FOR

AGENDA

SM/13/290
Correction 1

November 19, 2013

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Turkey—Selected Issues**

The attached corrections to SM/13/290 (11/6/13) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 13, para. 1, lines 6 and 7: for "banks can convert up to 60 percent of their reserve requirements into FX and up to 30 percent into gold with the ROCs ranging from 1.4 to 2.8." read "banks can convert up to 60 percent of their reserve requirements into FX with ROCs ranging from 1.4 to 2.8 and up to 30 percent into gold with the ROCs ranging from 1.4 to 2.5."

Page 20, para. 6, line 8: for "-1.7 percent" read "-1.8 percent"

Page 30, para. 4, line 4: for "during 2000-2005 to less than 3 percent in 2012" read "during 2000-2002 to 3½ percent in 2012"

Page 33, para. 14, line 2: for "In late 2011" read "From the beginning of 2012,"

Page 34, para. 18, line 5: for "more than 100,000" read" approximately 100,000"

Page 47, para. 1, line 4: for "from 0.3 to 5.5 percent" read "from 0.3 to 5.8 percent"

Evident Ambiguity

Page 31, para. 7, line 16 and 17: for "capital spending grew" read "budgetary capital spending grew"

Page 35, para. 20, lines 6 and 7: for "social security institutions to finance their deficits grew from" read "social security institutions grew from"

Typographical Errors

Page 33, para. 15, line 2: for "but typically they typically end-up" read "but typically they end up"

Page 34, para. 18, line 4: for "on top on salaries" read "on top of salaries"

Page 43, para. 43, first bullet, line 3: for "will be better align with" read "will be better aligned with"

Page 43, para. 43, third bullet, line 2: for "should not growth beyond" read "should not grow beyond"

Questions may be referred to Mr. Miniane, EUR (ext. 38791), Mr. Tchaidze (ext. 36603) and Ms. Tambuniertchai (ext. 34033) in SPR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (9)

Other Distribution:
Department Heads

CBRT'S RESERVE OPTION MECHANISM[1]

1.   In late 2011, the Central Bank of Turkey (CBRT) introduced a new tool into its continuously evolving monetary framework—the Reserve Option Mechanism (ROM). The ROM allows commercial banks to meet their reserve requirements on lira-denominated liabilities by using foreign exchange and gold. Conversion happens at the market exchange rate times a mark-up penalty parameter, the Reserve Option Coefficient (ROC), introduced in May of 2012. Currently, banks can convert up to 60 percent of their reserve requirements into FX with ROCs ranging from 1.4 to 2.8 and up to 30 percent into gold with the ROCs ranging from 1.4 to 2.5.

A.   Motivation and Mechanics

2.   The ROM was to help increase the resilience of the economy against external finance shocks and achieve financial stability by (i) limiting fluctuations in the exchange rate; (ii) limiting conversion of FX inflows into bank lending; and (iii) incentivizing banks to accumulate FX for "a rainy day." While an externality rather than a goal, the ROM also helped banks reduce costs of fulfilling regulatory obligations. Finally, being a market-driven facility, it was to help the CBRT do away with perceptions of it targeting the exchange rate.

3.   The ROM was designed so that with strong inflows, banks would voluntarily increase use of the ROM facility, redirecting inflows into the facility, releasing lira and countering appreciation pressures, while the opposite would happen during outflows.

- Alper et al (2012) and Küçüksaraç and Özel (2012) describe an optimization problem that banks face, as they choose to what extent to utilize the ROM facility. They show that given current costs of TL and FX liquidity, current and expected exchange rate, as well as the reserve requirement ratios on FX-denominated liabilities, one can derive a break-even ROC, at which banks would be indifferent between meeting their reserve requirements on lira-denominated liabilities by depositing liras or FX. Thus, a bank would utilize—i.e,. deposit FX in lieu of liras—all those tranches of the ROM, for which the corresponding ROCs are less than the break-even ROC and deposit lira to meet the remaining reserve requirements.

- This break-even ROC increases (inducing a bank to rely more on FX) when the cost of lira funding increases, lira appreciates or is expected to depreciate. Similarly, it increases when the cost of FX liquidity decreases or when reserve requirement ratio on FX-denominated liabilities decreases. As these variables change, banks choose to utilize the ROM more or less, releasing FX from the ROM or placing it into the facility, mitigating pressures on lira to depreciate or appreciate.

---

[1] Prepared by Robert Tchaidze.

- In particular, during periods of strong inflows, costs of FX liquidity decline and quantity constraints become less binding. Thus, the break-even ROC increases and banks voluntarily increase use of the ROM facility, being able to meet the required reserves at a lower cost. This redirects inflows into the ROM facility and releases lira, previously locked in the central bank, countering appreciation pressures and limiting conversion of the inflows into bank lending, as long as the marginal ROC is greater than 1.

- Likewise, when inflows weaken, costs of FX liquidity increase and quantity constraints become more binding. This leads to a decline in the break-even ROC, a fall in the ROM utilization rates, release of the FX liquidity back into the system, and a reduction of the lira liquidity in the system as it is being placed back into the central bank to meet the reserve requirements.[2] Altogether, this limits the depreciation pressures and lowers possibility of a credit squeeze.[3]

