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11:55 a.m., December 9, 2019

1. Turkey—2019 Article IV Consultation

Documents: SM/19/266 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; SM/19/267; and Correction 1

Staff: McGettigan, EUR; Flanagan, SPR

Length: 1 hour, 1 minute

Executive Board Attendance

D. Lipton, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A. Tivane (AE), Temporary
M. Raghani (AF)	
	R. Morales (AG), Temporary
	C. White (AP)
A. Bevilaqua (BR)	
Z. Jin (CC)	
L. Villar (CE)	
	A. McKiernan (CO)
R. Kaya (EC)	
H. de Villeroché (FF)	
R. von Kleist (GR)	
S. Bhalla (IN)	
D. Fanizza (IT)	
T. Tanaka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
	R. Doornbosch (NE)
	J. Sigurgeirsson (NO)
	A. Biriukv (RU), Temporary
	R. Alkhareif (SA)
A. Mahasandana (ST)	
P. Inderbinen (SZ)	
	D. Ronicle (UK)
M. Rosen (US)	

S. Bhatia, Acting Secretary
J. Morco, Summing Up Officer
L. Briamonte, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: W. Amr. European Department: A. Culiuc, P. Gerson, V. Guzzo, D. McGettigan, B. Rayner. Fiscal Affairs Department: J. Hooley. Legal Department: C. DeLong. Monetary and Capital Markets Department: M. Moore. Strategy, Policy, and Review Department: J. Andritzky, M. Flanagan. World Bank Group: L. Moorty, E. O'Halloran. Executive Director: L. Levonian (CO), A. Mozhin (RU). Alternate Executive

Director: S. Benk (EC), K. Chikada (JA), M. El Qorchi (MD), C. Just (EC), K. Obiora (AE), H. Razafindramanana (AF). Senior Advisors to Executive Directors: M. Choueiri (MI), J. Damgaard (NO), F. Fuentes (BR), L. Marek (EC), C. Sassanpour (MD). Advisors to Executive Directors: A. Abdullahi (AE), M. Albert (FF), O. Bayar (EC), S. Belhaj (MD), X. Cai (CC), L. Cerami (IT), T. Chrimes (UK), S. David (AP), P. Dhillon (IN), I. Fragin (GR), M. Mehmedi (EC), L. Nankunda (AF), A. Olhaye (AF), R. Pandit (ST), B. Rankin (CO), S. Senich (US), M. Shimada (JA), A. Zaborovskiy (EC), Z. Zedginidze (NE).

1. TURKEY—2019 ARTICLE IV CONSULTATION

Mr. Kaya and Mr. Bayar submitted the following statement:

On behalf of the Turkish authorities, we would like to thank Mr. McGettigan and his team for the comprehensive set of reports which reflect the depth and candor of the discussions in Ankara and Istanbul.

Macroeconomic Context

A deterioration in the sentiment toward emerging market economies as well as a number of adverse geopolitical developments have triggered a major bout of stress for the Turkish economy and financial markets in the second half of 2018. Reflecting the run on Turkish assets, the Lira depreciated sharply and market valuations suffered. The adverse developments in the monetary and financial markets led to a temporary spike in inflation, while also undermining broad confidence to hamper private consumption and investment. The authorities responded to these shocks with a host of policy measures - including a significant monetary tightening by the Central Bank of Republic of Turkey (CBRT), a judicious use of the fiscal policy to introduce targeted incentives, and the restructuring of the Financial Stability and Development Committee with a stronger mandate - to (i) reinstate monetary and financial stability, (ii) facilitate the rebalancing of the economy, and (iii) avoid a sharp and protracted downturn in economic activity.

Buoyed by the authorities' supportive policies as well as a more favorable external backdrop, the Turkish economy has embarked on a recovery path starting from Q1/2019 and y-o-y growth returned to positive territory as of Q3/2019 after having registered negative rates for three quarters. The Lira gained strength which was accompanied by more favorable market valuations as well as a gradual improvement in broad confidence indicators. Inflation, after reaching its peak (25.2 percent) in October 2018, has retreated significantly to 10.56 percent (y-o-y, end-November 2019) reflecting the tight monetary policy stance, supportive demand conditions, favorable base effects, as well as a stronger Lira. The current account has registered a remarkable correction – in the order of US$63.8 bn (i.e. around 8.3 percent of GDP) – to return to surplus after many years. The current account adjustment came on the back of resilient exports, decreasing import demand, and a strong tourism performance. Unemployment, on the other hand, has risen to 14 percent reflecting a broad-based slowdown in economic activity as well as the ongoing sectoral rebalancing, particularly affecting the construction sector.

The authorities have used the available fiscal room to avoid an excessive slowdown, and to aid the ongoing rebalancing of the economy. The recently announced New Economy Program has set the year-end central government budget deficit target at 2.9 percent of GDP, implying a 0.9 percentage point widening in the fiscal deficit relative to 2018. The headline figures reflect both the deliberate fiscal stimulus provided via targeted transfers and temporary tax breaks, as well as the role of automatic stabilizers (e.g. weaker indirect tax revenues). The authorities also took some steps to compensate for the weak tax revenues by non-tax revenues. Beyond the central government, the authorities do not envisage a deterioration in the balances of the rest of the public sector, including local governments. Consequently, the EU-defined general government debt stock is forecast to be at 32.8 percent of GDP as of end-2019.

Outlook and Policies

The New Economy Program[1] 2020-2022 (NEP), released in September 2019, is prepared in line with the key themes of Balance, Discipline, and Transformation and aims to uplift economic growth back to its historical averages while enhancing price and financial stability and consolidating gains on external balances.

The authorities are more sanguine on the growth outlook as they expect 5 percent real growth over the planning horizon. Following the weak performance in 2018 and 2019, the authorities believe that the slack in the economy will enable a convergence of economic activity toward its long-run trend under a moderate growth momentum without necessarily jeopardizing the price stability and external balance objectives. This `U-shaped` recovery hinges on the assumption of a benign external environment which would enable a continued improvement in financial conditions for the Emerging Market Economies. Policies will continue to be geared towards supporting the tradable sectors, increasing R&D expenditures, improving the energy and logistical infrastructure, as well as upgrading the human capital. With the gradual dissipation of sectoral drags on employment (i.e. mostly from the construction sector), the authorities expect employment generation to gain pace and the unemployment rate to decline to 9.8 percent by the end of 2022.

[1] New Economy Programs are flagship policy documents of the Turkish economy, providing a macro framework and setting out the policy objectives for a period of three years.

Monetary Policy

Inflation is projected to decline to low single-digit levels. The CBRT, while retaining the medium-term inflation target at 5 percent, has set interim targets to better anchor expectations in the short term. As such, the headline CPI, which is forecast to be at 12 percent as of end-2019, is projected to decline gradually to 8.2 percent in 2020, 5.4 percent in 2021, and stabilize around the target by 2022.

The authorities concur that managing inflation expectations is critical for a sustained disinflation process. Currently, 12 and 24-month ahead expectations hover above the CBRT's forecasts while there is a gradual convergence of expectations toward the authorities’ interim targets. On that note, the authorities believe that the CBRT’s improved forecast accuracy since October 2018 has significantly supported the credibility of the monetary policies and help anchor expectations. With medium-term expectations still lying outside the uncertainty band around the inflation target, the authorities agree that all macroeconomic policies should be coordinated to bring the inflation down.

The authorities consider the current monetary policy stance consistent with the projected disinflation path. The CBRT has cut the interest rates by a cumulative of 1000 bps since July 2019, in view of the improving inflation outlook amid upbeat indicators for underlying inflation, supply-side factors, and favorable import prices. Additionally, the authorities take the global monetary conditions into consideration in their decision processes as well.

The recent rate cuts by the CBRT led to a downward shift in the yield curves of bond and swap markets confirming a more favorable inflation outlook, the improvement in expectations, and a decline in the risk premium.

The authorities concur with the staff on the need to accumulate international reserves as economic and financial conditions permit. They also underscore that the international reserve data is compiled and published in a timely, comprehensive, and transparent manner, consistent with international standards.

Fiscal Policy

Fiscal policy will be growth-friendly and fiscal prudence - the long-standing anchor of the Turkish economy’s resilience - will be preserved. The overall fiscal policy stance, which was recalibrated in 2018-19 to buttress economic activity, will be broadly kept unchanged in 2020. On a similar note, the budget deficit-to-GDP ratio is targeted to remain below 3 percent in the outer years of the planning period as well. The authorities believe that stronger economic activity as well as improvements to the revenue administration will help reverse the relatively weak tax performance in 2019. Currently, the authorities do not intend to introduce new tax policy measures in addition to what was already enacted in 2019. Efforts to restrain expenditure growth as well as to improve the composition of the spending envelope will continue. Consequently, public debt is set to remain broadly flat between 32 – 34 percent of GDP throughout the NEP period.

Even though debt sustainability is not a source of concern, fiscal discipline will be used as a policy tool to complement the monetary policy efforts to tame inflation. In this regard, the 2020 central government budget aims to strike a delicate balance between buttressing economic activity and consolidating the gains of rebalancing. Furthermore, the authorities will continue to set public wages through a rules-based methodology and in line with the projected inflation path.

On Public-Private-Partnership (PPP) projects, building on the assessments and recommendations of the very productive technical assistance mission conducted in late 2017, a framework arrangement will be prepared to ensure efficiency, productivity, affordability, and integrity in PPP applications. On the Sovereign Wealth Fund (SWF), the authorities assured staff that they will adhere to international best practices in accounting of its activities.

Current Account

The current account will be kept at sustainable levels. The rapid and sizable adjustment in the current account is a defining feature of the rebalancing story of the Turkish economy. In view of the volatile external environment, the authorities are keen to keep the current account in close check and avoid any undue expansion of the deficit that would expose the economy to the swings in the global sentiment. In that vein, the current account is expected to post a deficit of 1.2 percent of GDP in 2020 - a level that is in broad conformity with the Fund’s norm current account assessments and will keep the external financing needs at a reasonable level. The authorities will also give prominence to structural policies that aim to increase exports of high value-added products, reduce import dependence on key sectors, and bolster the tourism potential.

Financial Sector

The Turkish banking system has proven its resilience in the face of severe adverse shocks. Turkish banks are well capitalized with a system-wide capital adequacy ratio above 18 percent (latest data as of October 2019) which is well above the regulatory minimum. The total non-performing loan ratio, notwithstanding a modest increase, remains at manageable levels (i.e. 5.15 percent). By regulation, banks are not allowed to carry net open FX positions beyond a certain limit (i.e. 20 percent of regulatory capital) and therefore, the balance sheet of the banking system is effectively immune to the direct effects of currency valuation, including through appropriate use of off-balance sheet hedging instruments. The authorities do not agree with staff's assessment of a continued positive credit gap and believe that although the latest credit developments indicate a revival of loan growth, the credit gap is still in negative territory. Furthermore, both the banking regulator as well as the analysts from the banking sector concurred that the weakness in loan growth is primarily driven by sluggish credit demand rather than supply side constraints. The authorities, while acknowledging the possible confidence effects of a third-party asset quality review, consider the current supervisory framework robust – aided by regular, detailed on-site examinations as well as an effective stress test framework.

The authorities agree that an effective insolvency regime and an out-of-court restructuring system will be crucial to resolve remaining balance sheet issues in the non-financial corporate sector. Therefore, the authorities are working on a new legislation that will modernize the legal framework as well as address identified stretches in the current system, including those pertaining to debtor-creditor rights. The authorities also encourage private-sector driven initiatives to facilitate voluntary restructuring of debt contracts.

Structural Reforms

The current political landscape gives a window of opportunity to implement comprehensive structural reforms in an effort to improve the Turkish economy's competitiveness, strengthen its resilience to external shocks, and address impediments to job creation and investments. Policies are already underway to improve the efficiency of inter alia the labor market, business environment, public financial management, capital markets, and judicial and education systems. Targeted incentives will continue to support the renewable energy as well as other critical and technology-intensive sectors. With a stronger focus on social inclusion, poverty alleviation, and providing equal opportunity to all, the authorities are also intensifying their efforts to improve social outcomes in Turkey. These efforts are bearing fruit as the rank of Turkey in World Bank Doing Business Indicators has improved to 33 in 2019, from 60 in 2017. The authorities acknowledge the need for better prioritization of the reform agenda and appreciate the thematic analysis by staff which has provided valuable insights.

International Development Efforts and Refugees

Turkey, despite recent economic challenges, continues to expand its global humanitarian outreach in support of the UN Sustainable Development Goals, with its total development assistance reaching USD 9.3 billion just in 2017 - affirming its position as one of the most generous countries globally.

With more than 4 million refugees, Turkey continues to host the largest population of displaced people globally. Significant efforts and funding were mobilized to provide essential public services, including education and health for these people. The authorities continue to take measures to integrate refugees to social and economic life in Turkey, while also spearheading international efforts to secure a safe and voluntary return of these people to their home countries.

Final Remarks

The Turkish authorities are grateful for the analytical depth and rigor of the Article IV consultations and associated policy advice, which will carefully be assessed. The authorities will continue to work closely with the Fund.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for the excellent reports and Messrs. Kaya and Bayar for their helpful buff statement. Supported by expansionary fiscal policy, rapid credit expansion by state-owned banks, and more favorable market sentiment, economic growth in Turkey resumed since the currency shock and recession in 2018. At the same time, the lira recovered, and the current account saw a remarkable adjustment thanks to import compression and a strong tourism season. The Article IV discussion appropriately focused on reforms to address vulnerabilities, strengthen policy credibility, and boost productivity. In this connection, the recently released New Economy Program rightly aims to uplift economic growth, while enhancing price and financial stability and strengthening the external position. We appreciate staff’s analytical work, including the work presented in the Selected Issues Paper, and broadly concur with the staff appraisal.

Amidst a difficult environment for monetary policy in the second half of 2018, the Central Bank of Republic of Turkey (CBRT) significantly tightened monetary policy, and inflation came down sharply after the late-2018 surge. The authorities expect inflation to decline to single-digit levels starting in 2020, as conveyed in the buff. Nonetheless, staff considerers that rates are too low to strengthen monetary policy credibility and lower inflation durably, and we would welcome their elaboration on the reasons for the difference of views with the authorities in this area. We see merit in staff's call for clearer monetary and intervention policy to strengthen central bank credibility.

The authorities and staff concur that fiscal policy should remain a key policy anchor, and we take positive note of the authorities' intention to use fiscal discipline as a policy tool to complement the monetary policy efforts to tame inflation. Staff suggests a series of revenue and expenditure measures to improve debt dynamics in the medium term. In this connection, the possible measures outlined in ¶30—including reforming the VAT and streamlining VAT exemptions, controlling the wage bill, and containing net lending and rationalizing transfers/subsidies—deserve consideration. Can staff comment on the political feasibility of carrying out some of the suggested measures, and on the potential for revenue administration improvements—a measure proposed by the authorities—to support revenue mobilization?

Despite the currency shock and recession in 2018, the Turkish banking sector appears to remain resilient, with a capital adequacy ratio that exceeds the regulatory minimum and a manageable non-performing loans ratio, according to the buff. Staff recommends reining in rapid credit growth by state-owned banks, which has weakened their balance sheets, hampered needed deleveraging, and fueled dollarization. We note the difference in views between the authorities and staff regarding credit growth and the existence of a credit gap. We would be grateful for staff's views on how well the Turkish banking system is prepared to deal with additional credit risk, should the economy face adverse shocks.

As noted by Messrs. Kaya and Bayar, Turkey continues to host over four million refugees, which is the largest population of displaced people globally. The Turkish authorities are to be commended for mobilizing significant efforts and funding to provide essential public services to the refugee population, including education and health. Turkey and other countries in the region, that host large refugee inflows, need continued international support to address the refugee challenge.

