GRAY/23/3467

January 13, 2023

Statement by Mr. Trott and Ms. Campbell on Turkey
(Preliminary)
Executive Board Meeting
January 18, 2023

We thank staff for a clear set of papers and Mr Mert and Mr Akben for their informative Buff. We agree with the main elements of the report and with the recommendations. We strongly agree with the general tone of the report that the present policy approach is unsustainable. Notwithstanding the remarkable recovery from the pandemic, the increasingly complex policy interventions introduced under the new framework for economic policy ("TEM") are eroding the previous strengths of the Turkish economy (healthy public finances, resilient banking system) without helping to address its long-standing macroeconomic vulnerabilities (the weak external payments positions and high inflation). **We therefore agree with staff that a quick reversal from the existing monetary policy approach and winding down of complex and distortionary macroprudential measures are essential steps in turning the economy's trajectory around.**

We agree with staff's assessment on the financial sector that macrofinancial and regulatory measures should be phased out carefully, prudential standards strengthened and systemic FX liquidity risks closely monitored. Financial repression has become widespread and removal of these measures should happen as soon as possible without compromising financial stability. We highlight that this could happen more quickly if monetary policy was tightened and if this had the intended impact to lower inflation. The current heterodox approach is triply damaging – it fails to control inflation, undermines policy credibility, heightens capital flow risks and requires complex and damaging regulatory measures to limit impacts on exchange rate and capital flows.

We welcome the analysis provided in the FSAP report and we continue to 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. Separately, we understand that banks have increased their local currency deposit rates in order to avoid the regulatory obligations to increase their holdings of low yielding local currency sovereign bonds. It appears that this has caused deposit rates recently to rise above rates on commercial loans which does raise issues about the long-term health of the banking sector. *Staff comments welcome.*

The recommendations in this report would clearly improve fundamentals and reduce the significant exposure to changes in global financial conditions given the large current account deficit, high external debt level, and associated need to rollover high levels of maturing dollar-denominated debt. The vulnerabilities of emerging markets generally to a tightening of global financial conditions further emphasizes the importance of the authorities taking decisions now to tackle macroeconomic and financial vulnerabilities, boost resilience and deliver sustainable growth in the medium term. We would also be interested in staff views on the sources of finance (building on the box on errors and omissions) for the external deficit and the composition of CBRT reserves. There is currently a market perception that much of the recent rise in reserves is due to a combination of inflows which may prove to be unreliable in a stress and/or be dependent on the state of bilateral political relations.

We agree that a tight fiscal stance combined with targeted measures to support the vulnerable would preserve fiscal space to deal with future shocks. The debt burden remains low but fiscal space is being eroded by rising spending pressures, higher contingent liabilities, quasi-fiscal risks and large debt exposures to FX shocks in an environment of a weak external position. We note that in contrast to a limited budget deficit in 2022, additional spending measures were announced shortly after parliamentary approval of the 2023 Central Government Budget, where a significant budget deficit was already forecast. These measures included above-inflation wage hikes, an early retirement scheme that allows more than 2 million employees to retire, a credit expansion package for businesses, and a new housing scheme for middle-income earners. As the election approaches, it's expected that the size and scope of these measures will increase. *Could staff comment on the risks associated with this including storing up vulnerabilities for the private sector?*

Finally, we welcome the analysis in the Selected Issues chapter on Labor Market Gender Gaps given the issue's importance to growth and inclusion. We commend the authorities for the steps taken already to develop its gender budgeting framework and would encourage focus on this in future discussions and reports. Additionally, we would emphasize the existence and strength of non-economic barriers to female participation in the labor force (e.g. views on the roles of men and women in households and family life). Any further assessment of policy design should take these into account to help determine whether desired outcomes can be achieved through only economic interventions, or if other measures would be needed to incentivize change.