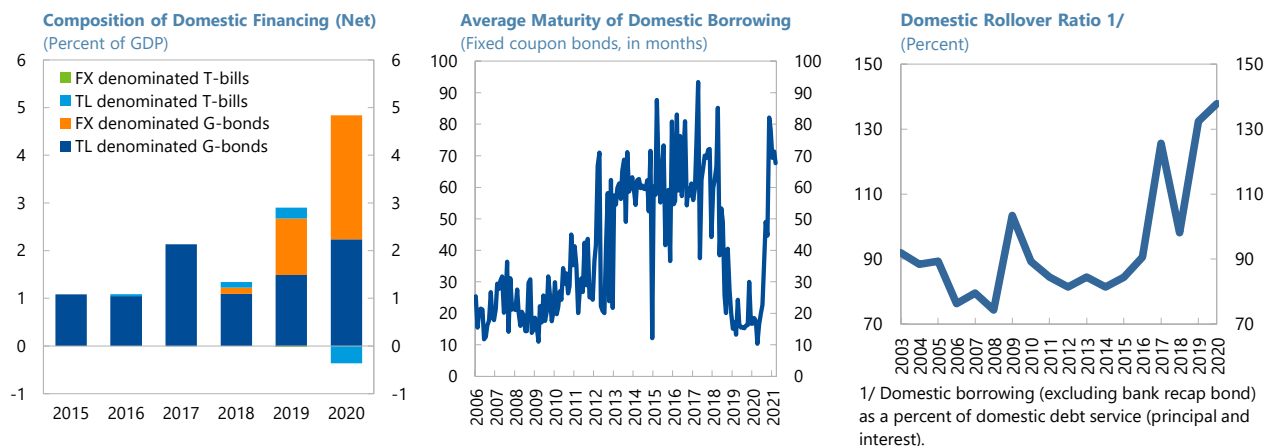
<sup>7</sup> Absent additional consolidation measures, staff's baseline projects the general government primary deficit (IMF program definition) to settle at around 3 percent of GDP over the medium term, compared to a debt-stabilizing primary deficit of about 2 percent of GDP (see Annex III).

<b>Turkey: Menu of Possible Medium-Term Fiscal Measures</b> (Percent of GDP)	
<b>Possible consolidation options:</b>	<b>Yield</b>
<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—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.



Sources: MOTF; and IMF staff calculations.

### Authorities' Views

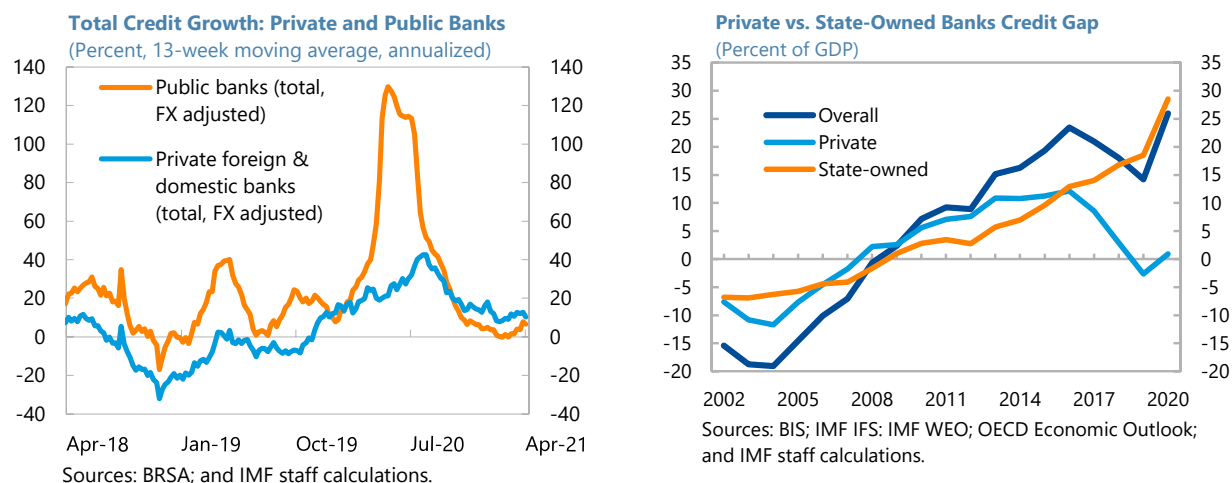
**38. The authorities agreed they had fiscal space that could be used if needed, but favored a more frontloaded fiscal consolidation than staff.** They noted fiscal discipline was a longstanding strength in Turkey and that frontloaded fiscal tightening would help increase policy credibility. And they indicated they had room, within their targets, to provide any additional pandemic-related support. They therefore judged their revised 2021 deficit target to be appropriate. Looking further ahead, they planned to continue to pursue prudent fiscal policy over the medium term to preserve the fiscal anchor. The authorities saw the benefit of better monitoring and managing fiscal risks from state-owned enterprises, PPPs, and extra-budgetary funds. They planned to prepare a fiscal risk assessment in due course. They also noted that they were better integrating PPPs with the public investment management framework, having included all PPP projects in the public investment database. They were also developing a value-for-money model for project appraisal. The authorities agreed with the need to continue to lengthen borrowing maturities and to reduce the reliance on domestic FX debt.

## C. Financial Sector—Reining in Credit Growth and Strengthening Balance Sheets

*State-owned bank credit growth should be reined in further. Other priorities include monitoring bank FX liquidity risks and encouraging banks to use some of their capital buffers to deal with distressed assets. Over time, these moves should be accompanied by a refocusing of state-owned bank lending, and by phasing out regulatory flexibility and recognizing more fully legacy issues on bank balance sheets. The authorities should also commission a third-party asset quality review and continue to improve Turkey's crisis resolution and AML/CFT frameworks. The request that the Financial Sector Assessment Program (FSAP) be brought forward is welcome.*

**39. Credit growth should be reined in further and, as the pandemic recedes, state-owned bank and Credit Guarantee Fund lending should be better focused.** After high double-digit annual growth for most of 2020, credit momentum slowed at the end of the year as policy rates increased and regulations promoting lending were dropped, before ticking up again in March 2021.

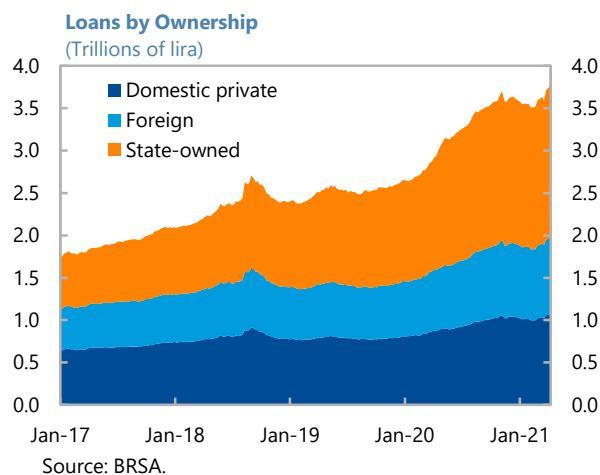
To help address the credit overhang, staff recommends that state-owned bank lending be reined in and focus, over time, on meeting identified market gaps. Ensuring a level playing field for both state-owned and private banks is crucial to promote prudent pricing of risk and efficient credit allocation 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.

**42. As the pandemic subsides, the authorities should commission a third-party asset quality review and undertake new stress tests based on the outcome.** The exposure of banks to sectors facing financial difficulties (Box 2) could undermine bank asset quality beyond that implied by reported non-performing loans and stage 2 loans. State-owned banks could be hit harder given their rapid credit growth provision in recent years. As the pandemic subsides, a third-party asset quality review would allow for new stress tests and for identifying measures to rebuild capital as needed. Such steps would further build confidence in the banking sector and would help develop a market for distressed assets. The distressed asset market would also benefit from additional policies and from the expertise of third-party specialists to quickly and effectively tackle high non-performing loan levels (see text box below).



**43. The cryptocurrency market warrants close vigilance.** While cryptocurrency trading volumes remain small as a share of GDP, they have grown rapidly. Following some market disruption in April, the authorities banned cryptocurrency payments and are developing a regulatory framework to eliminate counterparty risk in crypto-asset trading and to set appropriate capital requirements for crypto-asset exchanges. The upcoming FSAP will offer an opportunity to discuss these initiatives.

### Menu of Possible Policy Options to Deepen Distressed Asset Market

*Incentives for banks and third-party specialists should be strengthened*

- Rule out adverse tax implications for banks selling distressed assets to third-parties.
- Improve securitization, tax and debtor notification/approval rules to help efficient disposal and transfer of distressed assets.

*Transparency rules should be improved to avoid information asymmetries*

- Develop standardized data templates to reduce market entry costs and creditor/buyer information asymmetries.
- Adjust bank secrecy, data protection, and consumer protection rules to ensure fair and consistent treatment for debtors and creditors.

*Investment should align the interests of participants and encourage competition*

- Set up third-party and time-limited special purpose vehicles (SPVs) that are “bankruptcy remote,” with flexible and self-liquidating repayment schedules.
- Allow SPVs to be funded by financing instruments tailored to accommodate investor risk appetites.
- Allow “upside sharing” between investors and the bank selling distressed assets.
- Encourage asset management companies to participate in SPVs to align interests and help ensure a more competitive secondary market.

**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 bank 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.

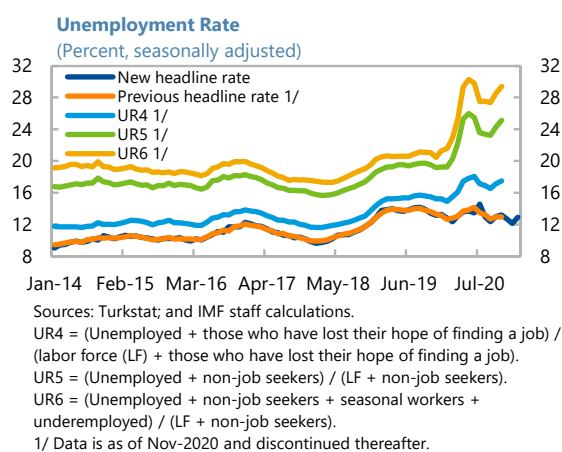
## **D. Structural Policy Pandemic Response—Supporting the Recovery and Mitigating Long-Term Scarring**

*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<sup>1/</sup>

#### 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).

<sup>1/</sup> Clear sunset clauses are needed for many measures to prevent later rigidities.

## Authorities' Views

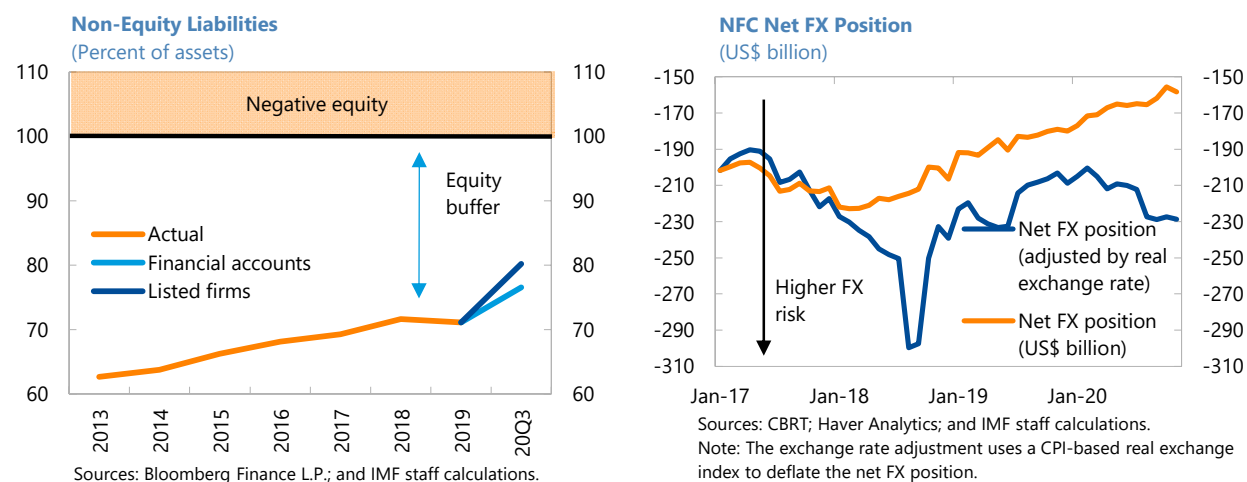
**49. The authorities agreed with the need to minimize scarring, but were more sanguine about recent developments.** They took comfort from the small size of the initial increase, and subsequent fall, in headline unemployment, and they expected labor market conditions to continue to improve. The authorities 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

increase access to affordable childcare but thought flexible work arrangements would mostly benefit male employees. The authorities argued that differences across stakeholders continued to hinder severance pay reform, a longstanding issue, and feared increased labor market flexibility could raise informality.

### **Non-Financial Corporates**

**50. Targeted measures could help minimize corporate debt distress.** Turkish non-financial corporates 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 (Box 2). Low equity buffers and elevated borrowing costs should encourage firms to reduce their reliance on debt. The ban on FX lending to firms without natural sources of FX revenues and the reduction in corporate income tax deductions for highly leveraged firms borrowing in foreign currency should also help. As the pandemic continues to weigh on firms, direct but temporary fiscal support may also be needed, including:

- *Tax deferrals* could be extended for hard-hit sectors, and a transparent and incentive-compatible mechanism developed to write down tax obligations for temporarily insolvent but viable firms (covering both in- and out-of-court restructurings).
- *Loan guarantees* should be better targeted at hard-hit sectors, with banks responsible for allocating the loans (benefiting from their firm-specific knowledge and maintaining their financial interests to help better align incentives).



**51. Carefully-calibrated policies could also help with corporate debt resolution.** Such policies would need to navigate the trade-off between preserving value and releasing resources for more productive uses. Policies should allow viable but temporarily-insolvent firms to restructure quickly, while putting unviable firms into orderly liquidation. Priorities include: (i) increasing the capacity and flexibility of the system to deal with restructuring, and (ii) setting up triaging to direct enterprises to the appropriate resolution procedure.

## 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).

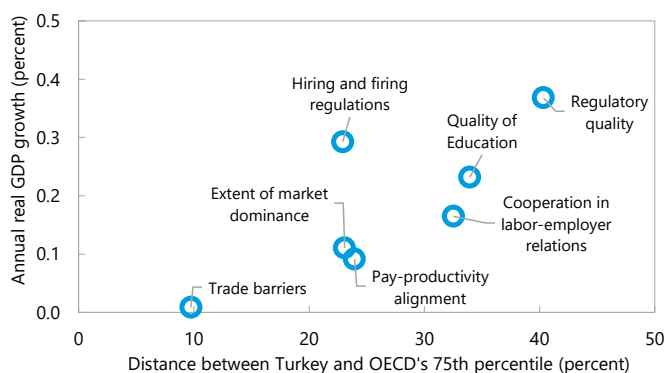
## **Authorities' Views**

**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 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.

### Broader Structural Reforms

**53. Over the medium term, broader, complementary, reforms would support strong durable growth.** The Turkish economy is nimble and entrepreneurial, which bodes well for adapting to the post-pandemic economy (Box 6). But rigidities remain and, once the pandemic subsides, the focus should return to broader structural reforms, notably to strengthen the business environment and the quality of education, as discussed in the 2019 Article IV report for Turkey. Product market reforms—simplifying business entry and exit and addressing administrative and regulatory barriers to competition—would increase productivity and encourage FDI.

Structural Reform Gaps and Payoffs Through Higher Efficiency



Sources: OECD; and IMF staff calculations.

Note: For each policy variable, the scatter plot presents Turkey's distance from the 75th percentile of OECD countries; and the estimated increase in average annual real GDP growth rate if half of the policy gap is closed in the long run (20 years).

**54. Governance reforms would also boost growth prospects.** In addition to fiscal (Section B) and AML/CFT (Section C) reforms, governance priorities include improving regulatory predictability, simplifying administrative procedures, and reducing corruption vulnerabilities. Taken together, these reforms would improve the business climate and economic efficiency, providing the basis for stronger and more durable growth.

### Authorities' Views

**55. The authorities acknowledged the importance of strong and durable growth, while identifying different policy priorities.** They highlighted a series of policy initiatives aimed at diversifying the economy into high value-added tradable sectors, which would also help further reduce external imbalances. Policies to increase small and medium-sized enterprise productivity were also a priority. They noted judicial reforms should strengthen transparency and efficiency in legal procedures.

## STAFF APPRAISAL

**56. As in other countries, the human and economic toll of the COVID-19 pandemic 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.

**57. Turkey's economy was vulnerable going into the pandemic.** In the years leading up to 2020, growth in Turkey was driven by externally-funded demand stimulus. Large current account deficits, financed mainly by debt, led to high external financing needs. Rapid credit growth 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.

**58. The policy response to the pandemic initially relied on rapid monetary and credit expansion, as well as on extensive liquidity support.** Large interest rate cuts, state-owned banks, administrative and regulatory credit incentives, and loan guarantees and loan service deferrals all played a role. Despite some fiscal space, direct fiscal support was relatively modest.

**59. While the initial collapse in economic activity was similar to elsewhere, the recovery was exceptional.** GDP rebounded to above pre-pandemic levels in the third quarter, with Turkey among the few countries with positive growth in 2020.

**60. But these same policies that buoyed growth also exacerbated pre-pandemic vulnerabilities.** Accommodative monetary and credit policies fueled inflation and widened the current account deficit, with the external position moderately weaker than the level implied by medium-term fundamentals and desirable policies. They also stoked dollarization pressures, which together triggered large foreign exchange sales in an attempt to limit exchange rate depreciation. But the lira fell nevertheless, along with reserves and reserves quality. Reserves remain well below the recommended adequacy range, and net international reserves are negative once foreign exchange swaps with the central bank are subtracted.

**61. Amid heightened uncertainty, GDP growth is expected to be strong this year, and to return to a lower trend from 2022 onwards.** Mainly reflecting a large positive carryover from the sharp activity rebound in the second half of 2020, growth should reach 5¾ percent this year. Absent additional reforms, economic growth is projected to return to trend, of about 3¼ percent a year, from 2022 onwards, inflation is expected to remain high, and reserve buffers to decline further.

**62. As vulnerabilities increased, downside risks have intensified.** With low reserve buffers, high external financing needs, and sizeable domestic foreign exchange deposits, the economy remains vulnerable to shocks and to changes in sentiment at home and abroad. Domestic risks include a premature relaxation of monetary and credit policies or other policy missteps that further erode credibility and buffers. External risks include interest rate increases in advanced economies and higher global risk aversion that could expose vulnerabilities. Other risks include vaccination delays and adverse geopolitical developments.