Mr. Fanizza and Ms. Cerami submitted the following statement:

We thank staff for the concise and well-focused papers and Mr. Bayar and Mr. Kaya for their candid buff statement. We broadly share staff's appraisal and policy recommendations. We concur on the need to shift the focus from short-run growth to higher and more resilient medium-term growth. Favorable market conditions together with expansionary fiscal, and more recently, monetary policies have helped the economic recovery from the recession, following last year's lira sharp depreciation. However, these policies have also contributed to a further widening of internal and external imbalances, leaving the country more vulnerable to a potential deterioration in market sentiment or an intensification of geopolitical tensions. A prudent and more balanced macroeconomic policy mix and a comprehensive reform package are therefore urgently needed to correct imbalances and rebuild macro-financial resilience.

We would also like to add some more specific comments:

Monetary policy should take a tighter stance to bring inflation down to target and anchor inflation expectations. Well-anchored inflation expectations would lower the output costs of disinflation, both directly and through the exchange rate passthrough, as shown in the helpful Box 4. A more transparent monetary framework, focused on the official policy instrument, would help clarify the policy stance and improve monetary transmission. Similarly, a more transparent framework for foreign exchange interventions would promote capital inflows and contribute to replenish foreign reserves.

A gradual fiscal consolidation is needed to ensure public debt remains low and stable. Turkey is still benefiting from past fiscal prudence and public debt remains slightly above 30 percent of GDP; however, rising financing needs, recent quasi-fiscal operations, and uncertain contingent liabilities have put public debt on an upward trend. In this respect, we welcome the authorities' intention to strengthen the Public-Private Partnerships framework building on the recent Fund's technical assistance and to ensure that the Sovereign Wealth Fund's governance is aligned with international best practices. We also agree on the need to enhance transparency on fiscal risks related to other public entities.

Bank regulation and supervision should prioritize stability over development. Rapid credit growth by state-owned banks, largely financed by short-term foreign exchange deposits, and directed to highly-leveraged corporates poses increasing risks to the stability of the financial sector and the public budget through contingent liabilities. We acknowledge divergences between staff and the authorities' assessment of the credit gap and of the strength of the supervisory framework. However, we see merits in staff's recommendation to conduct an independent asset-quality review, new stress tests, and take follow-up measures to strengthen banks' balance sheets and confidence in the financial sector.

Mr. Tanaka, Mr. Chikada and Mr. Shimada submitted the following statement:

We thank staff for their comprehensive report and Mr. Kaya and Mr. Bayar for their informative buff statement. While we welcome that the Turkish economy's growth has resumed, and market conditions have stabilized recently, we note with concern that underlying vulnerabilities are generally higher than at the peak of the Global Financial Crisis. In another word, Turkey remains susceptible to market runs observed in late-2018, and we encourage the authorities to strengthen their policy frameworks and proceed with necessary reforms so as to improve market confidence and to mitigate vulnerabilities. As we broadly agree with staff's appraisal, we would like to comment on some specific policy areas for emphasis.

Fiscal policy should remain a key policy anchor, and transparency regarding contingent liability should be improved. Well anchored fiscal policy has been a key strong feature of the country, and we expect it will be going forward. We agree with staff that fiscal stance needs to be prudent to create fiscal space to mitigate reform costs and address downside risks. Given the prominent role of state-owned banks in credit allocation and increases in public private partnership, it is important to closely monitor and manage the risk of contingent liability.

Central bank independence needs to be well protected to ensure market confidence and anchor inflation expectation. While we do not necessarily see monetary policy needs to be tightened at this juncture to anchor inflation expectation, it is imperative that monetary policies to be conducted in an evidenced based and well communicated manner. In this regard, as we acknowledge the different view about policy rate level between staff and CBRT, could staff elaborate more on the reasons for the difference of views? As for monetary policy tools, we understand that it is important for the central bank to have multiple policy toolkits to react to different monetary situations. However, transparency and clear communication with market participants are needed to make the tools effective. We also concur with staff that FX intervention by CBRT should be more transparent and current capital flow management measures should be lifted as soon as economic conditions so warrant.

Financial sector's balance sheet needs to be strengthened. While we welcome that Turkish banks are well capitalized, asset quality has been deteriorating as evident in rises in NPL and Stage 2 Loan ratios. We concur with staff that comprehensive asset quality review (AQR) would be helpful to strengthen market confidence. Getting the whole picture of banks' assets is the basic for strong banking supervisions, and without it, stress test could not be conducted. While we understand the effectiveness of on-site examination which the authority points out, the information taken from on-site examination could be less comparable among banks compared with AQR. We also take note with concern that state-owned banks expand TL lending through collecting FX deposits, which have kept Net Open Position (NOP) before hedging per regulatory capital as more than - 40 percent. While these FX positions seem almost fully hedged, could staff elaborate more on the risk posed by FX hedge, considering the roll over risk of hedging transaction in case that Turkish banks' credit risk is highlighted?

Structural reforms are important to underpin financial market stability and medium-term growth. Given the financial vulnerability caused by dependence on FX funding, domestic bond markets denominated in local currency needs to be fostered. Boosting competitiveness, by reducing labor market rigidities, stimulating private investment through improving the business climate, and increasing labor force participation and productivity through addressing human capital bottlenecks, is indispensable. To promote structural reforms, appropriate sequencing is important to mitigate reform costs. In this regard, staff's analysis on prioritization of reforms in SI is welcome and we encourage the authorities to promote necessary reforms going forward.

Mr. Rosen and Ms. Senich submitted the following statement:

We thank staff for the comprehensive report and Messrs. Kaya and Bayar for the buff statement. Last year's sharp depreciation and recession exposed the vulnerability of Turkey's dependence on externally-funded credit and demand stimulus. While growth has resumed, it has done so only with extensive expansionary policy support, and many of the vulnerabilities that were building in the first half of 2018 remain, including inflation well above the target rate, opaque monetary policy, large currency mismatches in the private sector, and increasing credit provided through state-owned banks. To address the growing risks to domestic and external stability, we urge the authorities to adopt prudent macroeconomic policies and address rising financial sector weaknesses. As we generally agree with staff's assessment of Turkey's economy and policy recommendations, we focus our remarks on a few key issues.

Continued rapid easing of the policy rate before the Central Bank of the Republic of Turkey (CBRT) has met its inflation target would seem to prematurely declare victory over inflation. To restore credibility, the CBRT should prioritize bringing inflation within the target range through tighter monetary policy. We agree with staff's recommendation to increase monetary policy transparency through using a limited number of instruments and rates and to increase transparency through the regular publication of information on amounts and rates of these instruments.

Tighter monetary policy will also support the stability of the currency. We support staff's view that Turkey should use the space provided by the relatively benign external environment to rebuild reserves through a transparent framework for FX intervention. We also urge the discontinuation of unconventional policies such as the two capital flow measures highlighted in the report and the export rediscount credit facility. Could staff comment on whether they consider the capital flow management measures appropriate under the Institutional View?

Turkey's public debt remains low but is expected to rise over the medium-term without a gradual fiscal consolidation. We see the rationale for using available fiscal space to accommodate the nascent recovery in the near term, but are concerned that the authorities risk losing a key policy anchor should fiscal expansion continue into the foreseeable future.

We are also troubled that credit expansion has grown rapidly in state-owned banks, which have doubled Turkish lira loans over the past three years despite the downturn in the economy. This credit growth has led to an increase in external financing and to liquidity strains in the financial sector. Meanwhile, recent currency depreciation and low economic growth have strained the balance sheets of non-financial corporations and shifted their trade financing abroad. We support the recommendation for a third-party review of financial asset quality and further improvements to non-financial corporation bankruptcy and debt restructuring.

Further efforts are needed to improve the implementation of the AML/CFT framework. Turkey's recently concluded Financial Action Task Force mutual evaluation highlighted the need to strengthen its ability to freeze without delay, the assets of entities designated by the United Nations Security Council related to terrorism, the financing of terrorism and proliferation of weapons of mass destruction. We urge the authorities to fully implement the evaluation's recommended actions as identified in the forthcoming report.

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

We thank staff for their valuable set of reports and Mr. Kaya and Mr. Bayar for their informative buff statement. Following the 2018 bout of market volatility, lira depreciation and the related recession, substantive policy support has revived short-term growth, but has also increased vulnerabilities. The latter include low FX reserves, high external financing needs, the rising fiscal deficit, and stressed corporate and banking sector balance sheets. We agree with staff that macro-policies need to be re-oriented toward increasing resilience and securing growth over the medium term.

There is a need for more durable policy measures. According to the risk matrix, eight out of nine major risks are very likely to materialize. Almost half of these risks would have a significant impact on the Turkish economy, if they were to materialize. The current focus on boosting short-term growth increases the risk of undermining policy credibility, reduces buffers and increases balance sheet risks of state-owned banks. Without a comprehensive reform package, longer-term growth will likely remain subdued, exposed to bouts of volatility, and vulnerable to internal and external shocks.

It will be critical to enhance central bank credibility and address inflation. We concur with staff that central bank credibility depends on a clear monetary and intervention policy. We note that the dismissal of the former central bank governor and changes in senior management were accompanied by large policy rate cuts. In this regard, we encourage the authorities to ensure central bank independence. This would be key to support policy credibility. The real policy rates are now well below levels that would underpin the currency and keep inflation and inflation expectations in check. The low rates also prevent the accumulation of foreign exchange reserves to a level sufficient to shield against the volatility of capital flows. Could staff elaborate on whether the reported decline in the central bank's revaluation account is related to the transfer to the Treasury mentioned in paragraphs 8 and 9?

Fiscal prudence and a return to the consolidation path will be key for stabilizing debt. We welcome that the authorities agree on the importance of fiscal discipline. However, despite the consolidation foreseen in the 2018 New Economy Program, fiscal stimulus continued. Fiscal expansion will affect public debt sustainability over the longer term and limit room for future policy. In that context, an adjustment to curb debt and bring down financing needs would be necessary. Structural fiscal measures would also help in that regard.

To contain a further build-up of contingent liabilities, lending through state-owned banks should be curtailed. Rapid credit growth and the growing currency mismatch have weakened the balance sheets of the state-owned banks, as evidenced by the recent capital injections. The macroprudential measures that incentivize lending by SOBs should be abolished. We support the proposed third-party asset quality review, which will be key for assessing the true condition of banks' balance sheets and promoting deleveraging and resource reallocation.

Strengthening growth in a more sustainable manner would require a comprehensive reform package. Shifting from short-term measures to more sustainable policies along the five-pronged response proposed by staff would enable more resilient growth. We emphasize the need for structural measures to boost productivity. Additionally, renewed efforts are needed to tackle Turkey's substantial informal sector, which impedes fair competition, distorts resource allocation and decreases fiscal revenues.

Mr. Sigurgeirsson and Mr. Damgaard submitted the following statement:

We thank staff for the useful set of papers, and Mr. Kaya and Mr. Bayar for their informative buff statement. We welcome the resumption of growth following the sharp lira depreciation and recession in 2018. At the same time, it is important that the authorities shift focus from short-term stimulus to improving the underlying medium-term growth potential of the economy. We broadly agree with staff's appraisal and offer the following points for emphasis.

Fiscal discipline should remain a key policy anchor. While a fiscal expansion was helpful to restore growth in the wake of the 2018 recession, we encourage the authorities to consolidate medium-term fiscal policy. Strong fiscal discipline has been a cornerstone of Turkish economic policies, but it is a cause for concern that staff's projections in Table 1 show a gradual expected increase in general government gross debt to GDP from 28 percent in 2017 to 37 percent in 2024. Given the elevated vulnerability indicators shown on p. 5, fiscal responsibility is even more important than usual at this juncture.

Monetary policy should be strengthened and reserves replenished. We agree with staff that the monetary easing cycle has been too aggressive. A tight monetary policy is necessary to bring down inflation expectations and to mitigate macro-financial risks. In addition, we note that the reserves are well below the IMF's ARA metric. We strongly encourage the authorities to build reserves given the vulnerability to external capital outflows.

Deleveraging and balance sheet cleanup in the financial sector should be main priorities. While state-owned bank credit growth also supported the recovery, vulnerabilities are emerging. Despite relatively high capital ratios, we note that the loan-to-deposit ratio has increased significantly since the GFC and is substantially higher than the EM median. Given the discretion in recognizing loan impairment, we agree with staff on the need for a comprehensive third-party assessment of bank assets, new stress tests, and follow-up measures. We note that the authorities disagree with staff's assessment that the credit gap is positive. Could staff elaborate on the underlying reasons for this discrepancy, including methodological differences? Regarding AML/CFT, we welcome the authorities' efforts to strengthen the framework and encourage further enhancements.

Focused structural and governance reforms are necessary to lift potential growth. We appreciate staff's Selected Issues Paper on productivity payoffs of structural reforms in Turkey. In this context, we encourage the authorities to implement reforms aimed at the business and regulatory environment, labor market flexibility, and the quality of human capital. We also welcome the authorities' targeted reforms, which have led to a significant increase in Turkey's ranking in the World Bank's Doing Business Indicators as highlighted in the buff statement. Finally, we encourage the authorities to improve governance reforms, especially those aimed at improving regulatory predictability and reducing corruption vulnerabilities.

Ms. Levonian, Mr. Ronicle, Ms. McKiernan, Mr. Chrimes and Mr. Rankin submitted the following joint statement:

We thank staff for the very informative and well-articulated papers, and Mr. Kaya and Mr. Bayar for their detailed buff statement. We agree with staff's overarching assessment and main policy recommendations and offer the following for emphasis.

The return to positive year-on-year growth is welcome, but we share concerns about the sustainability of Turkey's recovery: it has been facilitated by relatively benign external market and geopolitical conditions for much of this year and supported by policy stimulus focused on the short term, which could exacerbate other vulnerabilities. The high stock of external and FX-denominated debt, much of which is short term, leads to high external financing requirements in the next few years and remains a key vulnerability. The authorities have managed to avoid a more severe downturn this year, and – as staff highlight – have delivered a remarkable turnaround in the current account in the short run. However, the need to transition to a focus on higher and more resilient medium-term growth with lower internal and external imbalances is acute.

We agree with staff's emphasis on the importance of boosting the credibility of the Central Bank of the Republic of Turkey (CBRT) and to tighten monetary policy to deliver durably lower inflation that is critical for Turkey's longer-term prospects. In 2019, base effects have played an important part in bringing down headline inflation and creating space to cut rates without undermining the currency – but those base effects are now fading. The external environment has been relatively benign for much of 2019, but this cannot be guaranteed going forward. Inflation expectations also remain well above target. In our view, these factors all sharpen the need for the CBRT to pursue policies to bring down inflation, and to adopt a clearer approach on foreign exchange intervention. We note that clearer communication would strengthen the credibility of Turkey's monetary policy and increase predictability for market participants. We welcome the authorities' views on the need to accumulate international reserves as conditions permit, but share staff concerns about the difficulty in assessing reserves. Furthermore, unorthodox interventions may have been effective in the short term in supporting the currency, but they are likely to discourage foreign investment in the future as they will make it more difficult for foreign investors to hedge foreign exchange risk on their Turkish exposures. This will make it more difficult for the authorities to achieve their ambitious targets for medium-term GDP growth, especially if domestic savings continue to be relatively low. Could staff comment on the risk of capital flow reversal and recommendations for risk mitigation?

A third-party asset quality review and new stress tests would complement Turkey's supervisory framework and help authorities better understand and strengthen bank health. We caution that state-owned banks' balance sheets may be carrying more NPLs than anticipated, given banks' discretion in recognizing loan impairment. The comparison of state-owned and private/foreign banks [Box 1] is striking. In the context of the increased dollarization of deposits and the use of state-owned banks as drivers of renewed credit growth, the weakening liquidity position of state-owned banks, especially in foreign exchange, could represent another potential source of risk in a future stress scenario, with potential adverse consequences for the public finances if extra public support were needed to support state-owned banks.