4.   Thus, the ROM induces banks to voluntarily accumulate FX at the central bank, reducing their dependence on currency swap contracts, which have been commonly used to convert banks' FX funds into the TL liquidity, used to extend domestic loans. Instead, banks effectively "swap" FX into lira with the central bank as a counterpart.
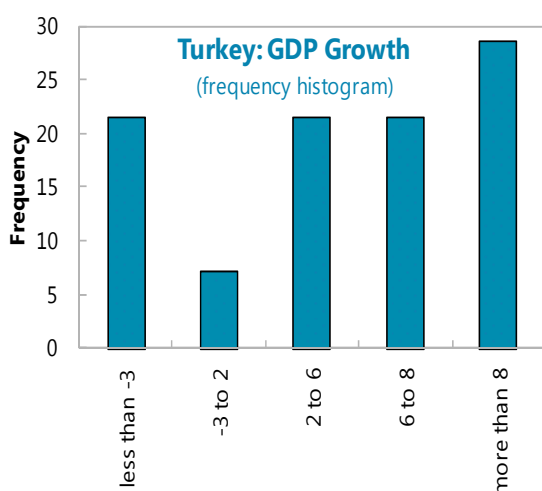
5.   According to the CBRT, the ROM is superior to other tools that a central bank could use when dealing with volatile capital flows. The ROM works in a fashion similar to FX interventions, redirecting inflows into the central bank's vaults, yet is more powerful as long as the effective ROC is greater than 1. It impacts banks as an increase in the reserve requirement ratios on FX liabilities would, but allows banks, short of FX, to avoid being unduly penalized, compared to banks with sufficient FX liquidity. Finally, while the ROM has no impact on net international reserves, it boosts gross reserves during inflows, which could be used to mitigate the BOP pressures during outflows.

6.   The key difference is that FX interventions, changes to the reserve requirement ratios, etc reflect decisions undertaken by the monetary authorities. Hence, they may lead to various interpretations of the motives behind these actions (such as targeting a certain exchange rate level), while utilization of the ROM reflects voluntary decisions by individual commercial banks, and thus, is driven by market forces.[4] Thus, having the ROM in place could make it easier for a central bank to communicate its objectives and actions to market participants concentrate on its other objectives, such as inflation.
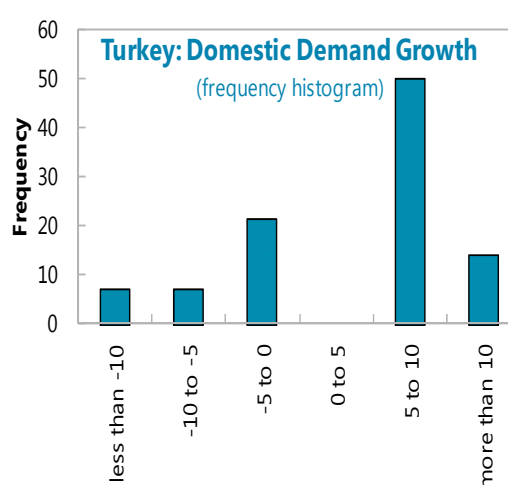
---

[2] This is assuming the amount and structure of banks' lira liabilities have not changed.

[3] Note that the automatic stabilization feature of the ROM works as long as banks are not using the facility to the full extent, known as the reserve option ratio, ROR.

[4] For the same reasons, the ROM would not run the risk of provoking speculative FX demand.

Source: Haver; WEO; IMF staff calculations.

Source: Haver; WEO; IMF staff calculations.

3.   Given these numbers, it should come as no surprise that Turkey has one of the most volatile growth patterns of any large country.[3] The standard deviation of output or domestic demand growth in Turkey has been about twice the average in the G-20+Poland space, and this is true whether one looks at all the countries in that group or solely at Turkey's emerging market peers.[4] In fact, only Argentina has shown itself to be more volatile than Turkey over this period.

Standard Deviation of Output

Turkey	5.27
Peers - Average	2.78
Peers - Highest	6.55
Peers - Lowest	1.49

Source: Haver; WEO; IMF staff calculations.

4.   An important reason behind Turkey's high volatility is its dependence on capital inflows for growth. In a study on Turkey's low savings problem, IMF (2012a) argued at length that Turkey's low national savings meant that, at the margin, investment is financed via foreign savings. When capital inflows are ample, investment expands rapidly, and when capital inflows dry up investment goes into reverse, dragging the economy down with it. Several things seem to confirm this view: (i) on average over the period under study, Turkey has had the second lowest savings rate of any large emerging country, some 10 percentage points of GDP lower than the peer average; (ii) Turkey has suffered the largest decline in its savings rate of any country in the G-20+Poland

---

[3] We focus on the G-20+Poland group as it is well known that small countries are by nature more volatile, and hence do not provide a valid reference point for the purposes of this discussion.

[4] The peer group is comprised of Argentina, Brazil, China, India, Indonesia, Korea, Mexico, Poland, Russia, and South Africa.

space over this period; (iii) the correlation between economic growth and capital flows is higher in Turkey than in any other country in this group, by far. This correlation is 80 percent.

<div align="center">

Correlation - Capital Flows and Growth[1]

Turkey	0.79
Peers - Average	0.18
Peers - Highest	0.61
Peers - Lowest	-0.29

</div>

Source: Haver; WEO; IMF staff calculations.
[1] Correlation between the change in net capital plus financial account flows (including changes in foreign reserves) measured a a share of GDP, and GDP growth.

5.   Not only is Turkey dependent on foreign savings, but in addition capital flows to Turkey have been more volatile than to other countries. The year-to-year absolute change in net capital inflows has averaged close to 3 percent of GDP over the last fifteen years. This compares with a G-20+Poland average of 1.7 percent, and a peer average of 2 percent. Only Russia and Argentina have experienced more volatile net inflows. This begs the question why. One possible explanation is that Turkey has traditionally relied on less stable sources of foreign funding. For example, inward FDI has been below that in peer countries (IMF, 2012b), and in recent years the bulk of the current account deficit has been financed via short-term external debt and portfolio inflows, what is traditionally called "hot money." Another explanation can be found in IMF (2013), which shows that countries which are "more resilient" to capital flows tend to show high co-movement between gross inflows and gross outflows; in periods of large inflows (outflows) by non-residents, outflows (inflows) by residents are large enough to offset their impact, resulting in small net inflows (outflows). This is not the case in Turkey: in fact, Turkey has one of the lowest co-variances between the current account and gross inflows of any country in the forty four country sample in the study, and the lowest among all large emerging countries.