**63. A more sustainable set of policies would improve prospects for strong durable growth and reduce Turkey's vulnerabilities to shocks.** Although policy uncertainty and vulnerabilities have increased, Turkey's challenges are not insurmountable. Efforts should be intensified to rebuild credibility and buffers, while also responding to the human and economic needs arising from the pandemic. Strongly committing to, and delivering, a firm monetary stance, along with additional fiscal support that is temporary and targeted, should be complemented by an upfront announcement of medium-term fiscal consolidation to lower debt over time. As the recovery unfolds, policies should move from preserving existing jobs and firms towards helping labor and capital reallocation to minimize long-term scarring. These policies would, over time, lead to a more decisive improvement in sentiment and help create the conditions to rebuild buffers. The authorities' latest Economic Reform Program outlines many reasonable objectives, but could have benefited from a clearer diagnosis of Turkey's key challenges and further elaboration of policy measures to address them, which would also help policy credibility.

**64. Monetary policy should focus on attempting to restore credibility and on bringing inflation towards target.** The shift towards a firm monetary policy stance since the Fall is welcome, as is the accompanying simplification of the CBRT's operational framework. Going forward, any premature easing should be avoided and further timely and well-calibrated tightening would be needed if inflation expectations increase further, to, at a minimum, keep the ex-ante real policy rate unchanged. The more upfront a commitment to a firm monetary policy stance is made, the sooner interest rates can subsequently be cut. Such policies would pave the way for lower inflation, sustainably lower interest rates, a stronger lira, and, over time, the rebuilding of reserves, especially if combined with meaningful reforms to strengthen central bank independence and credibility.

**65. Turkey has some fiscal space, part of which should be used to address pandemic-related needs, along with a commitment to future consolidation to strengthen Turkey's fiscal anchor.** The authorities' fiscal targets for 2021 appear tight. Additional targeted and temporary fiscal support, of around 1 percent of GDP, should be deployed this year to support the most vulnerable and help minimize scarring, accompanied by a credible fiscal consolidation plan to lower debt over time. This consolidation plan should be legislated now and enacted when the recovery is entrenched. Further strengthening of debt management policies, targeted fiscal structural reforms, and enhanced monitoring of quasi-fiscal operations and extra budgetary institutions would also support consolidation and mitigate fiscal risks.

**66. State-owned bank credit growth should be reined in further and, as the pandemic recedes, legacy issues on bank balance sheets recognized more fully.** Lending by state-owned banks and through the Credit Guarantee Fund should be reined in further and refocused to meet identified market gaps. Bank foreign exchange liabilities need to be carefully monitored. Regulatory flexibility and loan deferrals should be reversed gradually, and some of banks' capital buffers used as needed. As the pandemic fades, a third-party asset quality review should follow to better assess bank health. The review should be accompanied by efforts to further strengthen regulatory, resolution, and AML/CFT frameworks.

**67. Focused structural reforms would help minimize adverse long-term effects in the labor market and the non-financial corporate sector.** While activity has recovered, scarring risks remain from remaining labor market slack and possible non-financial corporate debt distress. Structural policies should focus on supporting female labor force participation and youth employment, increasing labor market flexibility, and ensuring that viable but temporarily-insolvent firms are restructured, while winding down unviable firms. Taken together, these policies would provide the basis for a more durable and inclusive recovery.

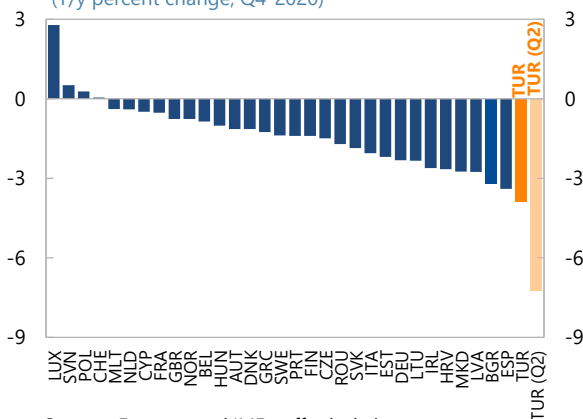
**68. It is recommended that the next Article IV consultation with Turkey be held on the standard 12-month cycle.**

### 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.

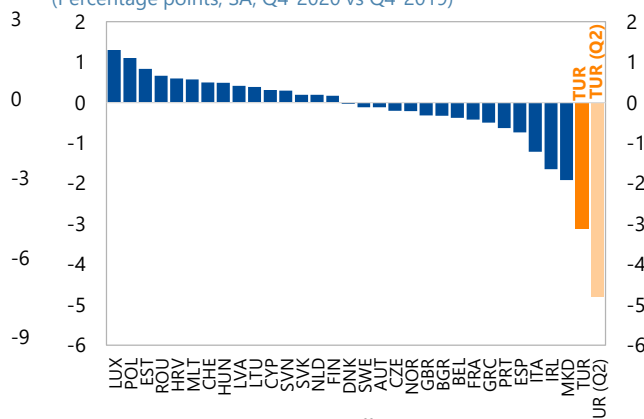
**Labor market conditions deteriorated sharply during the pandemic.** Employment registered its largest fall on record—and the largest in the region—in the second quarter of 2020. Most of the decline was matched by a sharp drop in labor force participation rather than an increase in the number of unemployed, 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.<sup>1</sup> While conditions have improved along with the recovery in economic activity, employment and labor force participation remain lower than before the pandemic, particularly in the most affected sectors.

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



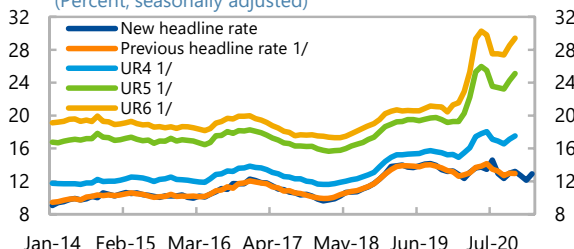
Sources: Eurostat; and IMF staff calculations.

**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.

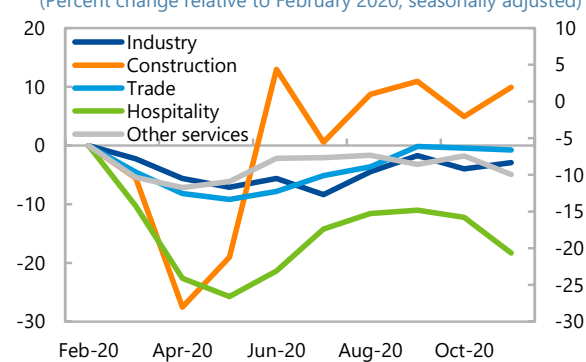
UR4 = (Unemployed + those who have lost their hope of finding a job) / (labor force (LF) + those who have lost their hope of finding a job).

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

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

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

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



Feb-20 Apr-20 Jun-20 Aug-20 Oct-20

Sources: Turkstat; and IMF staff calculations.

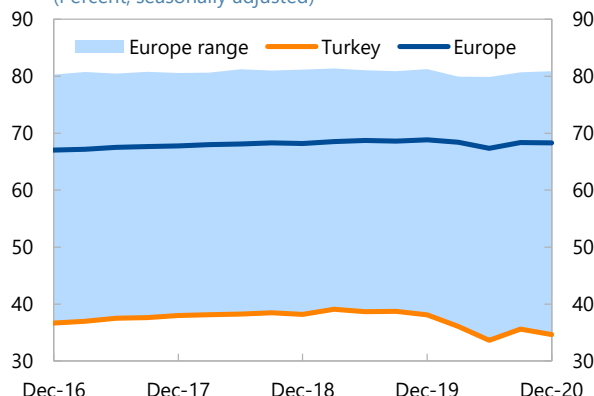
Note: Data is through Nov-2020 and discontinued thereafter.

**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 1. Labor Market Developments and Policy Response (Continued)

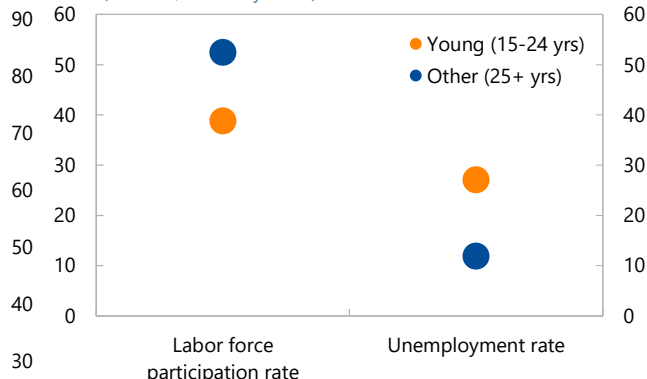
in recent years, much of it has been erased since the pandemic. The crisis has also badly affected low-skilled and informal workers, who account for a large share of Turkey's labor market, and are not well-placed to work from home. The World Bank estimates that over 1½ million people were pushed below the poverty line in 2020, with a significantly worse outcome had it not been for the authorities' policy response.<sup>2</sup>

**Box Figure 5. Labor Force Participation Rate, Female**  
(Percent, seasonally adjusted)



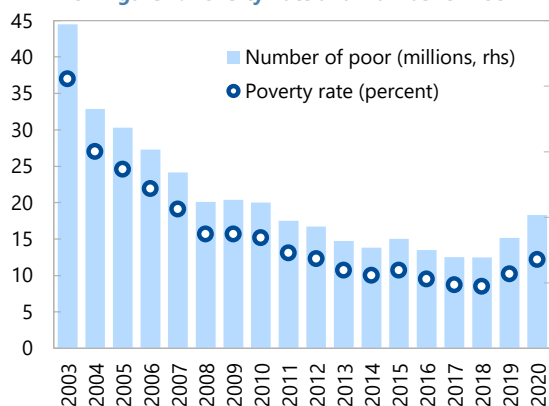
Sources: Eurostat; and IMF staff calculations.

**Box Figure 6. Labor Market Indicators by Age Group**  
(Percent, February 2021)



Sources: Turkstat; and IMF staff calculations.

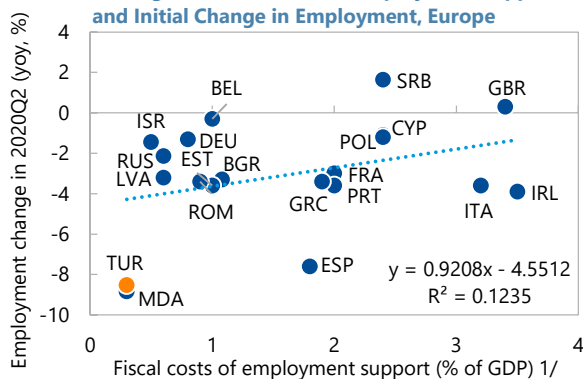
**Box Figure 7. Poverty Rate and Number of Poor**



Source: World Bank simulations based on the Household Budget Survey 2003-2019.

Note: Poverty is measured as proportion of people with per capita consumption below \$5.5 a day 2011 PPP.

**Box Figure 8. Fiscal Cost of Employment Support and Initial Change in Employment, Europe**



Sources: Country authorities; and IMF staff calculations.

1/ Short-term work scheme and unemployment benefits. For Turkey, additional employment support in the form of wage subsidies and cash aid to employees and households (not shown in this figure) consisted of another 0.4 percent of GDP.

**The authorities' policy response was broad, but small in scale.** The response included many internationally-used measures, such as unemployment insurance, wage subsidies, lump sum transfers, and a work retention scheme (Table 1), as well as a temporary ban on layoffs. But despite being comprehensive, Turkey's labor market support package was modest compared to many peers, while the initial fall in employment was the largest in the region.

**Box 1. Labor Market Developments and Policy Response (Concluded)****Table 1. Major types of labor market policy programs for the COVID-19 pandemic<sup>3</sup>**

Type	Objective	Considerations	In Turkey
<b>Short-Term Work - Retention Schemes</b>	Preserve existing worker-firm relations	Temporary subsidized reduction in working hours	<ul style="list-style-type: none"> <li>The Short-Term Work Allowance program (STWA) for highly impacted firms provides a wage subsidy to employees of partially or completely closed businesses</li> </ul>
<b>Unemployment insurance</b>	Sustain consumption of laid-off workers	Increasing benefit amount is preferable to increasing benefit duration	<ul style="list-style-type: none"> <li>Automatic stabilizers in Turkey are well-targeted and have good coverage, but the benefit amount is low<sup>4</sup></li> </ul>
<b>Targeted + Temporary Wage Subsidies</b>	Preserve jobs or workers' incomes	<p>More cost-effective than generalized payroll tax cut</p> <p>Must be temporary with clear sunset clauses, to not hinder labor reallocation across industries</p>	<ul style="list-style-type: none"> <li>The state covers the employees' and employers' social security contributions for three months after a business leaves the STWA</li> <li>The government provides wage and health insurance support for workers on (company-enforced) unpaid leave</li> </ul>
<b>Expanding Social Assistance Programs</b>	Informal workers	Examples: relaxing eligibility criteria, increasing benefit levels, or setting up new transfer schemes	<ul style="list-style-type: none"> <li>Social Support Program</li> <li>The targeting and coverage of public transfers in Turkey are good, but benefits are low<sup>4</sup></li> </ul>
<b>Targeted + Temporary Hiring Subsidies</b>	Speed up job recovery post lockdown	Careful policy design needed to avoid "gaming"	<ul style="list-style-type: none"> <li>Unemployment insurance contribution support provided to employers for new hires</li> </ul>
<b>Active labor market policies</b>	Structural transformation post lockdown	Skill-enhancing programs (e.g., digitalization)	<ul style="list-style-type: none"> <li>Some skills-training converted to online platforms, but few workers can work remotely</li> </ul>

<sup>1</sup>According to the [ILO](#), the fall in employment captures only one third of the total impact of the pandemic on hours worked, with the rest accounted for a reduction in the number of hours by those who continued working and workers sent on leave without pay.

<sup>2</sup> World Bank, 2021. 'Turkey Economic Monitor April 2021 – Navigating the Waves'

<sup>3</sup> Based on the October 2020 Fiscal Monitor and the IMF Special Series on COVID-19: 'Options to Support Incomes and Formal Employment During COVID-19' and 'Options to Support Incomes of Formal Workers During COVID- 19'.

<sup>4</sup> World Bank, 2020. 'Turkey Economic Monitor August 2020 – Adjusting the Sails'.

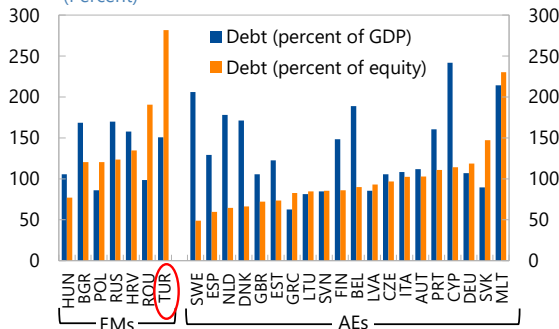
### Box 2. Vulnerabilities in Non-Financial Corporates (NFCs)

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

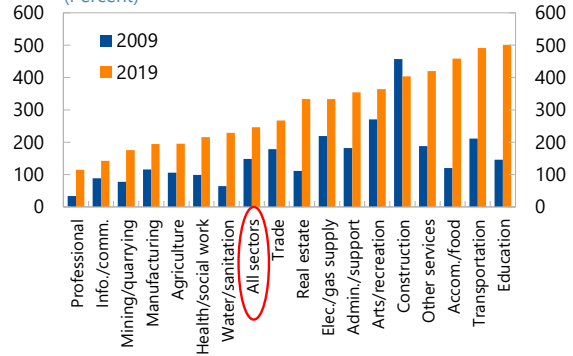
**Firm leverage increased considerably over the last decade** (Box Figures 1 and 2). NFC debt as a share of total equity rose sharply over the last decade, from 150 to 250 percent, standing out from peers. While the increase in leverage was widespread, it was particularly large in the transportation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

**Box Figure 1. NFC Debt, 2019**  
(Percent)



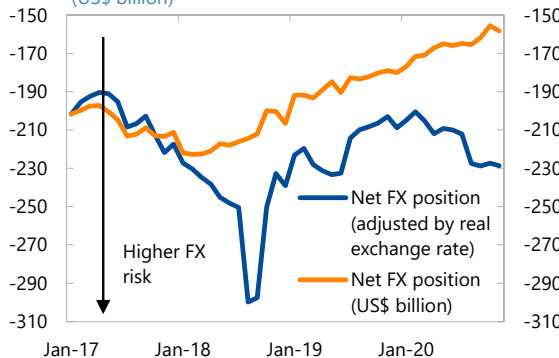
Sources: Haver Analytics; and IMF staff calculations.  
Note: Uses unconsolidated financial accounts data, which involves different accounting principles to the company accounts data in the "Leverage by Industry" chart.

**Box Figure 2. Leverage by Industry**  
(Percent)



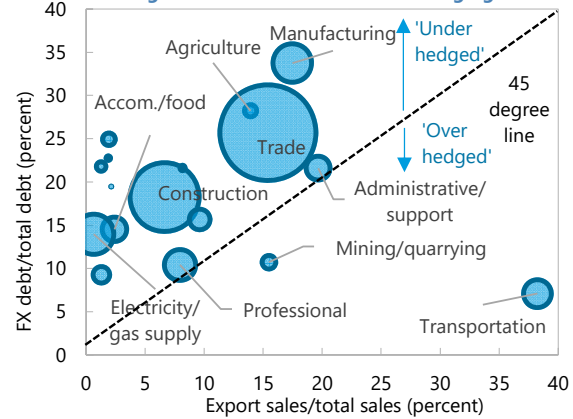
Sources: CBRT; and IMF staff calculations.  
Note: Leverage = non-equity liabilities/total equity using the new CBRT company accounts database.

**Box Figure 3. Net FX Position**  
(US\$ billion)



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'**



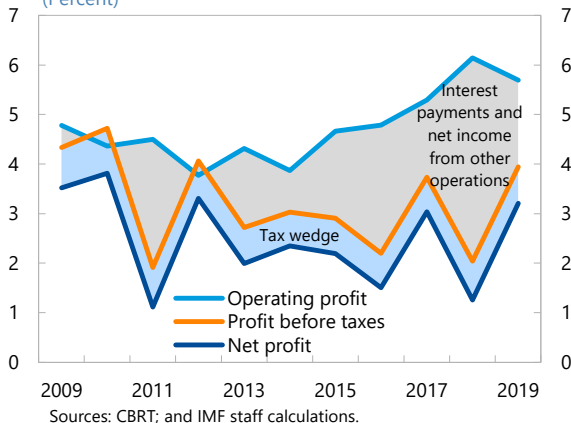
Sources: CBRT; and IMF staff calculations.

