Office Memorandum

To: Members of the Executive Board June 3, 2014

From: The Secretary

Subject: **Turkey—Assessment Letter for the World Bank**

Attached for the **information** of Executive Directors is the Fund's assessment letter on the macroeconomic conditions in Turkey, which was requested by the World Bank.

If the authorities of Turkey consent to the publication of this assessment, it may be published by the World Bank.

Questions may be referred to Mr. Ramirez Rigo (ext. 34340) and Mr. Tieman (ext. 34434) in EUR.

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

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Turkey—Assessment Letter for the World Bank
June 2, 2014

Background

1. **Turkey faces the difficult task of reducing its persistent external imbalances in the face of tighter external financial conditions**. In the short run, adjustment will require slower domestic demand growth, but is necessary to lower vulnerabilities. Over the medium to long run, Turkey's policy challenge is to increase domestic savings in order to be able to maintain or increase its current level of investment while reducing its external vulnerability.

Recent Developments and Outlook

2. **Economic growth picked up in 2013 on the back of pro-cyclical macro-policies.** Turkey grew by 4 percent in 2013 driven by a 6.3 percent expansion of domestic demand and negative net exports. As a result, the current account deficit widened to 7.9 percent of GDP, financed mostly by short-term debt creating inflows. Inflation accelerated to 7.4 percent, above the central bank's (CBRT) 5 percent target. The authorities over-performed the overall budget target due to higher than expected revenues, but, with real spending outpacing potential growth, the fiscal stance remained expansionary. The banking sector capital adequacy ratios remained high at 15½ percent and there was no deterioration in the ratio of non-performing to total loans. Finally, unemployment increased slightly to 10 percent.

3. **Severe market turbulence hit Turkey in December 2013 and early 2014.** Fed tapering combined with a loose monetary stance and the political cycle led foreigners and residents to reduce their lira positions and caused capital inflows to decrease. As a result, the currency depreciated by 15 percent between mid December 2013 and late January 2014. The authorities initially took recourse to sterilized FX intervention, leading to a significant decline in net international reserves. On January 28, the central bank normalized policy—which boosted credibility and facilitated communication of the monetary policy framework—and increased interest rates by an effective 300 basis points. Since then, the exchange rate has first stabilized and subsequently strengthened, leading the central bank to lower the policy rate by 50 bps on May 22. Seen against the bank's recent acknowledgement that its 5 percent inflation target will likely be missed by a large margin this year, this move raises concern. Staff sees the current level of the real effective exchange as closer to its equilibrium level, which is reflected in a narrowing of the current account deficit since the start of this year.

4. **IMF staff expects growth to slow markedly in 2014 and remain moderate over the medium-term.** Monetary policy tightening, macroprudential measures, and a weaker real exchange rate are expected to contain private domestic demand. However, public sector spending remains strong, and the real exchange rate movement since mid 2013 and stronger growth in Europe should help boost net exports. Overall, IMF staff expects GDP growth to decelerate to 2.3 percent in 2014, while the current account deficit is expected to narrow to 6.3 percent of GDP. However, inflation will remain elevated due to exchange rate pass-through, reflected in inflation expectations significantly above the central bank's target.

Over the medium-term, staff expects the availability of external financing to constrain annual growth to around 3½ percent and, assuming a constant real exchange rate, the current account deficit to gradually decline to below 5½ percent of GDP.

5. **Fiscal policy remains expansionary, but public debt is low.** Primary expenditure in real terms continues to grow faster than potential growth. Staff estimates that the 2014 budget targets may be missed by a modest margin, particularly on the back of higher-than-projected capital spending. However, with the general government debt projected at 36 percent of GDP, on current policies, public debt sustainability does not represent a concern.

6. **The banking sector maintains adequate buffers**. Although bank profitability is declining as monetary tightening has led to some compression in net interest margins, asset quality remains good and capital adequacy high. Banks' indirect exposure to FX risk, through FX loans extended to domestic corporates, remains a concern, as is the case for the increasing share of the banks' loan portfolio going to the real estate and construction sectors. However, the authorities have started work to address data gaps on FX exposure in the corporate sector, and real estate and construction sector loans make up just 10 percent of total loans.

7. **Turkey's external position remains the main medium-term vulnerability.** Turkey's large external financing needs and the short-term nature of capital flows exposes the country to rollover risk, particularly against the background of normalization of monetary policy in the United States.

Policy Challenges

8. **The main economic policy challenge for Turkey remains to reduce its external imbalance and hence its vulnerability to capital flow volatility.** Monetary and fiscal policies should play a key role in this regard – and would also serve towards the goal of tackling persistently above-target inflation. Macroprudential policies could play a complementary role, particularly in segments where credit growth or currency or maturity mismatches seem excessive. In the face of recent inflows, the central bank could build its net international reserves which are low given the external position. Over the longer term, structural reform will remain important tackle Turkey's competitiveness challenges.

9. **Monetary policy** needs to contribute through a significantly positive real policy interest rate. This would contain the growth of domestic demand and imports in the short run. In addition, it would serve to gradually bring inflation down towards the CBRT's 5 percent inflation target. Further normalizing the monetary policy framework—by providing unlimited liquidity at the policy rate—would strengthen transmission.

10. **Fiscal policy must play a major role in increasing domestic savings,** thus reducing the external imbalance. Therefore, for this year, it remains important to observe the

expenditure limits in the budget. Over the medium-term, the structural fiscal path should provide a more ambitious contribution to domestic savings.

11. **Macroprudential policies can support adjustment,** even though they are not a substitute for the right monetary and fiscal stance. Recent measures have successfully brought the pace of consumer credit growth down from excessive levels. In addition, given the rapid growth in FX lending over the last few years, macroprudential measures to tackle the financial system's reliance on FX funding and its lending to domestic corporates in FX could be considered going forward.

12. **Turkey's freely floating exchange rate has proved an important buffer.** The central bank instituted regular FX sales in 2013 and intervened directly in the market in January 2014, both of which dented net international reserves. Going forward, higher net international reserves would provide more comfort, especially now that the real exchange rate is closer to equilibrium. Thus, once exchange rate developments and capital flows permit, the CBRT should rebuild its reserves faster through FX purchases—on top of its regular purchases through EXIM bank loans.

13. **Structural reform should further boost competitiveness and growth.** The Turkish private sector has demonstrated an ability to adapt to shocks. Further improvements in the business climate could enhance this resilience and attract more foreign direct investment—a stable source of external funding. Reducing energy dependence further—in line with government policies and recent reforms—would help decrease the energy import bill, which represents a significant part of Turkey's trade deficit. Efforts to address the large informal sector have met with some success and need to be sustained. Reforms to improve the functioning of the labor market and to increase educational outcomes could boost productivity and employment. Lastly, policy changes that have boosted participation in voluntary private pension funds point to a potential avenue to further increase private sector savings.

IMF Relations

- On November 20, 2013, the IMF Board concluded the 2013 Article IV Consultation with Turkey (IMF country report 13/363).
- In April 2014, an IMF mission visited Istanbul and Ankara for a regular staff visit.
- The IMF provides technical assistance to the Turkish authorities in the fiscal, monetary and financial, and statistical areas.