6.   However, the low savings-volatile inflows nexus, although key, is not the only factor behind high output volatility in Turkey. To start, some countries with saving rates similar to Turkey's such as Brazil, Poland, and South Africa, have suffered significantly less output volatility–though here one should note that capital inflows to these countries have been significantly less volatile than flows into Turkey.[5] Moreover, there have been years that do not fit the lower inflows-lower growth pattern: to give but one example, GDP growth slowed sharply between 2011 and 2012, from 8.8 percent to 2.2 percent (domestic demand growth went from 9.5 percent to -1.8 percent) yet net inflows increased in 2012 relative to 2011, albeit slightly. Finally, there is the non-trivial issue of causality: in 2001 capital outflows coincided with a growth collapse in Turkey, but only a fraction of the decline in net capital inflows was truly exogenous (driven by the burst in the United States of the IT bubble); in good part, capital flew out of the country as a reaction to

---

[5] This is partly due to the composition of the flows, for example a much higher share of FDI in total inflows in Poland.

BUDGET RIGIDITIES IN TURKEY[1]

A. Introduction

1.   Budget flexibility is critical to sustain fiscal gains achieved in the past ten years. With revenues strongly dependent on growth (i.e. domestic demand and imports) and the composition of primary spending titled towards increasing mandatory spending, the room for fiscal maneuver has been reduced. The government's capacity to carry out priorities stated in the medium-term budgetary framework and allocate resources accordingly in an efficient manner can be affected by growing expenditure rigidities. This loss of flexibility in the composition of expenditures could jeopardize the capacity of fiscal policy to react nimbly to macroeconomic shocks, which could result in a persistent increase in expenditures and pressures on public debt. Finally, rigid expenditures affect the quality of fiscal adjustments by generating a bias towards under-investing in infrastructure, which hampers competitiveness, capital accumulation and a higher potential output.

2.   Greater budget flexibility appears warranted in Turkey to secure the role of fiscal policy in aggregate demand management and its contribution to higher national savings. Although the optimal level of budget flexibility is a matter of debate, from a normative perspective some degree of budget rigidity may be desirable so that some budget categories remain immune to short-term contingencies. Budget rigidity can then be understood as a mechanism permitting to isolate these budget categories from annual budget discussions, and promote a solid commitment by the government to fulfill these obligations. Yet, when budget rigidities are major— or growing at a rapid pace as in the case of Turkey—this argument losses power and encounters several objections. First, it is possible that some of the rigid expenditure categories are not an actual priority, and that their rigidity reflects just the power of interest groups. Second, even if dealing with priority expenditures, there is still the need to react to unexpected events that may justify turning away from previous commitments in favor of more pressing objectives. Third, large expenditure rigidities add considerable complexity to the budgeting process with the resulting loss in credibility due to increasing challenges to secure fiscal discipline. For all these reasons, the budget should remain flexible to be able to accommodate to potential shocks, while achieving the fiscal targets set in the medium-term budgetary framework.

3.   This paper assesses the change in composition of public expenditures in Turkey during the last decade (section B), reviews the major sources of expenditure rigidities at the central government (section C), and discusses the impact of expenditure rigidities on the effectiveness of the medium-term budgetary framework to secure fiscal discipline (section D). Finally, it suggests potential ways to reduce expenditure rigidities while fostering fiscal discipline (section E).

---

[1] Prepared by Isabel Rial.

B. The Changing Composition of Public Expenditure

4.   Turkey's fiscal effort over the last ten years brought about an impressive reduction in debt and interest costs. In little more than a decade general government gross debt was cut by half—from almost 80 to 40 percent of GDP by end 2012—reducing the fiscal burden in interest payments from 15 percent of GDP on average during 2000–2002 to 3½ percent in 2012 (Figure 1). Fiscal risks arising from the currency composition of public debt were also reduced, with the share general government debt denominated in foreign currency plunging from 43 percent of GDP to less than 11 percent by 2012.

5.   The fiscal space generated by lower interest costs was rapidly filled-in by higher primary expenditures, keeping public savings at low levels. After an impressive consolidation effort in 2002–2004, primary expenditure returned gradually to previous levels by 2008, and public saving-to-GDP ratio remained close to zero (Figure 2).[2] By 2009, the fiscal stimulus implemented during the global financial crisis pushed primary spending to historically high levels. Thereafter, reducing primary spending has proved challenging, despite several attempts as stated in subsequent medium-term fiscal plans. As a result, public savings has remained at very low levels throughout the whole period.

6.   The increasing trend of primary spending points to new budget rigidities. Past gains in terms of budget flexibility from lower interest costs were rapidly lost due to increasing pressures in categories of spending also rigid in the short-term, mainly compensation to employees and transfers to social security institutions (Figure 3). After a big fiscal effort at the beginning of the decade total expenditures remained subdued growing only by 0.7 pp of GDP between 2005 and 2012. While interest payments dropped by 3.6 pp

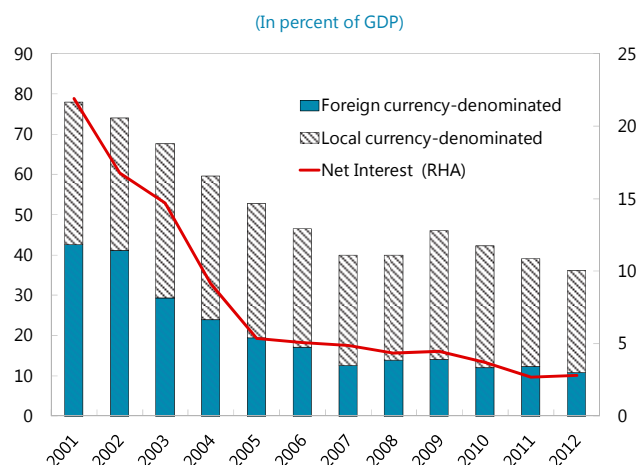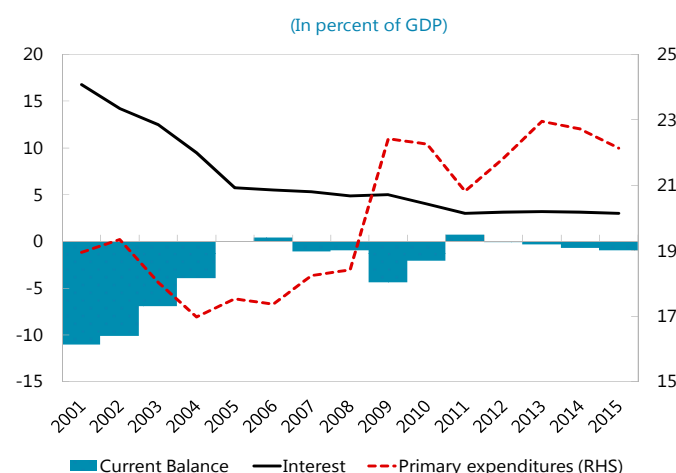**Figure 1. General Government Gross Debt and Net Interest**