**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.

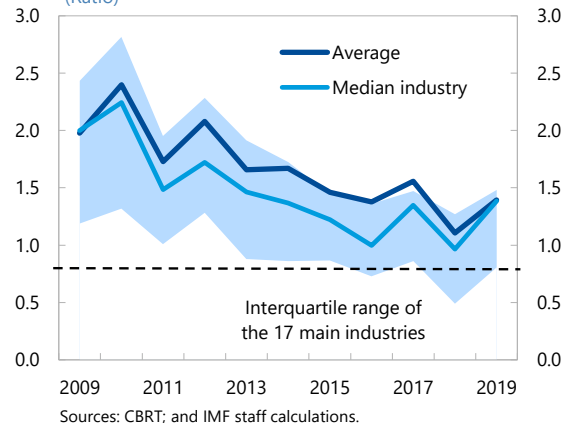
## Box 2. Vulnerabilities in Non-Financial Corporates (NFCs) (Continued)

**Higher interest payments have constrained net profits** (Box Figures 5 and 6). While operating profits grew steadily in recent years, net profits remained subdued, reflecting higher debt service costs. The higher debt service costs led in turn to a steady decline in the interest coverage ratio (ICR) across most sectors. The construction and transportation sectors—which together owe around one-third of all debt—saw a particularly large decline, with ICRs approaching 1 in 2019.

**Box Figure 5. Profit Margins**  
(Percent)



**Box Figure 6. Interest Coverage**  
(Ratio)

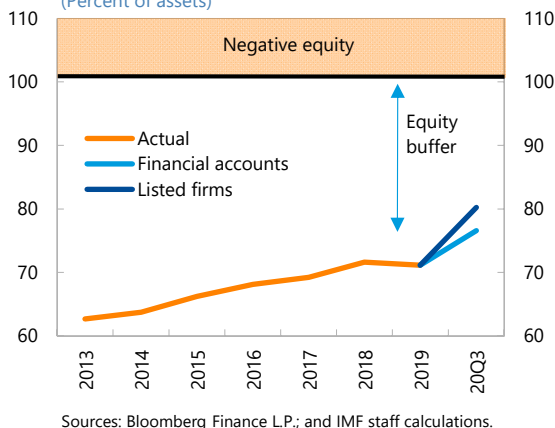


### Impact of the pandemic

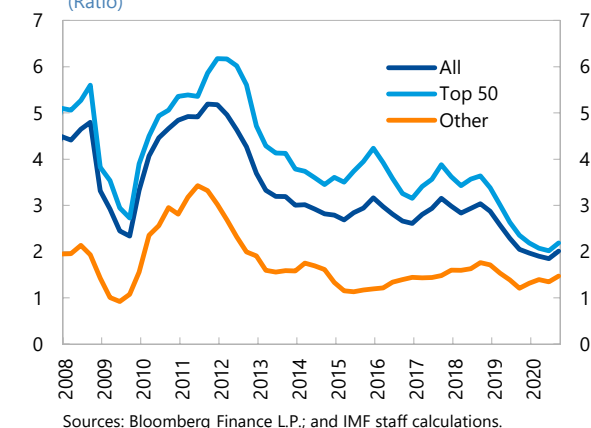
**Generous liquidity provision supported firms through the pandemic but further increased leverage.**

Liquidity measures included: (i) loan guarantees; (ii) payment deferrals by state-owned and other banks; and (iii) rapid lending by state-owned and other banks. While the liquidity provided was partly used to reduce currency risk—as firms increased cash holdings and switched from FX to TL debt—it also increased overall debt. Staff estimates, based on financial accounts information and listed firm accounts, that equity buffers declined from 30 to around 20 percent of assets between 2019 and 2020 Q3 (Box Figure 7). Meanwhile, shrinking profits saw ICRs for *listed* NFCs fall to multi-year lows (Box Figure 8).

**Box Figure 7. Non-Equity Liabilities**  
(Percent of assets)



**Box Figure 8. ICR, Listed NFCs**  
(Ratio)

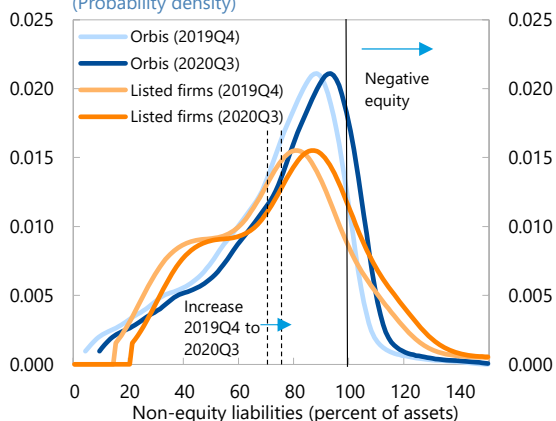


**The share of insolvent firms will likely increase as support measures are phased out.** The distribution of firms around average leverage values can be captured using firm-level data (Box Figure 9). This suggests that many firms are vulnerable to debt overhang challenges. The share of firms with negative equity has

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

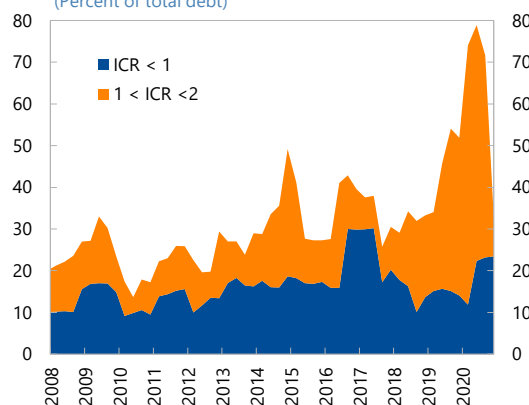
risen: from 7 to 13 percent (using the comprehensive Orbis database), or to 15 to 22 percent (for listed firms). For listed firms, over 20 percent of debt was issued by firms with an ICR below 1 last year (Box Figure 10). Importantly, the estimates are highly uncertain and dependent on the pace of the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

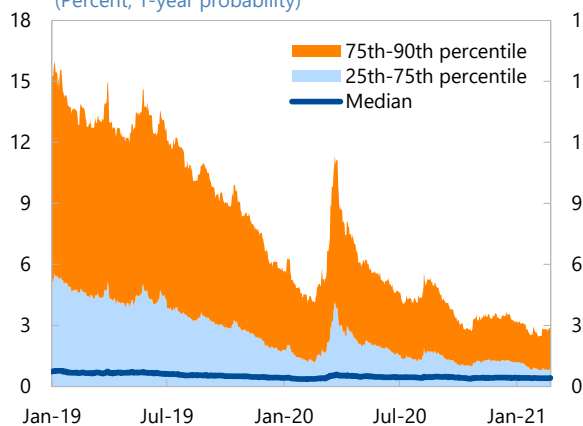
**Box Figure 10. Debt at Risk for Listed Firms**  
(Percent of total debt)



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

### Box 3. Developments in Public Institutions' Foreign Exchange Positions

State-owned banks, the Central Bank of the Republic of Turkey, and the Ministry of Treasury and Finance saw a significant worsening of their net FX positions in 2020. While the net position of state-owned banks has improved since, risks remain.

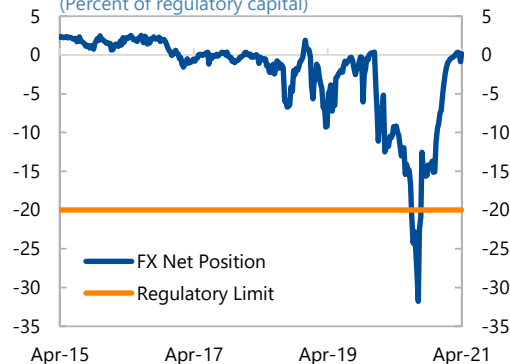
**The FX position of state-owned banks deteriorated in 2020, before improving in late 2020.<sup>1</sup>**

**At the same time, the Ministry of Treasury and Finance increased its FX liabilities.** Over the summer of 2020, state-owned banks increased their holdings of domestic Treasury FX securities by USD 11 billion—equivalent to 35 percent of these banks' equity—while transferring the equivalent negative net FX position from these banks to the Treasury.

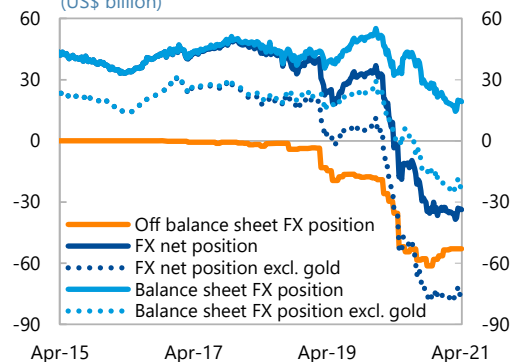
**The CBRT's FX position also worsened.** With the CBRT engaging heavily in FX swaps with local banks (borrowing FX reserves from these banks and lending them TL liquidity in return), the central bank's net FX position, after subtracting these swaps, deteriorated through 2020, reaching minus USD 39 billion in early 2021, according to CBRT data.

**Reflecting these developments, the system faces challenging FX risks.** In particular, a large adverse external or domestic shock could, in the event of external rollover problems or FX deposit withdrawals, lead to competition for scarce FX funding, especially between banks and the CBRT.

Box Figure 1. State-Owned Banks: Net FX Position (Percent of regulatory capital)



Box Figure 2. CBRT: Net FX Position (US\$ billion)



Sources: BRSA; CBRT; and IMF staff calculations.

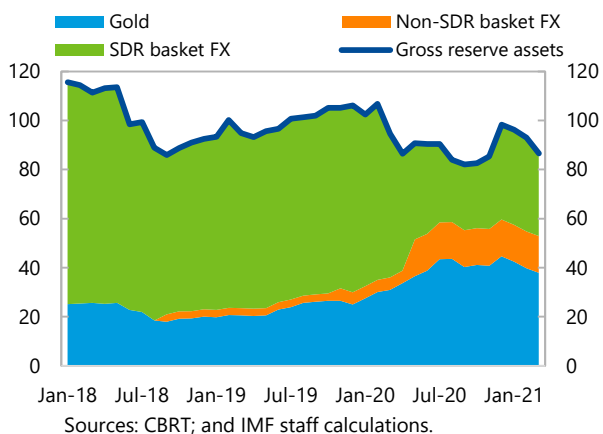
<sup>1</sup> With banks raising sizable funding in foreign currency, their negative *on-balance sheet* FX positions have tended to be broadly offset by positive *off-balance sheet* positions (as FX is swapped into lira for domestic lending).

### Box 4. Central Bank Reserve Developments

The quantity and quality of the central bank's reserves have fallen from pre-pandemic levels and the central bank now holds a far larger share of banks' liquid FX assets than before.

**Gross reserves fell by more than USD 12 billion in 2020 and SDR-basket currencies now account for less than half of reserve assets, a marked fall from pre-pandemic levels.** Sixty percent of total CBRT reserve assets are now held either in gold or non-SDR-basket currencies, rather than in more traditional reserve assets. This represents a marked increase from pre-pandemic levels.

**Box Figure 1. Gross Reserve Assets**  
(US\$ billion)



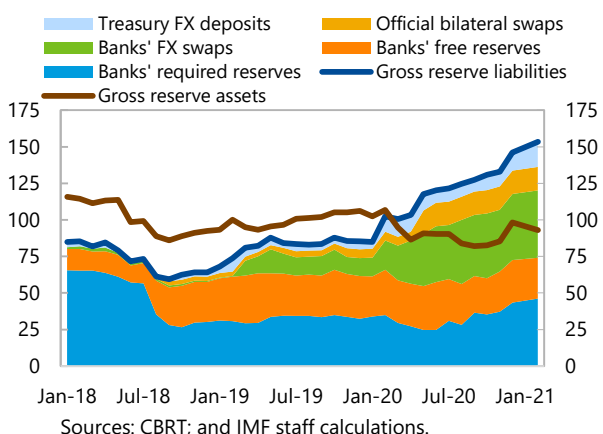
**Box Figure 2. Breakdown of Reserve Assets**  
(Percent of reserve assets)

	Jan 2018	Dec 2019	Dec 2020	Mar 2021
SDR basket FX	78	72	39	39
Non-SDR basket FX	0	5	15	17
Gold	22	24	45	44

Sources: CBRT; and IMF staff calculations.

**More than half of reserve liabilities are now accounted for by banks' liquid FX assets, compared to 20 percent only three years earlier.** This increases the risk of FX shortages in the economy in the event of a large adverse shock.

**Box Figure 3. Gross Reserve Liabilities**  
(US\$ billion)



**Box Figure 4. Breakdown of Reserve Liabilities**  
(Percent of reserve liabilities)

	Jan 2018	Dec 2019	Dec 2020	Feb 2021	
Banks' FX deposits		94	72	50	48
of which:					
Required reserves		77	38	30	30
Free reserves		17	34	20	18
Banks' FX swaps		1	14	31	30
Official bilateral swaps		0	7	11	10
Treasury FX deposits		4	7	9	11
Memo: percent of banks' FX liquid assets in CBRT reserve liabilities		19	48	51	48

Sources: CBRT; and IMF staff calculations.

### Box 5. Non-financial State-Owned Enterprises<sup>1</sup> (SOEs)

Available information points to modest fiscal costs from SOEs, but data coverage is limited.

**Available financial information on SOEs point to still-modest fiscal costs, despite declining profitability and increasing leverage.** Return on equity, profits, and interest coverage ratios have declined sharply in recent years (Box Table 1). But while capital injections have grown, they still amount to a small share of GDP (Box Figure 1).

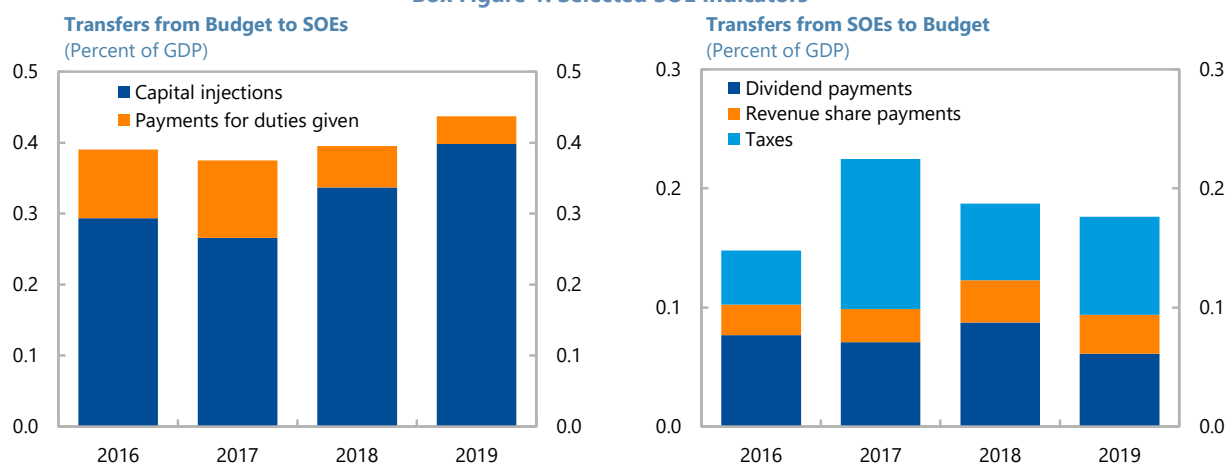
**But, as in many countries, coverage of SOEs in Turkey's fiscal accounts is not all-encompassing.** While there are more than 400 SOEs in Turkey, the New Economic Plan (NEP) focuses on 22 enterprises and subsidiaries subject to Decree Law 233<sup>2</sup> and on those in the privatization portfolio. Some large public enterprises, including Turkish Airlines, Turkish Post, and the Housing Development Administration of Turkey (TOKI), are excluded from NEP fiscal aggregates and there is no one document that consolidates financial information across all SOEs. And while financial and nonfinancial data of some SOEs is made public, no comprehensive account is provided of the fiscal implications of SOE activities.

Box Table 1. Selected SOE Financial Ratios

	2016	2017	2018	2019
Liquidity ratio	2.1	2.0	1.6	1.5
Interest coverage ratio	19.0	6.5	2.8	1.2
Return on Equity	13.3	4.2	2.0	-1.1
Operating profit / sales	15.7	2.4	-4.9	-0.9
Net profits (% of GDP)	0.5	0.2	0.1	0.0

Sources: MOTF; and SOE reports.

Box Figure 1. Selected SOE Indicators



Sources: MOTF; SOE reports; and IMF staff calculations.

<sup>1</sup> The analysis in this box focuses on the 22 SOEs in the Treasury Portfolio as of end-2019.

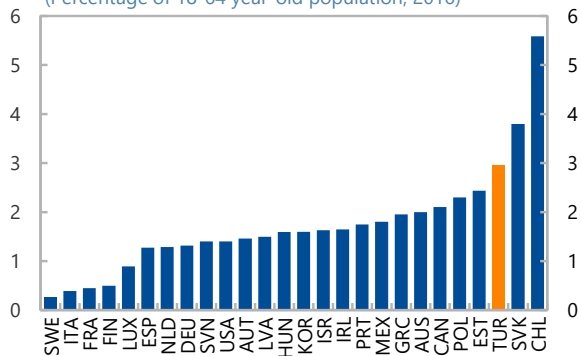
<sup>2</sup> The decree defines the role of the state as an owner, main ownership arrangements, respective roles, and responsibilities of different public institutions. The decree does not apply to the state-owned banks, enterprises owned by local governments, or to other SOEs that operate under separate laws (statutory corporations).

### Box 6. The Economy After the Pandemic

While the pandemic could cause structural shifts in consumption and work preferences, the Turkish economy is nimble and entrepreneurial, boding well for adapting to such changes.

