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

**We thank staff for its insightful report and Mr. Mert and Mr. Akben for their helpful Buff statement.** The Turkish economy has made a remarkable recovery, with GDP significantly above its pre-pandemic trend and the unemployment rate back to historical averages. Yet, the credit-driven growth has exacerbated already-large vulnerabilities and macroeconomic imbalances. The introduction of the new Turkey Economic Model in late 2021, relying on low interest rates, led to significant market pressure on the Lira. While large foreign exchange interventions and macrofinancial as well as regulatory measures reduced exchange rate volatility, inflation has accelerated sharply. In October 2022, inflation reached a 24-year high of 85 percent. Aggravated by Russia's war of aggression against Ukraine, the external position has further weakened. Despite increasing in recent months, reserve buffers remain low while financing of the external deficit mostly relies on unidentified sources going forward.

**We agree with staff's assessment that the policy stance is too loose.** Deeply negative (real) interest rates, still high credit growth and recent fiscal measures drive the positive output gap at the expense of macroeconomic stability. Pro-growth policies ahead of the elections pose the risk of further exacerbating the existing imbalances. We therefore call on the authorities to refrain from additional demand-stimulating policies. A tight fiscal stance is needed while support should be targeted to the most vulnerable. In that regard, we support staff's call for a phasing out of the FX-protected deposit scheme, given potentially unbounded fiscal liabilities in the event of a sharp lira depreciation.

**We want to emphasize the necessity of a tight monetary policy stance to rein in inflation and to reduce vulnerabilities.** Therefore, we encourage the authorities to return to a credible inflation-targeting regime and support staff's call for prompt, sizeable and credible policy rate hikes. To ensure

credibility, rate hikes should be complemented by policies to strengthen central bank independence. This includes a review of the arrangements for appointing and replacing senior central bank officials.

**We support staff's call for carefully phasing out the existing unorthodox macrofinancial and regulatory measures.** While the policy rate should be the primary monetary policy instrument, authorities instead steer credit growth through a complex set of macroprudential policies, banking regulations and liquidity-management measures. We agree with staff's assessment that these measures have distorted price formation and capital allocation while risks for banks have increased. Furthermore, we concur with staff's call for the authorities to reduce their outsized role in credit provision, especially via state banks and the Credit Guarantee Fund.

**We agree with staff's assessment that the financial stability risks are high and rising, stemming also from a strong FX liquidity nexus between the Central Bank (CBRT) and commercial banks.** To close a mismatch on their balance sheets, banks have swapped FX against Lira liquidity with the CBRT and hold sizeable FX deposits with the CBRT. Given that more than half of banks' FX liquid assets are held at the CBRT and more than three quarters of the CBRT's reserve liabilities are now owed to domestic banks, we encourage authorities to closely monitor systemic FX liquidity risks.