(In percent of GDP)

Figure 2. Central Gov. Expenditure and Current Balance

(In percent of GDP)

---

[2] Public savings is approximated by the central government current balance, which is the difference between total revenue and total expenditures, excluding capital.

of GDP, the wage bill increased from ¼ to almost ⅓ of the total spending, while transfers to the social security institutions and subnational governments showed a similar path.

7.   A more rigid composition of primary spending is a source of budgetary and macroeconomic concerns. It reduces the government's capacity to adjust fiscal aggregates to changing macroeconomic environments, and ultimately to achieve a higher level of public savings. Moreover, it reduces the quality of fiscal consolidation efforts by generating a bias towards under-investing in infrastructure and lower growth. Indeed, despite Turkey's low public investment level relative to other developing economies, budgetary capital spending grew only by 1.0 pp of GDP in the last six years, and keeps on being the more volatile category of spending.
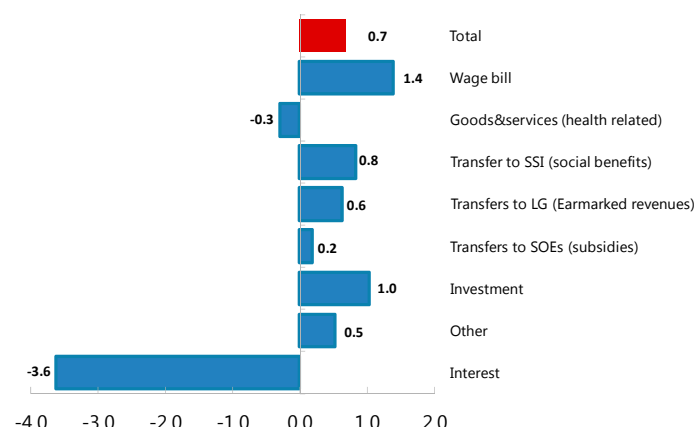
C.   Sources of Expenditure Rigidity

8.   A category of expenditure is regarded as rigid when its inclusion in the budget is not dependent upon the discretion of policy authorities in the short-term.[3] Thus, expenditure rigidity is defined as the unfeasibility of phasing, reducing, or abrogating public spending in immediate connection with the decision-making process concerning the annual budget. Rigid categories of spending are considered "mandatory"; while the remaining categories are referred as "discretional".

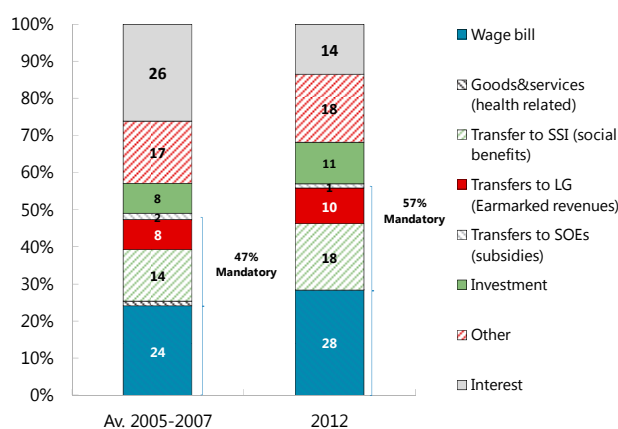**Figure 3. Central Government. Change in Expenditure**
(2005-2012 change in percentage points of GDP)

Total 0.7 · Wage bill 1.4 · Goods&services (health related) -0.3 · Transfer to SSI (social benefits) 0.8 · Transfers to LG (Earmarked revenues) 0.6 · Transfers to SOEs (subsidies) 0.2 · Investment 1.0 · Other 0.5 · Interest -3.6

Sources: Staff calculations.

Figure 4. Central Government Composition of Expenditure
(In percent of total expenditures)

Av. 2005-2007: Wage bill 24, 14, 2, 8, 8, 17, 26 — 47% Mandatory. 2012: 28, 18, 1, 10, 11, 18, 14 — 57% Mandatory.

Legend: Wage bill, Goods&services (health related), Transfer to SSI (social benefits), Transfers to LG (Earmarked revenues), Transfers to SOEs (subsidies), Investment, Other, Interest

---

[3] Not all sources of expenditure rigidity are of the same order. Specifically, it is essential to distinguish between causes of a technical nature on the one hand and causes of a political nature on the other. While it is possible to estimate potential measures to overcome technical rigidities, no such estimate is reasonable in the case of political rigidities. In this paper we refer to budget rigidity only in the technical sense.

9.   Expenditure rigidities typically fall into three main categories. First, expenditures can be legally obligatory so that, they cannot be limited without first changing the law. This category of mandatory spending is regarded as completely inflexible in the short-term (e.g. social security benefits). Second, rigidities can arise due to procedures that have been established for such cases. For example, personnel related expenditures cannot be cut back without changes in personnel procedures and policies and/or renegotiations with unions; interest on public debt cannot be cut back without addressing the fiscal and macroeconomic implications of sovereign default. Finally, expenditure rigidities may be of a technically complementary nature so that expenditure cannot be limited without annihilation of previously invested capital (e.g., maintenance of fixed capital such as roads and public buildings in the sphere of consumption, or capital expenditures related to the continuation of an ongoing project).