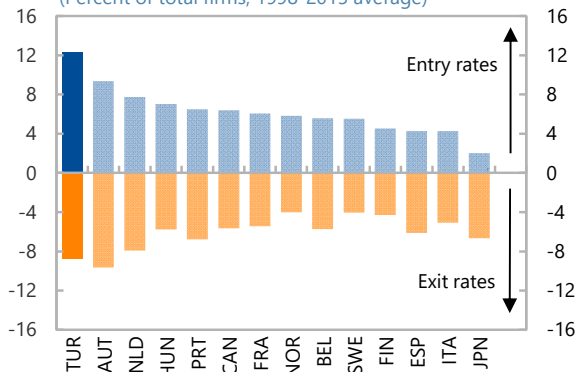
**Entrepreneurial culture.** With a high share of entrepreneurs aiming to create large and expanding businesses, the Turkish economy enjoys a strong degree of economic dynamism (Box Figure 1). Indeed, the relatively rapid turnover of businesses supports reallocation of capital and workers, which will be critical if structural changes emerge in the post-pandemic economy (Box Figure 2).

**Box Figure 1. Transformational Entrepreneurship 1/**  
(Percentage of 18-64 year-old population, 2016)



Source: OECD.  
1/ Entrepreneurs that aspire to build a large or expanding business.

**Box Figure 2. Average Entry and Exit Rates**  
(Percent of total firms, 1998-2015 average)

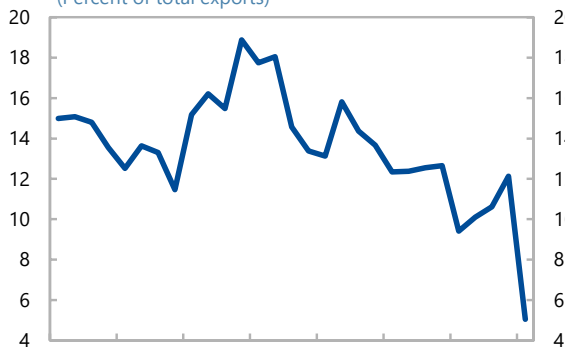


Source: OECD.

**Export diversification.** While lingering health-related travel concerns could lead to a more protracted pandemic impact on tourism, recent export diversification, including away from a reliance on tourism, and targeted policy support would likely help mitigate the impact (Box Figure 3).

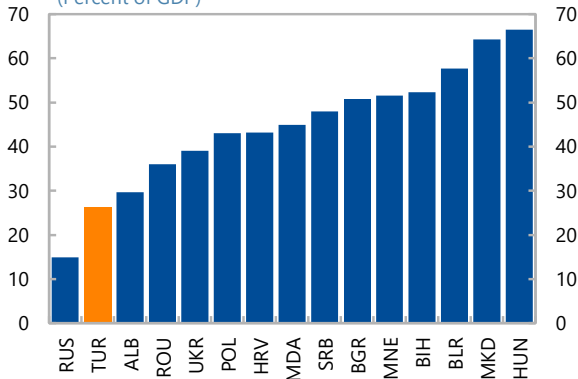
**Muted exposures.** While greater trade protectionism could emerge as nations seek to secure supply chains, Turkey remains a relatively closed economy, minimizing any direct effects from greater protectionism (Box Figure 4). The transportation, administrative, and manufacturing sectors are most reliant on exports and would likely experience the greatest need to modify business models.

**Box Figure 3. Tourism**  
(Percent of total exports)



Sources: Turkstat; and IMF staff calculations.

**Box Figure 4. Goods Exports, Europe**  
(Percent of GDP)



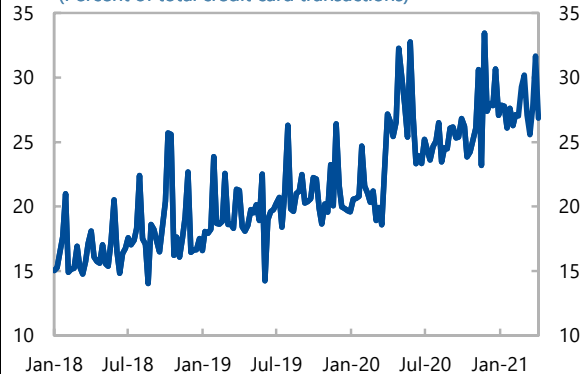
Sources: IMF WEO; and IMF staff calculations.

**Digital transformation.** The pandemic has the potential to accelerate, through the digital revolution, marked shifts to the nature of consumption and work. In Turkey, however, the impact of the pandemic on these trends appears transitory. Online purchases using credit cards jumped during lockdowns, but normalized as restrictions eased (Box Figure 5). And since relatively few jobs can be performed from home in Turkey, new

**Box 6. The Economy After the Pandemic (Concluded)**

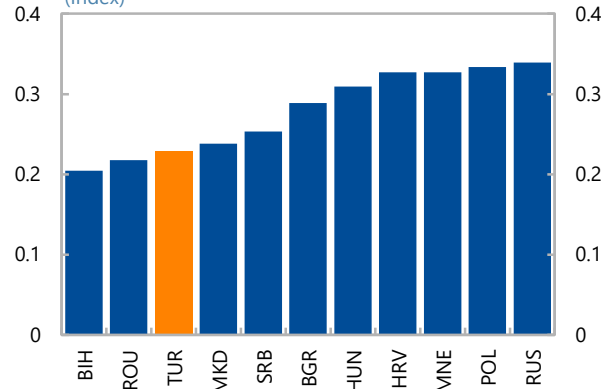
preferences towards home working are unlikely to lead to deep structural changes immediately after the pandemic (Box Figure 6).

**Box Figure 5. Online Purchases**  
(Percent of total credit card transactions)



Sources: CBRT; and IMF staff calculations.

**Box Figure 6. Teleworkability, Europe**  
(Index)

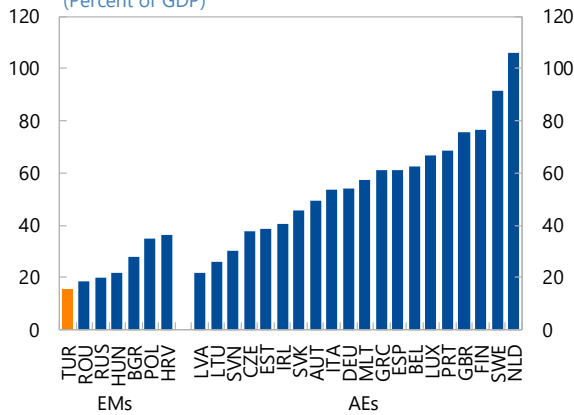


Source: Dingel and Neiman (2020).

**Figure 3. Turkey: Household Balance Sheets**

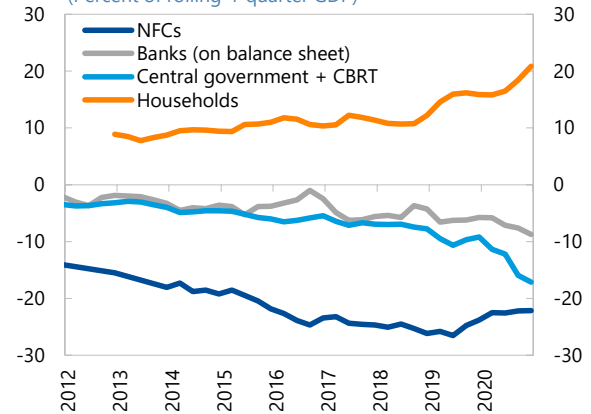
Household balance sheets were robust before the pandemic, with low debt levels ...

**Household Debt, 2019**  
(Percent of GDP)



... and a positive net FX position.

**Net FX Position**  
(Percent of rolling 4-quarter GDP)



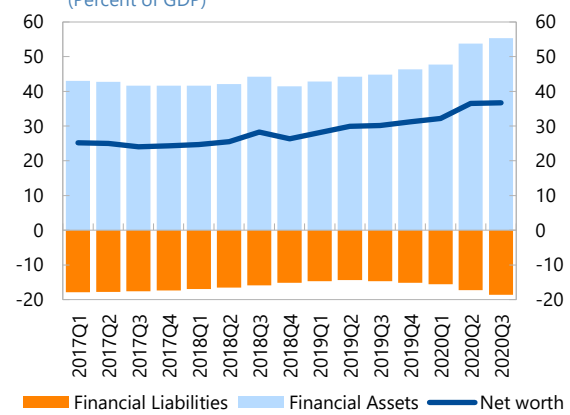
After a steep fall in 2020Q2, employee pay is now only moderately below pre-pandemic levels.

**Real Total Compensation of Employees**  
(TL millions, 2017 prices)



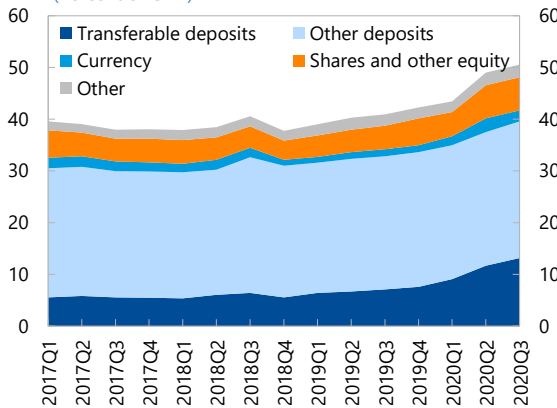
And household net worth rose in recent quarters, despite increasing debt ...

**Household Financial Net Worth**  
(Percent of GDP)



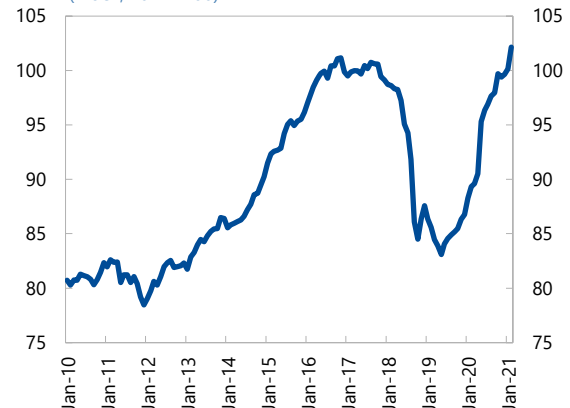
... as cash buffers rose ...

**Financial Assets**  
(Percent of GDP)



... and housing wealth continued to grow.

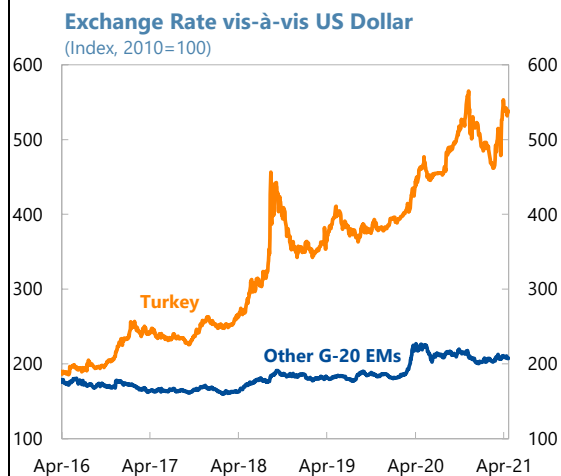
**Real House Prices**  
(Index, 2017=100)



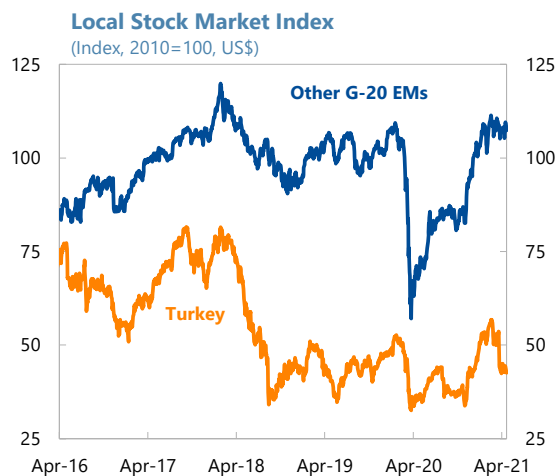
Sources: CBRT; Haver Analytics; and IMF staff calculations.

**Figure 4. Turkey: Financial Markets**

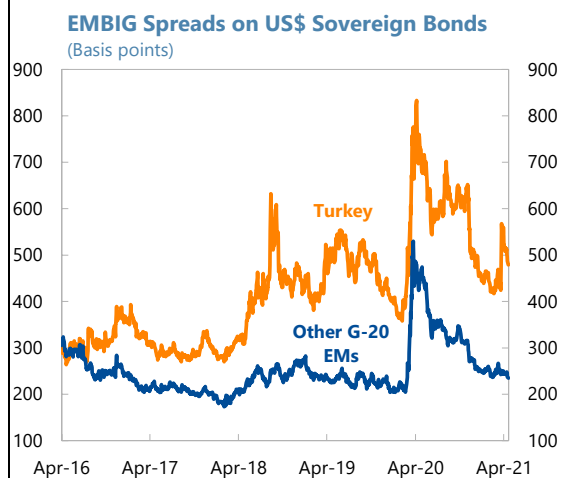
*The lira has underperformed in recent years ...*



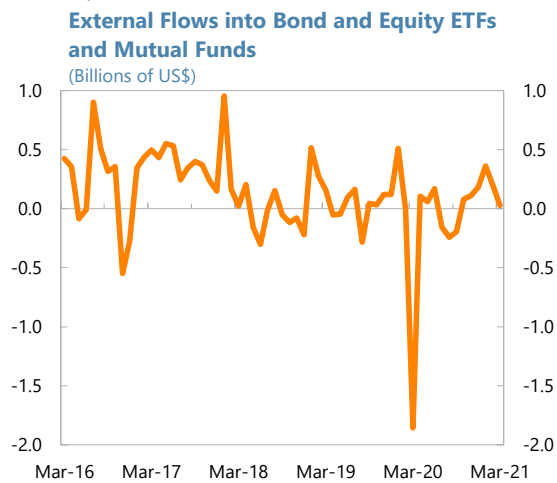
*... as have Turkish equities.*



*Turkey's risk premium remains high ...*



*... and portfolio flows have remained volatile.*

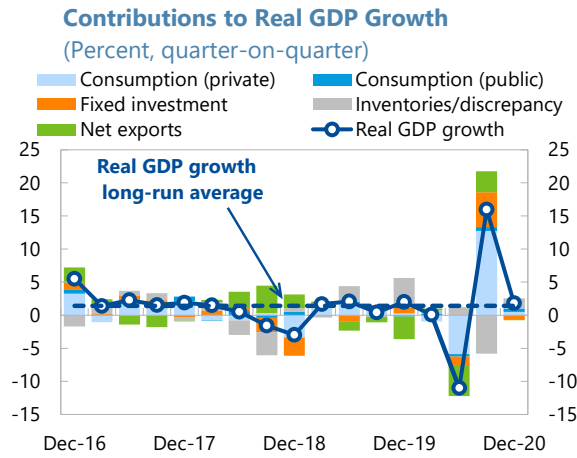


Sources: Bloomberg Finance L.P.; Haver Analytics; and IMF staff calculations.

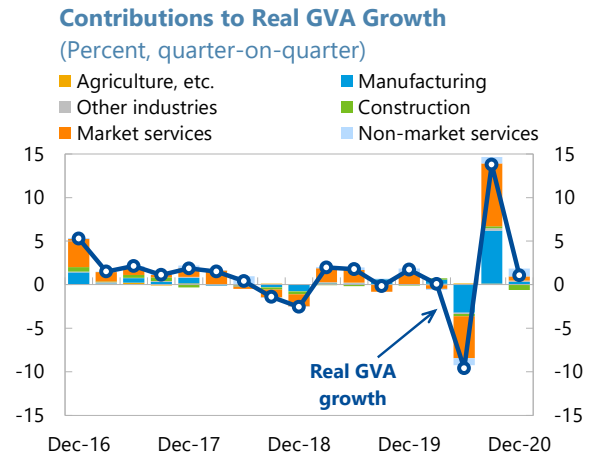
Notes: Average for other G-20 emerging markets covers Brazil, Mexico, India, Indonesia, Russia, and South Africa.

**Figure 5. Turkey: Real Sector Developments**

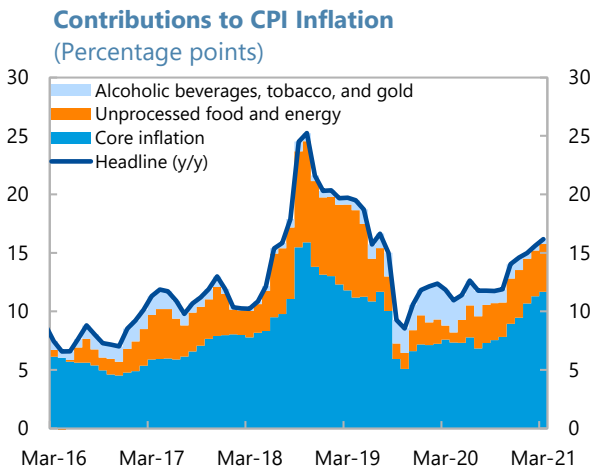
*GDP rebounded sharply, driven by domestic demand ...*



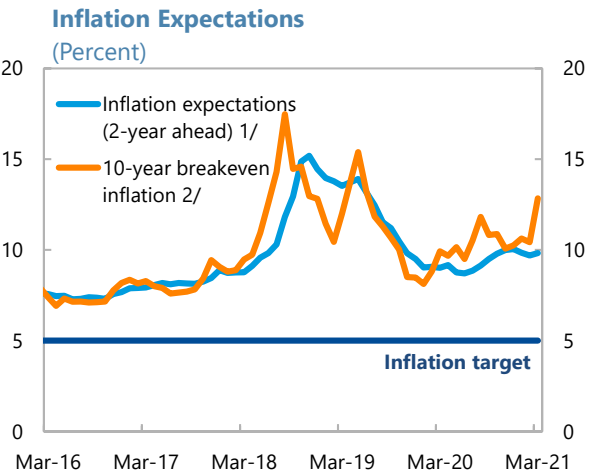
*... and both services and manufacturing activity.*



*Inflation picked up, driven by expansionary policies ...*



*... which also led to increasing inflation expectations.*



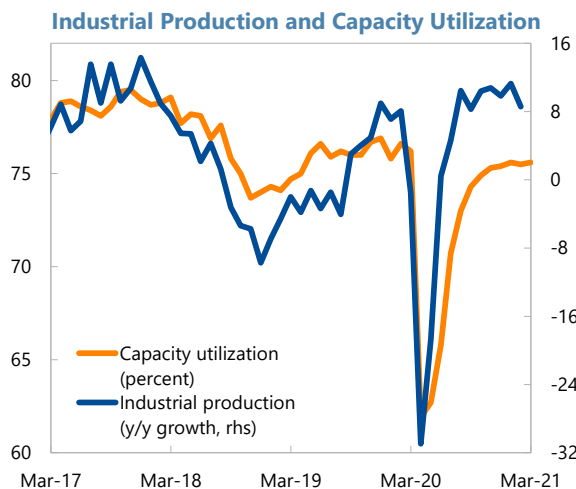
Sources: Bloomberg Financial Markets L.P.; CBRT; European Commission; TurkStat; and IMF staff calculations.