Shifting the growth model to deliver higher, sustainable growth in the medium term is a pivotal challenge. The Selected Issues Paper on the role of structural reforms in productivity highlights some important areas of focus.

We recognize the political challenges associated with staff's proposals on labor market flexibility, but also underscore the benefits such approaches, if appropriately calibrated, could bring. We also draw attention to the paper's reference to the importance of the institutional environment in the literature.

Fiscal policy should remain a key policy anchor, and we agree with staff that enhancing fiscal transparency, including on quasi-fiscal activity, is important. We note that the authorities' fiscal stimulus has helped the economy recover earlier this year. Looking to next year, the authorities should take a neutral fiscal stance to reduce the risks of overheating the economy. Over the medium term, a modest consolidation would help ensure public debt remains low; maintaining robust fiscal policy now will give the authorities policy space further down the line should they need it to support tighter monetary policy and structural reform. Fiscal credibility is an essential element of maintaining confidence in Turkey's policymaking. In this regard, we encourage the authorities to consider publishing reports of fiscal risks and strengthening the oversight and management of public-private partnerships and non-central government organizations as part of the budgetary process to ensure maximum value for, and transparency of, public spending.

We encourage the authorities to consider the economic benefits of further promoting gender equality. We note that female labor force participation lags Turkey's G20 peers. In this respect, we encourage the authorities to proceed with initiatives under consideration to expand early childhood education and childcare, and well as the introduction of flexible working arrangements for women. Evidence shows that closing gender gaps leads to greater revenue mobilization and higher growth.

Mr. Lopetegui and Mr. Morales submitted the following statement:

We thank staff for their clear reports and Mr. Kaya and Mr. Bayar for their informative buff statement. Turkey's economic activity has started to recover, but current stability appears fragile, as fiscal imbalances widen, international reserves remain low, and external financing needs rise, which conspire against prospects for strong sustainable growth in the medium term. A moderation of the recent policy stimulus measures appears advisable to preserve macroeconomic stability on a sustainable basis. As Mr. Kaya and Mr. Bayar highlight in their statement, the political landscape provides a window of opportunity to introduce a comprehensive reform package aiming at strengthening private and public balance sheets, reinforcing institutions, and continuing with structural reforms to support higher growth rates down the road.

Turkey's economic performance over the last two decades has been strong, but domestic and external challenges have increased. The 2018 run on the lira triggered by a change in market sentiment, and the unavoidable corrective measures that followed, have had a large impact on Turkey's economic activity. GDP growth has started to recover in the second half of 2019 following three quarters of negative y-o-y growth, but it is only expected to be slightly positive for 2019 as a whole. For this reason, it is important that the Turkish authorities give high priority to addressing remaining and emerging vulnerabilities to avoid a repetition of the damaging eruption of volatility of 2018.

Following the authorities' decisive action to address macroeconomic instability in the second half of 2018, the macroeconomic policy stance has turned expansionary in 2019. While some prudent use of available fiscal room appears understandable given negative growth in the first half of 2019, we are concerned about the weakening of fiscal discipline reported by staff. Higher spending has triggered higher-than-planned government borrowing and a drawdown of Treasury deposits. In spite of higher borrowing, the government has also resorted to central bank financing in the form of a large transfer to the Treasury to finance remaining outlays in the context of weak fiscal revenues. We agree with staff that a shift to a broadly neutral fiscal policy would contribute to medium-term public balance sheet strength, which would help restore credibility. In this respect, the statement by Mr. Kaya and Bayar that fiscal prudence will be preserved is reassuring. Fiscal measures to be considered include reforming the VAT, eliminating public wage indexation, and better targeting social spending to eliminate waste. Regarding capital expenditure, better integrating public-private partnerships within the public investment management framework and bringing investments and borrowing by the Turkey Wealth Fund into the budget should be priority measures. Finally, debt management practices should return to international standards of transparency and predictability.

Monetary policy helped bringing inflation down from its peak, but inflation expectations remain well above target. Moreover, high lending growth by state-owned banks threatens to weaken monetary transmission to domestic prices. In addition, international reserves are still low, which has led the government to impose some capital flow management measures and intensify central bank direct and indirect intervention in foreign exchange markets. On a related point, while the external current account adjustment has been significant, we wonder how much of the recent narrowing of the current account deficit would reverse if growth rates normalize. Staff comments are welcome. A strong commitment to the central bank inflation target would enhance internal and external credibility, contributing to monetary and financial stability, which would prevent a new episode of sharp deceleration of economic activity in the face of an external shock. We agree with staff that clarity in communicating monetary policy decisions is essential, which is complicated by the use of multiple instruments for different purposes (e.g., subsidized lending to primary dealers and long-term export rediscount credit). We encourage the authorities to assess the effectiveness of such instruments vis-à-vis the central bank policy objectives.

Banks’ balance sheets should be monitored closely to detect signs of weakening in a timely manner. Some financial indicators point to emerging weakness, such as lower profit margins, increased dollarization, and high loan-to-deposit ratios. Moreover, given banks’ discretion in recognizing impairment of their loan portfolios, there may be lags in the impact of higher credit risk on NPL indicators. Also, state-owned banks, tasked with supporting rapid credit growth, may be incurring a higher credit risk than what is shown in available financial indicators. We wonder if part of the new credit by state-owned banks is being used to repay outstanding obligations with commercial banks. Could the staff indicate if there is any evidence of this? In this context, it may be prudent to reverse the central bank decision to lower reserve requirements for banks showing high credit growth, which should not have an impact on activity as sluggish credit growth seems to be the result of weak credit demand rather than of supply constraints. We also agree with staff that tighter loan classification and provisioning rules should be put in place so that banks financial statements better reflect the financial soundness of banks.

We commend the Turkish authorities for their progress in improving the business environment. Turkey’s ranking improved from 60 to 33 in the 2019 World Bank Doing Business, which should translate into productivity gains with adequate policies. Looking forward, the government may focus on areas where Turkey lays behind OECD benchmarks, such as regulatory quality, quality of education, and worker-employer relations. On a related point, the initiative to expand early childhood education and the introduction of flexible working arrangements for women would be steps in the right direction.

We encourage the authorities to address the FATF recommendations to improve the AML/CFT framework. The recent discussion at the FATF Plenary indicated that Turkey has an adequate legal framework for effective action against AML/CFT crimes, but shortcomings in pursuing money laundering and terrorist financing and confiscating assets related to terrorism.

With these comments, we wish the Turkish authorities and people the best in the endeavors.

Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-focused reports and Mr. Kaya and Mr. Bayar for their helpful buff statement. We are in broad agreement with the staff appraisal and would limit our remarks to the following issues.

We welcome the economic recovery following the sharp lira depreciation and associated recession in late-2018. Indeed, growth resumed, supported by policy stimulus and favorable market conditions; inflation fell sharply, albeit still well above the target; the lira recovered; and the current account adjusted significantly, aided by import compression and strong tourism receipts. At the same time, vigilance is warranted as vulnerabilities have increased against the backdrop of Turkey's exposure to domestic and external risks. In this connection, we welcome the focus of the Article IV discussion on addressing existing weaknesses and setting the economy on a path toward stronger and more resilient growth. Here, we take positive note of the authorities' policy program, as laid out under the New Economy Program 2020-22, to enable a rapid return to high growth while enhancing price and financial stability and consolidating gains on external balances. To this end, pursuing a prudent macroeconomic policy mix and implementing focused structural reforms will be key.

Fiscal policy has been the longstanding anchor in support of the Turkish economy's resilience and this prudence should be preserved. In this connection, we welcome the authorities' aim to maintain public debt at low and stable levels. To this end, they should continue their efforts to strengthen revenue mobilization, including through revenue administration improvements, and restraint expenditure growth, including through controlling the wage bill. Improving the composition of spending especially increasing and better targeting social assistance spending should also be considered. On PPP projects, we take positive note in the buff statement of the authorities' plan to build on the assessments and recommendations of the Fund TA by preparing a framework to ensure efficiency, productivity, affordability, and integrity.

Tighter monetary policy stance would help in bringing inflation to the target more rapidly than currently projected, allow reserves to be rebuilt, and address dollarization. In this context, we found the analysis in Box 4 to be informative and agree with the conclusion that managing inflation expectations is critical for bringing inflation under control and allowing for sustainably lower interest rates. We noted in today's Global Markets Monitor that the Central Bank of Republic of Turkey (CBRT) has announced that it will hold 12 meetings in 2020, instead of only 8 as it has done since 2017. We would welcome staff comments on this announcement by the CBRT. We are encouraged by the authorities' efforts to rebuild international reserves, subject to economic and financial conditions. Here, we see merit in staff's call for a transparent framework to help promote high-quality capital flows, which would support the replenishment of reserves.

The banking system has shown resilience, but vigilance is essential in view of rapid credit growth by state-owned banks through borrowing heavily in FX, contributing to a sharp increase in deposit dollarization. We note the disagreement between the authorities and staff on the assessment about the positive credit gap and would welcome staff elaboration whether this is due to methodological differences in computing credit gaps. We also note the divergence of view on the strength of the supervisory framework. Can staff provide specific reasons for recommending a third-party assessment of bank assets and a new stress test framework? On AML/CFT, we welcome the implemented measures and encourage the authorities to continue their efforts to further strengthen the framework.

Finally, we welcome the analysis in the SIP on important structural reforms to enhance productivity and bolster Turkey's medium-term growth prospects. In this regard, priorities include improving labor market flexibility, skills, and the business and regulatory environment.

With these remarks, we wish the authorities further success.

Ms. Mahasandana, Mr. Doornbosch, Ms. Pandit and Mr. Zedginidze submitted the following joint statement:

We thank staff for the interesting set of papers and Mr. Kaya and Mr. Bayar for the informative buff statement. The Turkish authorities have made progress with reinvigorating the growth momentum by making some improvements in the macro-fiscal performance. However, challenges remain in terms of restoring market confidence and maintaining macroeconomic sustainability. While the current policy efforts focus on mitigating short-term vulnerabilities, they should be complemented by structural reforms to enhance longer-term resilience. We agree with the broad thrust of staff's appraisal and would like to add the following comments for emphasis.

Despite the rebound in some economic sectors, raising overall productivity growth remains crucial to ensure the sustainable growth in the medium term. The current growth-support policy has helped boost near-term growth but has also resulted in a positive credit gap, high inflation and strains in the non-financial corporate and banking balance sheets that could dampen future growth prospects. We broadly agree with staff's recommendation to shift the macroeconomic policy focus from short-term stimulus to the promotion of long-term sustainable growth through the implementation of a comprehensive reform. That said, we are mindful about the current fragile situation and weak market sentiment that could dampen the situation if the policy transition is not managed properly. Could staff provide further elaboration on the plan to re-orient the short-term growth policy, particularly on the preconditions and risk mitigation measures to facilitate an orderly transition period. Staff comments on the newly-launched New Economy Program in promoting sustainable growth in the long-term are also welcome.

The authorities should remain committed to fiscal discipline to address the fiscal risks stemming from the current vulnerabilities, while maintaining debt sustainability. While the fiscal policy has been a strong policy anchor for the country, the current scenario of declining fiscal balances with a widening primary deficit is worrisome. Furthermore, considering the tight domestic financing conditions as well as the increased spreads for external borrowing, potential debt-rollover pressures add an extra burden to the fiscal envelop given the high share of interest payments. Also, risks could arise from the contingent liabilities related to PPPs. A strong fiscal consolidation path through the broadening of the tax base, improving VAT efficiency, rationalization of the wage bill and better targeted transfers are essential to strengthen the fiscal position and improve fiscal buffers. In this regard, we also welcome the authorities' plan for the New Economy Program targeting a public sector consolidation program with the expectation of revenue increases and spending cuts.

A high inflation rate well above the inflation target underscores the challenges to the Central Bank's credibility. Monetary policy should focus on strengthening credibility and lowering inflation. This will also help lower interest rates later by lowering monetary policy neutral rates, thus support economic growth in the medium term. We observe a difference in the view of staff and the CBRT on the monetary policy stance and operations. While staff notes that the current policy rates are too low and advises the CBRT to streamline its market operations to send a clear signal to the markets, the CBRT deems the current policy stance to be appropriate to contain inflation and support economic growth. Can staff assess the consequence of current monetary policy stance on the growth outlook in the medium term?

Steadfast legal and procedural improvements are vital for the resolution of the highly indebted and ailing non-financial corporate sector as well as for the financial sector. We take note with concern that the health of the non-financial corporate sector has worsened with the increase in leverage. Similarly, the high lending effort through the CGF and state-owned banks is also magnifying the leverage conditions and creating balance sheet stress within the financial system. We observe the continued difference in views of authorities and staff and welcome staff's comments on the evaluation of the pros and cons regarding this subject. Going forward, we encourage the authorities to prioritize the review of insolvency legislation strengthening broader supervision procedures and a robust bank regulatory framework in line with international best practices. We also see merit in the conduct of a third-party asset quality assessment to support the health of financial system.

Further structural reforms are essential to underpin productivity growth. We welcome the authorities' efforts to diversify the economy towards high value-added tradeable sectors and their intention to improve the educational system and presume judicial reform. Furthermore, to enhance productivity growth, we share the staff's views that improvements in technical efficiency can be realized through structural reforms involving labor market flexibility, qualitative human capital and a better regulatory and competitive environment by simplifying business procedures. These could be complemented by governance reform and the automation of the energy sector.

Finally, given that Turkey plays an important role in the region, going forward we would welcome more focus on geopolitical risks and possible spillover risks in the report. Turkey is engaged in the peace operation in Syria and claims an important role in an unstable region. How does staff assess the influence of geopolitical instability on the implementation of the reform program?

Mr. von Kleist and Mr. Braeuer submitted the following statement:

We thank staff for its well-written report and Mr. Kaya and Mr. Bayar for their informative buff statement. Following a currency shock and recession in 2018, growth has resumed, the Turkish lira has recovered, and inflation has declined substantially. Nevertheless, the Turkish economy is still growing below potential with unemployment rising. External financing needs are still high, even though the current account deficit has shrunk on the back of weak domestic demand and a strong tourism season. Reserves, in particular on a net basis, are still low. The problems of non-financial corporate debt overhang and impaired loans on banks' balance sheets remain largely unsolved. The budget deficit has widened significantly over the course of the year and fiscal space has become increasingly limited, even though the level of public debt is still relatively low. Overall, as noted by staff, a shift away from policy stimulus boosting short-term growth to measures supporting sustained medium-term growth is warranted.

We support staff's recommendation to increase resilience to shocks and hence macroeconomic stability. We call on the authorities to take determined steps to clean up bank and corporate balance sheets. This should include a third-party asset quality review and stress tests to assess the extent of the asset quality problem. We caution against further efforts to expand lending, as the rapid credit growth by state-owned banks has already contributed to a weakening of their balance sheets.

A prudent and stability-oriented monetary policy is necessary. Against the backdrop of still-high inflation rates, elevated inflation expectations, and lingering macro-financial risks, we share staff's view that the CBRT easing cycle has gone too far. The primary aim of monetary policy should be to ensure stability by sustainably lowering inflation. This, in turn, would help restore institutional credibility and boost investor confidence and thus private-sector led growth.

We encourage the authorities to give high priority to further bolstering confidence in the sustainability of fiscal policies. While we broadly concur with staff's assessment in this regard, we would welcome a clarification on the expected fiscal stance in 2020. We note that staff recommends a "broadly neutral stance" compared to the authorities' program that implies an unspecified consolidation effort of close to 2 percent of GDP. However, staff's baseline still foresees an adjustment in the cyclically adjusted primary balance of around one percentage point of GDP, which would imply a tightening rather than a broadly neutral stance. Staff comments would be welcome.

