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May 25, 2021

**Statement by Ms. Riach and Ms. Campbell on Turkey
(Preliminary)
Executive Board Meeting
May 27, 2021**

We thank staff for a clear set of papers and Mr Azal and Mr Dogan for their informative Buff. We strongly agree with the main elements of the report and with the recommendations. We agree with the recommendation for firmer monetary and fiscal policy, whilst also ensuring targeted economic support for the most vulnerable. We encourage the authorities not to shy away from the tough decisions and trade-offs necessary to tackle macroeconomic and financial vulnerabilities, boost resilience and deliver sustainable growth in the medium term. We strongly agree with staff's assessment that the medium and long-term benefits of a rebalanced policy framework outweigh any near-term costs.

The authorities' initial and quick response to Covid-19 through monetary and credit expansion and liquidity support helped to mitigate economic fallout from the pandemic, as demonstrated by positive economic growth of 0.3% in 2020. However, we agree with staff's assessment that this policy response also came with significant costs and exacerbated pre-existing vulnerabilities in Turkey's economy. Even before the crisis the need for Turkey to transition to focus on higher and more resilient medium-term growth with lower internal and external imbalances was acute. Covid-19 policies worked in the opposite direction and led to higher inflation, increased dollarization, a negative shift in the current account position and more reliance on external debt financing and demand stimulus.

Looking ahead, we agree on the need to deliver a restrictive monetary policy in order to bring both inflation and the external deficit down and to maintain stability in the banking system. It is therefore reassuring that the authorities agreed with the need to deliver a firm monetary stance and credit tightening. However, we have concerns around implementation given the President's recent decision to dismiss one of the central bank deputy governors - the third senior official to be dismissed in two months. With inflation driven primarily by expectations, this underscores the need to establish meaningful and credible central bank independence. *Do staff believe that all the various institutions*

currently affecting monetary policy in Turkey (current central bank leadership, government ministers and the presidential administration) are convinced of the need for tighter monetary policy and are committed to implement it even at the cost of a sharp slowdown in economic growth? Market participants and local residents (as shown by their reluctance to shift deposits back from dollars to local currency) appear sceptical. **More generally we strongly agree with staff that targeted institutional reforms are needed to strengthen central bank independence which is a prerequisite for price stability and policy credibility.**

We agree with staff's assessment on the financial sector that credit growth should be reined in and balance sheets strengthened. The authorities' request for the FSAP to be brought forward to later this year is extremely helpful. We encourage the authorities to commission a third-party asset quality review to complement their own review and broader supervisory framework. This will help the authorities to better understand and strengthen bank health. This is particularly important in the context of increased dollarization of deposits and the use of state-owned banks as drivers of credit growth. This could represent a source of risk in a future stress scenario with potential adverse consequences for public finances if extra public support were needed to support state-owned banks. Relatedly, in the discussion of risks [pg 18, and Annex 1] there is no mention of the risk that depositors may seek to withdraw some of their FX deposits from the banking system. With the increase dollarization of deposits this, rather than risks related to rollover of foreign lending, would seem to be the major risk facing the banking system. *Do staff agree with this assessment?*

With a needed tightening in the monetary stance and slower credit growth, we encourage the authorities to prioritise available fiscal space to provide additional support to those most affected by the pandemic and to minimize scarring, rather than to frontload fiscal consolidation. Turkey's relatively low spending rate (c 2% of GDP) compared to other emerging markets for direct support to households, firms, employees and healthcare, and the stronger than expected government revenues suggests that there is more room for support for those most affected by Covid-19. We agree with the authorities that it very important to communicate a credible and detailed fiscal consolidation plan early, but we agree with staff that this should only be enacted when the post pandemic recovery is entrenched.

We agree that the scope and role of extra-budgetary funds and other non-central government entities should be carefully monitored. We support staff's recommendation for investment and borrowing by the Turkey Wealth Fund to be integrated into the budget and its financial statements audited by the Court of Accounts and governance framework refined to limit potential conflict of interest. However, we would have welcomed further coverage of tools taken off-budget and a recommendation for greater transparency of public and central bank finances more broadly. Increased transparency would help the authorities counter allegations of stolen funds (e.g. recent reports of the "missing" \$128bn of Central Bank funds) which damage public confidence in the institutions further. Relatedly we welcome Mr Azal and Mr Dogan's confirmation in their buff that the authorities are unequivocally determined to combat money laundering and the financing of terrorism. Transparency could be further enhanced by publishing the names of companies awarded pandemic procurement contracts and beneficial ownership information.

Turkey is particularly exposed to changes in global financing conditions, due to the large current account deficit, high external debt level, and associated need to rollover high levels of maturing dollar-denominated debt. The recommendations in this report would clearly improve fundamentals and reduce this exposure. The analysis in this April's Global Financial Stability Report (GFSR) on the vulnerabilities of emerging markets to a tightening of global financial conditions, for example if a persistent rise in US rates brings about a repricing of risk, further emphasizes the importance of the authorities taking tough decisions now to tackle macroeconomic and financial vulnerabilities, boost resilience and deliver sustainable growth in the medium term.