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

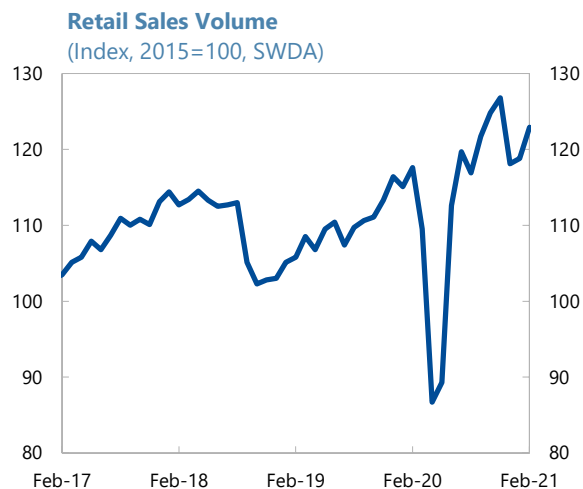
2/ Difference between the yield on a nominal fixed-rate bond and the real yield on an inflation-linked bond.

**Figure 6. Turkey: Coincident and Leading Indicators**

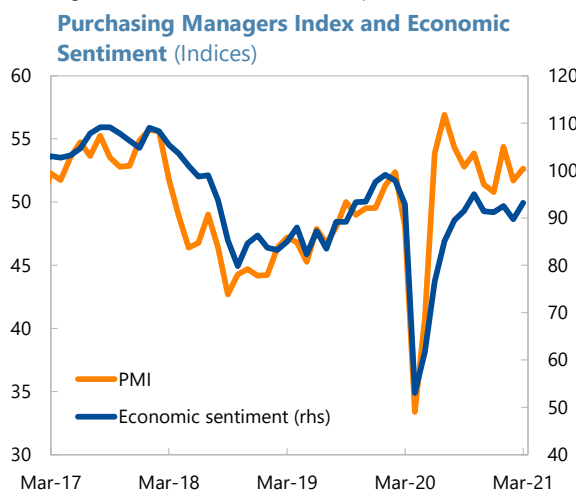
*Industrial activity rebounded sharply ...*



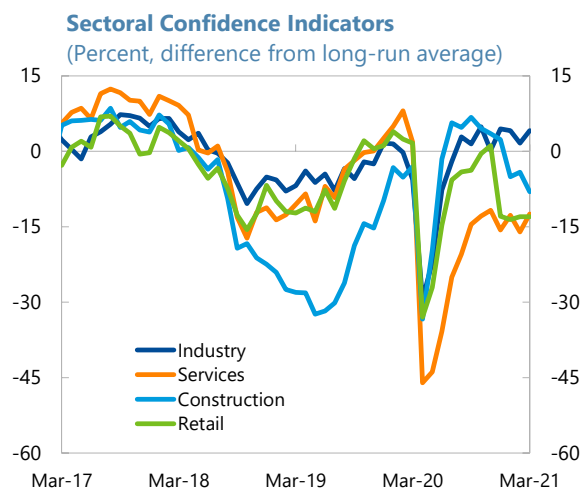
*... as did retail sales.*



*Leading and sentiment indicators improved ...*



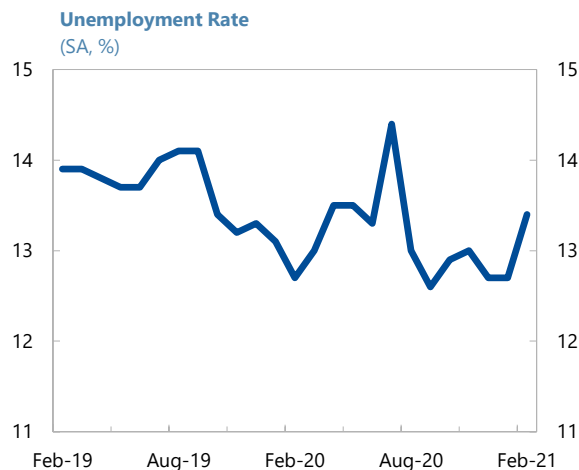
*... with increased confidence across sectors.*



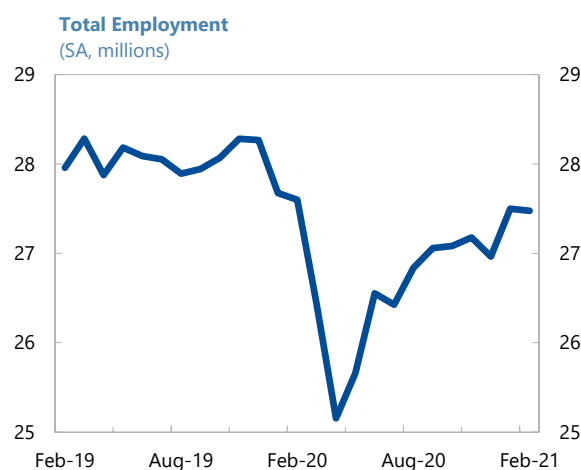
Sources: Turkstat; Haver Analytics; and IMF staff calculations.

**Figure 7. Turkey: Labor Market Developments**

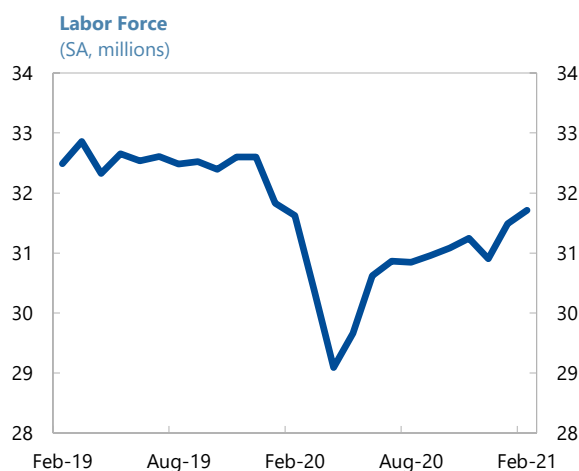
*The unemployment rate has fallen from its 2020 peak.*



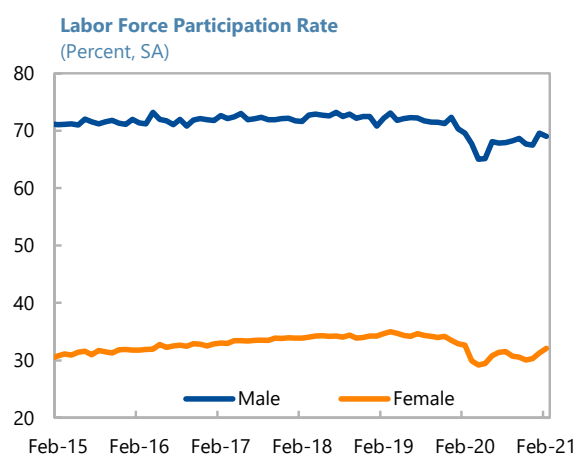
*But hidden slack remains given lower employment ...*



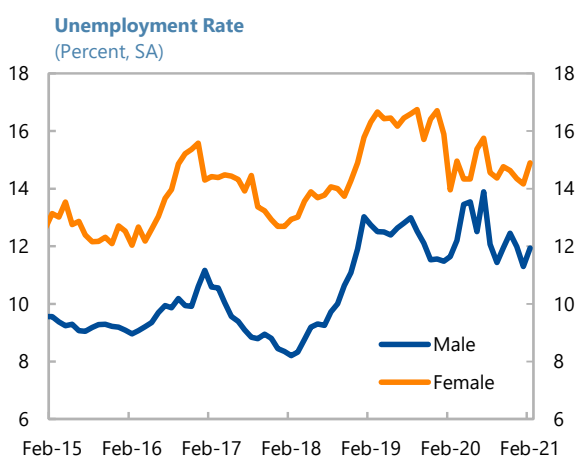
*... and lower overall labor force participation.*



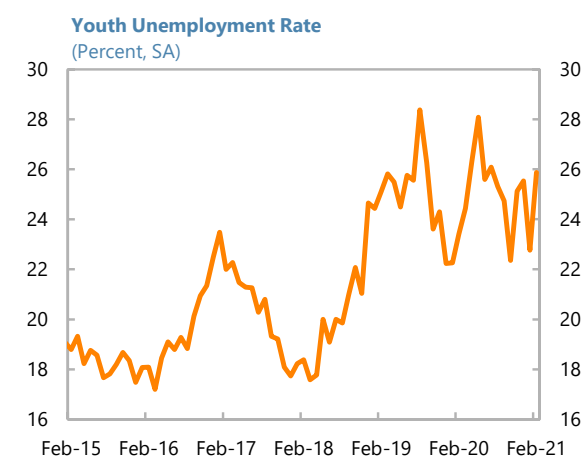
*Low female labor force participation ...*



*... and high female unemployment ...*



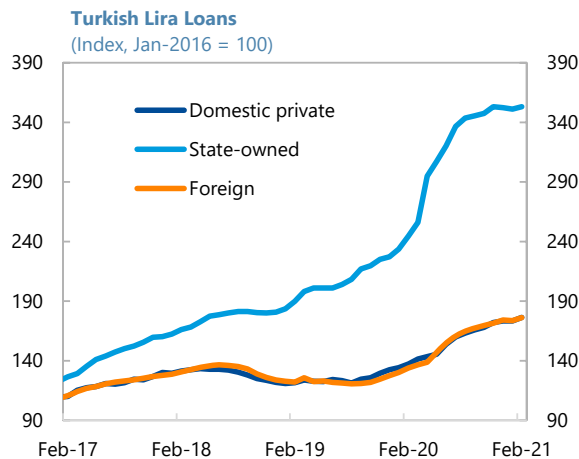
*... and youth unemployment remain key challenges.*



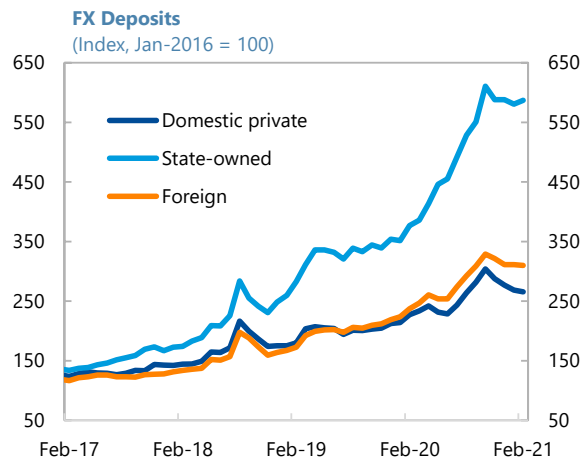
Sources: Turkstat; Haver Analytics; and IMF staff calculations.

**Figure 8. Turkey: Financial Sector**

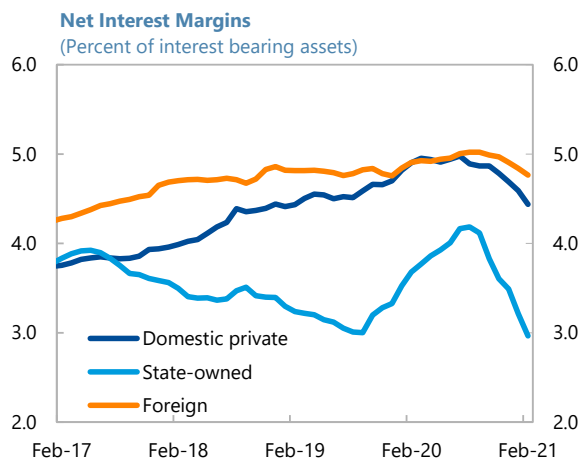
*Lending grew rapidly, driven by state-owned banks.*



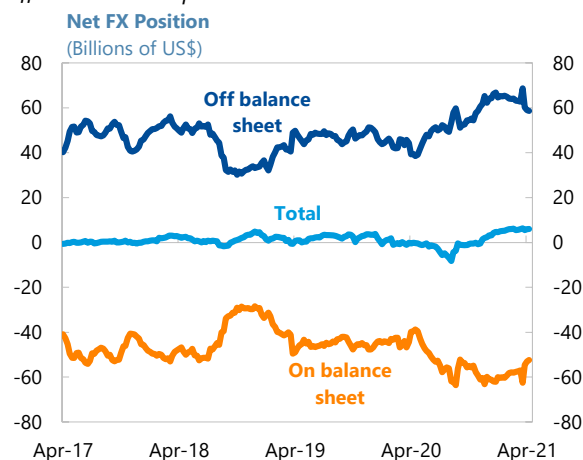
*SOBs raised sizeable funding in foreign currency.*



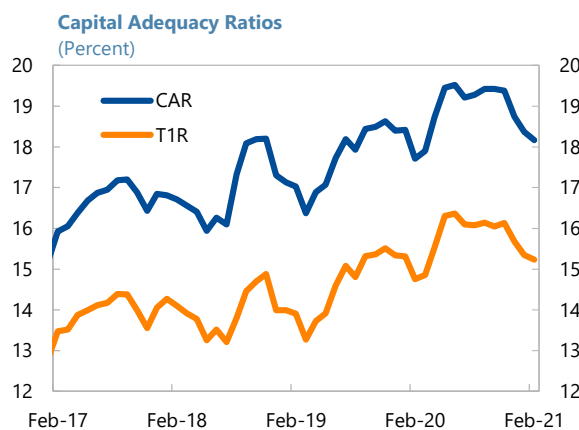
*Net interest margins benefitted from expansionary monetary policy and regulatory flexibility.*



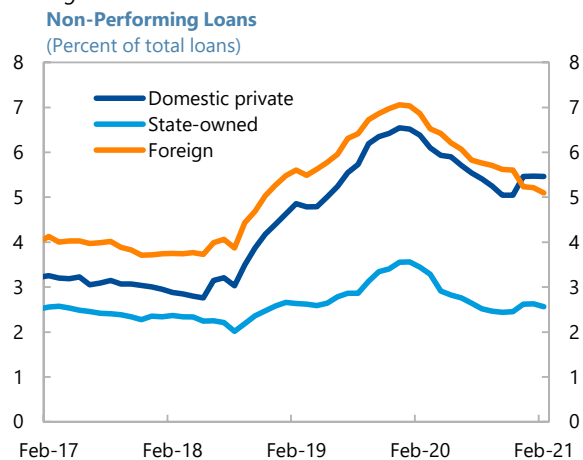
*Bank net FX positions are broadly balanced, as the negative on-balance sheet position is offset by a positive off-balance sheet position.*



*Banks continue to report high capitalization ...*



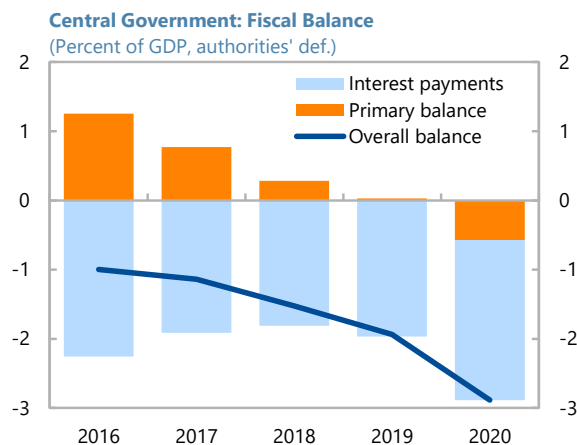
*... and moderate nonperforming loan ratios, reflecting regulatory flexibility and strong loan growth, especially among state-owned banks*



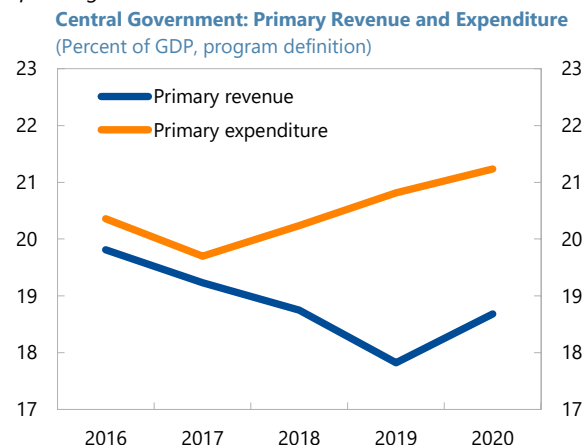
Notes: Monthly EOP NSA. CAR= Regulatory Capital/RWA. T1R= T1 Capital/ RWA. Sources: BRSA; CBRT; and IMF staff calculations.

**Figure 9. Turkey: Fiscal Stance**

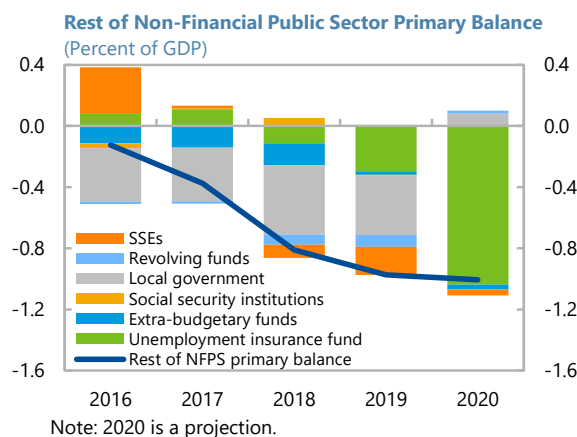
The central government deficit widened marginally ...



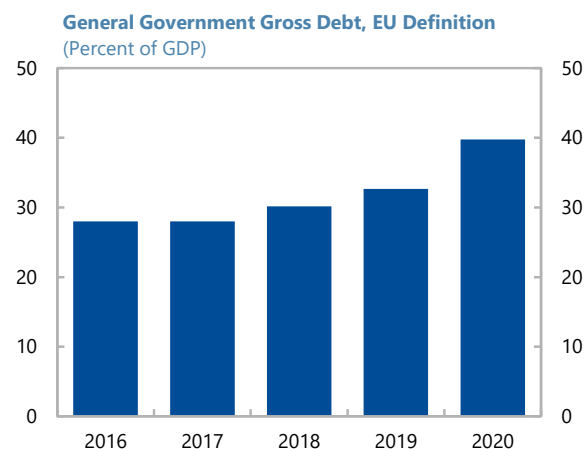
... reflecting strong revenues and a modest rise in spending.



