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January 13, 2023

**Statement by Ms. Shortino and Mr. Sturm on Turkey
(Preliminary)
Executive Board Meeting
January 18, 2023**

We thank staff for their comprehensive reports and Mr. Mert and Mr. Akben for their Buff statement. The adoption of the Türkiye Economic Model (TEM) has supported near-term growth at the expense of economic and financial stability, exacerbating inflation and spurring a depreciation of the lira that has far outpaced emerging market peers. High inflation, distortive credit allocation, low reserves, and rising financial vulnerabilities raise major concerns about economic sustainability. The authorities will need a coordinated and much tighter policy mix to reduce rising medium-term vulnerabilities. **We broadly agree with staff advice and offer the following comments for emphasis.**

We strongly agree with staff that a U-turn on monetary policy is needed. Türkiye's high inflation is driven by excessively loose monetary policy and the resulting exchange rate depreciation and shifting inflation expectations. As the report notes, the CBRT's ad hoc regulatory measures have had some effect in reducing credit growth, but we agree with staff that such measures are not sufficient to constitute policy tightening, which poses issues for central bank credibility and calls into question central bank independence. Staff rightly highlight in Box 2 that high inflation disproportionately harms poorer segments of society with consumption baskets tilted toward essential goods amid limited ability to hold wealth in asset classes that see strong real returns. We also note that particularly steep inflation in investment goods relative to consumer goods can discourage investment, in turn inhibiting the reorientation of growth toward a more sustainable path. Therefore, we strongly echo staff's call for a policy shift toward higher policy rates to help to contain inflation. Moreover, we urge the authorities to swiftly restore interest rates as the main instrument of monetary policy transmission. Policy rate tightening would create room for a gradual phaseout of the complex array of macrofinancial and regulatory measures that has clouded the transmission of monetary policy, obscured the pricing of risk, and could ultimately crowd out investment. Raising interest rates, as the main monetary policy instrument, would help rebuild policy credibility and reduce the risks of inflation expectations resetting at ever-higher levels.

We welcome the authorities' plans to maintain fiscal discipline. While public debt remains low, we are reassured to see an ongoing commitment to fiscal discipline, which would avoid further exacerbating the stimulative stance of monetary policy. We agree with staff's concerns about the rise in contingent liabilities, including from FX-protected deposits, in the context of high external financing needs and a large share of FX in public debt. In this context, we fully support staff's call for fiscal governance reforms. As in other countries, the authorities should work to eliminate subsidies, including for natural gas, and provide targeted support for vulnerable households in a phased and carefully communicated manner.

Spillovers from Russia's war against Ukraine have exacerbated Türkiye's external vulnerability with a further widening of the current account deficit. We understand that TEM sought to close Türkiye's current account deficit out of concern about reliance on capital flow financing. However, the deficit instead widened sharply over the past year. We echo staff messages that while the shock to global energy prices explains much of the deterioration, high inflation has eroded gains to competitiveness, hindering improvement in the current account even excluding energy imports. Furthermore, we are concerned by the low levels of available reserves and agree with staff on the need to address negative net reserves. It is remarkable that net errors and omissions have steadily increased in the balance of payments to the point that they cover more than 65 percent of the current account deficit in 2022 YTD. While predictably large net errors and omissions inflows may mitigate risks of a balance of payments crisis by limiting the drawdown of reserves, the situation may not be sustainable in the long term. *Do staff see any gaps in data collection that could be addressed through IMF technical assistance, given that high net errors and omissions has become a consistent pattern? Do staff have any broader concerns about the quality of data?*

We note with concern that the authorities cite the Fund's work on Integrated Policy Framework (IPF) as a justification for their unorthodox policies. While we appreciate staff's clear stance that IPF policies are not suitable to achieve disinflation and are not a good substitute for interest rate hikes, we believe the Fund needs to more effectively communicate that IPF tools should not substitute for warranted macroeconomic adjustment. We welcome that staff clearly call for the discontinuation of the export surrender requirement, an existing capital flow measure (CFM) in line with the Fund's Institutional View (IV).

We share staff's concerns that regulatory forbearance and non-performing loans are a key area to watch going forward for signs of financial instability. Further, we agree on the importance of Türkiye taking steps to strengthen its AML/CFT framework.

We fully support staff's view that carefully implemented structural reforms to increase growth potential offers a superior growth path over continued demand stimulus. We echo staff's priorities for structural reforms including measures to improve the business and regulatory environment, promote labor market flexibility, develop the quality of human capital, and increase the size of Türkiye's labor force through higher female participation. We are pleased to see the authorities' receptiveness to further work on gender and climate issues, including through collaboration with international organizations, which can help improve economic competitiveness and resiliency over the medium term. We underscore the importance of closing gender gaps in the labor market, as highlighted in the Selected Issues Paper, with Türkiye's labor force participation (LFP) gender gap among the largest in the G20 and significantly higher than other emerging markets. Staff emphasize that Türkiye's

LFP gender gap is driven by less skilled workers. *Could staff elaborate on other metrics, beyond education, that would be a measure of “skill” and help inform possible structural reforms?*