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January 13, 2023

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

We thank staff for the rich set of reports and Mr. Mert and Mr. Akben for their helpful Buff statement. Driven by strong consumption and net exports under sturdy stimulative policies, the economy benefited from a robust post-COVID-19 recovery, which was also reflected in solid employment growth. Nevertheless, measures focused on excessively loose monetary policy increased existing vulnerabilities, which were further exacerbated by the spillovers from Russia's war in Ukraine. This policy approach led to substantial market pressure on the lira, falling reserves, increased dollarization, and sharp acceleration of inflation, which reached multi-decade highs. Given the risks of high inflation becoming entrenched, and rising economic distortions, the authorities' policy response should aim at tightening to put inflation on a sustainable decelerating path and rebuild buffers. **We are in broad agreement with staff's analysis and recommendations** and would like to make a few points for emphasis.

**The authorities should reconsider the current accommodative policy stance, which is detrimental for inflation and deepens the prevailing weaknesses.** We commend the authorities' efforts to support growth momentum propelled by the recovery from the pandemic. However, outsized monetary stimulus in an environment of already high inflation and ongoing global tightening has put additional pressure on inflation and imposed large economic costs. Moreover, the regulatory measures to contain credit growth proved to be distortionary and costly. We agree with staff that the authorities should reinstate interest rates as the primary monetary policy instrument and that prompt tightening of monetary policy will be key to rein in inflation, rebuild buffers and contain vulnerabilities. While this might be detrimental to near-term growth, growth in the long run will be stronger and more sustainable, underpinned by low interest rates and inflation and stronger buffers. The increase in the policy rate should be supplemented by measures to enhance the independence of the central bank, including its financial autonomy.

**To promote stronger and more inclusive growth, the authorities should step up their efforts to implement the structural reforms.** We share staff's view that the policy tightening should be accompanied by supply side reforms to promote competitiveness, exports and increase growth

potential. The latter could significantly benefit from implementation of reforms leading to higher productivity, such as enhancing labor market participation, including through closing gender gaps, and improving governance as well as the business and regulatory environment.

**Fiscal policies should focus on enhancing fiscal sustainability, minimizing quasi-fiscal risks, and preserving debt sustainability.** We commend the authorities' strong commitment to fiscal discipline, and we note the difference in views between the authorities and staff on materialization of spending pressures. *Staff's comments on the divergent assessments of potential spending increase are welcome.* Further actions will be key to enhance fiscal sustainability, including through removing energy subsidies while ensuring better-targeted support to the vulnerable, and addressing fiscal risks, in particular phasing out FX-protected deposit schemes. While public debt remains low and sustainable, we see scope in further monitoring the rise in contingent liabilities, and limiting the quasi-fiscal risks stemming from PPPs, SOEs and state-owned banks.

**We call on the authorities to reduce the role of the state in credit allocation, and to address the risks in the financial sector.** Macroprudential policies, banking regulations and liquidity-management measures have lately driven credit allocation, rather than market forces. Regrettably, this has distorted price formation and credit allocation, increasing the risks for the banking system. We agree that the role of the state in credit provision should be minimized, and we advocate a gradual removing of the measures to contain credit growth. In this regard, we encourage the authorities to meticulously prepare the exit strategy to mitigate likely risks and costs. *We invite staff to elaborate on estimated costs stemming from phasing out the above measures.* It is also worrisome that the capital adequacy ratios might be overstated. We welcome the 2022 FSAP and encourage the authorities to implement its recommendations diligently, in particular the timely recognition of loan losses, monitoring of restructured loans and carrying out of an independent third-party asset quality review, as well as close monitoring of FX liquidity. *Can staff elaborate on the authorities' strategy to implement the 2022 FSAP recommendations?* We welcome the progress in addressing the AML/CFT risks, including those linked to crypto assets. Additional steps are required to address the remaining weaknesses in the AML/CFT framework and fully implement the FATF action plan.

**We encourage the authorities to accelerate reforms to enhance climate resilience.** We welcome the authorities' announcement of more ambitious emission level reductions before 2030 as stated in their updated Nationally Determined Contribution, and we encourage them to explore ways to further implement the policy priorities to meet the country's climate goals, as identified in the 2022 CCDR produced by the World Bank. We also welcome staff's recommendation to combine the ETS with a robust price floor to encourage private investment and to auction emissions to raise revenue. Furthermore, we encourage the timely implementation of carbon pricing, especially considering the consequences of the implementation of CBAM in 2026. *Could staff elaborate on the consequences of CBAM for Türkiye without a timely implementation of carbon pricing? Additionally, could staff clarify whether there are any options for fiscal stimulus for emission reductions other than carbon pricing?* We agree with staff's analysis that there is a need to decarbonize Türkiye's carbon-intensive industries. According to the IEA, the country is still very dependent on fossil fuels and their imports for its energy supply. *Could staff elaborate on the risks of this dependency and whether the dependency on the imports of fossil fuels has been affected by the war in Ukraine and the energy crisis?* Staff notes that more frequent natural disasters are a risk for Türkiye as droughts could pose challenges for the country. In its 2021 report, the IPCC concluded that Türkiye would experience three accelerating trends: rising temperatures, dehydration, and rising sea levels. In the next Article IV, we

would welcome a more in-depth overview of physical risks of climate change and possible adaptation measures.