To improve medium-term growth prospects, structural reforms are indispensable. Rather than stimulating the economy through debt-financed programs to boost short-term growth, we recommend taking the necessary steps to improve product market efficiency and a market-based reallocation of resources to productive sectors. We especially second staff's call to invest more in education and training and to increase female labor force participation.

Mr. Bhalla and Ms. Dhillon submitted the following statement:

We thank staff for the excellent reports and Messrs. Kaya and Bayar for their helpful buff statement.

Turkey's economic performance for nearly two decades has remained impressive. So, after the currency shock and recession in 2018, the present rebound in the economy aided by a policy stimulus, and recovery of the Lira is encouraging. But external headwinds including a deterioration in sentiment towards emerging markets, geopolitical tensions and domestic risks related to political developments and policy implementation, endure. The New Economy Program released in September 2019, further aims to uplift economic growth back while enhancing price and financial stability and consolidating gains on external balances. Meanwhile, the authorities remain more hopeful of growth outlook than staff. We broadly agree with the thrust of the staff report and would offer additional comments on the points of divergence between the buff and the Article IV report.

Turkey remains committed to its fiscal policy for sustaining the economy's resilience. The recent fiscal stimulus has been focused on bolstering economic activity. Moving ahead, we do see a need for a modest consolidation to sustain the recovery, maintain the low public debt, (especially given the financing needs) and support an increase in the transparency on the contingent liabilities. We take positive note of the authorities' efforts on Public-Private-Partnership proposed framework arrangement to ensure efficiency, productivity, affordability, and integrity. On tax measures the authorities have indicated in the buff that they do not intend to introduce new tax policy measures in addition to what was already enacted in 2019. Could staff elaborate on the appetite in the economy for the additional tax measures suggested in the report and the alternate policy levers which could be deployed instead?

Even as inflation targeting remains the common goal, the authorities and the staff have a difference in approach for achieving this. The staff consider the easing cycle has been too aggressive and have recommended a clearer monetary and intervention policy to strengthen central bank credibility. We remain fully supportive of clear transmission and intervention policy. Separately, we would like staff to offer their views on the authorities' stance that the current monetary policy stance is consistent with the projected disinflation path?

The authorities have highlighted that the financial system is sufficiently strong to support further credit growth. The staff on the other hand has offered diverging viewpoints on the credit gap and even the state of the banking sector. In the analysis on BOX 2, staff has mentioned that Turkey's output and credit developments in 2019 are like—if not worse than—developments recorded in the first year of typical banking crises. Overall, the staff has presentenced a pessimistic scenario in the report and we are struck by the extent of divergence, especially on the credit gap and third-party asset quality review, to get a better sense of bank balance sheet health. We do see that the authorities have expressed confidence in the current supervisory framework – aided by regular, detailed on-site examinations as well as an effective stress test framework. Could staff elaborate more on the performance of Banking sector, especially in the context of Islamic banking and on the reasons for this diverging assessment? Beyond this, we urge would the effective action on AML/CFT frameworks.

Finally, comprehensive structural reforms would improve Turkish economy's competitiveness and address impediments to job creation and investments. We positively note the efforts of the authorities to this end, including on the improved rank of Turkey in World Bank Doing Business Indicators to 33 in 2019, from 60 in 2017. Further, policies already underway to improve the efficiency of the labor market, business environment, public financial management, capital markets, and judicial and education systems are positively noted. We would like to see a selected issues paper on the developments in the education system and female labor participation in the next Article IV.

With these comments, we wish the authorities the best in their endeavor.

Mr. White and Mr. David submitted the following statement:

We thank staff for their reports and Mr. Kaya and Mr. Bayar for the informative buff statement. We note that strong growth in Turkey was impacted in 2018 by adverse sentiments towards emerging market economies combined with geopolitical developments, resulting in a run on the currency and a recession. We welcome the return to growth in 2019 but share staff's concerns about balancing short- and medium-term considerations to ensure sustainability. In particular, the short-term focus on monetary policy easing, credit growth, and expansionary fiscal policy, risks increasing vulnerabilities in an environment of favorable external conditions, which may not necessarily continue. We therefore broadly concur with staff's assessment and see merit in the proposed comprehensive reform package. The five-part policy response is well focused on moving the country towards a sustainable, medium-term growth path.

On monetary and foreign exchange policy, we agree that central bank credibility needs to be strengthened and that inflation remains a key concern. We share staff's concern that monetary policy is too loose and support the need to phase out multiple instruments which complicate communication and transmission, and to increase transparency in foreign exchange intervention.

Macro-economic risks can be further exacerbated by fiscal expansion which may run into external financing constraints as identified in the risk assessment matrix. With regard to fiscal policy, we note the recommendation by staff for a neutral stance in the short-term and for consolidation in the medium-term to address debt sustainability and create fiscal space. While historically strong fiscal discipline creates a good platform, the widening public deficit is putting the medium-term debt trajectory under pressure. We therefore agree that gradual fiscal consolidation is important and, in this regard, support staff's recommendations on broadening the VAT base and removing backward-looking public sector wage indexation over the medium term. We also welcome the call for improved transparency for contingent liabilities, especially for public-private partnerships. We note that the authorities expect stronger economic activity than staff, and hence plan to maintain the 2019 fiscal balance in 2020. Could staff comment on the reasons for the differences in growth forecasts?

We agree with staff's call for measures to enhance stability and rebalancing in the financial and corporate sectors. These would support the ongoing efforts by the authorities to strengthen the regulatory, resolution and AML/CFT frameworks and the insolvency regime. We note that credit growth is largely due to expansion by state-owned banks, at rates below the central bank cost of funding and that classification of NPLs is discretionary for banks. We acknowledge the authorities views about the strength of the regulatory framework, but nevertheless see merit in the recommendation for a third-party asset quality review to assess the health of the banking system.

We are encouraged by the authorities' ongoing commitment to structural reforms. Their reforms are broadly in line with staff's recommendations to boost productivity through improving the business and regulatory environment, labor market flexibility, human capital and female participation in the labor force. We particularly welcome the gender equality initiatives which would expand early childhood education and childcare and increase opportunities for flexible working conditions for women. We also welcome the authorities' focus on other areas as well, including the renewable energy and technology-intensive sectors, social inclusion, poverty alleviation and equal opportunity for all. The productivity pay-offs from structural reforms will help strengthen growth prospects for the medium term.

Mr. Obiora, Mr. Odonye and Mr. Tivane submitted the following statement:

We appreciate the analysis in this report and broadly agree with the thrust of the appraisal by staff. The Turkish has strengthened from the 2018 recession, aided by benign global financial conditions and a strong commitment by the authorities to push forward structural reforms to support medium term growth, boost external competitiveness, and foster human capital development. We are further comforted by the package of detailed information in the enlightening buff Statement from Messrs. Kaya and Bayar. In particular, the growth outlook for the outer years envisaged under the New Economy Program (2020-2022) seems robust. Yet, this outlook appears sensitive to a wide spectrum of risks that could be triggered by an adverse shift in market sentiments towards emerging markets, increased global uncertainty, as well as idiosyncratic shocks. We are encouraged by the authorities' commitment to sustain the implementation of their reform agenda to entrench macroeconomic stability, sustain the growth momentum, and enhance the resilience of the economy to external shocks, and believe these plans will serve the Turkish economy well in the short- to medium-term.

A commitment to a growth-friendly fiscal strategy is critical to improve debt dynamics and support the country's development objectives. We support staff's views that a medium-term consolidation strategy supported by revenue-enhancing measures and stepped up efforts to contain expenditure is critical to rein in public debt dynamics. These policies should be complemented by legislative steps underway to further improving the public-private partnerships (PPPs) risk management and reporting framework as well as ensuring its better integration with the budget. Similarly, invigorated steps to enhance oversight of risks associated with PPPs while ensuring that the Sovereign Wealth Fund's governance is in conformity with international best practices should contribute to enhance policy credibility. That said, we wonder if staff could reconcile the authorities' neutral fiscal stance in 2020 to the projected sharp decline in public consumption from 5.0 percent in 2019 to 0.4 percent in 2020.

We note the characterization of the main challenge facing Turkey but would like some clarification. Staff indicate, in several instances, that the authorities should move their focus from short-run growth to higher medium-term growth. This advice seems to suggest that short-run growth is mutually exclusive to higher medium-term growth. Could staff elaborate on their concerns around the authorities' current policies? How do the package of reforms advocated by staff inhibit short-term growth? In particular, are the authorities' current policies inhibiting higher medium-term growth?

Preserving monetary policy credibility remains critical for macroeconomic stability, financial sector resilience, and sustainable growth.

In this context, the authorities should aim to tighten monetary policy to boost the credibility of the central bank, underpin the lira, durably lower inflation, while strengthening reserves. We note the authorities' recent policy actions aimed at reining in inflation pressures and re-anchoring inflation expectations. Contrary to the authorities' assessment, staff's analysis seems to suggest that the Central Bank of Turkey's monetary easing cycle appears to be rather aggressive to keep inflation and inflation expectation in check. In light of this divergence in views, could staff comment on whether the Bank's policy of credit expansion could significantly jeopardize the hard-won gains in policy credibility achieved so far? Going forward, we underscore the importance of calibrating monetary policy prudently to rebuild reserve buffers and durably stabilize the Lira. Furthermore, we encourage the central bank to continue with actions underway to boost financial sector resilience by accelerating the deleveraging and strengthening of banking system capital buffers; enhanced monitoring of the financial stability risks from state-owned banks; enhancing the insolvency regime and out-of-court debt restructuring framework; and continuing on measures to strengthen the AML/CFT framework.

On the financial sector indicators, we found the similarities in the ROAE and ROAA surprising. Given the level of debt in the public and private sectors in Turkey, we are surprised to find ROAE and ROAA implying that the banking sector is basically debt-free. Can staff comment on this? Indeed, Paragraph 1 of Annex IV indicates that a large share of external debt (about 21 percent) is owed by banks. In view of this, could staff comment on why the ROAE and ROAA are basically the same in many years, suggesting that the banking sector has almost zero debt?

Lastly, deploying a comprehensive package of structural reforms is pivotal to support productivity and competitiveness growth, and buttress the economy' resilience to external shocks. We are encouraged by the initiatives underway to address structural challenges, including through steps to rebalancing the economy toward productivity-enhancing sectors, creating a robust set of incentives to support private sector development, improving human capital, promoting female labor force participation, and improving governance. We also believe that a robust communication strategy, coupled with an appropriate sequencing of the reform priorities, is essential to garner the required support from various stakeholders and mitigate the potential short-term trade-offs, as rightly pointed out by staff.

Mr. Jin and Ms. Cai submitted the following statement:

We thank Mr. Kaya and Mr. Bayar for their helpful buff statement. Expansionary fiscal policy, rapid credit growth, and a more favorable external financing policy have helped Turkey to maintain its economic growth. The lira recovered with a current account adjustment. Inflation also has fallen sharply, although still above the central bank's inflation target. As we broadly concur with staff's appraisal, we would like to limit ourselves to the following points for emphasis.

While fiscal policy successfully supported economic activity in 2019, it is still necessary to contain the fiscal deficit and public debt through fiscal consolidation. New spending commitments, including increases in the public wage bill, holiday payments to pensioners, and subsidies to companies, deteriorate fiscal primary balance. High public-private partnership (PPP) activity also pushed up contingent liabilities. We encourage the authorities to take further measures to achieve a general government primary surplus, including broadening the revenue base and containing ad-hoc subsidies. Strengthening the PPP risk management and reporting framework is conducive to preserving fiscal space. We welcome the authorities' efforts to strengthen oversight and management of the PPPs and encourage the authorities to integrate the PPP into the budget.

Given that inflation remains high and there is a need to anchor expectations, it is appropriate to maintain a prudent monetary policy stance. A more transparent policy framework and more conventional monetary policy instruments are conducive to underpinning credibility. Given that the deterioration in asset quality has not shown up fully on bank balance sheets due to the discretion in recognizing loan impairment, we encourage the authorities to further strengthen bank governance and supervision, including having a third-party asset quality review. In order to be better prepared for a "sudden stop" of capital inflows, macroprudential tools should be used to build buffers.

We commend the authorities' steady implementation of structural reforms to boost potential growth and reduce poverty. More needs to be done to accelerate total factor productivity growth against the backdrop of cyclical growth conditions. Labor market reforms are also crucial. We encourage the authorities to strengthen vocational training, enhance opportunities for more flexible work, and improve female labor participation.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. de Villeroché, Mr. Rozan, Mr. Bouvet and Mr. Sode submitted the following statement:

We thank staff for their insightful set of reports and Messrs. Kaya and Bayar for their instructive buff statement.

Last year's economic situation in Turkey, marked by the rapid depreciation of the lira and a strong pick-up in inflation, has been partly stabilized, thanks to a resolute action of the Central Bank of the Republic of Turkey (CBRT). However, challenges ahead remain numerous and will require a sounder policy mix and ambitious structural reforms, implemented by credible institutions. More transparency in the implementation of economic policies would also help restore the credibility of institutions and the confidence in the Turkish economy.

We concur with staff that fiscal policy should be adequately balanced to preserve the nascent recovery of growth while maintaining debt on a sustainable trend. In this respect, we see the recommendation to adopt a neutral fiscal stance as adequate. Maintaining the fiscal balance at its 2019 level would however require some consolidation effort, given that revenues this year were artificially boosted by a large transfer from the CBRT. In the future, we encourage the authorities to refrain from such non-fiscal operations, detrimental to the credibility of the fiscal and monetary policies. Besides, on the back of a depreciating lira, the authorities should carefully monitor the debt refinancing and interest rate risks, since they have shifted their borrowing strategy towards shorter maturities and FX denominated issuances. The low level of debt in Turkey is an asset that should be preserved though moderate fiscal deficits and sound debt management. We would appreciate elaboration from staff about the budgetary risks stemming from contingent liabilities, notably guarantees issued by the Credit Guarantee Fund, PPP or SOEs, as well as from potential costs of bank recapitalization needs, given financial sector risks.

We welcome the downward trend of inflation and inflation expectations, enabled by several increases in the one-week repo rate of the CBRT in the second half of 2018. However, as inflation remains above the CBRT's target, we share staff's view that the recent decreases in policy rates have been too fast and too strong to preclude another rebound of inflation in the coming months. More broadly, the credibility of the monetary policy could benefit from a clearer strategy and more transparency. Streamlining monetary policy instruments would facilitate the communication on monetary policy decisions and their transmission to the economy. In addition, enhancing transparency on foreign exchange reserves, taking into account all FX denominated liabilities and reflecting them in the net reserves position, would shore up the credibility of the central bank, which is all the more necessary as the current level of reserves is low. Could staff give us a sense of the amount of FX liabilities not recorded in the net foreign assets of the central bank and the level of coverage of FX liabilities by FX assets?

We encourage the authorities to address the vulnerabilities of the banking sector. Strong credit supply by state-owned banks, sometimes at negative interest margins, has taken a toll on their balance sheets and weakened their solvency. Although the official measure of non-performing loans (NPL) is low, the current dynamics of credit, compounded with loose national regulations on NPL classification, allowing for discretionary recognition of impairment, raises strong concerns. Besides, additional risks arise from the increase in FX denominated liabilities of state-owned banks, as their liquidity position is increasingly exposed to the volatility of international financial flows. Thus, in order to avoid excessive credit expansion, the authorities should swiftly strengthen banking regulation and supervision. An asset quality review and stress-test, led by an independent third-party, would be instrumental to shore up confidence in the banking sector. Could staff elaborate on its estimate of the share of NPL corresponding to classification rule in line with international standards?