10.   In the case of Turkey, we focus our analysis on mandatory "primary" expenditure. Since interest costs—a mandatory spending category—are expected to remain on a declining path, efforts to control increasing rigidities should be focused on primary expenditure. Moreover, we classify spending categories taking into account only legal and procedural rigidities, ignoring technical rigidities all along.[4] Accordingly, we defined mandatory primary expenditure as the sum of the following categories: compensation to employees, goods and services related to health spending, transfers to social security institutions, transfers to local governments, and subsidies to state-owned enterprises.[5]

11.   The rapid increase of primary expenditure rigidities should not be disregarded. As shown in Figure 4, the share of mandatory primary expenditures grew from 47 percent of total spending to almost 60 percent in the last six years. With revenues strongly dependant on domestic demand and imports, concerns about primary expenditure rigidities are rapidly gaining momentum. Unaddressed, rigidities can jeopardize macroeconomic stability for they hamper the adjustment of fiscal magnitudes to changing environments, which often results in a persistent increase in expenditure and pressures on public debt. In the medium-term, the budget should remain flexible to allow fiscal policy to play a significant role in aggregate demand management and contribute to higher and stable national savings.

12.   We identified two main sources of expenditure rigidities. First, rigidities arise from the dynamic of particular categories of mandatory spending. In Turkey, compensation to employees and transfers to social security institutions explain a big part of the increasing trend in budget rigidities,

---

[4] Technically complementary expenditure both in the sphere of consumption (i.e., maintenance) and investment (i.e. capital expenditure) can be considered partially flexible even in the very short-term. Experience shows that countries under stress have often cut back maintenance spending, albeit acknowledging that in the medium-term it could reduce the of value of their stock of fixed capital. Similarly, investment can be phased out over a longer period of time at the expense of some lost benefits resulting from the later completion of the projects.

[5] There are other categories of spending that can prove to be legally and procedurally rigid, such as goods and services related to education spending following the 2011 education reform. In this regard, our estimation of mandatory spending should be regarded as a lower bound.

even though health related spending, education, and subsidies have gained relevance in recent years. Second, expenditure rigidities also arise from weaknesses in the overall budgetary framework by reducing the government's capacity to control main fiscal aggregates in line with its medium-term fiscal targets (i.e., fiscal discipline). In this section, we briefly review sources of rigidities arising from key category of spending; while in the next section we discuss the link between expenditure rigidities and fiscal discipline from a public financial management perspective.

Rigidities in key spending categories

Compensation to employees

13.   **Compensation to employees—or the "wage bill"—is the largest single category of total expenditure, and one of the most rigid.** Between 2005 and 2012 the wage bill rose by 1.4 pp of GDP, growing from 23 to 28 percent of percent of total expenditure in this period. Various policy measures explain this evolution.

14.   **The collective bargaining mechanism imposes an important rigidity to the budget, constraining expenditure consolidation efforts in the short-term.** From the beginning of 2012, a legislative change introduced a collective bargaining mechanism for civil servants salaries, which represent the majority of the total public workforce. The salary agreement resulting from the bargaining mechanism is binding for the next two years, but salary increases for the second year may differ from headline increases as a result of ex-post inflation adjustment. Public employees not belonging to the civil servants category remain under different salary adjustment mechanisms.[6]

15.   **Salary negotiation are based on four pillars mutually reinforcing:** (i) salary increases are negotiated in line with expected inflation, but typically they end up exceeding the latter; (ii) ex-post inflation adjustment clauses for the second year of the agreement, which had been significant;[7] (iii) ad-hoc lump-sum increases; and (iv) side benefits (i.e., allowances, etc). Each salary negotiation is different, and may not include all four pillars.
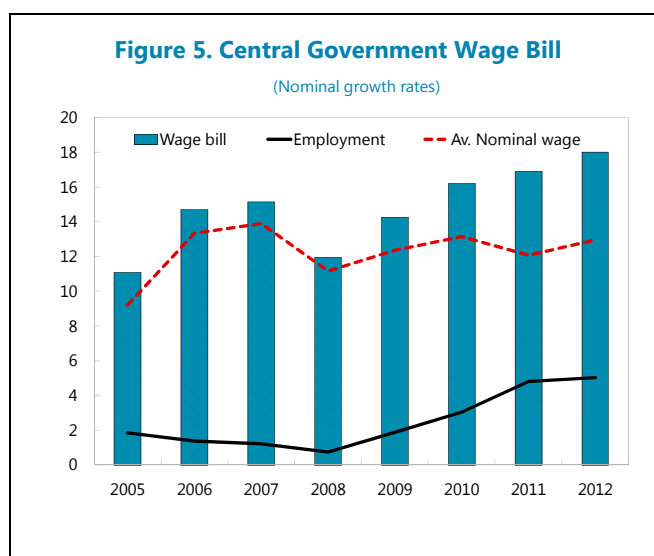
16.   **All four pillars of the salary negotiation amplify expenditure rigidities.** First, the salary negotiation is indexed to inflation which is not under control of the budgetary authority. Both the first and second pillar of salary adjustment ensures that there will be no real losses for salary earners, but allows for real increases if semi-annual inflation outturn comes out lower than the headline semi-annual salary increase. Experience shows that wage indexation typically leads to high wages

---

[6] They are approximately 10 percent of total public workforce.

[7] For a given semi-annual period, the ex-post inflation adjustment compares the half-year inflation outturn with the pre-announced half-year salary increase. If the former is higher than the latter, the increment is added on top of the next half-year (pre-determined) salary increase. However, this is not a symmetric adjustment. If semi-annual inflation outturn turns out to be lower than pre-announced semi-annual salary increase rate, no downward ex-post inflation adjustment is made, granting real gains to salary earners.

relative to the private sector comparator.[8] Second, lump-sum increases have been common in the last year especially for low-paid employees, which have raised the average salary levels well above headline increases. This lump-sum increases for low-paid compresses the wage margin between high and low-paid. Although, efforts to compress the wage margin between unskilled and skill workers have been based on equity concerns, they cannot be supported on grounds of efficiency and flexibility of public spending.[9] Finally, the increase in side benefits is difficult to evaluate but certainly introduces further rigidities to the wage bill.