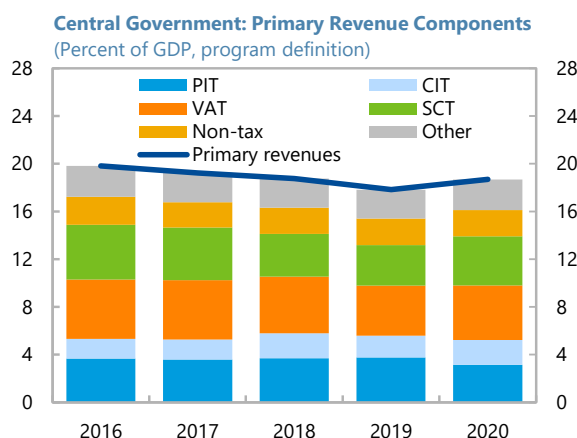
The deficit for the rest of the public sector was stable.



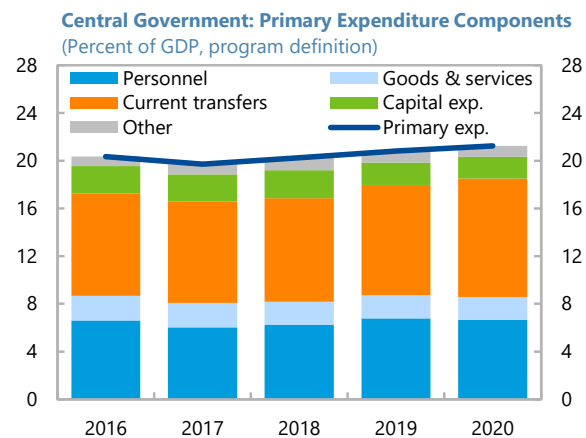
Public debt increased but remained relatively low.



Revenue strength was driven by indirect taxes and CIT.



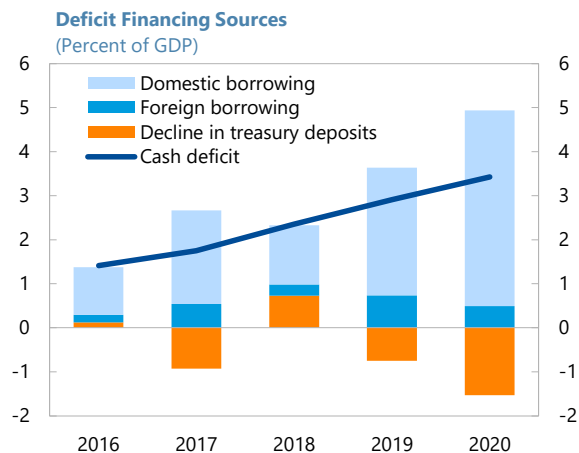
Spending was contained despite higher current transfers.



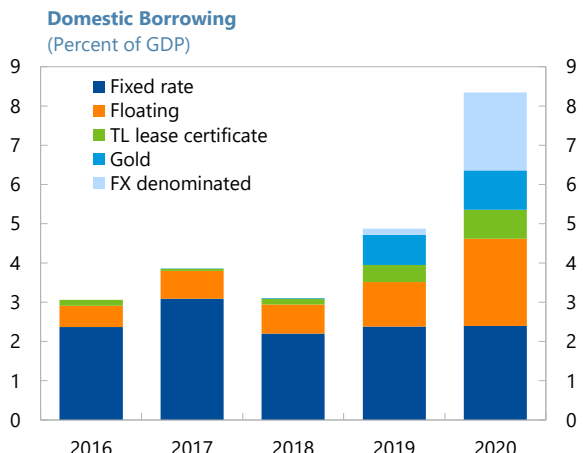
Sources: Ministry of Treasury and Finance; and IMF staff calculations.

**Figure 10. Turkey: Fiscal Financing**

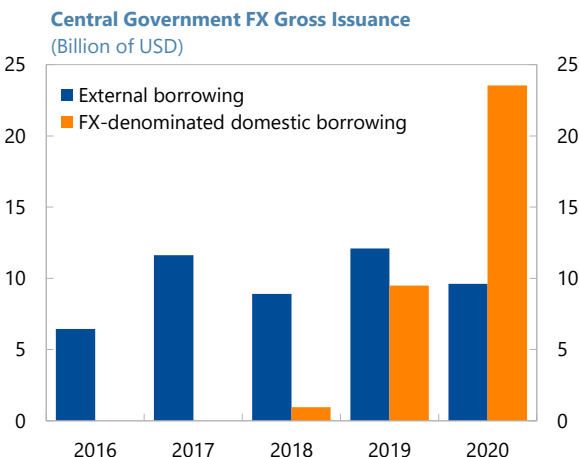
Reliance on domestic borrowing ...



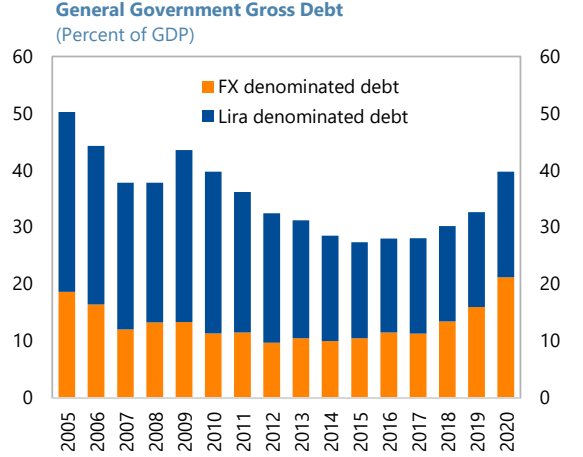
... and on alternative borrowing instruments has increased.



Both FX-denominated domestic borrowing ...

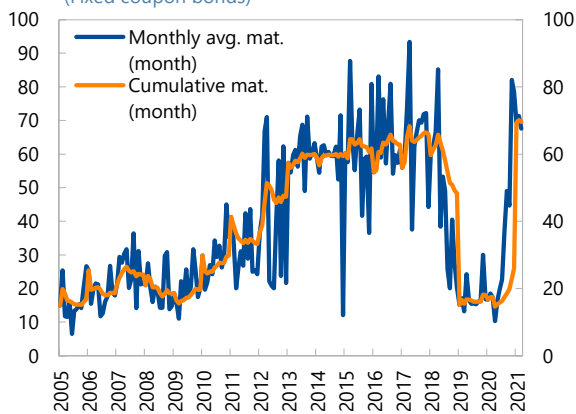


...and FX-denominated debt have increased ...



... while debt maturities fell sharply until recently.

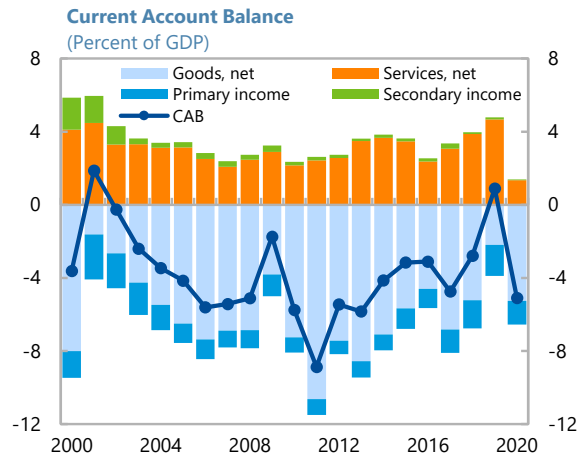
**Average Maturity of Domestic Borrowing (Fixed coupon bonds)**



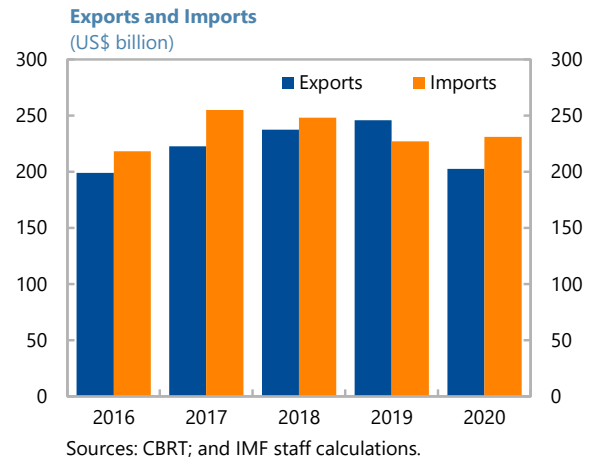
Sources: CBRT; MOTF; and IMF staff calculations.

**Figure 11. Turkey: External Sector**

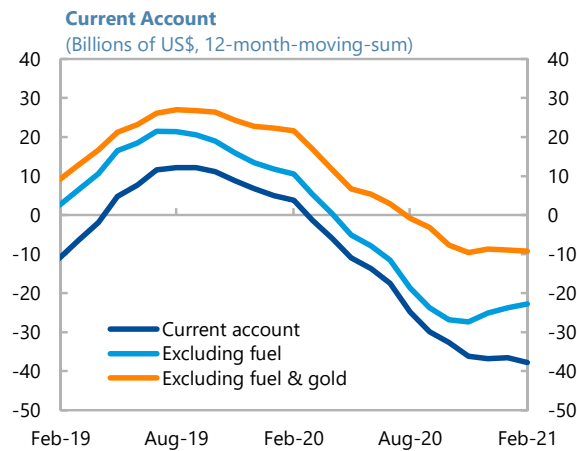
The current account deteriorated sharply ...



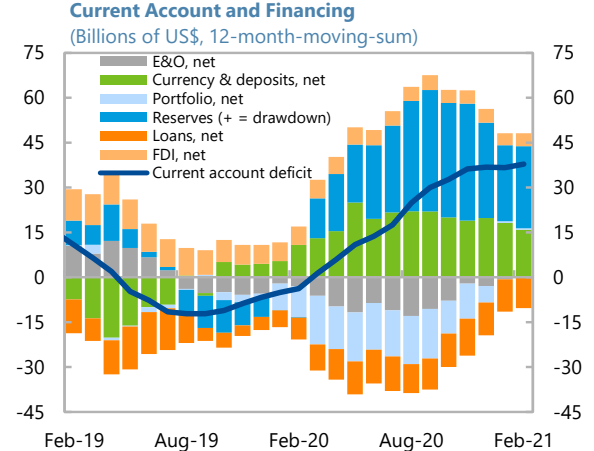
... reflecting lower exports and resilient imports.



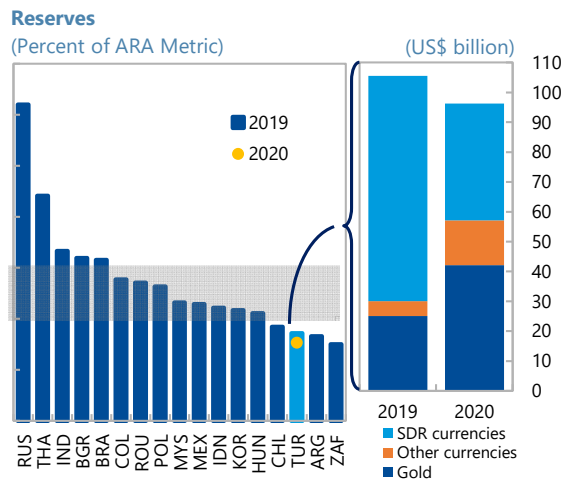
... exacerbated by increasing gold imports.



A large reserve drawdown helped fund the deficit.



Reserve quantity and quality deteriorated.



Sources: CBRT 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 million									
Per capita GDP (2020): US\$8,505									
Life expectancy (2018): 77.4 years									
Gini index (2018): 41.9									
Quota: SDR 4,658.6 million									
<b>Real sector</b>									
	(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
<b>Contributions to real GDP growth 1/</b>									
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)									
<b>Fiscal sector</b>									
<b>Nonfinancial public sector</b>									
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	40.2	41.5	43.4	44.6	45.6	46.5
<b>External sector</b>									
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	...	...	...	...	...	...
<b>Monetary conditions</b>									
	(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	...	...	...	...	...	...
<b>Memorandum items</b>									
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 2. Turkey: Summary of Balance of Payments, 2018–26**  
(Billions of U.S dollars, unless otherwise noted)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
			Prelim.	Proj.					
Current account balance	-21.7	6.8	-36.8	-20.9	-14.1	-16.0	-18.2	-21.3	-24.8
Balance on goods and services	-10.6	18.8	-28.3	-10.4	-1.5	-2.0	-4.4	-6.3	-12.2
Goods, net	-40.7	-16.8	-37.8	-21.9	-20.9	-27.3	-35.6	-42.0	-52.5
Exports of goods	178.9	182.2	168.4	205.1	214.2	225.1	236.8	251.9	266.0
Imports of goods	219.6	199.0	206.3	227.0	235.1	252.4	272.5	294.0	318.5
of which fuel imports	43.6	41.7	28.9	45.3	45.0	44.1	44.4	45.5	47.0
of which gold imports	11.3	11.3	25.2	20.4	17.5	13.7	15.0	16.6	18.2
Services, net	30.2	35.5	9.5	11.5	19.4	25.3	31.3	35.7	40.3
Credit	58.6	63.6	34.7	46.1	55.7	67.5	79.8	91.0	103.4
Debit	28.5	28.1	25.2	34.7	36.3	42.3	48.6	55.3	63.1
Primary income, net	-11.9	-12.8	-8.7	-10.8	-12.9	-14.2	-14.1	-15.2	-12.9
of which interest expenditure	-7.7	-8.1	-6.1	-5.9	-7.5	-8.5	-7.8	-8.4	-7.9
Secondary income net	0.8	0.8	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital account	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	10.8	-5.5	-2.9	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	-10.9	1.3	-39.8	-20.9	-14.1	-16.0	-18.2	-21.3	-24.8
Direct investment, net	-9.2	-6.3	-4.6	-5.9	-7.3	-7.9	-9.1	-9.9	-11.0
Portfolio investment, net	3.1	1.4	5.5	0.0	-1.7	-1.7	-2.0	-2.4	-2.9
of which government eurobonds, net	-3.9	-6.8	-4.6	-3.1	-2.3	-3.8	-0.6	0.6	-3.5
Other investment, net	5.6	-0.1	-8.7	0.0	-4.5	-5.3	-5.9	-7.0	-7.9
of which short-term borrowings	6.0	4.9	-0.5	-0.1	-0.7	-0.8	-0.9	-0.9	-1.0
Reserve assets	-10.4	6.3	-31.9	-15.0	-0.7	-1.1	-1.3	-2.0	-2.9
				<i>(Percent of GDP)</i>					
Current account balance, <i>of which</i>	-2.8	0.9	-5.1	-2.7	-1.7	-1.8	-1.9	-1.9	-2.0
Nonfuel current account balance	2.1	5.3	-1.8	2.2	2.9	2.4	2.0	1.6	1.3
Goods and services balance	-1.4	2.5	-4.0	-1.3	-0.2	-0.2	-0.4	-0.6	-1.0
				<i>(Percent year-on-year)</i>					
Export value growth	6.7	3.5	-17.4	23.7	7.4	8.0	8.5	8.4	8.0
Import value growth	-2.7	-8.5	1.9	13.1	3.7	8.6	9.1	9.2	9.4
Oil price (US\$ per barrel)	68.3	61.4	41.3	58.5	54.8	52.5	51.3	50.7	50.5
Change in terms of trade	-8.4	0.4	2.9	-7.6	0.6	0.7	0.7	0.6	0.4
Gross international reserves (USD bn)	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)	74.3	83.8	73.5	...	...	...	...	...	...
Net international reserves (USD bn)	30.2	40.6	14.5	-0.5	-1.2	-2.3	-3.6	-5.5	-8.5
Net international reserves (excl. govt. FX deposits) (USD bn)	27.1	35.1	2.6	...	...	...	...	...	...
Ratio of external debt service to exports (percent)	79.1	75.2	88.6	79.1	75.4	71.2	68.2	65.4	61.2

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

**Table 3. Turkey: External Financing Requirements and Sources, 2018–26**  
(Billions of U.S. dollars, unless otherwise noted)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
			Prelim.	Proj.					
Gross external financing requirements	201.9	169.9	210.6	213.7	210.2	215.8	226.4	237.3	243.1
Current account deficit	21.7	-6.8	36.8	20.9	14.1	16.0	18.2	21.3	24.8
Government eurobonds (amortization)	3.8	4.4	4.7	6.9	7.7	6.2	9.4	10.6	6.5
Medium- and long-term debt amortization	56.3	54.9	46.2	47.4	46.5	46.4	46.3	46.3	46.3
Government 1/	2.4	2.2	1.8	2.3	2.3	2.3	2.3	2.2	2.2
Banks	36.9	30.6	26.4	26.5	26.0	25.8	25.8	25.8	25.8
Other sectors	17.0	22.0	18.0	18.6	18.3	18.3	18.3	18.3	18.3
Short-term debt amortization	120.1	117.4	122.9	138.5	141.9	147.4	152.4	159.0	165.5
Government 1/ 2/	1.8	5.9	8.4	21.4	21.4	21.4	21.4	21.4	21.4
Banks	67.2	57.0	55.7	58.0	58.7	59.4	60.2	61.1	62.5
Other sectors	51.1	54.4	58.7	59.1	61.8	66.5	70.8	76.5	81.6
Available financing	201.9	169.9	210.6	213.7	210.2	215.8	226.4	237.3	243.1
Sale of assets (net) 3/	-13.6	-13.5	0.5	0.9	-0.3	0.4	-0.6	0.6	0.5
Foreign direct investment (net)	9.2	6.3	4.6	5.9	7.3	7.9	9.1	9.9	11.0
Portfolio flows	3.8	7.7	-0.5	6.9	9.3	7.8	11.3	13.0	9.4
Government eurobonds (drawings)	7.7	11.2	9.3	10.0	10.0	10.0	10.0	10.0	10.0
Domestically-issued government bonds (net)	-0.9	-3.1	-5.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks' equity and bonds (net)	-1.8	-0.2	-0.8	-1.7	-0.3	1.4	1.5	1.6	1.7
Other sectors' equity and bonds (net)	-1.1	-0.1	-4.0	-1.4	-0.4	-3.6	-0.1	1.5	-2.2
Medium and long-term debt financing	53.1	42.5	36.2	43.1	45.9	46.2	46.2	46.2	46.2
Government 1/	1.6	1.3	1.3	2.2	2.2	2.2	2.1	2.1	2.1
Banks	28.2	22.5	21.1	25.1	25.5	25.8	25.8	25.8	25.8
Other sectors	23.3	18.7	13.7	15.8	18.3	18.3	18.3	18.3	18.3
Short-term debt financing 4/	117.4	122.9	138.5	141.9	147.4	152.4	159.0	165.5	172.9
Government 1/	5.9	8.4	21.4	21.4	21.4	21.4	21.4	21.4	21.4
Banks	57.0	55.7	58.0	58.7	59.4	60.2	61.1	62.5	63.5
Other sectors	54.4	58.7	59.1	61.8	66.5	70.8	76.5	81.6	88.0
Official transfers	0.3	0.6	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	21.6	10.3	-0.7	0.0	0.0	0.0	0.0	0.0	0.2
GIR change ( - denotes increase)	10.4	-6.3	31.9	15.0	0.7	1.1	1.3	2.0	2.9
Memorandum items:									
Net public sector financing (incl. IMF, excl. reserves)	7.5	8.9	17.3	3.1	2.3	3.8	0.6	-0.6	3.5
Government debt rollover rate (in percent)	192	166	215	110	107	113	102	98	111
Banks' loan rollover rate (in percent)	82	89	96	99	100	101	101	102	101
Other sectors' loan rollover rate (in percent)	114	101	95	100	106	105	106	105	106
Gross external financing requirements (percent of GDP)	25.9	22.3	29.4	27.6	25.9	24.2	23.0	21.6	19.9
International Investment Position (percent of GDP)	-47.5	-45.7	-56.4	-54.9	-54.2	-51.1	-48.0	-45.1	-42.5

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

1/ Includes CBRT and the general government, excluding eurobonds issuance.