An enhanced focus on structural reforms is warranted to increase productivity and support growth in the long term. As staff's Selected Issues analysis shows, important payoffs could be obtained through more flexible product and labor markets, as well as, stronger investment in human capital, via education and training spending.

Mr. Raghani and Mr. Olhaye submitted the following statement:

We thank staff for the well-focused Article IV reports, including the interesting Selected Issues Paper (SIP). We also thank Mr. Kaya and Mr. Bayar for their insightful buff Statement.

We commend the Turkish authorities for overcoming the sharp lira depreciation and the related recession of late 2018 by pursuing supportive policies and leveraging the favorable external financing conditions. As a result of policy stimulus—which was possible with sensible fiscal space—and improved market sentiment, growth has recovered while inflation experienced a significant reduction from the highs of 2018 although it remains above target. In spite of implementing capital flow measures under the Fund's Institution View, reserves remain low. In the meantime, fiscal deficit increased somewhat without undermining debt sustainability in an environment of increased financing needs.

We note that corporate balance sheet risks and financial sector stability concerns are weighing on the outlook. External factors including geopolitical tensions and lower market sentiment towards emerging economies add to the downside risks. Yet, we share the view that Turkey can overcome its economic challenges by shifting the focus towards higher and more resilient growth while pursuing sound macroeconomic policies. In this vein, it is essential that the authorities maintain growth-friendly fiscal discipline over the medium term and roll out a comprehensive reform package geared towards rebuilding buffers, strengthening corporate and bank financial viability, enhancing governance, and fostering productivity growth.

As we agree with the thrust of staff's assessments and recommendations, we wish to offer the following additional comments for emphasis.

We see merit in integrating the authorities' New Economy Program (NEP) for 2020-22 into staff's medium-term macroeconomic framework, which may imply finetuning policy advice. We note that the NEP was released after the completion of the Article IV mission. This program envisages a fast return to high growth, which is absent from staff's framework. In addition, it assumes that deleveraging has been completed and that further credit expansion is needed to achieve high productivity growth in the tradable sector. Moreover, the NEP forecasts a fiscal consolidation based in part on a 1.2 percent-of-GDP spending cuts including "unspecified current expenditure measures" (Box 3 of the main report). We would expect staff to elaborate on possible divergence of views with the authorities on forecast assumptions, outlook and policy priorities. Staff's comments are welcome.

Reinforcing monetary policy credibility, with a focus to durably reducing inflation and inflation expectations, is warranted. While we view the tight monetary policy as appropriate, we also encourage the authorities to improve the liquidity management approach and to take steps towards upgrading their communication strategy. In addition, the necessary rebuilding of external buffers should encompass a strengthening of reserves management. To this end, the authorities should make efforts to tackle capital flow volatility and enhance transparency in well-communicated foreign exchange interventions.

The necessary pursuit of fiscal discipline as a main policy anchor and the move towards moderate consolidation in the medium term will require a policy mix to create fiscal space for social spending while remaining growth-friendly. We encourage the authorities to increase revenues through expanding the VAT base and reducing exemptions. On the other side, curtailing spending through streamlining ad-hoc subsidies is welcome. We commend the authorities for strengthening the oversight and management of public-private partnerships (PPPs) to tackle contingent liabilities which appear to be relatively elevated within an environment of rising financing needs. In this context, we urge the authorities to continue reflecting on ameliorating fiscal transparency, reducing fiscal risks, and improving debt management to lower financing costs.

While enhancements to the insolvency regime and out-of-court debt restructuring system are steps in the right direction, further efforts are required to address risks emanating from bank and corporate balance sheets and ensure financial sector stability. We share staff's view that the credit expansion by state-owned banks should be restrained as signs of strain are emerging. In addition, the fact that the banks' balance sheets do not reflect yet the deterioration in their asset quality is a source of concern, and we support a third-party asset quality review stress tests. Furthermore, reinforcing the regulatory and supervisory frameworks, particularly on loan classification and provisioning will be needed. With respect to financial integrity, we welcome the steps taken to strengthen the AML/CFT framework and increasing capacities for related law enforcement, while addressing risks and leveraging opportunities from fintech.

Well-planned and implemented structural reforms are needed to increase economic resilience, achieve sustainable growth and increase potential output. In this respect, to boost human capital, broaden the labor force and lift productivity, authorities adequately plan to expand universal education to pre-school grades, upgrade education and training, take steps to increase female labor participation rates, and reform severance pay in line with labor market conditions. We also see merit in the ongoing actions to reform the judicial system, with a view to improving the ease of doing business.

With these remarks, we wish the Turkish authorities success in their endeavors.

Mr. Villar and Mr. Montero submitted the following statement:

We thank staff for its insightful and comprehensive set of reports and Mr. Kaya and Mr. Bayar for their useful buff statement. We mostly share staff's appraisal, which is rightly focused on strengthening short-term resilience and on the need to adopt a more medium-term policy perspective in order to achieve a more sustainable growth path. We take note, though, of the important disagreements between staff and authorities in several areas.

The sharp rebound in the Turkish economy since 2017 ended abruptly by mid-2018, as deteriorating market sentiment exposed Turkey's vulnerabilities accumulated through strong policy stimulus measures that boosted credit growth and resulted in large internal and external imbalances. The ensuing recession and sharp increase in unemployment helped to partially correct some of the imbalances. Growth has since resumed, again buttressed by extensive policy support in the form of expansionary fiscal policy, rapid credit expansion by state-owned banks (SOBs), and an aggressive easing of monetary policy following the dismissal of the central bank governor.

As highlighted by staff, under these conditions, prospects for high sustainable growth have diminished because of weaker buffers and impending balance sheet adjustments. Moreover, the current policy mix is also slowing the needed reallocation of resources to more productive sectors —which is crucial to benefit fully from the large depreciation—and contributing to erode policy credibility. We believe that the five-part policy strategy suggested by staff is a good starting point to address the different policy challenges and that there is a good window of opportunity for reforms until the next major elections (in 2023).

We concur with staff that fiscal policy has been a long-standing strength in Turkey and should remain a key policy anchor. The recent fiscal stimulus has helped the economy recover, although the use of quasi-fiscal measures created distortions and potential contingent liabilities that could increase fiscal risks down the road. Going forward, a modest consolidation would be needed to ensure a low and stable public debt, which should be supported by increased transparency and control of quasi-fiscal activities (including those from public-private partnerships).

We note that following financial tensions, the authorities imposed some capital flow management measures (CFMs)—repatriation of export revenues and caps in banks' swap positions—and reportedly implemented large FX interventions through SOBs. More recently, the CBRT introduced an export rediscount credit facility which effectively acts as a FX intervention facility and, besides, as a liquidity provision tool. The CBRT also provides liquidity with other non-standard facilities, such as subsidized lending to primary dealers and FX swaps of various maturities. This complex and non-transparent set of monetary policy tools makes it difficult to assess the monetary policy stance and its transmission to the real economy. Moreover, it may affect negatively CBRT's credibility in a moment when inflation expectations do not seem well anchored, FX reserve levels are relatively low, and the degree of dollarization is increasing. Therefore, we share staff's recommendations to streamline policy tools, implement a transparent framework of pre-announced and sterilized FX interventions and gradually phase out the CFMs. Additionally, we wonder whether it would be desirable to revise legislation to further strengthen BCRT independence, in view of the unexpected removal of the former governor last summer. Staff's comments would be appreciated.

We welcome the notable narrowing of external flow imbalances, which was helped by both import compression and strong tourism receipts. According to the EBA model, Turkey's external position was broadly in line with fundamentals and desirable policies in 2018. However, at the same time the REER is estimated to have been undervalued by about 10-20 percent. Could staff explain why Turkey's external position is broadly balanced but the REER undervalued? Additionally, despite this correction in flows, big external stock imbalances remain, mostly in the private sector, reflected in large external financing needs (over 20 percent of GDP), which expose the economy to liquidity risks. We found striking the fact that errors and omissions were an important financing source in 2018. Does staff have an idea of what is behind this fact?

Rapid credit growth by SOBs has weakened their balance sheets—as it is being funded short-term and in foreign currency—blunted monetary transmission and slowed down the needed resource reallocation to more productive firms. Moreover, the current regulatory framework offers discretion in recognizing impairment, particularly with stage 2 loans, which complicates the assessment of banks' asset quality. We thus see merit in staff's proposals of a comprehensive third-party asset quality review and tighter loan classification rules to better assess banks' health and strengthen confidence in the financial system. Additionally, this should be accompanied by measures to improve the insolvency regime and out-of-court restructuring. We very much welcome the authorities' ongoing efforts in this regard.

A final leg in the strategy to enhance resilience and boost productivity growth should be a set of structural reforms focused on improving the business environment, labor market flexibility, the quality of human capital and female labor force participation with the aim of facilitating the reallocation of resources and supporting a more sustainable growth pattern. The Selected Issues Paper contains a panoply of measures that would deserve authorities' attention. We note that the estimated share of the informal economy is high compared to peers. The effectiveness—or even the sign—of structural reforms depend both on the relative size and on how reforms affect the shadow economy. We would invite staff to provide some comments regarding the interaction between proposed reforms and the informal economy.

Finally, we would like to acknowledge Turkey's generosity for hosting the largest refugee population in the world. Managing the socioeconomic impact of such a large number of displaced people is challenging and involves significant funding efforts. We believe that this issue— neglected in staff's analysis—deserves more attention going forward, not only for the Turkish case, but for other countries in similar circumstances as well.

Mr. Mozhin and Mr. Biriukov submitted the following statement:

We thank staff for the insightful Article IV report and Mr. Kaya and Mr. Bayar for their comprehensive buff statement. Economic growth has resumed and the lira has recovered after economy entered recession and currency depreciated in the second half of 2018. However, imbalances remain, leaving the economy susceptible to new shocks. FX reserves are relatively low, while external financing needs are high. We encourage the authorities to prioritize achievement of stronger and more resilient medium-term growth over the short-term boost.

Public finances have been one of the Turkish economy's most reassuring qualities. Low budget deficits and public debt ratios reflect the positive impact of cautious fiscal policies in the past periods. We agree with staff that a broadly neutral fiscal stance would be appropriate in 2020 to contain financing needs without undermining the nascent recovery. Over the medium term, fiscal consolidation would be warranted to stabilize debt burden around the current levels. On the revenue side, there is a need to broaden the VAT base by streamlining the widespread exemptions and unifying the reduced VAT rates. On the expenditure side, savings could be generated by reducing backward-looking wage indexation in the public sector. We would also welcome greater transparency and control of quasi-fiscal activity, in particular, of the recently established Wealth Fund.

Turkey needs tighter monetary policy to rein in inflation and underpin the lira. We concur with staff that the recent CBRT easing cycle has been rather excessive, taking rates from the point of view of building credibility and re-anchor inflation expectations. Monetary policy would also benefit from greater clarity as a large number of instruments and rates complicates understanding of the exact policy stance. Additionally, more transparent FX interventions framework would be beneficial for capital inflows and replenishment of FX reserves. The current export rediscount credit facility looks less attractive than the pre-announced and sterilized FX purchases from a broader set of market participants.

The lira stabilization helped the situation in the financial system. However, staff estimate that there is a large positive credit gap with emerging balance sheet and liquidity strains in the banking system. Thus, a more cautious lending by state-owned banks is required to contain potential fiscal contingent liabilities. We also acknowledge the potential positive effect of an asset quality review, taking into consideration the discretion in recognizing loan impairment.

Implementation of structural reforms remains critical to strengthening private sector development and improving the business environment. We praise staff for a timely selected issues paper on the role of structural reforms in enhancing productivity growth in advanced and emerging economies. We encourage the authorities to close the identified existing structural policy gaps, in particular, in the areas of regulation, quality of education, and worker-employer relations. This would bolster Turkey's sustainable medium-term growth prospects.

Mr. Bevilaqua, Mr. Saraiva and Mr. Fuentes submitted the following statement:

We thank staff for the informative report and Mr. Kaya and Mr. Bayar for their helpful statement. After entering a steep recession in 2018, Turkey is undergoing a moderate recovery in economic activity supported by an accommodative policy mix. Yet, weaknesses in domestic demand and persistent macroeconomic imbalances continue to pose headwinds for faster and more sustainable growth. While policy support for recovery in domestic demand is expected to continue, the economy remains vulnerable to changes in market sentiment and geopolitical developments. Under these circumstances, strengthening macroeconomic policy implementation is critical to safeguard stability and rebuild external buffers to increase resilience, as well as addressing deep-seated structural bottlenecks to boost potential output.

Fiscal policy has successfully supported economic activity but focus now should turn to preserving the remaining fiscal space. We welcome authorities' longstanding commitment to fiscal discipline as they continue to pursue medium term sustainability, maintain public debt at low and stable levels, and boost revenue mobilization. Fiscal discipline has been the bedrock of the Turkish economy and must remain so moving forward. However, the ongoing fiscal stimulus has significantly increased the underlying deficit and large contingent liabilities and potential debt rollover could further reduce available fiscal space amid the low growth environment. Furthermore, containing financing needs and limiting the implementation of quasi-fiscal measures are also crucial to support fiscal policy as a policy anchor.

Reinforcing the monetary policy framework is paramount to support macroeconomic stability. The inflation outlook in 2019-20 continues to improve with the contribution of strong base effects, the stabilization of the Turkish lira and the weakening in domestic demand. In this context, the Central Bank of the Republic of Turkey (CBRT) has shifted its focus to easing financial conditions – mainly through unconventional policy measures – to provide further growth stimulus. Staff, however, has identified the continuation of the current easing cycle as a factor that could undermine policy credibility and weaken the CBRT capacity to support a durable reduction in inflation and inflation expectations. We concur with staff that strengthening monetary policy credibility should be a key priority given that medium-term inflation expectations remain outside the band around the target. Lowering inflation expectations would help to reduce inflation faster, opening room for sustainably lowering interest rates.

Renewed focus on tackling structural bottlenecks is needed to lift potential growth and address structural vulnerabilities. Authorities agree that progress in reform implementation remains necessary to achieve sustained growth over the medium term. Therefore, reforms aimed at raising human capital, improving the business environment and strengthening governance would help foster stronger and more sustainable growth, whilst increasing the economy's resilience to shocks. Enhancing labor market flexibility and facilitating the integration of women and refugees are also vital to elevate overall productivity and competitiveness. In any case, considering Turkey's shock exposure and budgetary constraints, we concur with staff that reforms should be carefully sequenced and calibrated to alleviate short-term trade-offs.

The role of state-owned banks in supporting credit growth merits a closer look. State-owned banks have engaged in a major credit expansion supporting activity in the downturn, while fostering a large-scale debt consolidation process, primarily centered around non-performing loans. We note that despite the sizeable risk transfer from private banks to state entities, asset quality among private intermediaries still needs to improve. That said, we know from the experience of other countries that the use of rapid credit growth by state-owned banks as a countercyclical device runs the risk of eroding their capital bases and could hamper needed deleveraging process. We take note that the authorities are quite confident about both the soundness of the banking system and the quality of their regulatory and supervisory framework. That notwithstanding, as Mr. Fanizza and Ms. Cerami, we agree that bank regulation and supervision should prioritize stability over development. That said, we wonder whether some of staff's suggestions to smoothen credit expansion should be considered by the authorities. For instance, progress in public banks' balance sheet adjustment could help stave off risks stemming from contingent liabilities and support resumption of growth on a sounder footing.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for an informative report and Mr. Kaya and Mr. Bayar for their insightful buff statement. Turkey is in the midst of economic transition. The nascent economic recovery, that is taking root following the recent currency crisis and a period of negative market sentiment, needs to be nurtured in the near term. In the medium to longer run, the authorities' continued commitment to prudent macroeconomic policies and structural reforms should form a strong base for productivity-driven sustainable and resilient growth, as economic rebalancing also takes hold. At the same time, however, the 2018-19 economic crisis has exposed some of the vulnerabilities in the Turkish economy that need to be addressed in a timely and effective manner before confidence could fully return.