17.   Increase in public employment makes the wage bill more rigid. Particularly in the last two years employment at the central government level has increased by close to 5 percent. Main reasons behind such increase are: (i) natural catch up after the program era; (ii) the impact of educational reform introduce in 2012;[10] and (iii) discretional increases in number of judges and security personnel due to low levels inherited from the past. Although an increase in public employment is consistent with the need to improve the quality and quantity of public services, and even recognizing that

Figure 5. Central Government Wage Bill
(Nominal growth rates)

some upward pressures are structural and thus will fade out in the medium-term, the employment growth rate is still considerable (Figure 5).

18.   Some recent measures added further rigidities to the wage bill. In 2011, the government approved the equalization scheme of civil servants salaries. "Equal salary for equal job" scheme tried to eliminate discrepancies among equivalent jobs due to the existence of side benefits and additional lump sum payments on top of salaries. Similarly, in 2013 the Parliament passed a bag law that included provisions, among others, to convert approximately 100,000 contracted public employees to the permanent civil servant category, with the corresponding extra fiscal cost.

19.   Despite short-term rigidities, the wage bill is not inherently rigid in the medium-term. Thus, scope remains to reduce the wage bill significantly over the medium term, as discussed in section E.

---

[8] Stronger job security in the civil service typically allows for a discount of 10-20 percent relative to private sector wages.

[9] Unskilled workers tend to remain in the civil service pay longer than skilled workers.

[10] The education reform was introduced in 2012. While its total fiscal impact is still uncertain, the increase in the years of education requires a larger number of teachers, which has put pressures on public employment particularly in the last two years.

Transfer to Social Security Institutions

20.   In Turkey, as in most developed and emerging economies, increasing expenditure rigidities are largely related to growing pressures from social security systems. Central government transfers to social security institutions grew from 2.0 percent of GDP in the early 2000s to a peak of 5.5 percent of GDP in 2009, after stabilizing around 5.0 percent in recent years (Figure 6).[11] Despite favorable demographic conditions, high informality and key features of the pension system explain this trend.
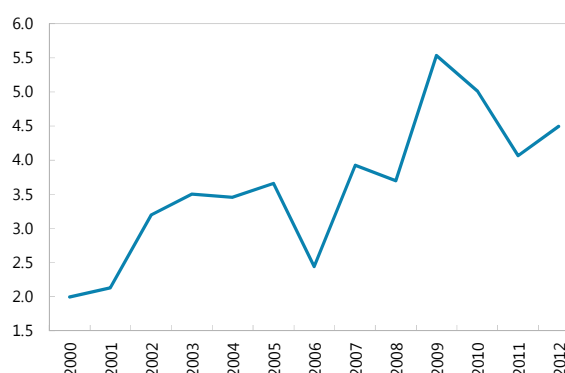
21.   To stem the rise of pension expenditures, Turkey has implemented two pension reforms over the last decade.[12] These reforms brought retirement ages, contribution periods, accrual rates, and indexation rules closer to international norms and are estimated to achieve significant savings over the long-run relative to old system. They also simplified the overall administration of the pension system by unifying three previously independent pension regimens, reducing previous inequalities.[13]

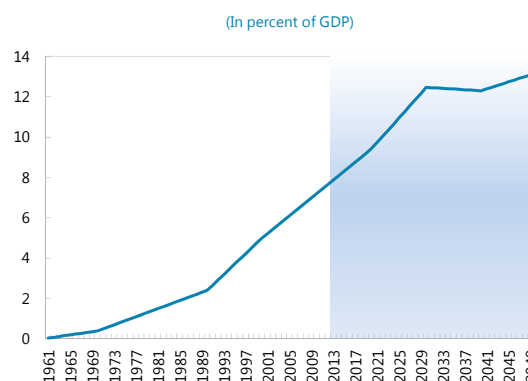**22.   Despite significant reform efforts, challenges remain to rein in pension expenditures in the short and medium-term.** Past reforms moved the pension system towards a more sustainable position and slowed the growth rate of pension expenditures. Yet, the pace of the reform implementation is extremely slow. As shown in Figure 7, pension expenditures stabilize only after 30 years. Therefore, although the

Figure 6. Central Government Transfers to Social Security

(In percent of GDP)

Sources: Official data.

Figure 7. Estimates for Turkey's Pension Expenditure

(In percent of GDP)

Sources: IMF Fiscal Monitor (2013).

---

[11] Approximately half of social security total expenditure is financed by transfers from the central government.

[12] The first reform was introduced in 1999 and the latest in 2006/2008. Additional measures were also implemented during this period beyond those included in the reform packages.

[13] Despite three pension regimens (i.e., ES, SSK, and BK) where unified under one system (i.e. SSI), ES still enjoys a separate grandfathered treatment due to constitutional court rulings.

reforms were a remarkable progress towards long-term fiscal sustainability, they did not stabilize the pension expenditure in the short-term. Based on current parameters, staff estimates growing pension expenditure in the next 30 years, stabilizing only in the long-run.[14]

23.   Main drivers of pension expenditure rigidities are: (i) high eligibility and replacement rates; (ii) pension indexation mechanism for civil servants; and (ii) slow pace of reform implementation. Even after the 2006/2008 reform is fully implemented, Turkey's pension system will continue struggling with high eligibility rates due to very generous conditions for retirement (e.g., the length of service required to be eligible for a pension will remain significantly below current OECD averages). The ratio of average gross pension to average gross wage (i.e. the replacement rate) is also quite high in Turkey compared to OECD countries. Even more important, is the differential in the pension indexation mechanism. Previous to the 1999 reform all categories of pensioners have monthly increases linked to the growth rate of civil servant wages. After both reforms efforts private sector employees, self-employed, and civil servants joining the system after 2008 have their pensions linked to semiannual inflation. Although this a change in the right direction, this indexation mechanism does not apply to civil servants that joined the system before 2008, which continue to have their pensions linked to the salary increase rate of active civil servants. Moreover, due to recent court rulings, it is not even clear if indexation to semiannual inflation will apply for civil servants that joined the system after 2008. This amplifies existing rigidities, by linking a significant portion of pension expenditures to the results of the collective bargaining mechanism for civil servants not under direct control of the government. Finally, the slow pace of the implementation of the reforms does not contribute to curtail current rigidities, since many measures will not be effective for 3 to 4 decades.[15]

24.   Given that Turkey's pension parameters are still far from international norms, there is room to press on with renewed reform efforts. The pension system remains broadly generous, compared to other advanced economies, thus short-term expenditure rigidities could be handled by adjusting main parameters and/or accelerating the implementation of past reforms. Section E discusses some options in this regard.