2/ The increase in government amortization in 2021 largely reflects swaps held by the CBRT, which are assumed to be rolled over.

3/ Includes sales and purchases of portfolio assets by the government, banks, and other private sectors; and sale of assets classified under Other Investments.

4/ Includes currency and deposits of non-residents.

**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	-5.0	-5.3	-5.5	-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	-3.5	-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	30.2	32.6	39.7	40.2	41.5	43.4	44.6	45.6	46.5

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
<b>Capital Adequacy</b>									
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
<b>Asset Quality</b>									
NPLs / Gross Loans	3	3	3	3	3	3	4	5	4
Provisions / Gross NPLs	75	76	74	75	77	79	68	65	75
<b>Profitability</b>									
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
<b>Funding and Liquidity</b>									
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
<b>FX Risk</b>									
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
<b>Balance Sheet</b>									
	<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
<b>Off-Balance Sheet</b>									
	<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
<b>Miscellaneous</b>									
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).

Risks	Likelihood	Economic Impact	Policy Response
<b>Conjunctural shocks and scenario (Global)</b>			
<p><b>Unexpected shifts in the COVID-19 pandemic:</b></p> <ul style="list-style-type: none"> <li><b>Asynchronous progress.</b> Limited access to, and protracted deployment of vaccines</li> <li><b>Prolonged pandemic.</b> The disease proves harder to eradicate, requiring costly containment efforts and prompting persistent behavioral changes rendering many activities unviable.</li> </ul>	<b>Medium</b>	<p><b>High.</b> Reassessment of growth prospects triggers capital outflows, depreciation, inflationary pressures, and debt defaults. Prolonged support—while needed to cushion the economy—exacerbates stretched asset valuations, fueling financial vulnerabilities. Risk that room for policy support is insufficient.</p>	<ul style="list-style-type: none"> <li>Extend containment measures as needed and expedite vaccination.</li> <li>Provide additional temporary and targeted fiscal support to the most vulnerable.</li> <li>Maintain a firm monetary stance</li> <li>Use exchange rate as a shock absorber, strictly limiting FX intervention given low reserves.</li> </ul>
<p><b>Sharp rise in global risk premia exposes financial vulnerabilities.</b> Reassessment of market fundamentals triggers widespread risk-off event.</p>	<b>Medium</b>	<p><b>High.</b> Risk asset prices fall sharply and volatility spikes, leading to significant losses in major non-bank financial institutions. Higher risk premia generate financing difficulties for the government and leveraged firms and households. A wave of bankruptcies erode banks' capital buffers.</p>	<ul style="list-style-type: none"> <li>Tighten monetary policy.</li> <li>Use exchange rate as a shock absorber, strictly limiting FX intervention given low reserves.</li> <li>Allow automatic fiscal stabilizers to operate and provide targeted, temporary fiscal support to the most vulnerable.</li> <li>Adopt a medium-term fiscal plan that creates fiscal space.</li> <li>Promote out-of-court debt workouts.</li> </ul>
<p><b>Widespread social discontent and political instability.</b> Social tensions erupt as the pandemic and/or inadequate policy response to it cause socio-economic hardship, or due to unequal access to vaccines.</p>	<b>High</b>	<p><b>High.</b> Growing political polarization and instability weaken policymaking and confidence.</p>	<ul style="list-style-type: none"> <li>Expedite vaccination program.</li> <li>Additional temporary and targeted fiscal support to the most vulnerable.</li> </ul>

<sup>1</sup>The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

<p><b>Widespread social discontent and political instability.</b> Social tensions erupt as the pandemic and/or inadequate policy response to it cause socio-economic hardship, or due to unequal access to vaccines.</p>	<p><b>High</b></p>	<p><b>High.</b> Growing political polarization and instability weaken policymaking and confidence.</p>	<ul style="list-style-type: none"> <li>• Expedite vaccination program.</li> <li>• Additional temporary and targeted fiscal support to the most vulnerable.</li> </ul>
<p><b>Intensified geopolitical tensions and security risks</b> cause socio-economic and political disruption.</p>	<p><b>High</b></p>	<p><b>High.</b> Disorderly migration, higher commodity prices, and/or lower confidence could accelerate capital outflows and pressure the currency. Refugee migration to Turkey could increase and exacerbate social pressures.</p>	<ul style="list-style-type: none"> <li>• Tighten monetary policy.</li> <li>• Allow automatic fiscal stabilizers to operate and provide targeted, temporary support to the most vulnerable.</li> <li>• Use exchange rate as a shock absorber, strictly limiting FX intervention given low reserves.</li> <li>• Domestic action, with international support, for refugees.</li> </ul>
<p><b>Structural risks (Global)</b></p>			
<p><b>Accelerating de-globalization.</b> Geopolitical competition leads to further fragmentation.</p>	<p><b>Medium</b></p>	<p><b>Medium.</b> Reshoring and reduced trade lower potential growth. Turkey's market access could be adversely affected, worsening balance of payments pressures.</p>	<ul style="list-style-type: none"> <li>• Use exchange rate as shock absorber.</li> <li>• Tighten monetary policy.</li> <li>• Accelerate reforms to improve export competitiveness, diversify markets and support multilateral rules-based trade system.</li> </ul>
<p><b>Higher frequency and severity of natural disasters related to climate change</b> cause severe economic damage to smaller economies susceptible to disruptions.</p>	<p><b>Medium</b></p>	<p><b>Medium.</b> Domestic vulnerabilities arise from the impact on agriculture and inflation, notably on the most vulnerable households.</p>	<ul style="list-style-type: none"> <li>• Accelerate reforms to enhance climate resilience (drought resistant crops, improved infrastructure).</li> <li>• Deploy temporary and targeted policies to mitigate impact on households.</li> </ul>

Domestic risks			
<p><b>Disorderly macro-financial cycle of deleveraging and income compression:</b> External financing pressures and/or domestic policy mistakes (including premature monetary policy easing or inadequate policy response to market pressures) could give rise to rapid exchange rate depreciation, which weakens corporate balance sheets and worsens bank asset quality, triggering sharp deleveraging and a slowdown of economic activity.</p>	<p><b>High</b></p>	<p><b>High.</b> Continued erosion of policy buffers and monetary policy credibility, leading to weaker confidence, capital outflows, accelerated dollarization, reserve depletion, and pressure on currency. NBFCs lose access to external finance.</p>	<ul style="list-style-type: none"> <li>• Tighten monetary policy.</li> <li>• Use exchange rate as a shock absorber, strictly limiting FX intervention given low reserves.</li> <li>• Allow automatic fiscal stabilizers to operate and provide targeted, temporary support to the most vulnerable.</li> <li>• Undertake third-party asset quality review, followed by rigorous stress tests and follow-up measures as needed.</li> <li>• Promote out of court debt workouts.</li> <li>• Adopt a medium-term fiscal plan that creates fiscal space.</li> </ul>

## Annex II. External Sector Assessment

<p><b>Overall Assessment:</b> <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><b>Potential Policy Responses:</b> 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>							
<b>Foreign Asset and Liability Position and Trajectory</b>	<p><b>Background.</b> 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.<sup>1</sup> 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><b>Assessment.</b> 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		
<b>Current Account</b>	<p><b>Background.</b> 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><b>Assessment.</b> 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
<b>Real Exchange Rate</b>	<p><b>Background.</b> 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><b>Assessment.</b> 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>						
<b>Capital and Financial Accounts: Flows and Policy Measures</b>	<p><b>Background.</b> Net capital inflows increased only modestly in 2020, from USD 5.5 to USD 8.2 billion. E&amp;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><b>Assessment.</b> 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>						
<b>FX Intervention and Reserves Level</b>	<p><b>Background.</b> 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 27 billion to USD 13.7 billion by end-2020.<sup>2</sup> The composition of reserves has also changed, with an increasing share of gold and non-SDR-basket currencies.</p>						

## TURKEY

	<p><b>Assessment.</b> Gross reserves decreased from 84 to 74 percent of the IMF’s ARA metric during 2020, falling further below the floor of the recommended 100-150 percent ARA adequacy range, and covering only 54 percent of ST external debt (at remaining maturity). Steady reserve accumulation over the medium term is needed given Turkey’s large external liabilities, dependence on short-term and portfolio funding, and large domestic FX deposits.</p>
<p><sup>1</sup> A higher share of external assets relative to external liabilities are denominated in FX. Despite persistent CA deficits, the NIIP fluctuated with no clear trend during 2009–19, due to a mix of positive valuation effects and large net BOP E&amp;O.</p>	
<p><sup>2</sup> NIR are defined as gross international reserves minus the central bank’s FX liabilities to banks, including the Reserve Option Mechanism.</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.<sup>1</sup> 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 39.7 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 over 500 bps, 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

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

projections assume a gradual lengthening of borrowing maturities and less reliance on domestic FX borrowing, in line with trends observed in recent months.

## Shocks and Stress Tests

### 6. The public DSA suggests that Turkey's government debt will remain below vulnerability benchmarks under the baseline and under various individual shock scenarios.

Among all individual shock scenarios (Table 1), GDP growth, interest rates, and contingent liability shocks lead to a significant increase in public debt while the primary balance shock does not substantially affect debt dynamics. Under a combined macro-fiscal shock, debt would reach around 70 percent of GDP in 2026, while under a more extreme macro-fiscal-contingent liability shock, debt would exceed 80 percent of GDP. Also, debt would not stabilize by 2026, absent policy adjustment.

- **Primary balance shock.** A deterioration of the primary balance by 1 standard deviation for 2 years starting in 2022 would increase public debt only moderately in the medium term (to 48 percent of GDP in 2026). Under this scenario, sovereign borrowing costs are also raised by 25 basis points for each 1 percentage point of GDP worsening in the primary balance. The impact on gross financing needs is modest.
- **Growth shock.** Real output growth rates are lowered by 1 standard deviation (3.2 percentage points) for 2 years starting in 2022. The primary balance would deteriorate significantly compared to the baseline (to -5.7 percent of GDP by 2023) as nominal revenues would fall against unchanged expenditures. This would also lead to higher sovereign borrowing costs. By 2026, the debt-to-GDP ratio would reach about 53 percent while gross financing needs would climb to 16 percent of GDP.
- **Interest rate shock.** The real effective rate reaches similar levels to those prevailing in 2013, which implies a permanent increase in spreads by about 635 basis points. The government's interest bill reaches an implicit average interest rate of about 14 percent over the medium term. By 2026, the debt-to-GDP ratio and gross public financing needs would increase to reach about 50 percent and 16.5 percent, respectively.
- **Contingent liability shock.** This shock could be seen as hypothetical contingent liabilities related to the financial sector, PPPs, and non-financial state-owned enterprises. The shock is assumed to increase non-interest expenditures by 10 percent of GDP in 2022. This is combined with a real GDP growth shock (1 standard deviation for 2 years). Sovereign borrowing costs are pushed up (25 bps for each 1 percent of GDP worsening in the primary balance) while inflation declines (0.25 percentage points for each percentage point decrease in GDP growth). The debt-to-GDP ratio would rise sharply in 2022 and gradually increase afterwards, reaching 66 percent of GDP in 2026. Gross financing needs would reach about 20 percent of GDP in the medium term.
- **Combined macro-fiscal shock.** A combined macro-fiscal shock incorporates the largest effect of the individual macro-fiscal shocks (i.e., excluding the contingent liability shock) on all relevant

variables (real GDP growth, inflation, primary balance, exchange rate, and interest rate). Public debt and gross financing needs would reach about 70 and 21 percent of GDP over the medium term.

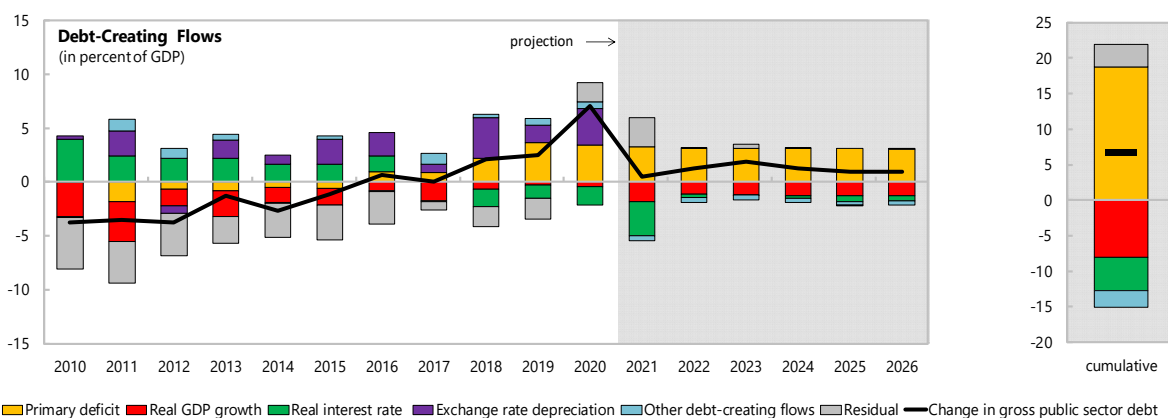
- **Combined macro-fiscal-contingent liability shock.** This extreme combined shock incorporates the largest effect of the above shocks, including the contingent liability shock, on all relevant variables. Public debt would breach the 70 percent benchmark in 2022 and reach 82 percent of GDP by 2026. Gross financing needs would also increase to around 25 percent of GDP over the medium term.

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

	Actual			Projections						As of April 01, 2021		
	2010-2018 <sup>2/</sup>	2019	2020	2021	2022	2023	2024	2025	2026	Sovereign Spreads		
Nominal gross public debt	31.3	32.6	39.7	40.2	41.5	43.4	44.6	45.6	46.5	EMBIG (bp) 3/		542
Public gross financing needs	7.9	8.4	10.5	12.1	12.9	13.3	13.5	13.8	14.1	5Y CDS (bp)		476
Real GDP growth (in percent)	6.4	0.9	1.6	5.8	3.3	3.3	3.3	3.3	3.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	8.9	13.9	14.3	19.3	11.1	10.7	11.2	12.0	11.8	Moody's	B2	B2
Nominal GDP growth (in percent)	15.8	15.0	16.2	26.2	14.7	14.4	14.9	15.6	15.5	S&P's	B+	BB-
Effective interest rate (in percent) <sup>4/</sup>	9.4	9.5	10.1	10.3	10.7	10.9	11.0	11.0	11.0	Fitch	BB-	BB-

### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026		
Change in gross public sector debt	-1.5	2.5	7.1	0.5	1.3	1.9	1.3	0.9	1.0	6.8	
Identified debt-creating flows	1.6	4.3	5.4	-2.2	1.3	1.5	1.2	1.0	0.9	3.7	
Primary deficit	0.0	3.7	3.4	3.3	3.1	3.2	3.1	3.1	3.1	18.8	-2.1
Primary (noninterest) revenue and grants	31.4	29.5	27.9	27.8	28.0	28.0	28.1	28.2	28.2	168.3	
Primary (noninterest) expenditure	31.3	33.2	31.3	31.1	31.1	31.2	31.2	31.3	31.3	187.1	
Automatic debt dynamics <sup>5/</sup>	1.2	0.0	1.3	-5.0	-1.4	-1.2	-1.5	-1.8	-1.8	-12.7	
Interest rate/growth differential <sup>6/</sup>	-0.3	-1.5	-2.1	-5.0	-1.4	-1.2	-1.5	-1.8	-1.8	-12.7	
Of which: real interest rate	1.6	-1.3	-1.7	-3.2	-0.3	0.0	-0.2	-0.5	-0.5	-4.7	
Of which: real GDP growth	-1.9	-0.2	-0.5	-1.8	-1.2	-1.2	-1.3	-1.3	-1.3	-8.0	
Exchange rate depreciation <sup>7/</sup>	1.5	1.6	3.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.4	0.6	0.7	-0.4	-0.4	-0.4	-0.4	-0.3	-0.3	-2.3	
General Government: Net Privatization Proceeds (negative)	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.6	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
General Government: Financing: Net Acquisition of Financial Assets	0.8	0.8	0.8	-0.3	-0.3	-0.3	-0.3	-0.2	-0.2	-1.7	
Residual, including asset changes <sup>8/</sup>	-3.0	-1.9	1.7	2.7	0.0	0.4	0.0	0.0	0.0	3.1	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as  $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+gn)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