As reflected in the statement of Mr. Kaya and Mr. Bayar, the authorities are more sanguine than staff about the near and medium-term economic prospects and, while agreeing in principle with staff, they believe that the strength of current policies will deliver positive outcomes. We note the differences between staff and the authorities' medium-term projections—as outlined in the New Economic Program 2020-2022 (NEP). Although the NEP was released at the time of the staff visit, there is surprisingly little discussion and assessment of the NEP in the staff report. Staff comments are welcome.

On growth policy, while we agree with staff that the focus should shift from short-term to a more resilient medium-term growth, it is important to ensure that the current economic recovery is firmly grounded. The authorities' fiscal stimulus in 2019 supported growth and the staff's recommended neutral fiscal stance in 2020 seem appropriate to maintain the growth momentum. Fiscal prudence has been a key policy anchor in Turkey and policy creditability, including greater transparency, is essential to preserve macroeconomic stability, increase fiscal space and maintain the debt ratio around the current low levels. Medium-term fiscal measures recommended by staff merit serious consideration, but as most of these measures are structural in nature, proper sequencing will be important not to jeopardize the growth momentum.

The authorities’ disinflation policy has been successful, and both the headline inflation and inflation expectations seem to be firmly decelerating, although still above comfort levels. Nevertheless, there is a difference between the authorities’ and staff’s projected inflation path: while the authorities expect inflation to dip and stay in single digits as early as 2020, staff project inflation to stay stubbornly in low double digits over the medium term. Given the distributive impact of the inflation, we encourage the authorities to err on the side of caution by keeping the monetary policy tight enough to deliver low sustainable inflation. We also support staff’s call for clearer monetary and intervention policy and avoiding unconventional measures.

The staff report flags some of the fragilities in the financial sector, notably balance sheet weaknesses in state-owned banks—including increasing reliance on FX deposits and short-term funding—and the depth of nonperforming loans. While we note the authorities’ disagreement with staff assessment on the strength of bank regulation and supervision currently in place, we encourage the authorities to consider staff’s suggestion for a third-party asset quality review.

Turkey’s dynamic private sector is well known globally and Turkey’s climb in Doing Business ranking from 60 to 33 in just two years is quite remarkable. We commend the authorities for taking advantage of the current favorable political landscape to embark on initiatives to address the remaining impediments to job creation and investment, as noted in the statement of Mr. Kaya and Mr. Bayar. We also welcome the authorities’ stronger focus on social inclusion and poverty alleviation. In view of the sharp economic turbulence of the last two years, we were expecting a deeper analysis of poverty and unemployment issues in the staff report, as well as the likely structural changes in the labor market due to the ongoing rebalancing of the economy. Staff views are welcome.

We wish the authorities continued success.

Mr. Raghani made the following statement:

We would like to offer a couple of additional remarks.

First, we note the authorities’ New Economy Program (NEP) that was released this past September. The key themes of the NEP--which are balance, discipline, and transformation, with the aim to uplift economic growth while enhancing price and financial stability--are encouraging. To this point, we thank staff for the response to our question about the forecast assumptions and outlook presented in the NEP. That said, we wish to hear more from staff on the NEP's policies to repair private sector balance sheets, on medium-term fiscal objectives, and plans to restore the credibility and independence of economic institutions, which are the conditions assumed by staff to avoid a shallow L-shaped recovery and achieve sustainable high growth.

Second, as raised by some Directors, Turkey hosts the largest population of displaced people, and the authorities should be commended for providing such essential global good. In this respect, the international community should continue to support Turkey and other countries in the region facing similar challenges.

Ms. McKiernan made the following statement:

We issued a comprehensive joint gray statement with Mr. Ronicle and Mr. Chrimes, so I just want to emphasize three interlinked points this morning.

First is about shifting the growth model, from unsustainable short-run growth to more resilient medium-term growth. We recognize that as the key challenge. We welcome the return to growth in Turkey, but we share concerns at it being short-term stimulus-driven that has led to economic imbalances that leave the country more vulnerable to shocks. On this, we join Directors in encouraging the authorities to transition to a more conservative fiscal and monetary stance. That shift would reduce the risk of overheating, anchor inflation expectations, and help build buffers for resilience to external shocks. Of course, such a shift comes with short-term trade-offs but would ultimately support more durable growth over the longer term.

This brings me to my second point, which is on the importance of enhancing policy credibility to boost investor confidence and private sector-led growth. As the staff highlighted, the stimulus-driven growth will, over time, lower policy credibility. Boosting credibility requires policy to not just be right but to also be clear. On this, we think that less reliance on unconventional policy measures, like foreign exchange contract limits or price controls or credit growth-linked reserve requirements, as well as a clearer communication from the central bank on intervention policy would increase predictability for market participants and, thus, the effectiveness of policy interventions. Similarly, providing greater transparency on contingent liabilities related to public-private partnerships (PPPs) and state-owned entities would enhance fiscal credibility, which has long been a strength for the Turkish authorities.

This brings me to my final point, which is on the importance of undertaking a third-party asset quality review of the state-owned banks. Like many Directors, we are concerned that state-owned bank balance sheets may be weaker than anticipated due to the combination of rapid credit expansion and discretion in recognizing nonperforming loans (NPLs). So, a third-party asset quality review would complement Turkey's supervisory framework and help the authorities to both better understand and ultimately strengthen the health of the banking sector and the fiscal position.

Mr. Rosen made the following statement:

We thank staff for the comprehensive report and Mr. Kaya and Mr. Bayar for the buff statement. We broadly agree with the findings and recommendations in the staff report but want to highlight two points.

The staff is clear in the report and answers to Directors' questions that monetary policy is too loose to durably bring down inflation. We encourage the authorities to heed this view. Cutting 1,000 basis points from the policy rate in the last six months and signaling future cuts while inflation is well above the target range calls into question the credibility of the target and, indeed, the central bank, itself.

Finally, regarding fiscal policy, we support the authorities using available fiscal space to support the nascent recovery in the near term, but we note in the medium term that fiscal consolidation is likely to be needed to preserve confidence that fiscal responsibility is still a policy anchor.

Mr. Jin made the following statement:

I would like to thank staff for the well-written report and Mr. Kaya and Mr. Bayar for their helpful buff statement.

Despite the challenging circumstances, the expansionary fiscal policy and the more favorable external financing policy still helped Turkey to maintain its economic growth. The lira recovered with the current account adjustment. Inflation also has fallen sharply. These all reflect the authorities' sound macroeconomic management. Meanwhile, vulnerabilities remain, and prudent macroeconomic policies would be warranted to address imbalances and to unleash medium-term growth potential.

As noted by Mr. Kaya and Mr. Bayar, Turkey continues to expand its global humanitarian outreach in support of the U.N. Sustainable Development

Goals and hosts the largest population of displaced people globally. We commend the authorities' efforts in this regard, including providing essential education and health services for these people.

Mr. Beblawi made the following statement:

We issued a gray statement in which we welcomed the resumption of economic growth in Turkey since the currency shock and the recession in 2018, the more favorable market sentiment, and the remarkable adjustment in the current account.

We appreciate staff's analytical work, including the work presented in the selected issues paper. We agree with their call for prudent fiscal and monetary policies, as well as structural reforms to address economic imbalances. In this connection, we look forward in future reports to a staff assessment of the role of the newly launched New Economic Program in promoting sustainable growth.

Mr. Kaya and Mr. Bayar raised an important issue in their buff statement, that of refugees. Turkey continues to host over 4 million refugees. This is the largest population of displaced people globally. The Turkish authorities are to be commended for mobilizing significant effort and funding to provide essential public services to the refugee population, including education and health. Turkey and other countries in the region that host large refugee inflows need continued international support to address the refugees' challenges.

Mr. de Villeroché made the following statement:

I will limit myself to a few remarks, very much in line with my colleagues.

First, we welcome the reduction of imbalances in Turkey over the past months. The exchange rate has stabilized to a certain extent. Inflation is now lower--although high, but it is still lower--and we have some stabilization here. More broadly, and more fundamentally, the current account deficit has narrowed. The pressures on external financing have eased somewhat. On top of that, Turkey's low level of debt is a factor of resilience and has proven to be a factor of resilience.

While the growth model of Turkey over the last 10 years has relied on a high investment rate, financed by foreign borrowing, we think that this strategy needs to evolve.

And I would think that there is a possible new growth trajectory, a new strategy for Turkey. We would be happy to hear more from the authorities on how they would like to design the medium term of this strategy, based on more sustainable financing.

Going forward, we see the risks in the banking sector, which are not a surprise, looking at the past exposures. We would like to associate ourselves with the staff's recommendation to conduct an asset quality review. We think it would be timely in terms of transparency.

Lastly, I would like to commend the authorities for hosting a very large number of refugees. It is a global public good for the international community.

Mr. Mojarrad made the following statement:

Let me begin by commending the authorities for their timely response to bringing stability to the lira and for setting the economic recovery in motion. The challenge ahead is to nurture the nascent recovery in the near term while putting in place policies to sustain growth over the medium term and increase the resilience of the economy to external shocks.

The 2018 lira crisis and recession have exposed some areas of vulnerability in the economy at a time when buffers are low and risks to the outlook are elevated. As pointed out by Mr. Inderbinen in the risk assessment matrix, staff attaches a high likelihood to eight of the nine major sources of risk, half of which, if materialized, would have a high impact on the economy. Of particular concern are balance sheet weaknesses of state-owned banks and nonfinancial corporations. Like most other chairs, we encourage the authorities to conduct an independent third-party review of financial asset quality and to take remedial measures, if necessary, to strengthen the confidence in the financial sector.

There are wide differences in the near- and medium-term projections between staff and the authorities, particularly with regard to growth and inflation. The authorities are more sanguine about the outlook and believe that more favorable outcomes are achievable on the strength of current policies.

We also noted in our gray statement that there is surprisingly little discussion or assessment in the staff report of the New Economic Program which, according to the statement of Mr. Kaya and Mr. Bayar, is the flagship policy document of the Turkish economy. The brief staff's written response still leaves many unanswered questions for us. The likely outcome probably lies somewhere in between. This is one area where we urge the authorities to err on the side of caution, but it is also important to allow the nascent economic recovery to take root.

In our gray statement, we encouraged the staff to conduct a thorough analysis of poverty and unemployment issues and the likely structural changes in the labor market, in view of the ongoing rebalancing of the economy. We are glad to learn from staff's response that they intend to follow up on these issues with the authorities.

Mr. Tanaka made the following statement:

We welcome that Turkish economy's growth has resumed and market conditions have stabilized recently, compared with the situation last year. On the other hand, we note from the various illustrative comparison data in the staff report that the underlying vulnerabilities are generally higher than at the peak of the global financial crisis. We encourage the authorities to strengthen their policy frameworks and proceed with necessary reforms in order to improve market confidence and mitigate vulnerabilities.

We believe fiscal policy should remain a key policy anchor. Well-anchored fiscal policy has been a key strong feature of the country. We agree with staff, that the fiscal stance needs to be prudent to create fiscal space to mitigate reform costs and address downside risks. Given the prominent role of state-owned banks in credit allocation and increases in public-private partnership, it is important to closely monitor the risk of contingent liability and enhance transparency on that.

While we acknowledge the different views about the policy rate level between staff and the Central Bank of the Republic of Turkey (CBRT) and the staff places more weight than the central bank on the inflation gap in a basic Taylor Rule, it might be possible to monitor the price developments for the moment with vigilance, whether monetary policy needs to be further tightened to anchor inflation expectations. In general terms, it is imperative that monetary policy should be conducted in an evidence-based and well-communicated manner, and central bank independence should be secured to ensure market confidence and anchor inflation expectations.

As for the financial markets, we take note with concern that state-owned banks expand Turkish lira lending through collecting forex deposits. These forex positions seem fully hedged; but as staff's answer to our technical question illustrates, a currency mismatch would be a serious cause of risk posed by the rollover risk of hedging transaction in case that Turkish banks' credit risk is highlighted.

Given the financial vulnerability caused by the dependence on forex funding, domestic bond markets denominated in local currency need to be fostered. Structural reforms are important to underpin financial market stability and medium-term growth. Staff's analysis on the prioritization of structural reforms is appreciated. We encourage the authorities to promote necessary reforms going forward.

Mr. Bhalla made the following statement:

I just have a few words on monetary policy, as contained in the staff report.

My colleagues and I have noted that there is a divergence in the view of the staff and the authorities on whether the present monetary policy is appropriate and whether more policy tightening is needed. This is a familiar question, especially for those coming from emerging economies. And perhaps coincidentally, the authorities--with a few notable exceptions--all want to have a looser monetary policy, and the staff--again, with a few notable exceptions--all want to have a tighter monetary policy. The same divergence, of course, exists with the fiscal deficit question.

A detailed analysis of monetary policy, and especially the impact of inflation expectations, has been presented by the staff. In my interpretation, they base their entire case for policy tightening on the use of inflation expectations. I just have a few points on the use of inflation expectations to reach any conclusions on monetary policy.

First, inflation expectation measure is derived from market behavior; that is, a divergence between an indexed inflation rate and actual inflation. I do not believe it should be used at all.

Second, and related to that same point, inflation expectations is very much a developed country concept, which is not easily transferrable to developing economies; therefore, the conclusions based on inflation expectations are not easily transferrable. For example, in India, inflation expectations from a survey measure have consistently been in the 8 to 10 percent range for the last five, six years when inflation has fallen sharply below that level and, indeed, has been below 4.5 percent for the last four and a half years.

I am not reaching any conclusion on whether monetary policy is appropriate or not, but it would be helpful if the analysis was supported by estimates of the real policy rate and how it is comparable to other countries with similar characteristics. My guess is that if you do that according to the Taylor Rule and no matter what parameters you give to the Taylor Rule, as long as you give broadly the same parameters to the others on the weightage on the inflation gap and on the output gap, you would find that the Turkish monetary policy, indeed, has much further room, compared to its comparators, than what the staff infers it to be.

All I am saying is that I think there can be and there should be other methods of approaching whether monetary policy is appropriate or not. This is a tussle that will keep coming up. It does come up for all countries at all times. And I think we need a little bit more rigorous basis for concluding one way or the other, whether with the authorities or with the staff.

Mr. Alkhareif made the following statement:

We would like to take this opportunity to welcome the economic recovery following the sharp currency depreciation and recession in late 2018. The authorities' timely policy stimulus and interventions have contributed to the macroeconomic stability. And here, I echo the points raised by Mr. Rosen, that the fiscal space could be used to stabilize short-term economic turbulence while keeping in mind the importance of maintaining fiscal sustainability.

On fiscal policy, we welcome the authorities' aim to maintain public debt at low and stable levels. We encourage the authorities to continue their efforts to strengthen revenue mobilization, including through revenue administration improvements, and restrain expenditures.

On the financial sector issues, given the mention of the report of the private banks and state-owned banks, we encourage the authorities to take into consideration the financial stability risks stemming from high credit growth. We also encourage the authorities to continue their efforts to strengthen the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework.

Finally, we would like to raise a point on the third assessment recommended by staff. We do not fully share the view that a third-party comprehensive assessment of bank balance sheets is appropriate in all cases. In our view, we would have appreciated more capacity development and closer engagement with the authorities on strengthening the current regulatory framework, rather than relying on an external assessment.

Mr. Villar made the following statement:

We mostly share the staff's appraisal and I will restrict my intervention to highlight two particular issues.