Other spending categories

25.   Others spending categories also contribute to the growing rigidity in the composition of primary expenditure. For example, the pattern of health expenditures reflects a mixture of discretional policy targets and expenditure rigidities. Although health expenditures are not explicitly covered in our analysis, central government transfers to social security also include transfers to cover for health-related services financed by social security institutions. Pressures on health spending arise from both demographics and supply costs, both of which have implications in terms of rigidities.

---

[14] Staff estimates published in the IMF Fiscal Monitor are based on current parameters and latest OECD figures for pension expenditures.

[15] For example, the transition period for the retirement age reform will only be completed by 2075.

policy decisions announced by the government; and (ii) to explain any other circumstances that may have an impact on the economic or fiscal outlook. In Turkey, these mechanisms are used for internal evaluation purposes but are not disseminated. As a result, there is no clear explanation of the reasons behind the systematic breach of expenditure ceilings, which hampers the credibility of the MTP and could potentially raise concerns about future fiscal discipline.

E. Options for Improvement

41.   Given current budget rigidities, achieving spending priorities and public savings levels set in the MTBF may prove challenging. While overall Turkey has managed to meet deficit targets in the past, the consequences of spending rigidities are far reaching. With almost 60 percent of primary spending already committed, the authorities will need to find ways for freeing up space for other priority spending, such as education and investment, if they want to increase public savings without additional tax measures.

42.   A pressing question is how to minimize primary expenditure rigidities while securing hard-won fiscal discipline. A comprehensive solution would require a combination of rationalization of mandatory spending and improvement in public financial management practices.

Options for rationalizing mandatory primary expenditure

43.   In the area of compensation to employees options include:

- Eliminate indexation to inflation. As a first step, the ex-post inflation adjustment should be eliminated. As a second step, the salary negotiation and adjustment should be linked to private sector comparators. By doing this, wage increases will be better aligned with productivity growth.

- Streamline side benefits and gradually incorporate them in the wage base.

- Stabilize public employment growth rate. Once the short term impact of structural reforms is exhausted (e.g., the education reform), public employment should not grow beyond the natural replacement rate.

- Perform an expenditure review targeted to key areas of inefficiency. Use this review to assess the optimal level of employment by sectors.

44.   In the area of social security options include:

- To reduce eligibility rates authorities could consider increasing the statutory retirement age (a one year increase reduces pension expenditure by about 5 percent) and tightening eligibility for disability pensions and early retirement. Past reforms already prescribed the increase in the statutory retirement age, but the path could be faster.

- To reduce replacement rates, international experience shows that other countries have used a combination of the following measures: allow pensions to decrease over time, tax pensions like

other forms of income, and change the benefit formulas. Based on past reforms, the minimum pension level is projected to gradually decrease from 60 percent to 38 percent of average wage in the next three decades. The authorities could consider unfolding this process at a faster pace, while avoiding ad-hoc pension increases, as happened in the past.

Options for strengthening public financial management practices

45.   Although there is no single MTBF model, international best practice suggests that effective MTBFs have the following key elements in common: (i) multiyear expenditure limits that define the nature, level, and terms of the restrictions being placed on future budget decisions; (ii) expenditure prioritization mechanism that ensure that expenditure is allocated in a manner that reflects government policy priorities; (iii) forward-looking expenditure controls through which the consistency of updated medium-term expenditure projections with approved medium-term expenditure plans is monitored and enforced; and (iv) dynamic accountability arrangements through which adherence to stated medium-term objectives can be assessed by parliament and the general public over time.

46.   Current financial management practices embedded in the MTP might have contributed to exacerbate expenditure rigidities resulting in low compliance with expenditure ceilings. There are areas where further efforts are warranted to ensure that expending ceilings are met and fiscal discipline secure. Based on best international practices options in this regard are:

- International best practices show that countries with binding MTBFs are better at meeting their medium-term objectives, including their expenditure ceilings and thus at securing fiscal discipline. So consideration should be given to gradually more to a more binding MTP.

- In a more binding MTP, multiyear ceilings should not be revised on a rolling basis, and some mechanism for adjusting for past deviations should be introduced. The multiyear projections should lock the ceilings for a period of two to three years. During that period ceilings should not be reopened to allow for changes in discretionary policy.

- Revenue windfalls and one-offs should be saved, instead of partially used to financed expenditure overruns. Eliminating this source of expenditure uncertainty will facilitate better anchoring the expectation of future appropriations by line ministries.

- Experience shows that among countries implementing binding MTBF models, fixed aggregate ceilings based on a broad institutional coverage are most effective at controlling future expenditure. In this regard, consideration should be given to reduce the level of detail at which the ceilings are currently imposed (i.e., number of budget appropriations), while extending the institutional coverage of the MTP (e.g., to cover at least social security institutions).

- To deal with uncertainty and foster compliance with MTP targets, best practices suggest that the level of reserves should be commensurate with the volatility faced over time. Given the volatility faced by public finances in Turkey, the reserve level could be increased with a rising profile for the outer years.