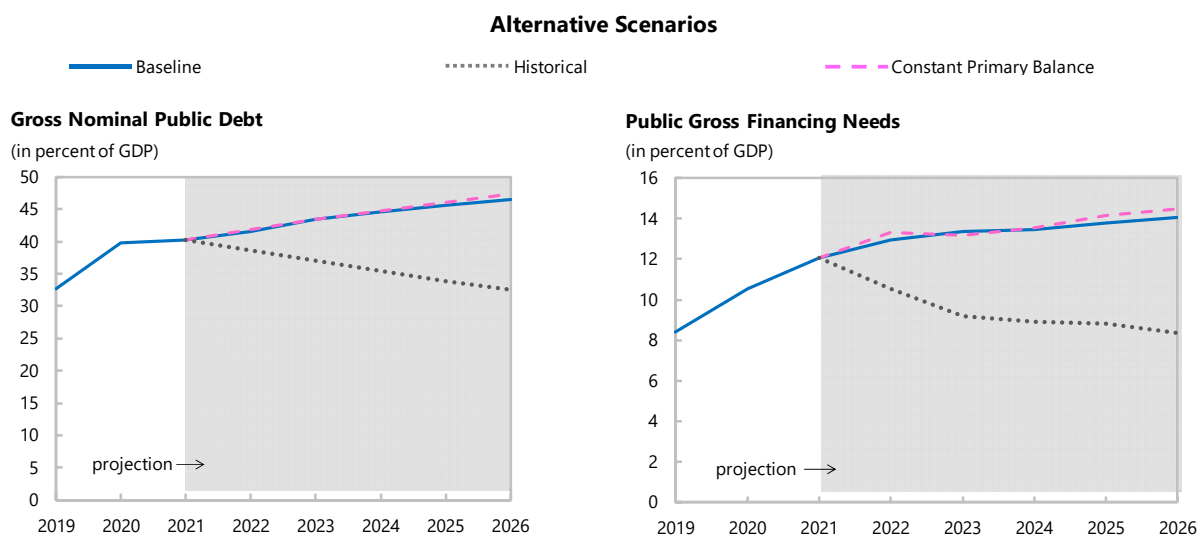
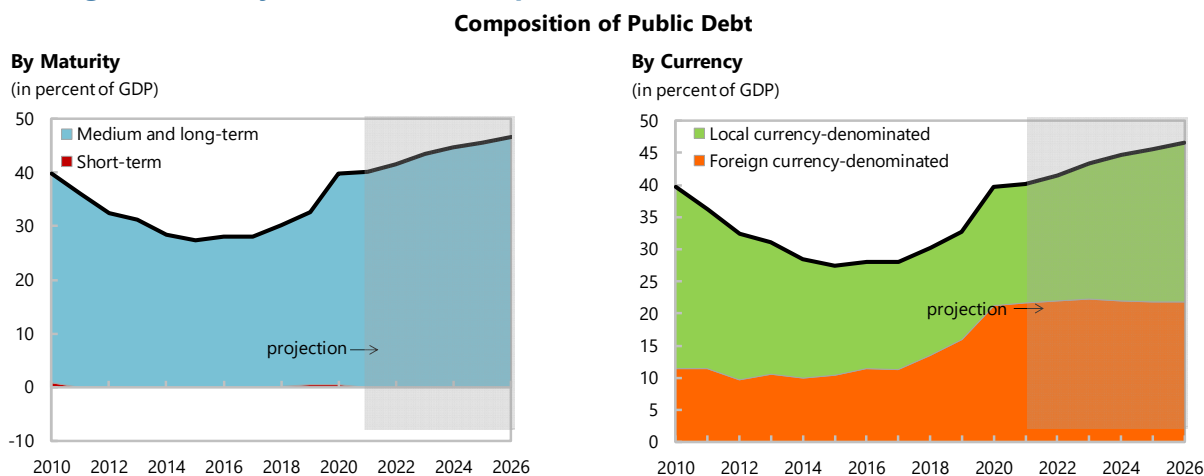
6/ The real interest rate contribution is derived from the numerator in footnote 5 as  $r - \pi(1+g)$  and the real growth contribution as  $-g$ .

7/ The exchange rate contribution is derived from the numerator in footnote 5 as  $ae(1+r)$ .

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

**Figure 2. Turkey Public DSA—Composition of Public Debt and Alternative Scenarios**



### Underlying Assumptions (in percent)

<b>Baseline Scenario</b>	2021	2022	2023	2024	2025	2026
Real GDP growth	5.8	3.3	3.3	3.3	3.3	3.3
Inflation	19.3	11.1	10.7	11.2	12.0	11.8
Primary Balance	-3.3	-3.1	-3.2	-3.1	-3.1	-3.1
Effective interest rate	10.3	10.7	10.9	11.0	11.0	11.0

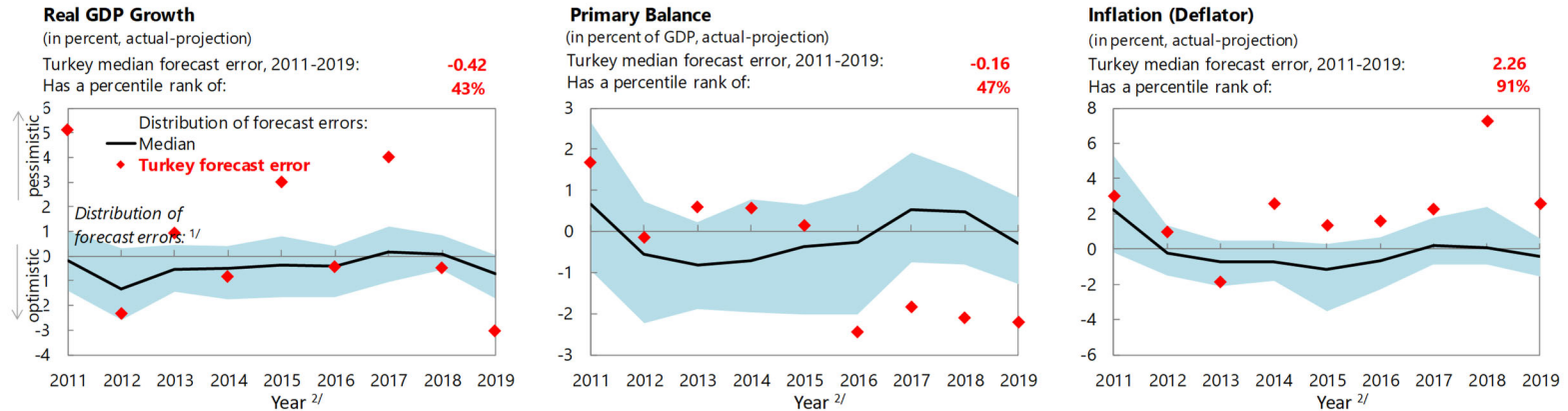
<b>Constant Primary Balance Scenario</b>	2021	2022	2023	2024	2025	2026
Real GDP growth	5.8	3.3	3.3	3.3	3.3	3.3
Inflation	19.3	11.1	10.7	11.2	12.0	11.8
Primary Balance	-3.3	-3.1	-3.1	-3.1	-3.1	-3.1
Effective interest rate	10.3	9.3	10.0	10.3	10.5	10.5

<b>Historical Scenario</b>	2021	2022	2023	2024	2025	2026
Real GDP growth	5.8	5.2	5.2	5.2	5.2	5.2
Inflation	19.3	11.1	10.7	11.2	12.0	11.8
Primary Balance	-3.3	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	10.3	9.3	10.0	10.4	10.8	10.9

Source: IMF staff.

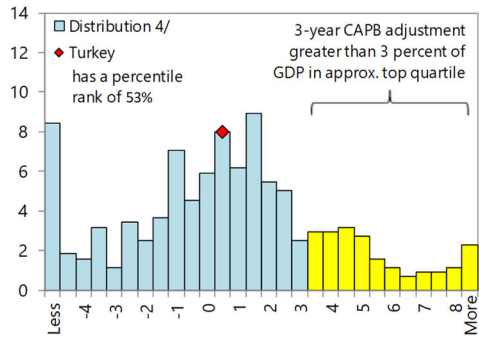
**Figure 3. Turkey Public DSA – Realism of Baseline Assumptions**

**Forecast Track Record, versus all countries**

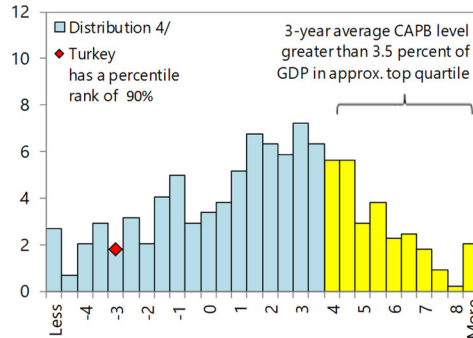


**Assessing the Realism of Projected Fiscal Adjustment**

**3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)

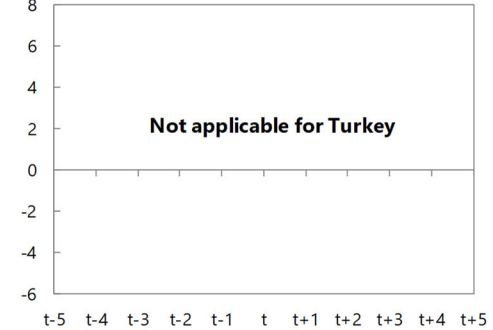


**3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)



**Boom-Bust Analysis 3/**

**Real GDP growth**  
(in percent)



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Turkey, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Turkey Public DSA—Stress Tests



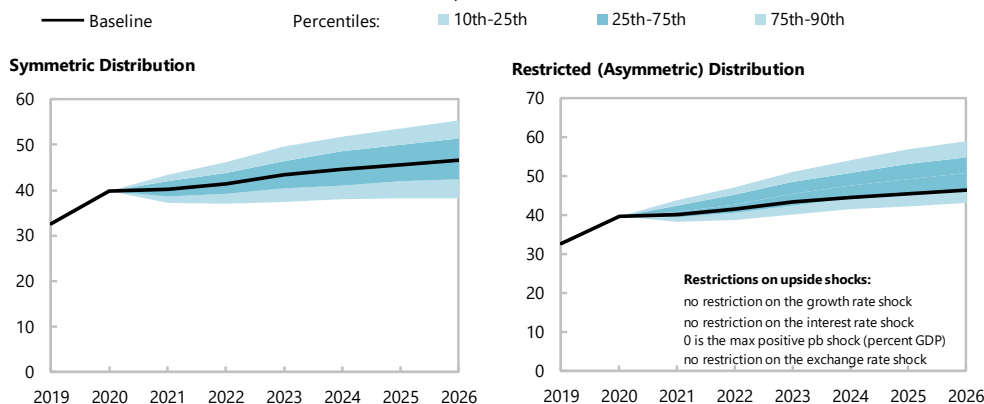
**Figure 5. Turkey Public DSA Risk Assessment**

**Heat Map**

Debt level <sup>1/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs <sup>2/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile <sup>3/</sup>	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

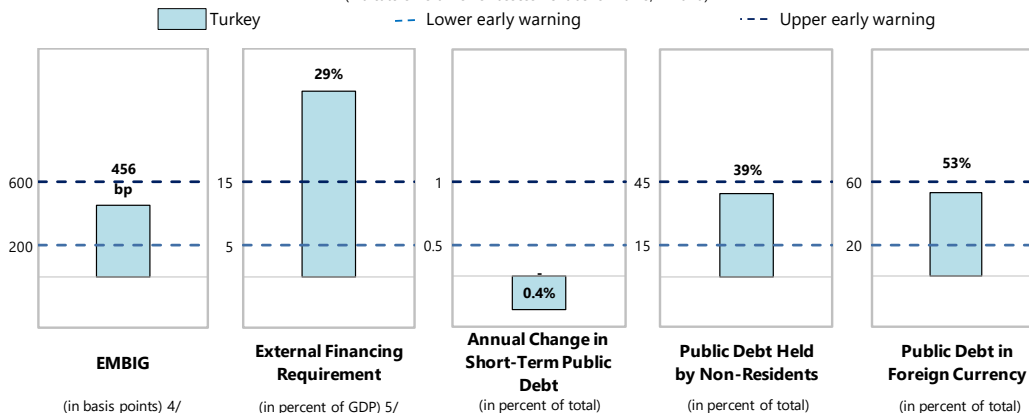
**Evolution of Predictive Densities of Gross Nominal Public Debt**

(in percent of GDP)



**Debt Profile Vulnerabilities**

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 01-Jan-21 through 01-Apr-21.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

## Annex IV. External Debt Sustainability<sup>1</sup>

*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 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.

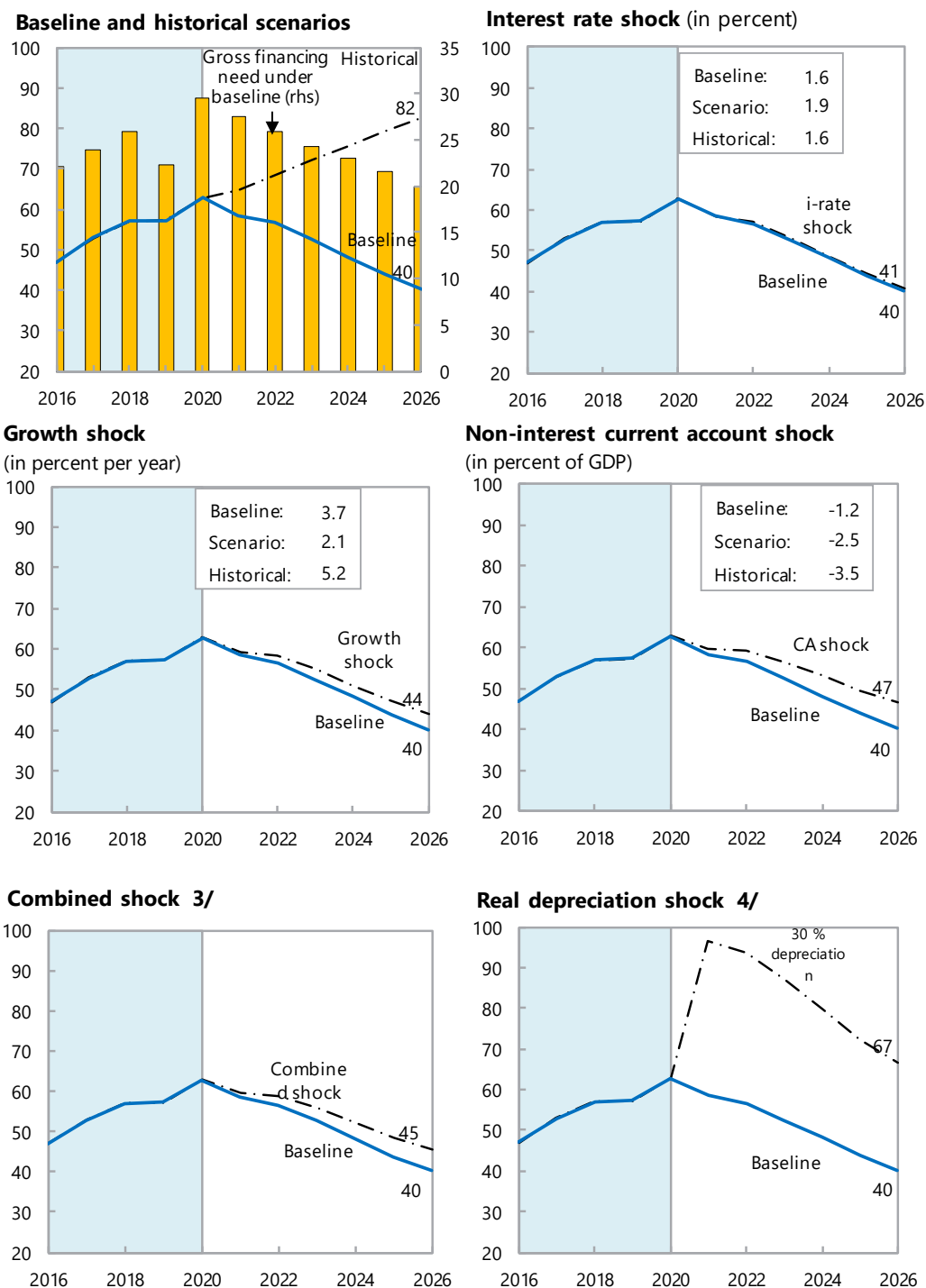
### Assessment

- 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.

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<sup>1</sup> 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.

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



Sources: IMF staff estimates.  
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. The shocks to interest rate was increased to 1 standard deviation. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.  
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

**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		
<b>Baseline: External debt</b>	47.0	52.9	56.9	57.2	62.9	<b>58.4</b>	<b>56.7</b>	<b>52.6</b>	<b>48.2</b>	<b>43.8</b>	<b>40.3</b>		
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		
<b>Gross external financing need (in billions of US dollars) 4/</b>	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		
<b>Scenario with key variables at their historical averages 5/</b>						<b>64.6</b>	<b>68.5</b>	<b>72.0</b>	<b>75.6</b>	<b>79.1</b>	<b>82.4</b>	<b>0.4</b>	
<b>Key Macroeconomic Assumptions Underlying Baseline</b>						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	1.6	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 deflator).

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 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 consultation<sup>1</sup> 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

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<sup>1</sup>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. Due to the COVID-19 pandemic, the 2021 discussions were carried out virtually.

standing nearly 40 percent below its pre-pandemic level. Gross reserves are well below the recommended adequacy range, and net international reserves are negative once foreign exchange swaps with the central bank are subtracted. Lira depreciation also added to non-financial corporate and bank balance sheet strains.

Amid heightened uncertainty and increased vulnerabilities, GDP growth is expected to be strong this year, but downside risks have increased. Mainly reflecting a large positive carryover from the sharp activity rebound in the second half of 2020, growth should reach about 5¾ percent this year, before returning to a lower trend from 2022 onwards. Inflation is expected to remain high, and reserves to decline further. With high external financing needs, sizeable domestic foreign exchange deposits, and low reserve buffers, the economy remains vulnerable to shocks and to changes in sentiment at home and abroad. Domestic risks include a premature relaxation of monetary and credit policies or other policy missteps that further erode credibility and buffers. External risks include interest rate increases in advanced economies and higher global risk aversion that could expose vulnerabilities. Other risks include vaccination delays and adverse geopolitical developments.

### **Executive Board Assessment<sup>2</sup>**

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<sup>2</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.IMF.org/external/np/sec/misc/qualifiers.htm>.

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

Population (2020): 84.2 million								
Per capita GDP (2020): US\$8,505								
Quota: SDR 4,658.6 million								
	2019	2020	2021	2022	2023	2024	2025	2026
						Proj.		
<b>Real sector</b>	<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>							
<b>Fiscal sector</b>								
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	39.7	40.2	41.5	43.4	44.6	45.6	46.5
<b>External sector</b>								
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
<b>Monetary conditions</b>	<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.