First, we note the important disagreements between staff and the authorities in several areas, particularly on the prospects for high sustainable growth. As other Directors, we see a difficult trade-off in the expansionary monetary policies adopted in the last few months in 2019, as well as in the rapid credit expansion by state-owned banks. These policies are helping to recover GDP growth in the short run but may make it more difficult to create the required conditions for sustainable growth in the future.

In this context, we would like to stress that, as stated in staff's responses to our questions, even when central bank legislation appears to support operational independence, the de facto operational independence is critical for a central bank to carry out its responsibilities and achieve its objectives.

Our second comment is about migration. We would like to acknowledge Turkey's generosity for hosting the largest refugee population in the world, something that does not receive enough attention in the staff analysis. Managing the socioeconomic impact of such a large number of displaced people is challenging and involves significant funding and fiscal efforts. We believe that this issue deserves more attention going forward, not only for the Turkish case but for other countries in similar circumstances.

Mr. Sigurgeirsson made the following statement:

Strong fiscal policies have been an important anchor of Turkey's economic policies. We are somewhat concerned to see that the debt-to-GDP ratio is gradually on an increasing path. At the same time, we note from state-owned banks that credit growth has grown rapidly in recent years. And I know from experience that such rapid credit growth, especially if there is an element of direct lending in it, is bound to have adverse consequences for the quality of the credit book at a later stage. So it is important to carefully monitor this development, as the government's potential contingent liabilities could lead to additional fiscal pressures down the road and potentially impact fiscal sustainability, not to mention financial stability.

Finally, as mentioned in our gray statement, we strongly encourage the authorities to move the focus from short-term stimulus toward medium-term growth-enhancing initiatives and structural reforms.

Mr. Bevilaqua made the following statement:

I would like to thank Mr. Kaya and Mr. Bayar for their insightful statement and staff for the well-written papers. We particularly appreciated the focus on productivity payoffs of structural reforms in the selected issues paper, which brought into perspective a central theme for achieving faster and more inclusive growth in Turkey.

We welcome the country’s New Economic Program, released in September, where the authorities had the blueprint to rekindle growth and consolidate gains on external balances.

Following last year’s recession, economic activity has been supported by an expansionary policy mix under more favorable market conditions; yet the staff report suggests the intense focus on stimulating short-term growth has exacerbated lingering vulnerabilities and macroeconomic imbalances. In this context, the policy framework and its implementation strategy must be strengthened to sustain economic growth without compromising macro-financial stability.

Regarding the fiscal policy assessment, we take note of the Turkish authorities’ commitment to preserve fiscal discipline as a policy anchor while maintaining the current fiscal stance to stimulate economic activity. Having said that, we caution that under these circumstances, striking a sustainable balance between supporting growth and bringing inflation back to the target range will be challenging. Also, keeping risks from contingent liabilities low will require reigning in quasi-fiscal activities. In addition, Turkey’s favorable public debt position, which exhibits a generally low risk composition and low vulnerability profile, could be weakened by liquidity risks emanating from the high external financing needs.

Finally, considering the persistent deviations from the inflation target, we firmly believe Turkey will benefit from taking steps to increase the credibility of monetary policy and implement more sound and sustainable policies to support price stability. In that vein, we associate ourselves with other Directors on the need to protect central bank autonomy and bolster low and stable inflation as a reliable policy anchor. Also, I consider the use of different measures of inflation expectations very useful for conducting monetary policy. Given that medium-term inflation expectations remain outside the band around the target, strengthening monetary policy credibility should be a key priority. Similarly, more transparency and clearer communication will contribute to enhancing the effectiveness of available monetary policy tools.

Mr. Fanizza made the following statement:

I find myself in broad agreement with staff's messages and recommendations.

My main concern is the stance of monetary policy. I believe there is an issue on how we measure inflation expectations: if one has inflation close to 15 percent and the target is 5 percent, loosening monetary policy gives the wrong signal to the markets. And I have the impression that it is dangerous because, in the best of cases, it will make the disinflation process more difficult. It will make it longer and more costly because one will have to go through further bouts of tightening, and that is what complicates life in a moment in which, actually, the economy is starting to rebound and the target is to sustain this rebound. So I think this is an issue which is central.

Let me also say that there is also another danger. I have seen in my experience very few gradual disinflation processes and you might not succeed to get to 5 percent eventually, which is what creates big problems and exacerbates vulnerabilities. So I think a reconsideration of the stance of monetary policy should be taken seriously by the Turkish authorities.

On the fiscal policy, I share the position of the staff, that a neutral fiscal stance is adequate. I do not think there is an immediate urgence for fiscal consolidation.

Saying that, I am impressed by the rebound capacity of the Turkish economy. I hope the authorities will be in a position to take measures, to step up their reform efforts in such a way to be able to maintain this favorable trend.

Mr. Mozhin made the following statement:

The Turkish economy has been experiencing a necessary correction after a period of very high growth, clearly above potential, at least according to the staff report. This correction was necessary to get away from the overheating, which was fueled by significant capital inflows, attracted by the very strong fiscal position of the Turkish economy and the overall health of the Turkish economy. I believe this correction was necessary. The good news is that the recovery is already taking hold. It is still at an early stage, but the projection for next year is that this recovery will strengthen significantly.

I can understand the intention of the authorities, to support the recovery by both fiscal and monetary means. But like many others, I would also advise the authorities to be a little more patient on the monetary policy side, a little more patient on the loosening of monetary policy. As so many others have already mentioned, inflation remains significantly above the target, and it is important to make sure that it comes down in the period ahead.

Let me also immediately mention that the Turkish authorities' generosity toward the millions of foreign refugees who settled in this country is very much appreciated by my authorities, and I would want to emphasize this. I really wish the Turkish economy to progress further.

Mr. von Kleist made the following statement:

Since I agree with everything Ms. McKiernan and Mr. de Villeroché said, I can be brief. I especially want to also highlight their mentioning of the hosting of and taking care of the very large population of refugees.

Turkey geographically straddles Europe and Asia and is the cornerstone of regional stability. Therefore, ensuring macroeconomic stability through appropriate fiscal, monetary, and structural measures is paramount. The risks in the banking sector, as many others have mentioned, need to be urgently addressed.

On the inflation discussion, which I found very interesting, building on the comments of Mr. Bhalla and Mr. Fanizza, I think it is very easy. Inflation is too high, and inflation hurts the poor the most. In the end, that is all that matters. Therefore, the overwhelming conclusion from that is that the authorities need to do more to address that.

Mr. Ronicle made the following statement:

I cannot resist commenting--even though I issued a joint statement with Ms. McKiernan, and she has made all of our points very well this morning already. Following the Comprehensive Surveillance Review discussion, it would be nice to reflect a little bit on this Article IV in that context. Why do I think the staff papers are a really excellent set of papers?

First, Turkey's recent stabilization is fragile. That means further reform is needed, but it also means that they have a window for thinking about things. I think staff have seized that in offering a coherent set of proposals. I really liked the fact that they provided coherent advice across both monetary and fiscal policies.

I completely agree with Mr. Fanizza and Mr. Bevilaqua, who have already spoken very well about the monetary policy challenges that Turkey faces.

I like the fact that the structural reforms were prioritized, and they were sequenced. Too often, we get a shopping list of nice-to-have policies but with no sense of which ones really need to be implemented now and how to make those work in the context.

Finally, I just want to add my voice to other Directors in thanking Turkey for hosting the refugee population it does.

Ms. Mahasandana made the following statement:

We have issued a comprehensive gray statement with the Netherlands office, so I will only focus on one point for emphasis.

While we welcome the recent economic recovery from the authorities' short-term growth policies, we are mindful of the buildup of financial vulnerabilities and the country's long-term economic sustainability. In this regard, we are supportive of the long-term structural policies to boost the country's competitiveness and structural reform.

That said, the current economic situation in Turkey is still somewhat fragile and is linked very much to the financial market sentiment. So there still would be a need for further reserve accumulations and deal with high inflation, which is higher than the central bank's target, and also external imbalance. In this regard, we encourage the authorities to work closely further with the staff in formulating proper policies and risk mitigation measures in order to gradually shift from the growth stimulus policy to a move toward more long-term economic growth.

Mr. Zedginidze made the following statement:

First of all, like many others, I associate myself with Mr. Fanizza in saying that as long as inflation is persistently high, this indicates that monetary policy could be challenged in that sense and shifting away from a short-term policy to long-term should also help lower inflation expectations and long-term interest rates that actually matter the most for long-term economic growth. In that sense, we agree with staff's findings in the report.

I would like to ask staff a question regarding the case that, whether this problem is--what can be outward spillovers toward the region? In the report, it was highlighted that, of course, Turkey is important in the region, so there might be outward spillovers; but on the other side, it was also mentioned that there could be idiosyncratic difficulties in the country. But we observed over the recent years quite a persistently high correlation among the currencies of Turkish lira and some of the neighboring countries. I would welcome more elaboration on this issue, whether this is more idiosyncratic or more systemic in nature.

One more question. For the next Article [IV], whether there is room to focus on some other macro-critical areas of the economy, such as, for example, climate and pollution.

The staff representative from the European Department (Mr. McGettigan), in response to questions and comments from Executive Directors, made the following statement[2]:

I would like to thank Directors for their very helpful gray statements. These statements provide a lot of room for thought, and we will reflect on them over the coming year and in the next Article IV cycle.

I would like to also thank the Turkish authorities for their gracious hospitality during the mission and for the excellent discussions.

There were a few follow-up questions raised by Directors, including one on the New Economic Program's policies to address private sector balance sheets and to restore the credibility of institutions.

On the balance sheet angle, staff believes that the balance sheets of nonfinancial corporates remain impaired, having been hit by higher interest rates, a sharp exchange rate depreciation, and lower growth. It is our view that this has not yet shown up fully on bank balance sheets.

It is also our view that it is very hard to get back to strong, sustainable growth without addressing these balance sheet issues, which is why, in our

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[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

five-part policy recommendations, we recommend undertaking an asset quality review to get at the true extent of the underlying problem and then following up with appropriate measures, as needed. This is essential. Otherwise, credit is left allocated to firms that are not necessarily the most efficient, and there will be a limited ability to reallocate credit to more efficient corporates. Without this and the other recommended policies, it will be harder to get to the kind of pre-crisis growth that we saw. In the end, it is important to address these underlying issues to secure more sustainable medium-term growth.

On the credibility of institutions, we set out in the staff report a five-part plan based on our diagnosis of the problems facing Turkey and based on the vulnerabilities that Turkey still faces. Our view is that this five-part plan would be enough to address the issues that Turkey faces: one, its vulnerabilities; two, its growth challenges; and three, and most importantly, the credibility of institutions. We think putting in place such a plan would be very helpful to further strengthen institutions in Turkey.

There was also a question on spillovers. Here our view is set out in the spillover analysis in the staff report; this analysis benefited from close coordination with SPR given their expertise on this topic. Based on the spillovers that occurred in August 2018, and given the nature of fragilities facing Turkey, the impact on spreads and exchange rates in Turkey was not all that large in other countries. In a way, the markets were seeing the challenges facing Turkey as shared by only one or two other countries. Therefore, we did not see significant evidence of the kind of financial spillovers that can be seen in other cases. We did not see these at the time, but we are happy to follow up bilaterally if you wish on that.

Finally, on new topics. We will, in the next Article IV, focus on what we see are the most macro-critical issues. You mentioned climate change. Other issues were mentioned as well, including poverty. We will consider these and other issues in the next Article IV cycle.

Mr. Kaya made the following concluding statement:

On behalf of the Turkish authorities, I would like to thank Mr. McGettigan and his team for their very constructive engagement, careful analysis, and informative and well-written set of reports. We also would like to thank Directors for their helpful comments raised both in their gray statements and during this meeting, which will be faithfully conveyed to our authorities.

We issued a buff statement in which we shared the authorities' perspectives in detailed manner. Therefore, I would like to limit my remarks today to six points to address some of the issues raised by Directors.

First, we need to assess the authorities' immediate responses to the market turmoil last year and the future path of policies in two different buckets. On the former, as the chief economist of a major private bank noted during a meeting with staff in Istanbul, fighting recessions is a right and obligation of every country. In that sense, there is nothing unusual about what the Turkish authorities have done to avert a deeper slowdown in economic activity. While the Turkish economy has defied market expectations in 2019 by avoiding a full year recession, it has also managed to net out a significant current account deficit, as well as to reverse a major deterioration in the pricing behavior. The situation now is different and, thus, the authorities will calibrate their policies accordingly. Naturally, the exclusive focus on the short term very gradually shifts to the longer horizon, which will entail a stronger commitment to structural reforms.

Second, on the transparency of fiscal accounts and risks beyond the central government, I would like to reassure Directors today that this is a live agenda in Turkey, and the authorities are working continuously to improve the coverage, robustness, and timelines of the fiscal accounts. The authorities have already published fairly comprehensive statistics and reports about the balances of the nonfinancial public sector accounts, including social security institutions, state-owned enterprises, extrabudgetary funds, and local governments. While there is some reporting about the quasi-fiscal implications of the PPP projects, the authorities acknowledge the need for improvement there; as such, they are working on a comprehensive framework.

Third, on the monetary policy, the authorities acknowledge the effect of favorable base effects in the decline of inflation figures lately. Nevertheless, I would like to underscore that these base effects will work favorably, so long as the authorities manage to curb the underlying inflation momentum. On that note, the CBRT has done a good job, which has helped rebuild its credibility.

On the current monetary stance, the authorities--while retaining the 5 percent target for medium-term guidance--are focusing on the projected disinflation path as their target. What that means in practice is that the policy rates are set at a level which the authorities believe would be sufficient to bring inflation down to the 2020 CPI estimate. That is 8.2 percent, not 5 percent. In that regard, in a global environment, while interest rates are set to remain low for longer, Turkey still offers a meaningful real rate of return.

Fourth, on the financial sector, many Directors have noted the recent credit expansion by state-owned banks as a source of concern. Here, I would like to highlight that the credit cycle of private banks and state-owned banks in Turkey tend to differ historically, whereas private banks tend to be more procyclical in their lending behavior. Therefore, what we observed last year was a recurrence of this phenomenon as private banks, which account for about 60 percent of the loan portfolio, overall deleverage their balance sheets from the plateau levels they reached during the boom times. Therefore, the NPLs behave differently for these two groups of banks, which should also converge as the economy normalizes.

On staff's recommendation to conduct a third-party asset quality review, the authorities acknowledge the possible confidence effects of such an exercise. Nevertheless, I would like to highlight that the Turkish banking regulator has recently completed a very comprehensive asset quality exercise on its own, supported by a risk-based sampling of loan files, as well as rigorous stress tests. Reflecting the results of this internal study, the authorities have asked the bank to reclassify roughly US$8 billion of loans as NPLs until the end of the year.

Fifth, on AML/CFT, I would like to re-emphasize that Turkey is a country at the forefront in the fight against terrorism. It is unequivocally determined to combat money laundering and the financing of terrorism. To that effect, not only is Turkey perpetually committed to addressing the remaining gaps and deficiencies in its AML/CFT framework, but Turkey is also pioneering initiatives to improve the international architecture in this field, including through proposals to enhance the FATF's mutual evaluation process.

Finally, on the structural field, I would like to reiterate my authorities' strong ownership and resolve to implement comprehensive structural reforms in an effort to improve the Turkish economy's competitiveness, strengthen its resilience to external shocks, and address the impediments to job creation and investment. As we mark the 85th anniversary of the law which recognized the electoral rights of women--far before many other countries--I also would like to underscore the importance that Turkey gives to empowering women in their professional lives.

With these remarks, I would like to, once again, thank Mr. McGettigan and his team for the fruitful, comprehensive, and candid engagement prior to, during, and after the Article IV consultation. The authorities look forward to continued dialogue and cooperation with the Fund.