TURKEY'S INTERNATIONAL COMPETITIVENESS[1]

Turkey's persistent current account deficit is closely linked to its competitiveness. The structure of the imbalance warrants concern, especially because it reflects low savings rather than high investments. This paper follows Hunya (2000) and Trabold (1995) in evaluating Turkey's ability to compete by examining the fundamentals of a nation's competitiveness—the ability to sell, the ability to attract FDI, and the ability to adjust— to identify where gains can be made. For Turkey, short-term policies can help with price competitiveness and increase national savings while longer-term structural policies must focus on improving export value-added, drawing in FDI, and increasing flexibility in the labor market.

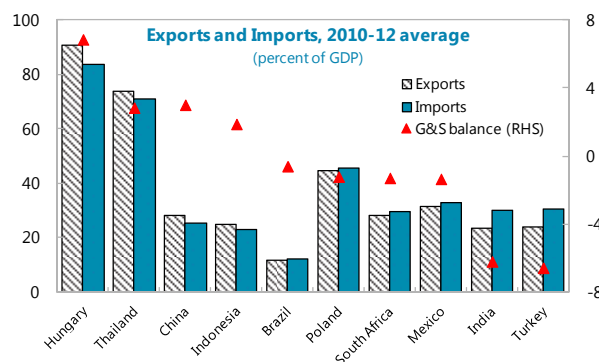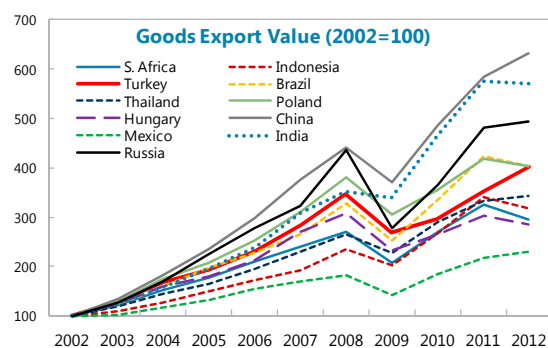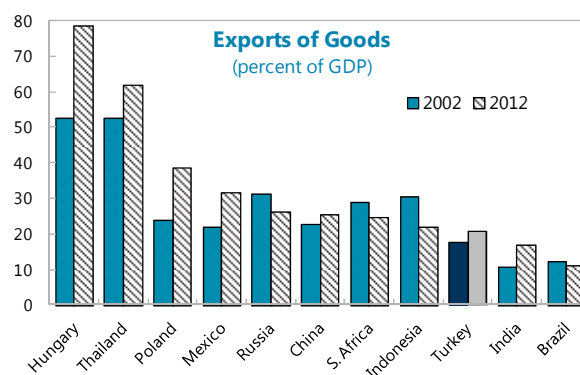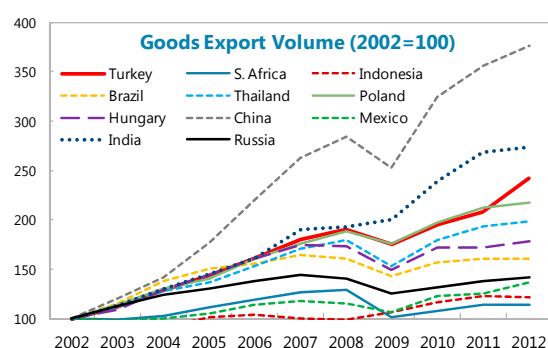## A. Turkey's Competitiveness Gap

1. **Turkey's current account deficit has been a feature of the last decade.** Strong growth led by domestic demand coupled with rising real effective exchange rate (REER) led to a gradual buildup of external imbalances. Between 2002 and 2007, the REER increased by nearly 30 percent. During that time, the current account deficit grew from 0.3 to 5.8 percent of GDP. After an adjustment in 2009 due to a sharp contraction in growth, the current account deficit grew again and has since stayed above 6 percent of GDP.

2. **As such, scrutiny on the Turkish economy has increasingly focused on issues of external sustainability and competitiveness**. Assessments of Turkey's external position point to a structural current account weakness and an overvalued exchange rate. The latest IMF's external sector report (ESR) assesses Turkey's 2012 current account balance to be 1 ½–3 percentage points of GDP weaker than levels that can be explained by fundamentals and desirable policy settings. On this basis, the REER is overvalued by about 10–20 percent. However, Turkey's external imbalance cannot only be explained by the usual policy variables. The ESR relies on the external balance assessment (EBA) methodology, which uses policy gaps in four areas to explain deviations of the current account from its norm—fiscal balance, social protection spending, capital control, and foreign exchange intervention. For Turkey, these policy variables account for only a small fraction of the estimated current account gap, suggesting the large role of structural factors related to competitiveness.

3. **This paper will explore gaps in Turkey's competitiveness that may explain its persistent external imbalance.** To this end, the paper will follow Hunya (2000) and Trabold (1995) in evaluating countries' abilities to compete through three fundamental qualities: the ability to sell, the ability to attract FDI, and the ability to adjust. These three qualities, which are closely linked with

---

[1] Prepared by Suchanan Tambunlertchai.

one another, offer different vantage points on a country's competitive advantage. In all three areas, Turkey's achievement is assessed against the performances of other large emerging markets (EM). This bottom-up approach complements the ESR's macro exercises by allowing a more detailed view as to where the problems may lie.

B. Ability to Sell

4.   Indicators of Turkey's ability to sell in the international market present a mixed picture. During the past decade, export volume out of Turkey saw relatively high growth. While the expansion was not as dramatic as in China or India, it outpaced most other EMs particularly starting in the mid-2000s. This growth however stemmed from a low base, and Turkey's export share in GDP remains small compared to most peers. To an extent, the small share of export reflects a relatively less open economy. While this in itself may not warrant concern, the fact that Turkey's current account deficit is the largest and most persistent among comparators certainly points to a problem—Turkey's ability to sell is inadequate for its buying needs. More importantly, Turkey may be losing ground on the world production value chain. Despite stronger growth in export volume, the value of Turkish exports has not kept pace with those from Russia, Poland, and Brazil. This development is linked to Turkey's ability to adjust, which will be discussed below.

Sources: WEO, IMF staff calculations.