The Acting Chair noted that Turkey is an Article VIII member; hence, no decision is proposed. The 2019 Article IV consultation with Turkey is concluded.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that stimulus-driven growth in previous years had contributed to large economic imbalances in the Turkish economy. Following the recession in 2018, expansionary fiscal policy, rapid credit provision by state-owned banks, and more favorable external financing conditions led to a resumption of economic growth. Directors emphasized that the current calm remains fragile and that vulnerabilities persist. These include low reserve buffers, large external financing needs, and stressed bank and corporate balance sheets. Against this background, Directors underscored the importance of prudent policies to address weaknesses and highlighted the need for a comprehensive package of reforms to secure stronger and more resilient growth over the medium term.

Directors emphasized that fiscal policy should remain a key policy anchor. While the recent fiscal stimulus has helped the economy recover, the underlying deficit has increased significantly. Directors recommended a broadly neutral fiscal stance in 2020, combined with tight monetary and quasi-fiscal policies, to strike a balance between supporting the nascent recovery while also containing financing needs and enhancing fiscal space. They noted that a modest consolidation is needed over the medium term to ensure that public debt remains low and stable. Directors welcomed the authorities' efforts to strengthen oversight and management of public-private partnerships.

Given still-high inflation expectations, Directors stressed that monetary policy should focus on durably lowering inflation, which would help permanently lower interest rates. In this context, they noted that recent monetary policy easing has gone too far. Directors also called for clearer monetary and intervention policy to bolster transparency and central bank credibility. They recommended rebuilding international reserves as conditions allow.

Directors emphasized that vigilance is needed in view of the rapid credit growth of state-owned banks. They encouraged taking steps to rein in credit growth and clean up bank and corporate balance sheets to support financial stability and stronger, more resilient growth. Directors generally agreed that a third-party asset quality review and new stress tests are needed to better understand underlying bank health. Additional reforms to improve the insolvency regime and out-of-court restructuring would also help release resources and restart productive lending.

Directors called for focused and carefully sequenced structural reforms to enhance medium-term growth and increase resilience to shocks. In particular, steps to improve product market efficiency, labor market flexibility, the quality of human capital, and female labor force participation would facilitate a reallocation of resources to productive sectors. Governance reforms would also help improve the investment climate and economic efficiency. Directors commended Turkey for hosting a large number of refugees.

It is expected that the next Article IV consultation with Turkey will be held on the standard 12-month cycle.

APPROVAL: January 20, 2022

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***Could staff comment on the reasons for the differences in growth forecasts?***
2. ***We would expect staff to elaborate on possible divergence of views with the authorities on forecast assumptions, outlook and policy priorities. Staff's comments are welcome.***
3. ***We note the differences between staff and the authorities' medium-term projections—as outlined in the New Economic Program 2020-2022 (NEP). Although the NEP was released at the time of the staff visit, there is surprisingly little discussion and assessment of the NEP in the staff report. Staff comments are welcome.***
4. ***Staff comments on the newly-launched New Economy Program in promoting sustainable growth in the long-term are also welcome.***
5. ***Could staff elaborate on their concerns around the authorities' current policies? How do the package of reforms advocated by staff inhibit short-term growth? In particular, are the authorities' current policies inhibiting higher medium-term growth?***

- The authorities believe that the slack in the economy will allow growth to revert to its longer-run trend; this is reflected in the NEP.
- Staff thinks balance sheet impairment makes a rapid return to the pre-crisis output growth trend of 5-5½ unlikely (Box 2). Achieving sustainably high growth calls for implementation of a comprehensive package of reforms to repair private sector balance sheets, build a stronger fiscal position over time, and ultimately restore the credibility and independence of economic institutions.

6. ***Could staff provide further elaboration on the plan to re-orient the short-term growth policy, particularly on the preconditions and risk mitigation measures to facilitate an orderly transition period***.

- The proposed policy response would likely sacrifice some near-term growth in favor of stronger and more resilient medium-term growth. Appropriate fiscal policy and careful sequencing of structural reforms would help with an orderly transition period.

7. ***Could staff comment on the risk of capital flow reversal and recommendations for risk mitigation?***
8. ***How does staff assess the influence of geopolitical instability on the implementation of the reform program?***

- Turkey remains exposed to domestic and external risks, including adverse geopolitical developments. In the RAM, staff flags the risk of a deterioration in market sentiment and has recommended reforms that would build Turkey's economic and financial resilience and help reduce vulnerabilities to geopolitical and other risks.

Monetary Policy

9. ***Staff considerers that rates are too low to strengthen monetary policy credibility and lower inflation durably, and we would welcome their elaboration on the reasons for the difference of views with the authorities in this area.***
10. ***In this regard, as we acknowledge the different view about policy rate level between staff and CBRT, could staff elaborate more on the reasons for the difference of views?***
11. ***We would like staff to offer their views on the authorities' stance that the current monetary policy stance is consistent with the projected disinflation path?***

- Staff and the authorities agree on the need to strengthen monetary policy credibility and lower inflation durably.
- The authorities view monetary policy as sufficiently tight to balance their dual objectives of achieving price stability while supporting economic growth and credit expansion.
- Staff has a different take on the appropriateness of policy rates. Staff places more weight than the central bank on the inflation gap in a basic Taylor rule, and less weight on the output gap (with staff seeing cyclical considerations as best dealt with by fiscal policy).

12. ***Can staff assess the consequence of current monetary policy stance on the growth outlook in the medium term?***
13. ***In light of this divergence in views, could staff comment on whether the Bank's policy of credit expansion could significantly jeopardize the hard-won gains in policy credibility achieved so far?***

- Staff sees tight monetary policy as a key anchor to strengthen credibility, durably lower inflation and inflation expectations, underpin the lira, rebuild reserves and bring down interest rates in a sustained manner.
- In staff's view, real policy rates are now well below levels that would underpin the lira, durably reduce inflation and inflation expectations, and strengthen central bank credibility.

14. ***Could staff elaborate on whether the reported decline in the central bank's revaluation account is related to the transfer to the Treasury mentioned in paragraphs 8 and 9?***

- The CBRT reserve transfers mentioned in the staff report were from a category of "other" domestic assets called "reserves," not from the revaluation account.

15. ***We noted in today's Global Markets Monitor that the Central Bank of Republic of Turkey (CBRT) has announced that it will hold 12 meetings in 2020, instead of only 8 as it has done since 2017. We would welcome staff comments on this announcement by the CBRT.***

- Increasing the number of meetings may help the CBRT react more quickly to developments and provide additional opportunities for forward guidance.

16. ***Could staff give us a sense of the amount of FX liabilities not recorded in the net foreign assets of the central bank and the level of coverage of FX liabilities by FX assets?***

- Net international reserves reflect the asset leg, not the corresponding liability of the CBRT's FX swaps. The central bank reports the forward leg of swap transactions in its monthly International Reserves/Foreign Currency Liquidity table.
- As of December 4, 2019, the CBRT's swap transactions amounted to about US$13 billion.

17. ***Additionally, we wonder whether it would be desirable to revise legislation to further strengthen BCRT independence, in view of the unexpected removal of the former governor last summer. Staff's comments would be appreciated.***

- In staff's view, central bank legislation appears to support CBRT operational independence. International experience shows that de facto operational independence is critical for a central bank to effectively carry out its responsibilities and achieve its objectives.

Fiscal Policy

18. ***Can staff comment on the political feasibility of carrying out some of the suggested measures, and on the potential for revenue administration improvements—a measure proposed by the authorities—to support revenue mobilization?***

19. ***Could staff elaborate on the appetite in the economy for the additional tax measures suggested in the report and the alternate policy levers which could be deployed instead?***

- The recommended fiscal consolidation is modest, equivalent to 1.5 percent of GDP to be undertaken gradually over the medium term. Staff also advise enhancing social protection spending in tandem with consolidation measures to ensure the most vulnerable are protected.
- Staff welcomes the authorities' intention to improve revenue mobilization but would need further details to make an assessment of the potential revenue gains.

20. ***While we broadly concur with staff's assessment in this regard, we would welcome a clarification on the expected fiscal stance in 2020. We note that staff recommends a "broadly neutral stance" compared to the authorities' program that implies an unspecified consolidation effort of close to 2 percent of GDP. However, staff's baseline still foresees an adjustment in the cyclically adjusted primary balance of around one percentage point of GDP, which would imply a tightening rather than a broadly neutral stance. Staff comments would be welcome.***

21. ***That said, we wonder if staff could reconcile the authorities' neutral fiscal stance in 2020 to the projected sharp decline in public consumption from 5.0 percent in 2019 to 0.4 percent in 2020.***

- Staff's forecast for 2020 implies a cyclical tightening of less than ½ percent of GDP (the central government cyclically-adjusted overall balance improves from -4.1 percent to -3.7 percent), as we assume the planned reduction in current expenditures will be difficult to fully achieve.
- Staff's recommendation of a cyclically neutral stance for 2020 would be consistent with a ½ percent of GDP looser stance relative to the baseline presented in the staff report.

22. ***We would appreciate elaboration from staff about the budgetary risks stemming from contingent liabilities, notably guarantees issued by the Credit Guarantee Fund, PPP or SOEs, as well as from potential costs of bank recapitalization needs, given financial sector risks.***

- Staff analysis of PPP-related contingent liabilities is presented in Box 3 of the 2018 Article IV for Turkey. Such liabilities are difficult to assess because of incomplete information on public guarantees and on contractual payment obligations of government.
- In 2018, SoEs ran a small deficit of -0.1 percent of GDP.
- The CGF's estimated loan guarantees constitute a contingent liability for the government of about ½ percent of GDP given that coverage is only for up to 7 percent of covered loans.
- A third-party asset quality review and rigorous stress test would help quantify actual and potential bank recapitalization needs, if any.

Financial and Corporate Sector Policies

23. ***We would be grateful for staff's views on how well the Turkish banking system is prepared to deal with additional credit risk, should the economy face adverse shocks.***
24. ***Could staff elaborate more on the performance of Banking sector, especially in the context of Islamic banking and on the reasons for this diverging assessment?***

- Banks continue reporting adequate capitalization and moderate NPL ratios. However, balance sheets may deteriorate as: (i) the effects of last year's recession and financial market dislocation fully materialize; (ii) the current regulatory framework offers discretion in reporting impaired loans; (iii) the adopted restructuring solutions may not support repayment capacity in a durable manner; and (iv) major credit expansion at state-owned banks may be source of further credit risk.
- A third-party asset quality review and new stress tests would be needed to better understand underlying bank health.
- Against this background, staff is of the view that reining in credit growth and allowing balance sheet repair would support sustainable growth for the sector in the medium term, including in Islamic banking.

25. ***While these FX positions seem almost fully hedged, could staff elaborate more on the risk posed by FX hedge, considering the roll over risk of hedging transaction in case that Turkish banks' credit risk is highlighted?***

- Greater reliance on FX deposit funding has resulted in state-owned banks swapping a growing amount of liquidity to support local currency credit expansion. State-owned banks' traditionally-muted off-balance sheet open FX position has therefore increased rapidly in 2019.
- The recent partial shift from short-maturity swaps in the offshore market to the longer-dated swaps offered by the central bank has introduced a relatively stable source of funding.
- However, a large on balance sheet currency mismatch between bank assets and liabilities and continued dependence on externally provisioned TL liquidity are sources of risk for state-owned banks, especially at times of elevated market distress.

26. ***We note that the authorities disagree with staff's assessment that the credit gap is positive. Could staff elaborate on the underlying reasons for this discrepancy, including methodological differences?***
27. ***We note the disagreement between the authorities and staff on the assessment about the positive credit gap and would welcome staff elaboration whether this is due to methodological differences in computing credit gaps.***
28. ***Similarly, the high lending effort through the CGF and state-owned banks is also magnifying the leverage conditions and creating balance sheet stress within the financial***

system. We observe the continued difference in views of authorities and staff and welcome staff's comments on the evaluation of the pros and cons regarding this subject.

- Rapid credit growth by state-owned banks, including through the support of the CGF, has played an important role in reviving economic growth after last year's recession. If protracted, however, a major credit expansion would likely undermine needed deleveraging and lead to further currency and liquidity mismatches in state-owned bank balance sheets. Staff believes, therefore, that credit growth by state-owned banks should be reined in, while further significant reliance on the CGF should be avoided.
- Staff's analysis, based on a deviation of the credit-to-GDP ratio from values consistent with fundamentals, suggests that, while the private bank credit gap is now negative, the credit gap of state-owned banks remains large.

29. ***We wonder if part of the new credit by state-owned banks is being used to repay outstanding obligations with commercial banks. Could the staff indicate if there is any evidence of this?***

- Staff does not have the granular information on banks' loan portfolios to confirm whether this is the case.

30. ***Can staff provide specific reasons for recommending a third-party assessment of bank assets and a new stress test framework?***
31. ***Could staff elaborate on its estimate of the share of NPL corresponding to classification rule in line with international standards?***

- The current regulatory framework offers some discretion in reporting impaired loans. While this flexibility has allowed banks to deal with asset resolution over time, it has raised questions over the health of the banking system.
- Staff believes that a third-party comprehensive assessment of bank balance sheets would help bring clarity on the condition of the banks, especially for state-owned banks, and strengthen confidence in the sector.
- Staff does not have an estimate of NPLs under different classification rules.

External Sector Policies

32. ***Could staff comment on whether they consider the capital flow management measures appropriate under the Institutional View?***

- The measures taken are in line with the Institutional View.
- Staff has determined that the limit on banks' swap transactions with foreign investors, the surrender/repatriation requirement, and the tax on foreign currency transactions (but not the delayed settlement of FX transactions) constitute Capital Flow Measures. However, at

0.1 percent, the tax on foreign currency transactions was assessed as not macro-critical from the perspective of the Institutional View.

- In line with the Institutional View, staff advises that the remaining measures that aimed at containing excessive volatility in capital flows are phased out as volatility subsides.

33. ***On a related point, while the external current account adjustment has been significant, we wonder how much of the recent narrowing of the current account deficit would reverse if growth rates normalize. Staff comments are welcome.***

- Much of the current account adjustment has been from import compression, with a smaller contribution from exports including tourism. This suggests the adjustment has been largely cyclical. In staff's view, a durable improvement in the current account balance will require a comprehensive set of policies to repair private sector balance sheets and facilitate a reallocation of resources to more productive sectors, including exports.

34. ***Could staff explain why Turkey's external position is broadly balanced but the REER undervalued?***

- The difference between the EBA's results under the CA and the REER approaches for 2018 reflect the lagged adjustment of external balances to the sharp REER depreciation in 2018.

35. ***We found striking the fact that errors and omissions were an important financing source in 2018. Does staff have an idea of what is behind this fact?***

- It is reported that the large errors and omissions in 2018 reflect the repatriation of assets held abroad, perhaps from overseas accounts of Turkish residents.

Structural Reforms

36. ***We would invite staff to provide some comments regarding the interaction between proposed reforms and the informal economy.***

- As discussed in chapter 3 of latest WEO, structural reforms are a potent tool for raising productivity in high-informality economies as they can reduce informality. Product market reforms make it easier for informal firms to enter the formal sector by reducing entry costs. Reforming job protection legislation increases the profitability of formal sector firms directly; this encourages them to grow, increasing investment and reallocating resources from the less productive informal sector. (As discussed in the staff report, labor market reforms need to be carefully timed to minimize negative effects on employment.)

37. ***In view of the sharp economic turbulence of the last two years, we were expecting a deeper analysis of poverty and unemployment issues in the staff report, as well as the likely structural changes in the labor market due to the ongoing rebalancing of the economy. Staff views are welcome.***

- This is noted. Staff intends to discuss these important issues further with the authorities.